



Audit Report

District Inspector General for Audit
Rocky Mountain District

*First Preston Management Inc.
Denver, Colorado*

*Management and Marketing
Contract for Denver Area 3*

*00-DE-222-1003
September 21, 2000*

U.S. Department of Housing and Urban Development
District Inspector General for Audit
633 17th Street
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Denver, CO 80202-3607



Audit Report

District Inspector General for Audit Rocky Mountain District

Report: 00-DE-222-1003 Issued: September 21, 2000

TO: Ronald C. Bailey, Director, Denver Homeownership Center, 8AHH

FROM: Robert C. Gwin, District Inspector General for Audit, 8AGA

**SUBJECT: Management and Marketing Contract for Denver Area 3
First Preston Management Inc.
Denver, Colorado**

We have concluded a review of the Department of Housing and Urban Development's (HUD's) Management and Marketing Contract with First Preston Management, Inc., as it pertains to HUD properties in Denver Area 3, which consists of the states of Missouri, Kansas, Arkansas, Louisiana and Oklahoma. This program contracts out the full responsibility for the management and marketing of properties owned by, or in the custody of, HUD. The primary objective of the review was to determine whether First Preston Management, Inc., managed HUD single family properties in compliance with HUD policies, procedures, and regulations, and within the terms and conditions of the Management and Marketing Contract. This included assessing whether First Preston's: (a) operations are effective, efficient, and economical and (b) management controls are adequate to effectively identify and address operational deficiencies and noncompliance with requirements.

First Preston has been performing within the Management and Marketing contract for a little over a year, and while improvements were noted in their overall compliance with the contract over the last year, we identified where First Preston needs to improve its:

- procedures for the protection and preservation of HUD properties within Area 3, and
- timeliness for the completion of the processing steps for acquired HUD owned properties.

Within 60 days please furnish to this office, for each recommendation in this report, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

We appreciate the courtesies and assistance extended by the personnel of the Denver Single Family Homeownership Center, especially those of the Real Estate Owned branch, and to the management and staff

of First Preston Management Inc., during this audit. Should you have any questions, please call Ernest Kite, Assistant District Inspector General for Audit, at (303) 672-5452.

Executive Summary

In March 1999, HUD's Federal Housing Administration (FHA) awarded 7 companies a total of 16 Management and Marketing (M&M) contracts to manage its single family property inventory. Although FHA outsourced its property management activities to contractors, its program mission did not change. With regard to HUD owned properties, FHA's program mission is to reduce its single family property inventory in a manner that:

“(1) expands homeownership, (2) strengthens neighborhoods and communities, and (3) ensures a maximum return to the mortgage insurance fund.”

We performed an audit of First Preston Management, Inc., HUD's Denver Area 3 M&M Contractor, to determine whether the contractor was managing HUD owned single family properties in compliance with HUD's policies, and in accordance with the terms and conditions of the M&M Contract. Our audit work included interviews with HUD and First Preston officials, inspections of properties managed by the contractor, analysis of HUD's Single Family Acquired Assets Management System (SAMS) data, and examination of records, reports, correspondence and other documents.

This report presents the results of our assessment of the M&M contractor's property management operations, and its ability to manage and market single family properties in a manner that enables FHA to accomplish its mission.

Since the inception of the M&M contract in March 1999, First Preston has successfully reduced both the single family property inventory level and the number of properties in inventory for over 6 months. These accomplishments were achieved through significantly increased property sales. First Preston has also improved its fixed fee and pass through costs vouchering procedures and its property sales closing operation, including the accounting for HUD's sales proceeds. However, the average sales price per property and the amount of revenue recovered as a percent of the appraised value have continued to decrease over the past 12 month period ending May 31, 2000. Also, over the same period, the number of property sales to owner occupants have decreased while sales to investors have steadily increased.

The audit identified two areas where First Preston's property management operations need improvement. First, HUD properties were not always being secured or maintained in a presentable condition and health and safety hazards were not always reported and repaired within 24 hours of discovery. Secondly, First Preston was not always marketing HUD properties in a timely manner. Specifically, property processing requirements were not accomplished within the time frames prescribed in the M&M contract. First Preston needs to initiate corrective action in these areas to ensure compliance with the Management and Marketing Contract, and to ensure the effective management and marketing of HUD properties, from acquisition through sales, in a manner that enables FHA to accomplish its program mission.

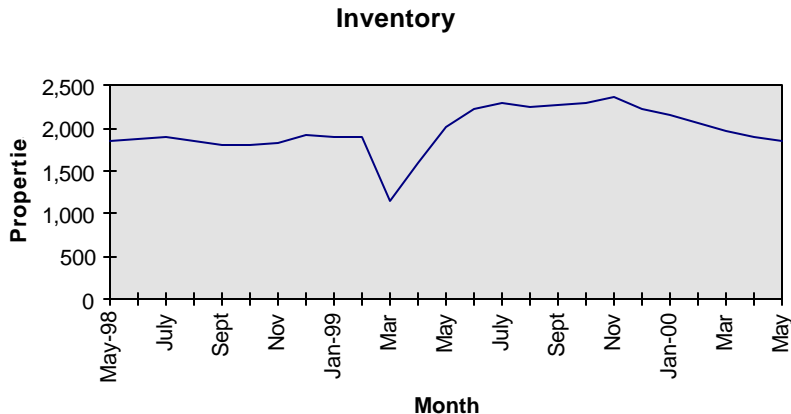
Management and Marketing Contractor's requirements

As stipulated in the Management and Marketing Contract, First Preston is to provide management and marketing services to successfully manage single family (1-4 units) properties owned by, or in the custody of, the Department of Housing and Urban Development; to successfully market those single family properties; and to successfully oversee the sales closing activity, including proper accounting for HUD's sales proceeds.

Per the Management and Marketing Contract, Exhibit 3, the disposition approach selected for each property must consider the objective of reducing the inventory in a manner that ensures maximum net return to the FHA mortgage insurance funds, while complying with HUD Secretarial initiatives, preserving and maintaining residential areas and communities, and applicable environmental, legal and policy requirements.

The inventory level and the amount of time the inventory is held have both decreased

Both the inventory level and the amount of time the inventory is being held have been reduced. In May 1998, the inventory of HUD owned properties within the Denver Area 3 jurisdiction was 1,861. Denver Area 3 consists of the states of Kansas, Missouri, Arkansas, Louisiana and Oklahoma. From the time First Preston was awarded the M&M Contract in March 1999 to November 1999 the inventory of HUD owned single family properties increased to 2,366. By May 2000, First Preston had reduced the number of single family properties in the inventory to 1,844. These changes are reflected in the following graph.

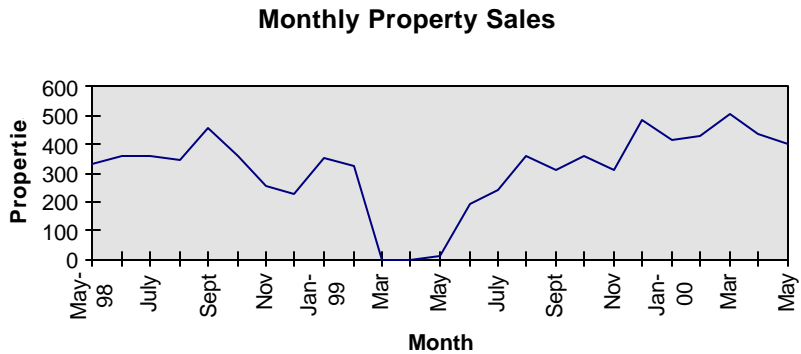


In addition, the number of properties in the inventory held for six months or more has decreased from 333 in May 1998 to 324 in May 1999, and then to 319 in May 2000. The number of properties in the inventory held for 1 year or more has decreased from 144 in May 1998 to 93 in May 1999, with a slight increase to 96 in May 2000.

Property sales have increased

Single family property sales have increased by 23% since May 1998. Since the inception of the M&M contract in March 1999, there generally

has been a steady increase in the number of monthly property sales. In May 1999, due to the newness of the Contract, First Preston only sold 10 properties; however, in May 2000, First Preston sold 404 properties. The changes in property sales by month, since May 1998, are shown in the following chart.



Review of fixed fee, direct disbursement, and pass through cost vouchers

A review of the procedures for the submission of fixed fee, direct disbursement, and pass through cost vouchers was performed at First Preston's headquarters in Addison, Texas. Overall, the contractor followed proper invoicing procedures as outlined in the Management and Marketing Contract, Section G(IV). First Preston has management controls in place to ensure:

- proper segregation of duties;
- vouchers, with original invoices, are submitted to HUD for reimbursement only after the expense has been paid by First Preston (except for direct disbursement invoices); and
- all vouchers and invoices are reviewed by management prior to submission to HUD.

The average property sales price has decreased

Although the number of single family property sales has increased, the average sales price per property has decreased. During the 12 month period ending May 31, 2000, while appraised values remained about the same, the average sales price per property has continued to decrease. For example, in May 2000, the average sales price was \$5,121 less than the average established value. The actual sales price, as compared to the "As Is" appraised value, has declined from 96% of appraised value in June 1999 to 88% of appraised value in May 2000.

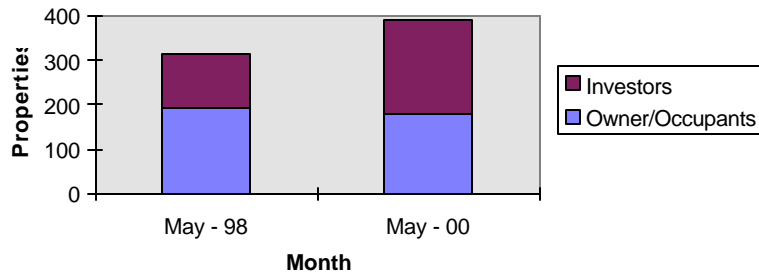
Decreased revenues on sale of HUD owned properties

Although sales have increased, because of the significant decreases in selling prices, HUD has realized decreased average revenues per property. During the 12 month period ending May 2000, First Preston sold 4,435 properties for an approximate total of \$177,314,965. If First Preston had sold these properties for their "As Is" appraised value, instead of the reduced sales amount, the FHA insurance fund would have received an additional \$17 million.

Property sales to owner occupants have decreased, while property sales to investors have increased

Even though single family property sales have increased, property sales to owner occupants are decreasing. In May 1998, 59% of the property sales were to owner occupants, while in May 2000, only 45% of the property sales were to owner occupants. Inversely, property sales to investors have increased. In May 2000, 52% of the single family property sales were to investors while in May 1998, only 37% of property sales were to investors. The difference in these percentages, so that total sales equals 100%, is accounted for by the sale of properties to non-profit entities. The following chart shows that during the period from May 1998 to May 2000 the sales to owner/occupants have decreased while the sales to investors have increased.

Sales to Owner/Occupants and Investors



Two areas of property management operations need improvement

The audit identified two areas where First Preston's property management operations need improvement:

1. ***Property conditions and the oversight of subcontractors.***

HUD properties were not always being secured adequately or maintained in a presentable condition at all times by First Preston. Also, health and safety hazards were not always reported and repaired within 24 hours of discovery, as required. Additionally, damage to HUD properties caused by acts of vandalism are not always being repaired by the contractor.

2. ***Timely accomplishment of the case processing steps.***

First Preston was not always marketing HUD properties in a timely manner. Specifically, the property processing steps were not being accomplished as prescribed in the Management and Marketing Contract. The key processing steps involved not inspecting properties within 24 hours of assignment to HUD, delays in obtaining property appraisals for acquired properties, and deviations from contract provisions in marketing the properties.

Failure to inspect the properties within 24 hours of assignment weakens the contractors ability to ensure that the mortgagee preserves and protects HUD's assets until the property is transferred. Failure to obtain appraisals in a timely manner can cause HUD to incur unwarranted

holding costs and could possibly result in the receipt of appraisals that are not accurate. Failure to market HUD properties in accordance with the contract may result in delayed property listings, thus properties may remain in inventory longer, which increases the holding costs and reduces the net return to HUD.

Auditee's Comments

The results of our review were discussed with officials of First Preston during the course of the audit and at an exit conference held on July 28, 2000. In response to our draft report, First Preston provided us with their written comments, dated August 31, 2000. A complete copy of their response is shown in Appendix A.

First Preston provided detailed information comparing their performance of preserving and disposing of HUD acquired properties under their contract with HUD to HUD's performance of preserving and disposing of acquired properties prior to HUD's contract with First Preston. Their comments also explain that the conditions under which First Preston must administer the preservation and sale of HUD acquired properties are different from the conditions that HUD followed prior to the contract with First Preston. They point out that HUD had different management and marketing tools that are not available to First Preston. Even with these differences, First Preston concludes that their performance has been at least equal to or better than HUD's performance.

We have acknowledged in the audit report that First Preston, since taking over the management and marketing of HUD owned properties in March 1999, has made improvements in several key areas. These key areas consist of:

- Reducing overall inventory levels,
- Reducing the number of properties held in inventory over six months, and
- Increasing the sales of HUD owned properties in their inventory.

First Preston basically concurred with the our findings and related recommendations. In fact, First Preston points out that based upon our review, they have taken positive steps to improve their operations and management of HUD acquired properties. Several of the improvements being made include:

- Implementation of an atmosphere of zero tolerance concerning the responsibilities of their personnel when it comes to property conditions and completion of processing steps for acquired HUD owned properties;
- Further training of inspectors and their Property Management Center personnel to better document and report property conditions to ensure timely preservation and protection of properties;

- Establishing penalties in contracts with their real estate asset managers for non-compliance; and
- Implementing improvements in their monitoring, tracking, and follow-up procedures.

Implementation of these positive steps should improve First Preston's compliance under their management and marketing contract with HUD.

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Abbreviations:

CFR	Code of Federal Regulations
FHA	Federal Housing Administration
GAO	General Accounting Office
HOC	Home Ownership Center
HUD	Department of Housing and Urban Development
M&M	Management and Marketing
REAM	Real Estate Asset Manager
REO	Real Estate Owned
SAMS	Single Family Acquired Asset Management System

Introduction

FHA's Single Family Mortgage Insurance Program insures home mortgage loans to help low and moderate income families become homeowners. However, in such cases where the mortgagor can not maintain their mortgage, the Secretary must develop a program that governs the disposition of one-to-four family properties acquired by the Federal Housing Administration, through foreclosure of an insured or Secretary-held mortgage loan under the National Housing Act, or acquired by HUD under Section 312 of the Housing Act of 1964. The National Housing Act (Act) of 1934 states that the Secretary shall have power to deal with, complete, rent, renovate, modernize, insure or sell for cash or credit, in his discretion, any properties conveyed to him in exchange for debentures and certificates of claim. The Secretary shall, by regulation, carry out a program of sales of such properties. Section 204(g) of the Act governs the management and disposition of single family properties acquired by the FHA.

Title 24, Code of Federal Regulations (CFR), part 291, *Disposition of HUD-Acquired Single Family Property*, implements this statutory authority and states that the purpose of the property disposition program is to dispose of properties in a manner that expands home ownership opportunities, strengthens neighborhoods and communities, and ensures a maximum return to the mortgage insurance fund. HUD Handbook 4310.5, Rev-2, dated May 17, 1994, *Property Disposition Handbook - One to Four Family Properties*, supplements the regulations.

FHA's Office of Insured Single Family Housing, Asset Management Division, is responsible for developing property disposition policies and procedures governing the management and sale of properties.

Notice H 99-4 (HUD), dated March 29, 1999, *Revisions to Single Family Property Disposition*, states that the Department has entered into contracts effective March 29, 1999 for the management and marketing of single family properties which are owned by or in the custody of HUD. FHA awarded 7 companies a total of 16 M&M contracts to manage and market its properties nationwide. First Preston Management, Inc., was awarded the contract for Denver Area 3, which consists of the states of Missouri, Kansas, Arkansas, Louisiana, and Oklahoma. The contract is for 5 years and has an estimated value of \$50 million dollars. First Preston's main office is located in Addison, Texas.

First Preston is responsible for the ongoing management, marketing, sales, and closing of acquired properties under their jurisdiction. First Preston's responsibilities include safeguarding and preserving inventoried properties; providing day-to-day property management functions; and ensuring the properties are maintained in a clean, safe, and presentable condition until the properties are sold or otherwise disposed of. First Preston often uses the services of subcontractors, including Real Estate Asset Managers (REAMs), to assist in its property management functions. However, First Preston remains responsible for ensuring contract requirements are met.

Audit Objectives and Methodology

Our overall audit objectives were to determine if: (1) the contractor managed single family properties in compliance with HUD policies, procedures, and regulations and in accordance with the terms and conditions of the management and marketing contract; (2) the contractor

had effective controls to ensure FHA's assets are adequately protected; and (3) contractor operations resulted in FHA accomplishing its mission and performance goals.

Our audit approach was to evaluate the management controls in place over the key areas of operations of First Preston and to ensure their compliance with the provisions of the Management and Marketing Contract. To accomplish our objectives we: (1) reviewed the law and regulations governing the management and marketing contract (2) interviewed various HUD officials from the Denver Single Family Homeownership Center; (3) interviewed First Preston officials from both their Denver Office and their Headquarters Office in Addison, TX; (4) performed on-site reviews of active, closed, and held off market cases; (5) analyzed SAMS data; (6) performed comparisons between property inspections, HUD-1s, and appraisals; (7) reviewed a sample of fixed price fee, direct disbursement, and pass through cost vouchers; (8) reviewed contracts between First Preston and their subcontractors; (9) reviewed First Preston's controls over their subcontractor's performance; and (10) performed on-site inspections of properties managed by the contractor. These procedures were performed to specifically review the following areas: property files, site inspections, vouchers, subcontracting, and the bidding and purchase processes.

HUD data systems used

To achieve our audit objectives, we relied, in part, on data maintained by HUD in the Single Family Acquired Assets Management System (SAMS) which is the only data base available relating to the management and marketing contract. We did not perform a detailed analysis of the reliability of HUD's SAMS data.

Scope

Our audit period generally covered the activities from contract inception on March 29, 1999, through May 31, 2000. We expanded our scope to other periods as necessary to accomplish the audit objectives. Our audit was performed from April through June 2000.

Generally Accepted Government Auditing Standards

We conducted the audit in accordance with Generally Accepted Government Auditing Standards. However, we did not test the general and application controls over HUD's Single Family Acquired Assets Management System. We relied on HUD's assertions that the information systems provides the only source of reliable data relating to single family property management.

Finding 1

Improvement Needed in Property Conditions and in the Oversight of Subcontractors.

First Preston's property management process did not ensure that HUD owned properties were protected, preserved, and maintained in accordance with the provisions of the Management and Marketing Contract. Specifically, our physical inspection of 26 properties, located in Kansas City, Kansas, Kansas City, Missouri, and New Orleans, Louisiana, revealed that health and safety violations were not being reported and corrected within the prescribed 24 hours; properties were not being protected properly from unauthorized entry; damages caused by vandalism were not being repaired; and the properties were not being maintained in a presentable condition at all times. Real Estate Asset Managers (REAMs) are not reporting to First Preston in a timely manner the true condition of HUD owned properties. In addition, REAMs did not insure that health, safety, and vandalism deficiencies were repaired as prescribed in the contract.

These deficiencies are impacting on HUD's goal of obtaining the maximum return to the insurance fund on the sale of HUD owned properties and the sale of these properties to low and moderate income owner occupants. While sales of HUD owned properties are on the increase and inventory levels are decreasing, sales revenues, based on the percent of appraised value, are on the decline. The cause of these deficiencies appears to be lack of training of the REAMs and the need for more oversight of subcontractors by First Preston Management, Inc.

First Preston is responsible for the preservation and protection of HUD owned properties

First Preston Management, Inc., entered into a M&M contract with HUD to eliminate, in a timely fashion, any hazardous conditions to HUD owned properties; to preserve and protect properties; to maintain properties in a presentable condition at all times; and to enable timely marketing and sales. The M&M contracts holds First Preston liable for damages to HUD property due to acts of vandalism, neglect, negligence of employees, and subcontractors, failure to secure property, or other misconduct by the Contractor. Additionally, property inspections are to be performed 24 hours after property acquisition and then on a routine basis. The property is to be secured immediately upon acquisition to prevent vandalism. Damages due to vandalism must be repaired by the contractor; also, conditions that present health or safety hazards are to be repaired by First Preston within 24 hours of discovery.

Weaknesses were found in the preservation and protection of properties

First Preston has subcontracted with a REAM, Clayton Williams, to perform routine property inspections in New Orleans, Louisiana. The REAM for the Kansas City, Kansas and Kansas City, Missouri regions are employees of First Preston. During a review of a select number of properties, significant deficiencies were noted in the areas of preserving and protecting HUD properties. First Preston and the REAMs have not

First Preston's Quality Assurance and Quality Control Plan

always secured the properties adequately or maintained properties in a presentable condition at all times. Also, health and safety hazards have not always been reported and repaired within 24 hours of discovery. First Preston's Quality Assurance and Quality Control Plan requires the REAMs to perform bi-monthly property inspections and to notify First Preston immediately of any damage or vandalism to the property. They are also required to write up detailed and clear repair specifications and request bids from qualified contractors to perform repairs when authorized by First Preston. They are required to remove or repair safety and health hazards and to order termite and other pest inspection when requested. Also, it is stated in the Plan that First Preston's Oversight Inspectors will perform a random basis file review with a subsequent property inspection. Additionally, repairs are audited by First Preston's Regional staff during their Field Office Reviews, to verify that they were necessary, cost effective, timely, and professional. The Field Office Reviews include auditing property files and viewing the physical property.

OIG Appraiser identifies deficiencies

The OIG Appraiser's on-site property inspections, of a random selection of 26 properties, identified several deficiencies with the quality of the property inspections being performed by the REAMs. (**Note:** The denominator used to determine the percent of the various categories often varies. This is because, of the 26 properties selected for review, the OIG Appraiser did not inspect the interior in 4 of the properties, because the property conditions were determined to be unsafe. Also, 4 of the properties were newly acquired and only had the REAM's Initial Property Inspection. Properties in which some of the categories were not inspected by the OIG Appraiser were deducted from the denominator.) The OIG rated 21 of the 26 properties, 80.77%, as being in poor condition, while the REAMs only showed 4, 15.38%, of the properties as being in poor condition.

Specifically the OIG Appraiser identified the following conditions:

- 45.83% of the properties inspected had unsecured windows and/or doors and/or garages;
- 40.91% of the properties had evidence of vandalism;
- 40.00% of the properties did not have proper HUD signs posted;
- 59.09% of the properties had evidence of deficient roofs;
- 68.18% of the properties had evidence of roof leaks;
- 38.10% of the properties had evidence of structural damage;
- 60.87% of the properties had evidence of defective exterior paint;
- 59.09% of the properties required emergency maintenance; and
- 42.31% of the properties had exterior hazardous conditions.

The OIG Appraiser also identified several properties that had the following safety deficiencies: electrical hazards; rotting out, unstable, or settlement of stairs and landings; fire damage; termite damage; openings in the properties' structure; tripping hazards; and missing light fixtures, switches, or outlets.



Case 291-188502, 2120 NW 58th St., Kansas City, MO. Major electrical hazard. Plus missing switch cover plate.

REAMs do not report property vandalism

Of the 26 properties that were selected for review, the OIG Appraiser identified 9 of them as having been vandalized. Of these 9 properties, two were identified by the REAMs, during their initial inspections, and two were identified during subsequent inspections, as having been vandalized. Several of the case files also contained work orders and invoices for boarding up the broken windows and doors after the vandalism but no evidence of repairs to other parts of the house due to vandalism were noted.

Doors and windows were not always properly secured

The OIG Appraiser identified doors that were not properly secured; incorrect locks that were used; doors and windows that were found broken; door frames that were found to be severely damaged; unlocked windows; hazardous car parts; toilets missing; toilet openings not capped allowing sewer gases to leak in; and broken glass inside and outside of the properties.



Case 181-980000, 2615 N. 11th St., Kansas City, KS 66104. Hazardous trash and debris litters the yard.



Property case 221-274304, 2720 Onzaga St., New Orleans, LA. Window on the right is missing. Allows entry into the unit. Property is not properly secured and can be vandalized.



Property case 221-274304, 2720 Onzaga St., New Orleans, LA. Unit has been vandalized by breaking down rear exterior door. The property is exposed to further vandalism and as evidenced by the growth of vegetation on the inside of the property, the door has been broken for an unknown period of time.



Property case 221-274304, 2720 Onzaga St., New Orleans, LA. Unit has been vandalized by breaking down rear exterior door. The property is exposed to further vandalism and, as evidenced by the growth of vegetation, the door has been broken for an unknown period of time.



Property case 221-232238, 1638 Clouet St., New Orleans, LA. Front exterior door is missing. Thin sheet of plywood has been substituted. This is not stable or secure. Property is not secured and can be vandalized.



Property case 221-232238, 1638 Clouet St., New Orleans, LA. Toilet has been removed. Sewer gas is allowed to enter unit. The hole in the floor is open to the ground below.



Property case 221-232238, 1638 Clouet St., New Orleans, LA. Bathtub has been removed. The hole in the floor is open to the ground below.

First Preston's Oversight Inspector noted the same property conditions

For those single family properties that had not been sold, First Preston's Oversight Inspector performed follow-up inspections of the properties identified by the OIG as having deficiencies. There were a total of 8 properties that were still in HUD's inventory. The Oversight Inspector identified, in these follow-up inspections, most of the same deficiencies that the OIG Appraiser had noted. The Oversight Inspector also noted additional deficiencies, such as a kitchen gas valve that was found open and some temporary kitchen wiring was detected.

REAMs are not doing adequate property inspections

Due to the quality of the REAM property inspection reports, the random file reviews performed by the contractor's oversight inspector are generally not effective. Pertinent information regarding property conditions are being omitted by the REAMs. This does not allow the oversight inspector to obtain a clear and accurate understanding of the properties' actual condition. It is apparent from the OIG Appraiser's inspection of properties in Kansas City, Kansas, and Kansas City, Missouri, and New Orleans, Louisiana, and subsequent follow-up inspections performed by First Preston's Oversight Inspectors, that the REAMs are not performing adequate inspections of HUD properties and/or identifying, correcting, and reporting to First Preston any and all safety and/or structural problems with the properties, and/or acts of vandalism.

Sales prices are declining

Fifteen of the 26 properties inspected by the OIG Appraiser have been sold, as of June 30, 2000. The net total to HUD from the sale of these properties was \$565,034. The average bid price to HUD, on these properties, was about 90.10% of the appraised value. This means that

HUD had a potentially loss of revenue, based on the appraised value, on these properties, of \$56,963.

Most properties sold after initial 45 day listing period

Of the 15 properties that were sold: 6 properties, 40.00%, were sold within 1 to 45 days of initial listing; 6 properties, 40.00%, were sold within 46 to 90 days of initial listing; 1 property, 6.66%, was sold within 91 to 135 days of initial listing; and 2 properties, 13.33%, were sold in 180+ days from initial listing. Twelve of the 15 sold properties, 80.00%, were considered in poor physical condition by the OIG.



Property case 221-276295, 6945 Downman Rd., New Orleans, LA. Hazardous metal carport roof and termite damaged wood with sharp nails. Requires removal ASAP. The metal roof and/or the damaged wood can fall and cause serious injury.



Property case 221-209295, 5505 Bundy, #182, New Orleans, LA. One of several dilapidated and hazardous carport covers in the complex. The cover can fall and cause serious injury.



Case 181-980000, 2615 N. 11th St., Kansas City, KS. Staircase and landing to second floor is rotted away.



Property case 221-149347, 6400 Lafaye St., New Orleans, LA. Rear steps of the kitchen exterior door has settled excessively. Very hazardous. Proper steps with a 8" riser and a handrail is required.



Property case 221-149347, 6400 LaFaye St., New Orleans, LA. Front steps have settled an excessive amount creating a top riser over 8". Very serious tripping hazard.



Property case 221-149347, 6400 LaFaye St., New Orleans, LA. Damaged roof fascia at the right front. Also the gutters are damaged. The opening allows excellerated deterioration of the roof and the ceilings.

Sale prices during the 12 months period ending in May 2000 have declined

An analysis was performed using the profit and loss data for the 12 month period ending in May 2000 for the properties acquired by First Preston in the Denver Area 3. This analysis disclosed that while appraised values have remained about the same, actual sale prices have steadily declined. The actual sale prices have declined from an average of 96%, of appraised value, in June 1999 to an average of 88%, of appraised value, in May 2000. Although total sales have increased, in part because of the significant decreases in selling prices, revenue losses continued to increase. One of the stated goals of FHA is to ensure a maximum return to the mortgage insurance fund. These statistics for Denver Area 3 are shown in the following table:

Month/ Year	Average Appraised Value	Average Sale Price	Percent of Appraised Value	Difference of Sales Price and Appraised Value	Sales Volume	Total Difference Between Average Sales Price and Appraised Value
Jun-99	\$42,025	\$40,464	96%	(\$1,561)	192	(\$299,712)
Jul-99	\$47,231	\$44,083	93%	(\$3,148)	244	(\$768,112)
Aug-99	\$45,155	\$43,490	96%	(\$1,665)	359	(\$597,735)
Sep-99	\$43,228	\$41,977	97%	(\$1,251)	311	(\$389,061)
Oct-99	\$45,758	\$43,843	96%	(\$1,915)	357	(\$683,655)
Nov-99	\$45,395	\$43,339	95%	(\$2,056)	300	(\$616,800)
Dec-99	\$43,235	\$40,103	93%	(\$3,132)	484	(\$1,515,888)
Jan-00	\$41,150	\$36,975	90%	(\$4,175)	412	(\$1,720,100)
Feb-00	\$44,043	\$38,906	88%	(\$5,137)	431	(\$2,214,047)
Mar-00	\$44,314	\$37,063	84%	(\$7,251)	509	(\$3,690,759)
Apr-00	\$42,685	\$36,962	87%	(\$5,723)	432	(\$2,472,336)
May-00	\$42,803	\$37,682	88%	(\$5,121)	404	(\$2,068,884)
	\$43,919	\$40,407	92%	(\$3,511)	4435	(\$17,037,089)

If First Preston had sold the HUD owned properties in the Denver Area 3, during the 12 month period June 1999 to May 2000, for their appraised value, instead of the reduced selling prices, the FHA fund would have been replenished approximately \$17,000,000 dollars more.

Auditee's Comments

First Preston has basically concurred with our finding and related recommendations on property condition and has initiated positive steps to alleviate the root causes of the problem. Several of the improvements include:

- Implementing an atmosphere of zero tolerance when it comes to property conditions;
- Additional training of inspectors and Property Management Center personnel; and
- Establishing penalties in future contracts with their REAMs.

A complete copy of First Preston's response to the audit can be found in Appendix A.

Recommendations

We recommend that First Preston:

- 1.A Provide additional training for all REAMs, both subcontractors and First Preston employees, on the proper procedures for performing and documenting property inspections, and the proper procedures for the protection and preservation of HUD properties.

- 1.B Establish and implement a more detailed oversight review of HUD owned properties to ensure that property inspections and repairs are timely and accurately performed. Contracts for subcontractors should be written to included fines and penalties that can be imposed on the REAMs, if omissions or misleading statements are found on any of their inspection reports.

Finding 2

Improvement Needed in First Preston's Timely Accomplishment of the Case Processing Steps

First Preston Management, Inc., does not have sufficient management controls in place to ensure that the case processing steps, as outlined in the Management and Marketing Contract, are met in a timely manner. Through reviews of 27 active case files, we found that First Preston did not process their properties timely in 21 of the 27 active cases, or 77.77%. Specifically, we found active case processing delays within the initial inspections, appraisals, receipt and review of form HUD-27011 Parts B, C, and D, and the case disposition program approval process. Case processing delays occurred because First Preston's management controls and the oversight of its subcontractors and staff personnel were not adequate to ensure the timely completion of all required processing steps.

These delays in active case processing can result in HUD owned properties not being listed as soon as possible; a possible deterioration of the properties; decreased revenues to the FHA insurance fund; and the possibility of inappropriate charges being passed on to HUD by mortgagees.

First Preston needs to insure that their management controls and oversight procedures contained within the Management and Marketing Contract's Quality Control and Quality Assurance Plan can detect and correct any deviations from the contract by their subcontractors and First Preston's own staff. Contracts with subcontractors should include sanctions for personnel for poor performance.

Management and Marketing Contract requirements

The Management & Marketing Contract, C-OPC-21337, Section C-2 V, outlines specific tasks that are applicable to each assigned property. The contract emphasizes that First Preston's actions shall be timely so as to eliminate any hazardous conditions, to preserve and protect properties, to maintain properties in a presentable condition at all times, and to enable timely marketing and sales. Part B of Section C-2 V specifically requires the contractor to perform an initial inspection within 24 hours of assignment, for newly acquired properties, using form HUD 9516A, Initial Inspection Report. Part B also requires the contractor to obtain an appraisal for each property's current value from a licensed, industry-recognized source. First Preston is to obtain an appraisal of the property no later than ten business days after assignment.

Exhibit 12 of the contract states that the Mortgagee is to send Parts, B, C, and D of form HUD-27011 to the contractor within forty-five (45) days of the date the deed is filed for record, or within fifteen (15) days of title approval, whichever is later. Parts B and C are to be compared to

the Initial Inspection Report, form HUD-9516A and the Appraisal Report. Line item 305 of Part D is to be reviewed to determine whether taxes charged were actually paid and whether the Mortgagee charged HUD for tax penalties.

In addition to the Management and Marketing Contract, HUD Handbook 4310.5 Rev-2, Property Disposition Handbook, dated 5/94, details specific requirements that are applicable to each assigned property. HUD Handbook 4310.5 Rev-2, Chapter 6, paragraph 6-17, requires the contractor to review and approve the written property disposition program within 3 days of receiving the property appraisal.

Review of active case files identified processing deficiencies

We randomly selected and reviewed 27 active case files. Ten of the 27 active case files were selected from the Kansas City, Missouri and Kansas City, Kansas areas. Seventeen of the 27 active case files were selected from the New Orleans, Louisiana area. These cases were in various phases or steps of the disposition process. We focused our review on the following functions within the disposition process: acquisition, title approval, initial inspection, appraisal, disposition program approval, sales contract acceptance and review, and sales closing.

Based on our review, we found that First Preston did not always process their properties timely. Specifically, we found active case processing delays within the initial inspection, appraisal, case disposition program approval, and receipt and review of Parts B, C, and D of form HUD-27011.

Four of the 27 active cases selected for review, did not require initial inspections, appraisals, or case disposition program approvals due to events such as adverse occupants, fire damage, etc.; therefore, only 23 of the active case files were reviewed for initial inspections, appraisals, and case disposition program approvals.

Late initial property inspections and appraisals

Based on our review, we determined that in 15 of 23 cases, 65.22%, First Preston did not perform the initial inspection within 24 hours of assignment. The number of days late ranged from 1 to 14 days. For 5 of 23 cases, 21.74%, First Preston did not receive a property appraisal within 10 business days of assignment. The number of days late ranged from 1 to 16 days.

Failure to accomplish timely inspections on HUD owned properties can result in property conditions deteriorating. Deteriorating conditions are caused by acts of vandalism and/or natural acts such as rain and wind. Therefore, it is vital that First Preston accomplish the initial inspections and document the exact condition of the property within 24 hours of assignment. In addition, the initial inspection and appraisal report are to be used at a later time to confirm that any property protection and/or preservation work represented on Parts B, C, and D, of form HUD-

27011 was properly completed by the mortgagee. Finally, the initial inspection report serves as a means to verify that the property is not being conveyed to HUD for items involving mortgagee neglect.

Property disposition
program deficiencies

For 12 of 23 cases, 52.17%, First Preston did not approve, and/or properly document the case disposition programs within 3 business days of receipt of the appraisal. Specifically, 2 of the reviewed cases were approved late and 10 of the reviewed cases did not have an approved date on the SAMS documentation provided in the case file.

First Preston staff stated that the reason the case disposition programs did not have an approved date on the SAMS documentation is because First Preston staff was only approving case dispositions on Mondays and Tuesdays. During the remaining portion of the week, staff personnel would enter the information into SAMS, without the approval date, and then wait until the following Monday or Tuesday to approve the program. Once the program was approved, First Preston staff did not update the new SAMS case disposition screen with the approved date in the case file. This process did not ensure that the case disposition programs were prepared and approved within 3 business days of receipt of the appraisal. First Preston indicated during the review that they have changed their procedures so that case dispositions are now prepared and approved daily.

The disposition program establishes the sales method and the listing price of each property. Failure to timely approve and properly document the property disposition programs may result in delayed property listing; thus, properties may remain in inventory longer, which increases the risk of property deterioration and may delay the sale of the property.

Deficient review of Parts
B, C, and D of form
HUD-27011

For our review of the processing of form HUD-27011, we only reviewed the 17 randomly selected cases for the New Orleans area. Our review involved the proper documenting and timely processing of the forms, particularly Parts B, C, and D of form HUD-27011.

Based on our review, we determined that in 16 of 17 cases, 94.12%, First Preston did not receive and/or show indications of review of Parts B, C, and D of form HUD-27011 in a timely manner. Specifically, in 12 of the 17 cases, 70.59%, Parts B, C, and D were not received within 45 days of the date the deed was filed for record, or within 15 days of title approval, whichever was later. In 4 of the 17 cases, 23.53%, Parts B, C, and D were received in a timely manner but there were no indications that they were reviewed.

Failure to receive and review Parts B, C, and D of form HUD 27011 in a timely manner may result in inappropriate costs being passed on to HUD by the mortgagee. Review of Parts B, C, and D will help confirm that: 1) any property protection or preservation work represented on Parts B, C,

and D was properly completed by the mortgagee, and 2) whether taxes charged were actually paid by the mortgagee and that no tax penalties or interest were charged to HUD.

Deficient performance by
First Preston's
subcontractors

First Preston's subcontractors are not fulfilling the requirements of their contracts. The initial inspections are not being accomplished within 24 hours of assignment and appraisals are not being completed and sent to First Preston within 10 business days after assignment. HUD's Real Estate Owned Division has noted these conditions on their monthly assessments to First Preston. Although First Preston has a Management and Marketing Contract's Quality Control and Quality Assurance Plan, and a Contract Oversight Division, these conditions continue to exist. The procedures written in the Quality Control and Quality Assurance Plan appear to be adequate; however, the above noted discrepancies indicate an apparent weaknesses in the implementation and accomplishment of the Plan. Modifications are needed by First Preston to ensure the timely inspections and appraisal of acquired properties by its subcontractors.

Summary

In summary, case processing delays can lead to deteriorated property conditions; properties remaining in HUD's inventory longer than they should; and a possible decline in revenue earnings for FHA's insurance fund. Because of these possible adverse effects, it is essential that First Preston undertake sufficient action to ensure the timely completion of initial inspections, property appraisals, case disposition program approvals, and receipt and review of Parts B, C, and D of form HUD-27011.

Auditee's Comments

First Preston has basically concurred with our finding and related recommendations on the timely accomplishment of processing step and has initiated positive steps to alleviate the root causes of the problem. Several of the improvements include:

- Implementing an atmosphere of zero tolerance when it comes to property conditions; and
- Implementing improvements in their monitoring, tracking, and follow-up procedures for the processing of HUD owned properties.

A complete copy of First Preston's response to the audit can be found in Appendix A.

Recommendations

We recommend that First Preston:

- 2.A. Modify its management and marketing procedures to ensure that the terms and conditions contained in its contract with HUD are met. This would include procedures that will:

- Ensure initially assigned acquired properties are inspected within 24 hours;
- Obtain property appraisals within 10 business days after assignment;
- Ensure that form HUD-27011 is properly and timely completed and used; and
- Ensure the individual case disposition programs are prepared and approved within three days of the property appraisal.

The modified management and marketing procedures will need to be incorporated into First Preston's Quality Control and Quality Assurance Plan.

- 2.B. Improve its monitoring and oversight of its subcontractors to ensure the subcontractors are properly and timely carrying out their contract responsibilities. In addition, First Preston needs to amend its contract with its subcontractors to impose fines and penalties for poor performance.

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Management Controls

In planning and performing our audit, we obtained an understanding of the management controls that were relevant to our audit. Management is responsible for establishing effective management controls. Management controls, in the broadest sense, include the plan of organization, methods, and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include systems for measuring, reporting, and monitoring program performance.

Management controls assessed

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

- Controls that ensure compliance with the Management and Marketing Contract;
- Controls that ensure compliance with HUD regulations; and
- Controls that ensure reliable reporting data.

Assessment procedures

The following audit procedures were used to evaluate the management controls:

- Interviews with Single Family personnel, First Preston employees and others deemed necessary for our audit;
- Reviews of servicing files, accounting records, and other records maintained by those entities reviewed; and
- Evaluation of established policies and procedures for implementing the Management and Marketing Contract, compared against actual policies and procedures followed by the contractor.

HUD data systems

We did not test the general and application controls over HUD's Single Family Acquired Asset Management System (SAMS), and relied on HUD's assertions that the information systems provided the only source of data needed for the audit.

Significant weaknesses

A significant weakness exists if management controls do not give reasonable assurance that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data is obtained and maintained, and fairly disclosed in reports. Based on our audit, we believe the following items are significant weaknesses within First Preston's management controls:

- The protection and preservation of HUD properties and the monitoring and maintenance of property disposition files is insufficient; and

- The processing steps for acquired HUD owned properties, managed and marketed by First Preston Management, Inc., are not accomplished in the time frame specified within the Management and Marketing Contract.

Follow Up on Prior Audits

This is the Office of Inspector General's first audit of First Preston's Management and Marketing Contractor for Denver Area 3.

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Other Matter Needing Action

Since the inception of the Management and Marketing Contract, First Preston has continued to improve the process to ensure that the pass through vouchers are in compliance with the Contract. This improvement of the pass through voucher process is demonstrated in the April 2000 implementation of the Contract Compliance Division. This capable pass through process is, however, allowing deficiencies to pass through the system. Examples of the deficiencies include not submitting all required supporting documentation, not including the required information on all of the documentation, and inconsistent information on the documentation. These deficiencies are in violation of the Management and Marketing Contract; however, these deficiencies do not cause the pass through vouchers to be invalid.

During the review of pass through vouchers requesting the payment of real estate taxes, we discovered several instances where First Preston requested, and HUD caught, the payment of taxes that had already been paid. These taxes had been paid by an entity other than First Preston, and due to the circumstances, First Preston should not have known that these taxes were already paid. We recommend that within 10 business days of assignment/acquisition, First Preston verify the tax status of each newly acquired property by reconciling tax information from both the taxing authority(s) and the mortgagee. Then the tax information could be entered into SAMS on the Tax Account Screen (STXTA). On a weekly basis, the tax records for each property could be updated in SAMS.

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Appendices

Appendix A

Auditee Comments



August 31, 2000

Mr. Robert C. Gwin
District Inspector General for Audit
U.S. Department of Housing and Urban Development
Office of Inspector General, Rocky Mountain District
633 17th Street, North Tower, 14th Floor
Denver, Colorado 80202-3607

Reference: OIG Draft Audit Letter dated August 14, 2000 – Denver Area 3

Dear Mr. Gwin,

The draft audit report performed by the office of Inspector General, Rocky Mountain District has been received and reviewed for content as it relates to findings, recommendations and suggestions in the performance of First Preston Management's administration of HUD contract C-OPC-21337B for the states of Arkansas, Missouri, Kansas, Oklahoma and Louisiana. We trust that our response will provide appropriate answers and potential remedies to directed concerns along with suggested alternatives and or suggestions for improvement that may or may not extend beyond the scope of this particular contract.

Discussion shall extend to each of the two immediate areas of concern noted in the draft with particular emphasis on curative measures that have been employed on or before the effective date of the instrument and those that are in the process of implementation. The flow of response will attempt to track that of the draft and shall include, but not be limited to property maintenance and file processing. Each of these defined areas will be addressed in a manner that should depict solid compliance initiatives and definable timelines with attainable goals.

However, before responding to the specific issues detailed in your report, please allow us to recap the historical condition of this portfolio and the progress we have made to date.

Executive Summary

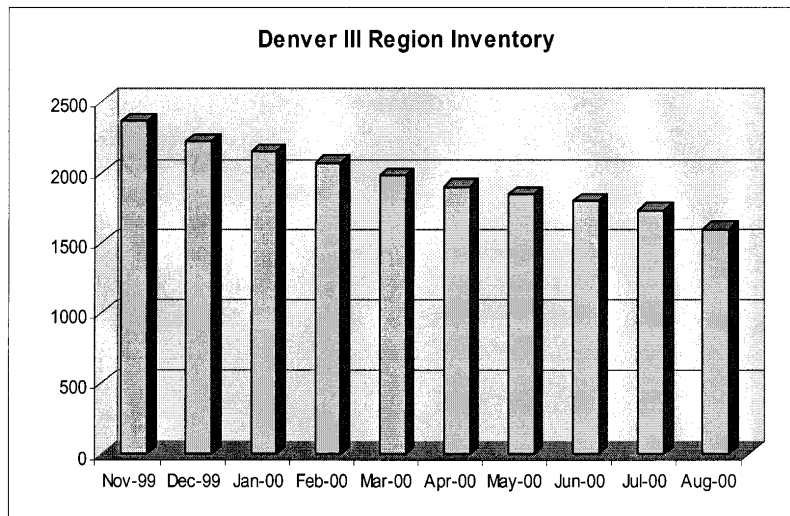
Accomplishment of FHA Goals

First Preston takes into account the department's objective of reducing inventory in a manner that ensures maximum net return to the FHA mortgage insurance funds, while

expanding homeownership, strengthening neighborhoods and communities, complying with Secretarial initiatives, preserving and maintaining property conditions, and applicable environmental, legal and policy requirements. We have adequately staffed offices of trained and professional industry experts and constantly monitor our efforts for all levels of administrative, managerial and field performance. Our understanding of the contract requirements and missions of the department are indicative of the many and various results we have achieved for HUD.

Reduction of Inventory

Upon takeover in April 1999, the initial inventory inflated to higher levels for the reason the turnover cases did not include properties under a sales agreement (Step 8). This resulted in First Preston beginning at ground zero with sales and closings. In addition, HUD shut down its sales activity prior to March 29, 1999, therefore, we experienced no significant closings in the first two months of our contract. Furthermore, HUD assigned to First Preston those properties that did not close (under HUD's management) over the first few months of the contract. Due to these anomalies, we will track our inventory reduction from its peak-level through July 2000. This graph will clearly indicate the continued and steady reduction of inventory, which also is below the level prior to the beginning of the M&M program.

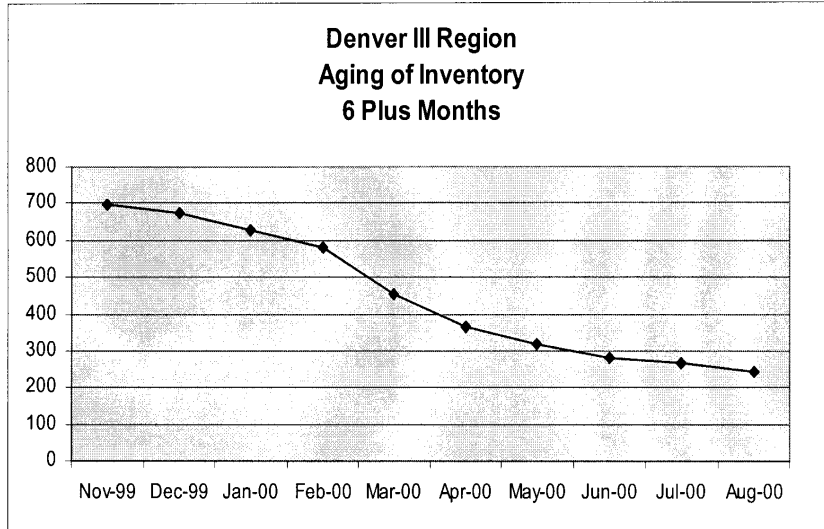


(Data provided by HUD MEAP Report)

Aged Inventory Reduction

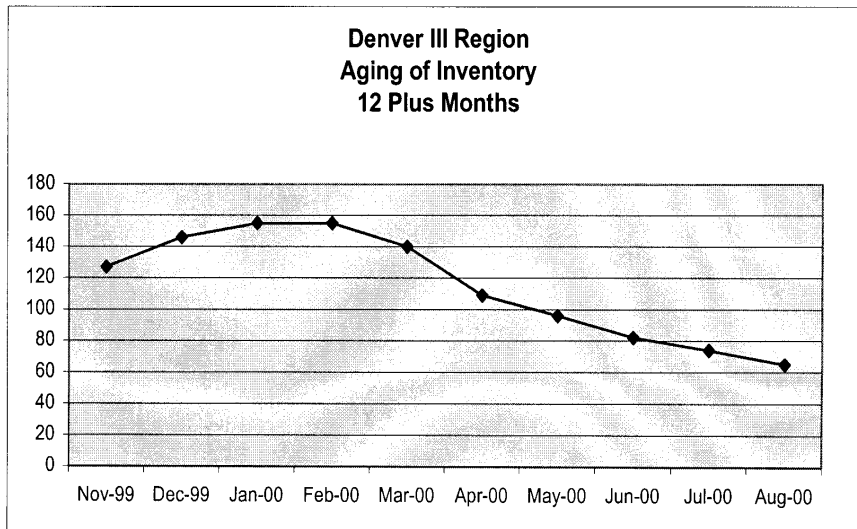
In November 1999, the number of properties in inventory over six months, according to HUD's MEAP report (SAMS Report MEAPSS00), was 698 or 29.5% of HUD-owned inventory. Today, there are less than 260 properties that have been held by HUD more than six months. This represents a continued reduction of over 62% under the constraint

of the requirement for higher acceptable bid thresholds and without the use of marketing incentives and property enhancements that were typical in this region prior to privatization.



(Data provided by HUD MEAP Report)

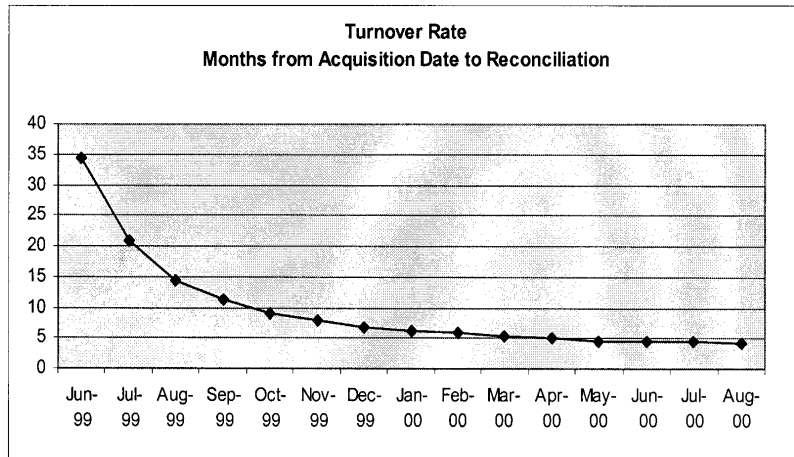
In addition to HUD experiencing a decrease in properties held over six-months in inventory, First Preston is also able to show where the number of properties held over one year have been reduced as well. This steady decrease has been constant since the peak levels of the contract as illustrated in the graph below.



(Data provided by HUD MEAP Report)

Reduced Turnover Rate – Returns \$3.2 Million to HUD Annually

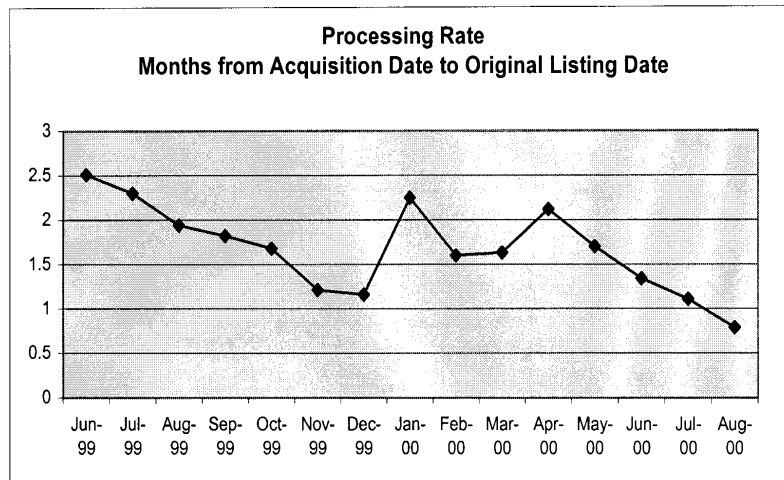
One of the major factors leading up to such a dramatic reduction of inventory can be found in the fact that First Preston successfully lowered the turnover rate of properties by 17%. We compared the turnover rate experienced by HUD prior to the M&M program. A reduction of this size represents a savings to the government of \$3.2 million dollars per year, or \$16.4 million over the life of our contract. We calculate this savings by multiplying current inventory by the turnover rate reduction and holding per diem cost, then we annualize this figure (1,597 X 26 days X \$28/day X 2.83 periods/year = \$3,290,203). [Note: The \$28 per day figure is HUD’s annually calculated and reported per diem holding cost per property.]



(Data provided by HUD MEAP Report)

Processing Time

According to HUD’s MEAP report, processing times were reduced from 1.67 to 0.79 months when comparing the period prior to First Preston’s takeover with our current results. This represents the number of days it takes from acquiring an asset to listing, which represents a 53% greater success rate. The following chart tracks the processing rate from its height, shortly after our involvement, to the current date. The trend shows a continual reduction, as First Preston’s systems for acquiring, appraising and listing have steadily improved.



(Data provided by HUD MEAP Report)

Increased Property Sales

The OIG mentions in the audit report that First Preston has increased property sales above those results experienced prior to the M&M contract. It is stated that single family property sales have increased by 23% since May 1998. Additionally, since the inception of the M&M contract in March 1999, there generally has been a steady increase in the number of monthly property sales. We agree with this determination.

Direct Disbursement and Pass Through Costs

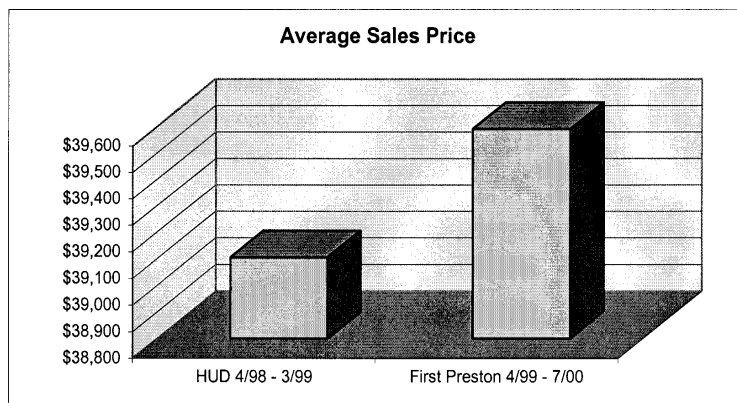
First Preston has management controls in place to ensure proper segregation of duties; vouchers are submitted to HUD for reimbursement only after the expense has been paid by First Preston (except for direct disbursement invoices), and an original invoice is included with the voucher; and all vouchers and invoices are reviewed by management prior to submission to HUD. We appreciate the OIG's concurrence of these procedures and with our added Quality Control Compliance Division HUD can expect results of this type throughout the term of our contract.

Increased Sales Prices

The OIG states in the report that sales prices under our management have decreased. However, although initial sales prices saw a decline, the net return, or, in our opinion a more crucial measurement of success, has experienced an upsurge indicating that First Preston has increased rather than decreased the return to the mortgage fund by \$9,265,787 [Total closings (5,150) x Average Net to HUD (\$36,718) x Increase in Average Net to HUD (.049)], without the benefit of incentives or repairs. The region's average sales price to appraised value since inception is an impressive 98% with an

average net to HUD of 93%. These numbers are further enhanced by the fact that marketable inventory has been reduced.

The average sales price for the period since the beginning of our contract through July 2000 is \$39,589. This represents an increase when compared to the annual average prior to our contract. The report distinguishes a reduction in sales price as compared to appraised value. It is important to mention, list prices are strictly set in accordance with our contract, as are price reductions and the percentages of acceptable net thresholds. The OIG's criticism of First Preston for not reaching a sales price consistent with 100% of the appraised value does not meet the policy goals of HUD. It is unrealistic to expect First Preston to achieve sale prices that represent 100% of appraised value, when you factor in the discounts offered in HUD's special-interest programs such as Officer Next Door, Teacher Next Door, Non-profit sales, ACA agreements and Dollar Home sales, many of which did not exist under HUD's direct management of the disposition program. These discounts, which cause sales prices to decrease dramatically as compared to appraised value, range from 10-50% of the sales price to \$1. One dollar in most cases is an immeasurable percentage (less than 1%) of appraised value. Under our contract, we must abide by all of HUD's policies relative to the acceptance of reduced sales prices.



(Information provided by HUD's SAMS Help Desk)

It is further stated in the Inspector General's draft, that if First Preston would have realized 100% of the sales price as compared to appraised value, that HUD would have received an additional \$17 million. It is inconceivable to expect First Preston to achieve unrealistic and unattainable results, and furthermore, based on the above explanation, there is no merit in documenting these losses when measuring the performance of First Preston or that of the M&M program.

Sales to Owner Occupants have Decreased

It should be noted that the realm of our control exists mainly in the listing process, and is strictly governed by HUD regulations and the terms of our contract. The OIG mentions that the number of sales to owner-occupants has decreased, implying that sales under our management are slanted towards investor purchases. Our contract requires us to accept sales contracts with offers representing the highest acceptable net proceeds to HUD, and does not allow us to deviate in favor of insured owner-occupant sales. Furthermore, the listing of insurable properties is influenced heavily by the conveyance condition of the properties, and the determination of the appraiser. Because of the advent of appraisal reform, appraisers have submitted more appraisals as uninsurable, concerned that the liability was now theirs. HUD has since issued a new Mortgagee Letter alleviating the appraisers concerns by allowing them to insure properties with conditions to be met by the buyer's system inspection. HUD should now experience an increase in insured sales.

Findings

Finding 1: Improvement Needed in Property Conditions and in the Oversight of Subcontractors

Weaknesses were found in the preservation and protection of properties

While property condition is a vulnerable area of risk for both HUD and the M & M contractor, there must be a realistic goal, as these properties will have the risk of vandalism, trash and securing issues on an ongoing basis. First Preston understands the impact of property condition; however, we also have to draw a distinction between inherent risk and compliance with our contract. Our goal is to insure that all initial and routine services are performed timely and completely and that the inherent risks of vandalism, etc. are addressed immediately upon discovery.

All regional field offices and applicable personnel have been notified that First Preston has an atmosphere of zero tolerance, which requires a 24-hour inspection or ample and acceptable documentation to the contrary. This policy includes the immediate or 24-hour satisfaction per the contract for safety, health or vandalism issues and the documentation of the action taken within the regional case file. In addition, each Property Management Center is required to forward to the corporate executive team, a completely documented physical inspection, denoting the condition of each property within its inventory during the month of September, in conjunction with posting the newly approved "For Sale" sign. We are further requiring that each Property Director document, for all properties assigned, and forward weekly to the corporate office the following:

- New Acquisition assignment date and initial inspection date

- Initial Services date (includes initial lawn maintenance, cleaning, debris removal, etc.)
- Date of follow-up inspection approving initial services
- Date of defective paint removal
- Date of routine inspections
- Date of routine lawn maintenance
- Date of subsequent cleanings

OIG Appraiser identifies deficiencies

First Preston oversight inspectors were immediately dispatched to the areas noted in the draft. Discrepancies within our control were addressed immediately and a reprimand issued to the subcontractor. One inspector was terminated and a replacement employed. We have since hired a full time oversight inspector for the area. In addition, First Preston reviewed the Property Management Centers files, policies and procedures, shored up deficiencies and further trained the staff and inspection team. The OIG reports a number of the properties as being recently vandalized, contributing to the poor condition rating it used in the report. Again, it is not an appropriate measurement of our performance when determining that First Preston is liable for vandalism, or other inherent risks, prior to our discovery. The contract and our Quality Control Plan limits our responsibility to cure these deficiencies within 24 hours **after** discovery. Eliminating vandalism and other inherent risks would require that our inspectors view properties 24/7, which is not practical or required.

REAMs do not report property vandalism

The OIG report indicates that four out of nine cases of vandalism had been reported by the REAM. It is conceivable that the OIG Appraiser, for the remaining cases, was the first person to discover the vandalism. As vandalism is a constant and ongoing issue, especially in the areas reviewed, we expect HUD to experience similar conditions, as does First Preston, between routine inspections.

Doors and windows were not always properly secured

Securing issues, broken door frames, stolen appliances and plumbing fixtures and broken glass, represent many of the ongoing inherent risks of managing vacant housing in blighted urban neighborhoods. While we appreciate that all of the conditions denoted by the OIG do not constitute acts of inherent risk, many do. In an effort to control more of the acts of vandalism and abuse, we are instituting a “neighborhood awareness” program consisting of “door-hangers” that advise the neighbors to contact First Preston and local authorities when witnessing improper activity at HUD’s properties. We have also further trained our inspectors and Property Management Center personnel to better document and report property conditions to ensure timely preservation and protection.

First Preston's Oversight Inspector noted the same property conditions

We appreciate the fact that the OIG and First Preston Oversight Inspectors denoted similar findings upon review of the same properties. This is a clear indication that our oversight team is properly trained and targeting contract specific issues. Any deficiencies denoted by these inspectors are reported to the Property Management Center, Regional Property Directors, Contract Mangers and members of the corporate executive team. This constant review of our field will ensure continued progress in the area of property condition.

REAMS are not doing adequate property inspections

First Preston's commitment to existing REAM performance and future expectations shall be reinforced by the following additions and modifications to present guidelines and on going initiatives:

1. In addition to ongoing and constant oversight inspections, the Senior contract manager, regional contract manager and property director will personally inspect a set number of properties in differing locations throughout defined regions. The ramp up effort of this contract tended to place emphasis on initial staffing and home based logistics, which was the first priority of our managers. This will immediately change and give managers a direct observation of the regions' performance in property maintenance. We will then focus specific efforts relative to these inspections to ensure all property inspectors report a "snap shot" of all properties as they exist at the time of inspection. Furthermore, we stress the importance of the REAMs identifying, correcting, and reporting to First Preston any and all safety, and/or structural problems, immediately upon discovery.
2. As further mentioned in the draft, the company is considering revisions to its property management contracts to provide for penalties when prescribed criteria are not met and potential bonuses for those who excel. These annual contracts are currently in the process of renegotiation.
3. Relationships between Broad Listing Brokers and property managers will be reviewed and strengthened where needed. This initiative provides a secondary review of the ongoing condition of properties and will serve to discover acts of vandalism in a more timely fashion.
4. First Preston has made a significant investment in an upgrade to our internal reporting systems and will include a detailed property services tracking module. This upgrade will provide expanded exception reporting and property analysis. The completion and implementations of this upgrade is anticipated by year-end.
5. The corporate oversight division has been expanded to perform a random 10% follow up to initial inspections performed by REAMs.

6. Property directors are in the process of holding independent meetings with REAM managers and area inspectors to review and strengthen quality assurance measures and to reinforce awareness of the contracts property inspection requirements. The REAM subcontractor from the New Orleans area is in the process of physically inspecting all properties under his direct control.

7. Regional efforts will be increased for a more in depth review of initial inspections to provide for required documented remedial action when discrepancies are noted. This will also extend to immediate notification to HUD GTRs for mortgagee neglect verification and potential expense relief through pass through approvals for items that should have been alleviated by the mortgagee.

We again assert our claim and ongoing commitment to professionalism and the pursuit of excellence in property management and maintenance. It is acknowledged that the most quantitative and qualitative measurement of success in this business is based on the overall quality and performance of the field.

Sales prices are declining

Again, as stated earlier in our response, our contract requires specific thresholds for the acceptance of bids and we are not allowed to deviate from these requirements. Our requirements are limited to preservation and protection and do not include a repair or spruce up initiative. The fact that the OIG witnessed properties in poor conditions, is a further reflection of the problems associated with conveyance and inherent risks.

Most properties sold after the initial 45 day listing period

First Preston, is again not required under the contract to raise the level of property condition, other than for preservation and protection. While our overall results have shown an improvement over the periods prior to the M&M program, HUD is still faced with the ongoing issue that some properties will never sell at 100% of appraised value, nor within the first 45 days of listing. The market, in an open-bidding scenario, determines the ultimate value of a property. Furthermore, the M&M contract requires an appraisal to indicate the "as-is" value, at current typical marketing periods, not a 90-day price as was required prior to this program. Therefore, this is a significant deviation from former methods, that in itself can cause marketing times to increase.

Sales prices during the 12 months period ending in May 2000 have declined

As stated earlier in this response, it is important to mention, list prices are strictly set in accordance with our contract, as are price reductions and the percentages of acceptable net thresholds. In addition, it is unrealistic to expect First Preston to achieve sale prices that represent 100% of appraised value, when you factor in the discounts offered in HUD's special-interest programs such as Officer Next Door, Teacher Next Door, Non-profit sales, ACA agreements and Dollar Home sales, many of which did not exist under

HUD's direct management of the disposition program. These discounts, which cause sales prices to decrease dramatically as compared to appraised value, range from 10-50% of the sales price to \$1. One dollar in most cases is an immeasurable percentage (less than 1%) of appraised value. Under our contract, we must abide by all of HUD's policies relative to the acceptance of reduced sales prices. Also, to use the OIG's chart from the report, it is worth reporting that we have increased the number of properties sold, indicating that all properties are selling not just those with higher values.

Finding 2: Improvement Needed in the Timeliness for the Completion of the Processing Steps for Acquired HUD Owned Properties

Review of form HUD 27011 B, C, & D

First Preston Management has taken further steps to insure the HUD 27011 Parts B, C & D is tracked and monitored in compliance with the contract. First Preston Management staff will follow up with the lender if the 27011 B, C & D is not received within forty-five (45) days of the date the deed is filed of record, or within fifteen (15) days of title approval. The requirements for the review of the B, C & D's have been performed in accordance with the M & M contract requirements. Adjustments have been implemented with the process to insure complete compliance with the contract.

Property Disposition Program and Review of active case files

Currently, property disposition programs are completed, reviewed and approved within 72 hours of receipt of the appraisal, as outlined by the HUD Handbook. The Marketing Specialist reviews the appraisal and property inspection report then determines the best marketing strategy for the property. The file is then given to the Marketing Manager for review and approval in the SAMS system. Exceptions to this scenario may occur if the appraisal is received on a Friday. In this case it may not be reviewed, entered into SAMS and approved until Monday.

There seems to be some confusion with regards to the statement in the OIG report, that First Preston Management personnel were approving case dispositions on Monday and Tuesday's only. This is not the case. Dispositions are approved on a daily basis however the listing dates correspond with the schedule outlined below. In the past there were cases where the dispositions were entered into SAMS on Thursday or Friday and approved on Monday mornings. This would create a one-day delay in the contractual timeframe. First Preston Management's procedure for case disposition approval serves to substantiate accurate documentation in the flow of the file. A secondary review of the process would show that listings are not delayed nor hold times increased on case files. Actual list dates are determined as follows:

- Tuesday - Dollar Home Listing
- Wednesday – Non Profit/OND/TND Listing
- Thursday – Regular (first time) Listings
- Friday – Sale Cancellations and Price Reduction Listings

Copies of dispositions were in all of the files reviewed, however, not all reflected the approval date. First Preston Management is insuring that an approved disposition is placed in the file. First Preston has implemented changes that have improved the step process timelines in all phases of the liquidation process.

Late Initial Inspections

Properties are consistently being inspected and secured within 24 hours of receipt. Our zero tolerance initiative and constant follow-up has proven a dramatic improvement from those cases reviewed by the OIG.

Late Property Appraisals

The current average turn around time for receiving appraisals is 10 business days or less. Delays in the appraisal category often relate to rural route addresses that require an address change due to 911 conversions. Case dispositions are consistently completed and approved within 72 hours allowing properties to be listed expeditiously.

Property sales to owner occupants have decreased while property sales to investors have significantly increased.

As indicated in our Executive Summary, the realm of our control exists mainly in the listing process, and is strictly governed by HUD regulations and the terms of our contract. The OIG mentions that the number of sales to owner-occupants has decreased, implying that sales under our management are slanted towards investor purchases. Our contract requires us to accept sales contracts with offers representing the highest acceptable net proceeds to HUD, and does not allow us to deviate in favor of insured owner-occupant sales. Furthermore, the listing of insurable properties is influenced heavily by the conveyance condition of the properties, and the determination of the appraiser.

In closing, the draft report criticizes First Preston Management for its performance as it relates to HUD's return on assets. The measurement of success as stated in the draft pointedly omits strategic devices employed by HUD regional offices prior to the inception of the contract. These devices included, but certainly were not limited to, incentives paid to selling brokers and repairs and/or improvements to properties. It would do well to note that First Preston has been contractually unable to use these incentive options. These findings should be coupled with declining conveyance conditions by mortgagees, which have been continually communicated to the Denver HOC. However, as described below, even though list prices are lower, sales prices and net proceeds are almost 5% higher. Furthermore, with the advent and inclusion of TND/OND and Dollar Homes First Preston is achieving net proceeds over 91% of appraised value.

Some of our statistics of performance indicate the following results:

HUD average list price (04/98-03/99)	\$41,219
First Preston average list price (contract)	\$40,293
Percentage decrease	2.2%
HUD average sales price (04/98-03/99)	\$39,104
First Preston average sales price (contract)	\$39,589
Percentage increase	1.2%
HUD average net to HUD (4/98-03/99)	\$34,992
First Preston average net (contract)	\$36,718
Percentage increase	4.9%

A cursory review of the above overall statistics seems to contradict some of the specific samplings noted in the audit. It would appear that First Preston Management's list price is in fact lower than that of HUD's performance in the previous year yet the net or actual return on assets is considerably higher. HUD's higher list prices should obviously be attributed to repairs and or improvements which allowed listings at "as repaired" values as indicated by appraisers. Appraisals performed prior to appraisal reform were required to indicate "as is" and "as repaired" values.

Borrowing the OIG's approach to this measure in the draft, it would seem to indicate that although initial sales prices saw a decline, it is apparent that the net return or crucial measurement of success would imply that First Preston Management has increased rather than decreased the return to the mortgage fund by \$9,265,787 (Total closings (5150) x Average Net to HUD (\$36,718) x .049) without the benefit of incentives or repairs. The region's average sales price to appraised value since inception is an impressive 98% with an average net to HUD of 93%. These numbers are further enhanced by the fact that marketable inventory has been reduced.

Our formal commitment to HUD is to continue our quest for the highest degree of performance of administrative processes, perfection in maintenance of HUD owned properties, maximizing the return on each asset through higher prices, reducing holding periods and above all, maintaining, while continually improving the continuity and synergy between the U.S. Department of Housing and Urban Development and First Preston Management, Inc.

The degree of professionalism exhibited by your staff in the process of this examination must be commended. We trust that your concerns and comments have been addressed in a way to provide sufficient reassurance that First Preston is complying with its objectives and has the ability to rapidly respond to any deviations from that course of action.

Respectfully submitted,



Patricia A. Doll
Contract Manager, Denver Area 3

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Appendix B

Distribution

Assistant Secretary for Housing/Federal Housing Commissioner, H, Room 9100
Deputy Assistant Secretary for Single Family Housing, HU, Room 9282
Director, Asset Management Division, HUAM, Room 9286
Director, Denver Single Family Homeownership Center, 8AHH
Secretary's Representative, 8AS (2)
Deputy Secretary, SD, Room 10100
Chief of Staff, S, Room 10000
Office of Administration, S, Room 10110
Assistant Secretary for Congressional and Intergovernmental Relations, J, Room 10120
Senior Advisor to the Secretary, Office of Public Affairs, S, Room 10132
Deputy Assistant Secretary for Public Affairs, W, Room 10222
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Assistant Deputy Secretary for Field Policy and Management, SDF, Room 7106
Chief Procurement Officer, N, Room 5184
Chief Information Officer, Q, Room 3152
Chief Financial Officer, F, Room 2202
Deputy Chief Financial Officer for Operations, FF, Room 10166
Director, Office of Budget, FO, Room 3270
Departmental Audit Liaison Officer, FM, Room 2206
Headquarters Audit Liaison Officer, Housing, HF, Room 9116
Acquisitions Librarian, Library, AS, Room 8141
Director, Office of Information Technology, AMI, Room 160
Secretary, Mortgagee Review Board, VD, Suite 200, Portals Building
The Honorable Fred Thompson, Chairman, Committee on Governmental Affairs, 340 Dirksen Senate Office Building, United States Senate, Washington, DC 20510
The Honorable Joseph Lieberman, Ranking Member, Committee on Governmental Affairs, 706 Hart Senate Office Building, United States Senate, Washington, DC 20510
Honorable Dan Burton, Chairman, Committee on Governmental Reform, 2185 Rayburn Bldg., House of Representatives, Washington, DC 20515
Henry A. Waxman, Ranking Member, Committee on Governmental Reform, 2204 Rayburn Bldg., House of Representatives, Washington, DC 20515
Ms. Cindy Fogleman, Subcommittee on Oversight and Investigations, Room 212, O'Neil House Office Building, Washington, DC 20515
Mr. Pete Sessions, Government Reform and Oversight Committee, Room 212, O'Neil House Office Building, Washington, DC 20515
Director, Housing and Community Development Issue Area, United States General Accounting Office, 441 G Street, NW, Room 2474, Washington, DC 20548 (Attention: Judy England-Joseph)
Department of Veteran Affairs, Office of Inspector General (52A), 810 Vermont Avenues, NW, Washington, DC 20410

Steve Redburn, Chief Housing Branch, Office of Management and Budget, 725 17th Street, NW, Room
9226, New Executive Office Building, Washington, DC 20503
Inspector General, G, Room 8256