
AUDIT REPORT



BAY TOWERS
MULTIFAMILY MORTGAGOR OPERATIONS
PROJECT NUMBER 012-11031
FAR ROCKAWAY, NEW YORK

2001-NY-1001

DECEMBER 7, 2000

OFFICE OF AUDIT
NEW YORK/NEW JERSEY



Issue Date	December 7, 2000
Audit Case Number	2001-NY-1001

TO: Deborah VanAmerongen, Director, New York Multifamily HUB, 2AH

Alexander C. Malloy

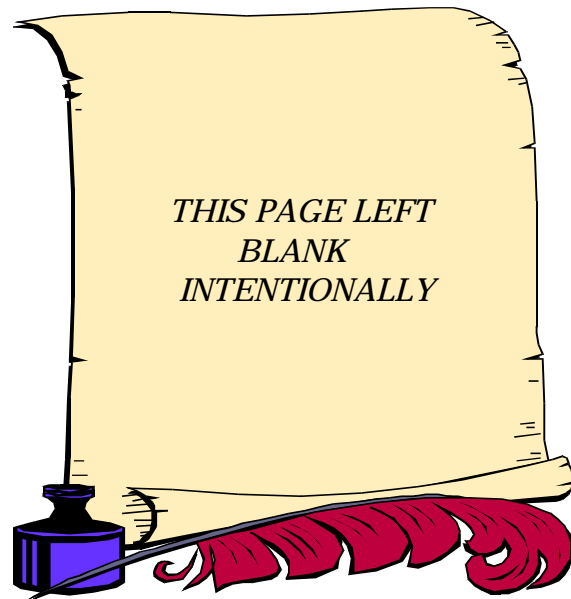
FROM: Alexander C. Malloy, District Inspector General for Audit, 2AGA

SUBJECT: Bay Towers
Multifamily Mortgagor Operations
Project Number 012-11031
Far Rockaway, New York

In response to your request, we conducted an audit of the books and records of the multifamily project, Bay Towers, Project Number 012-11031, (herein called the Project). The results of our audit are provided within this audit report, which contains three findings with recommendations for corrective action.

Within 60 days please provide us, 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.

Should you or your staff have any questions contact Edgar Moore, Assistant District Inspector General for Audit, at (212) 264-8000, extension 3976.



Executive Summary

We conducted an audit of the books and records of the multifamily project, Bay Towers. The objective of our review was to determine whether the Owners and Management Agent complied with requirements of the Regulatory Agreement.

Results

We concluded that the Management Agent generally complied with regulations and requirements of the U.S. Department of Housing and Urban Development (HUD), including those regarding the use of project funds for reasonable operating expenses and necessary repairs. However, our review disclosed that the Agent did not comply with the provisions of the Regulatory Agreement and other HUD requirements that pertain to: (1) computing and remitting Section 236 excess income to HUD; (2) using project funds to pay legal fees relating to the filing of bankruptcy petitions by the Owners; (3) maintaining documentation on an account receivable and a loan payable; and (4) the writing off of an account receivable and a loan payable.

Excess Income Was Neither Computed Correctly nor remitted to HUD

Specifically, we found that contrary to HUD requirements, the Management Agent did not properly compute excess income due HUD; as a result, excess income due HUD in the amount of \$199,205 was not remitted. Furthermore, we noted that the HUD New York State Office (NYSO) may have inadvertently given approval to the Project to retain future excess income amounts collected.

Ineligible Legal Fees Charged To Project

We also found that the Management Agent charged ineligible legal fees that pertain to the filing of petitions of bankruptcy by the Owners of the Project. As a result, the Project has been deprived of \$77,000, which should have been used for reasonable project operating expenses. In addition, the Management Agent wrote-off a \$201,312 account receivable, due from the Project's Owners; and a \$174,677 loan payable, without obtaining HUD's written approval. Consequently, we believe that the Project could be deprived of funds from a collectible receivable, and that its loans payable balance may be understated.

Questionable Write-Offs

Recommendations

As a result, we recommend that the HUD NYSO make a determination on whether (a) the \$199,205 in excess income collected and retained by the Agent during the period March 31, 1998 through March 31, 2000 should be remitted to HUD; and (b) the NYSO's April 10, 2000 approval to allow Bay Towers to retain future excess income collected should be rescinded. We also recommend that the Owners be required to immediately reimburse the Project's operating account for the \$77,000 in legal fees charged to the Project. In addition, we recommend that the amounts for the account receivable and the loan payable be put back on the Project's books until HUD makes a determination on their authenticity.

Exit Conference

On November 8, 2000, we held an exit conference with officials of the Agent to discuss the results of our draft findings and recommendations. The Officials provided us with written responses to the findings, which we included in its entirety as Appendix B of this report. We also provided a summary and an evaluation of their responses at the end of each finding.

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Abbreviations

HUD	U.S. Department of Housing and Urban Development
NYSO	New York State Office
RAP	Rental Assistance Program
TPA	Transfer of Physical Assets
NYC-HPD	New York City Department of Housing Preservation and Development

Introduction

Bay Towers, which was constructed in 1973, is a 375 unit multifamily project located in Far Rockaway, New York. The original Mitchell-Lama mortgage of \$13,670,000 was refinanced in 1977. Specifically, the original mortgage was recast into a \$5,476,900 first mortgage, which is insured under Section 223(f) of the National Housing Act and an uninsured second mortgage of \$8,943,600. The Project has an interest reduction contract under Section 236 of the National Housing Act. The Project has a Rental Assistance Payment (RAP) Contract with HUD for 75 units, and also receives Section 8 rental assistance from the New York City Housing Authority for approximately 58 units. The New York City Housing Development Corporation is the servicing mortgagee; however, applications for rental increases are submitted to HUD for approval.

Bay Towers Company owns the Project. There have been two unauthorized transfers of physical assets (TPA). One in 1986, this resulted in Bay Towers Associates becoming a limited partner in Bay Towers Company. In this regard, a TPA was submitted to HUD but was never approved. The second in 1992, during this one DAL Realty was made a general partner of Bay Towers Company without the approval of HUD. The President of DAL is also the President of the Management Agent, U.S. Housing Management, Inc., and is the general partner for Bay Towers Company. U.S. Housing Management, Inc. has managed the Project since November 1991. The financial books and records are maintained at the Management Agent's office at 326 Third Street, Lakewood, New Jersey.

Audit Objectives

The objective of our review was to determine whether the Owners and Management Agent complied with requirements of the Regulatory Agreement.

Audit Scope and Methodology

To accomplish our objectives, we interviewed HUD New York State Office officials as well as officials and staff members of the Agent. We obtained an understanding of the applicable HUD program requirements and internal control procedures employed by the Agent. We examined audited financial statements and other reports submitted to HUD.

We reviewed and verified cash disbursements made by the Agent and the Owners on behalf of the Project. We verified project rental income and recomputed Section 236 Excess Income using the rent rolls and other accounting information. We also conducted an inspection of the Project to ensure that necessary repairs were completed.

The audit generally covered the period January 1, 1998 through December 31, 1999, and where appropriate, was extended to cover other periods. The audit fieldwork was performed between January 3, 2000, and August 2000.

The audit was conducted in accordance with generally accepted governmental auditing standards.

The Agent Incorrectly Computed Excess Income Due HUD

Contrary to HUD requirements, the Management Agent did not properly compute excess income due HUD; as a result, excess income due HUD was not remitted. Furthermore, the HUD NYSO may have inadvertently given approval to the Project to retain future excess income amounts collected. We attribute this to the Agent's failure to follow HUD's procedures for calculating and remitting excess income. Accordingly, we recommend that the HUD NYSO make a determination on whether excess income in the amount of \$199,205, which was collected and retained by the Agent during the period from March 1, 1998, through March 31, 2000, should be remitted to HUD.

Criteria

Section 4 (I) of the Regulatory Agreement provides that "...owners agree to remit to the Secretary on or before the tenth day of each month the amount by which the total rentals collected on the dwelling units exceeds the sum of the approved basic rentals for all occupied units, which remittance shall be accompanied by a monthly report approved by the Secretary..."

HUD Housing Notice 98-10 changed the method of computing excess income (rent collected in excess of the basic rent) so that it would be computed on a unit-by-unit basis based on the rent roll effective with rents collected on March 1, 1998. The notice also required all excess income as calculated by these revised procedures to be remitted to HUD without delay on a monthly basis.

HUD Housing Notice 99-28 permitted former non-insured State Agency Section 236 assisted projects, whose mortgages were refinanced under Section 223(f) (Mitchell-Lama projects), to apply to HUD for approval to retain a portion of the excess income for specified purposes. These projects may retain excess income retroactively to October 21, 1998, the date that Congress authorized these owners to retain excess income. However, all past due, unpaid excess income should have been paid in full to HUD before future excess income may be retained, with the exception of

Mitchell-Lama projects that may have been holding such income while awaiting further instructions from HUD.

Excess Income Reports Were Not Correctly Prepared

During our review we learned that the monthly reports of Section 236 excess income that were submitted to HUD by the Agent during the period March 1998 through August 1998 were not properly prepared. These reports were prepared using the old forms and instructions that had been superseded. Agent officials were not aware that effective March 1, 1998 the method of computing excess income was changed by HUD Housing Notice 98-10. As a result, Excess Income reports submitted to HUD for this period showed that no money was due HUD. However, our audit of rental collections for the period March 1998 through August 31, 1998, revealed that a total of \$43,539 of excess rental income had been collected during this period; accordingly, the monthly amounts collected should have been remitted to HUD.

After learning of the new procedures, the Agent used the correct forms in September 1998; however, the excess income calculation was not mathematically correct. Subsequent to this, the Agent correctly calculated excess income for the periods from October 1998 through December 1999. However, the Agent chose not to remit the excess income to HUD. Agent employees indicated that the Project could not afford to pay the excess income to HUD; therefore, the excess income collected was used for project operations.

Bay Towers Request To Retain Excess Income Collected

On March 31, 2000, Bay Towers Company requested approval from HUD to retain all of its excess income per HUD Housing Notice 99-28. They requested to retain all excess income collected from February 2000 retroactive back to October 21, 1998, as well as any future excess income to be collected. The purpose of this request was to use these funds to meet project-operating shortfalls and to cover future repair costs for on-going projects. On April 10, 2000, the HUD NYSO, Director, Project Management approved Bay Tower's request for retention of excess income retroactive to October 21, 1998 for the purposes cited above. The excess income to be retained totaled \$145,204.

Questionable Eligibility To Retain Excess Income Collected

The HUD NYSO was not aware that prior excess income reports were not prepared correctly. Accordingly, HUD did not know that excess income collected and due HUD for periods prior to October 21, 1998 had not been remitted, as required. As a result, Bay Towers may not have been eligible for approval for retention of Section 236 excess income. HUD Housing Notice 99-28 provides that for former non-insured Section 236 projects whose mortgages were refinanced under Section 223(f) (Mitchell-Lama projects), excess income could be retained retroactively to October 21, 1998. If excess income collected during this period was remitted to HUD, the Agent could apply for a refund for the project. However, all past due amounts (excess income collected prior to October 21, 1998) must have been paid in full before future excess income could be retained.

\$56,606 Was Owed To HUD Prior To October 21, 1998

We calculated that the Agent collected a total of \$56,606 in excess income during the period from March 1, 1998 through October 20, 1998; however, this amount was not remitted to HUD. As a result, we believe that the \$56,606 should have been remitted to HUD prior to the Project being approved to retain future excess income collected. Furthermore, we believe that since the Agent did not request approval to retain all excess income collected until March 31, 2000, all excess income collected prior to this date should have been remitted to HUD.

We determined that the Agent collected a total of \$199,205 of excess income for the period March 1, 1998 through March 31, 2000; which should have been remitted to HUD on a monthly basis as required by the regulations. This amount consists of \$56,606 due for the period from March 1998 through October 20, 1998; \$109,565 due for the period October 21, 1998 through December 31, 1999; and \$33,034 collected by the Agent but not remitted during the period January 2000 through March 31, 2000. Since this excess income was not remitted to HUD on a monthly basis and since the Project did not request approval to retain excess income until March 2000, we do not believe that the Project is eligible to retain any excess income collected.

A HUD Determination is Needed

Accordingly, we believe that the NYSO should determine whether or not Bay Towers should be required to remit to HUD the \$199,205 in excess income collected from the period March 1, 1998 through March 31, 2000.

Auditee Comments

The auditee comments provide that in April 2000, HUD New York Field Office permitted the Bay Towers project to retain excess income based on the Projects difficulties meeting operating expenses, the need for immediate and future repairs and completion of ongoing renovations and improvements. HUD's verbal communications to U.S. Housing indicated that all excess income retroactive to March 1998 could be retained.

The Project regrets any misunderstanding over the filing of the excess income worksheets and any administrative problems that may have been caused HUD. However, regardless of what excess income may have been owed HUD, Bay Towers cannot afford to pay excess income to HUD at this time. The Bay Towers project has been substantially improved while under its present management and ownership and more than 1.5 million dollars have been invested in the Project. Since the Project is still in need of funds to undertake improvements, any excess income that HUD permitted the Project to retain has already been allocated and disbursed. Therefore, any revocation of previous determinations that excess income be retained would substantially prejudice the Project and ongoing improvements.

OIG Evaluation of Auditee Comments

OIG's position is unchanged. HUD Housing Notice 98-10 provides that all past due excess income must be paid in full to HUD before future excess income can be approved for retention. HUD staff must approve requests for retention of excess income in writing and excess income can only be retained beginning October 21, 1998. Therefore, at a minimum, the \$56,606, which was due for the period prior to October 21, 1998, should be paid if the Project is going to be considered eligible for approval for retention of excess income. HUD Housing Notice 99-28 states that all excess income is the property of the Federal

Government and must be remitted to HUD monthly without any delay for any reason. As a result, we also believe that the excess income due HUD should not be offset against prior or future contributions to project operations.

Recommendations

We recommend that the HUD NYSO:

- 1A. Make a determination as to whether the \$199,205 in excess income collected for the period March 31, 1998 through March 31, 2000 should be remitted to HUD. At a minimum, the Agent should be required to remit the \$56,606 in Section 236 excess income collected during the period prior to October 21, 1998 (The date Congress acted to allow retention of excess income).
- 1B. Determine whether the NYSO's April 10, 2000 approval to allow Bay Towers to retain future excess income collected should be rescinded.

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Ineligible Legal Fees Were Charged to the Project

Contrary to HUD regulations, the Management Agent charged ineligible legal fees that pertain to the filing of petitions of bankruptcy by the Owners of the Project. As a result, the Project has been deprived of \$77,000, which should have been used for reasonable project operating expenses. We attribute this to the Agent's belief that these costs were allowable project expenses. Accordingly, we recommend that the Owners be required to reimburse the Project the total amount of these costs.

CRITERIA

The Regulatory Agreement, Section 8, provides that, "Owners shall not file any petition in bankruptcy, or for a receiver, or in insolvency, or for reorganization or composition, or make any assignment for the benefit of creditors or to a trustee for creditors or permit adjudication in bankruptcy..."

Also, Section 6(b) of the Regulatory Agreement, provides that owners may not without the prior written approval of the Secretary: "... Assign, transfer, dispose of, or encumber any personal property of the project, including rents, or pay out of any funds, other than from surplus cash, except for reasonable operating expenses and necessary repairs."

The Partnership Bay Towers Company owns Bay Towers project. Bay Towers Company has a limited partner "Bay Towers Associates" and a General Partner "DAL Realty, Co. The President of DAL Realty Co. is also the President of the Project's Management Agent, US Housing Management, Inc.

Owners File For Bankruptcy

We found that in June 1996 the Owners of the project, Bay Towers (Bay Towers Company) and its General Partner (DAL Realty Co., Inc.) separately filed voluntary petitions under Chapter 11 of the Bankruptcy Code. Bay Towers Company having incurred accounts payable in excess of \$1 million and having a substantial doubt about its ability to continue as a going concern, precipitated this filing for

bankruptcy. In March 1997, while facing a disputed notice of acceleration and Uniform Commercial Code (UCC) sale, the limited partner of Bay Towers Company (Bay Towers Associates) filed for relief under Chapter 11 of the Bankruptcy Code.

Bankruptcy Legal Fees Paid With Project Funds.

The Management Agent indicated that the building services union had obtained a judgment against Bay Towers Company for back wages and wrongful termination of employees, which had forced the owners to file for bankruptcy protection. As a result, during the period from January 1, 1998 through December 31, 1999 a total of \$77,000 in legal fees related to these bankruptcy filings were charged to the Project.

Agent Believed Bankruptcy Legal Fees Were Allowable Project Expenses.

The Management Agent believed that the legal fees and costs associated with the filings and administration of the bankruptcies were allowable project costs. We disagree; and believe that the costs associated with the bankruptcies are the expenses of the Owners, which should not have been charged to the Project. Accordingly, we believe that the Owners of Bay Towers should reimburse the Project's operating account the total amount of the bankruptcy cost that was paid with project funds.

Auditee Comments

Officials of Bay Towers stated that there are circumstances where the owners may be liable for the legal fees; however, they believe that the particular circumstances of the Project and its Chapter 11 reorganization warranted paying the legal fees out of project funds. The owners believe that there was no alternative but to file for bankruptcy, which benefited the Project and not the Owners. The legal fees were incurred to protect the Project from failure. Should HUD insist the owners are responsible for the \$77,000 in legal fees, capital contributions of approximately 1.5 million dollars more than compensate the Project for the legal fees.

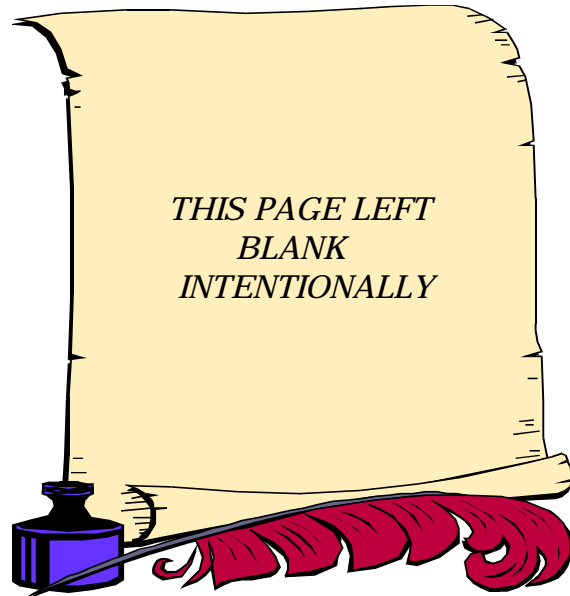

OIG Evaluation of
Auditee Comments

OIG's position is unchanged. The Regulatory Agreement prohibits the use of project funds except from surplus cash for other than reasonable operating expenses and necessary repairs. In addition, the Regulatory Agreement prohibits owners from filing for bankruptcy. Accordingly, we believe that the Project funds used to pay bankruptcy related legal fees benefited the owners by preserving their ownership interests and were not a reasonable and necessary project expense. Therefore, we believe that the bankruptcy related legal fees should be reimbursed to the Project's operating account.


Recommendations

We recommend that the NYSO:

- 2A. Instruct the owners of Bay Towers to reimburse the Project's operating account for the \$77,000 in legal fees and related costs that was charged to the Project, which resulted from petitions of bankruptcy being filed by the owners.



The Agent's Write-Offs Of An Account Receivable And A Loan Payable Are Questionable

Contrary to HUD requirements, the Management Agent wrote-off an account receivable that was due from the Project's Owners, and a loan payable, without obtaining HUD's written approval. We attribute this to the Agent's failure to follow HUD requirements; and to the Agent's and Owner's failure to maintain proper documentation of all financial instruments related to the Project. Consequently, the Project may be deprived of a \$201,312 receivable, which could be used to pay for necessary operating expenses, if collected. Furthermore, its loans payable balance may be understated by \$174,677. As a result, we recommend that the amounts for the account receivable and the loan payable be put back on the Project's books until HUD makes a determination on their authenticity.

CRITERIA

The Regulatory Agreement, Section 9 (a) provides that "Owners shall provide for the management of the project in a manner satisfactory to the Secretary..."

Section 9(c) of the Regulatory Agreement provides that "...Owners shall keep copies of all written contracts or other instruments, which affect the mortgaged property, all or any of which may be subject to inspection by the Secretary or his duly authorized agents."

Furthermore, Section 6 of the Regulatory Agreement provides that "Owners shall not without the prior written approval of the Secretary...(b) Assign, transfer dispose of, or encumber any personal property of the project, including rents, or pay out of any funds, other than from surplus cash, except for reasonable operating expenses and necessary repairs."

A \$201,312 Account Receivable, Due From Owners, Was Written Off

In examining the December 31, 1998, financial statements, we learned that various assets and liabilities were written off and charged to the Project's capital account as a prior-period adjustment. Included in the assets written-off was an account receivable entitled "Due from Project Owners" in the amount of \$201,312.

IPA Did Not Obtain Verification From Owners

The \$201,312 account receivable had been on the Project's books since at least January 1992. However, the Project's California based Independent Public Accountant (IPA) stated that the prior year's financial statements did not contain a reference about the account receivable (a note to the financial statements). The IPA was also unable to obtain information regarding the receivable from the Owners of Bay Towers. As a result, the IPA provided the Agent with the adjusting journal entries and the Agent without obtaining written approval from HUD, wrote-off the account as of December 31, 1998.

HUD Written Approval Was Not Obtained

A 174,677 Loan Payable Was Written-Off

Included in the liabilities that were written-off was a loan payable, which was unsecured and in the amount of \$174,677. The financial statements for the year ended December 31, 1996, indicated that a loan in the amount of \$234,864 was obtained from the New York City Department of Housing Preservation and Development (NYC-HPD). The loan was in connection with a 1984 transfer of partnership interest and for organization fees. The loan was payable in seven annual installments of \$33,512 commencing on April 1, 1985. The IPA informed us that after consulting with the Owners and the Agent, he was unable to verify the loan payable. Accordingly, an adjusting entry was prepared and the Agent wrote-off the payable. Again, the Agent did not obtain written HUD approval prior to writing off the amount. As a result, we are not certain that all available means to verify this account was exercised.

Neither Owners Nor Agent Verification; Nor HUD Written Approval

Loan Payable May Be An Owner's Obligation

Although the above loan was recorded in the Project's records, we believe that it may have been the Owners' obligation; inasmuch as, the loan was for organization fees, which are usually expenses that are paid by the Owners. The Regulatory Agreement prohibits the use of project funds, from other than surplus cash, for this type of expense. However, records indicate that the Project may have paid \$60,187 on this payable since at December 31, 1996, the balance of the payable had been reduced to \$174,677. No additional payments had been made up to the date the payable was written-off the books.

\$60,187 In Project Funds Was Used As A Payment On The Loan Payable

A HUD Determination Is Needed

Accordingly, we believe that a determination should be made whether this loan was an obligation of the Project or the Owners. If it is determined that the loan payable is an obligation of the Project, the obligation should be re-established on the books unless NYC-HPD provides documentation showing that the loan has been paid or forgiven. If the loan payable is not an obligation of the Project, then the Owners should provide documentation to show whether payments on the loan were made from non-project funds or from surplus cash. If payments on the loan were made with project funds, the Owners have a liability to the Project. Accordingly, we believe that the Owners should be required to reimburse the Project's operating account for the \$60,187 if project funds were used to make payments on the loan payable.

In both cases the IPA stated that he was unable to verify the amounts written off with the Agent or the Project's Owners. However, regulations provide that the Agent and Owners have a fiduciary relationship with HUD to properly maintain all documents, papers and instruments, which affect the mortgaged property. Furthermore, prior written approval from HUD must be obtained before assets are disposed of or encumbered. Since written HUD approval was not obtained, we believe that the amount written-off for the account receivable "Due from project Owners" and the loan payable-unsecured, should be put back on the books of the Project. The Agent and Owners should then be required to submit documentation to HUD so that a determination can be made as to the authenticity of the amounts.

Auditee Comments

The auditee commented that they have no proof, written or otherwise that the account receivable existed, therefore, the Project's current CPA firm has written off the account since the Project will never receive any of these apparently non-existent monies. With regard to the loan payable, the auditee again comments that there is no indication that the loan exists. HUD refers to a \$60,187 payment on the loan, yet the Project, its managers and accountants have no records of the loan or any payments on the loan. It also

appears that the New York City Department of Housing Preservation and Development, the lender, has no record of this loan. Both the account receivable and the HPD loan, if they ever existed, originated more than ten years ago. None of the parties involved appear to have records, which date back ten years. However, in the absence of any records, we respectfully submit that our auditors properly “wrote-off” these items.

OIG Evaluation of
Auditee Comments

The fact that the audited financial statements listed both the account receivable and the loan payable is evidence that this asset and liability existed. As a result, we believe that the owners have a fiduciary relationship through the requirements of the Regulatory Agreement to keep copies of all written contracts or other instruments, which affect the mortgaged property. The Regulatory Agreement also requires the Owners to obtain written approval from HUD prior to disposing of any property of the Project. Since a written approval from HUD was not obtained we are not certain that all available means to verify the authenticity of the amounts written off were made. Accordingly, OIG believes that the amounts should not have been written-off without proper HUD approval and verification.

Recommendations

We recommend that HUD NYSO instruct the Agent and Owners to:

- 3A. Put the \$201,312 account receivable “Due from Owners,” and the \$174,677 loan payable back on the books of the project Bay Towers.
- 3B. Submit documentation to HUD so that a determination can be made as to whether the account receivable of \$201,312 is authentic. If determined to be real, the Owners should be instructed to repay these funds to the operating account of the Project, or show that the receivable has been satisfied. HUD should also consider assessing an accrued interest charge if the amount is still owed by the Owners.

- 3C. Submit documentation to HUD so that a determination can be made as to whether the loan payable has been satisfied. If the loan is an obligation of the Owners the loan payable should be removed from the Project books. The Owners should then be instructed to reimburse the Project's operating account for the \$60,187 paid on the loan with project funds.

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Management Controls

In planning and performing our audit, we considered the management controls of the Management Agent in order to determine our audit procedures, not to provide assurance on controls. Management controls include the plan of organization, methods and procedures adopted by management to ensure that goals are met. Management controls include the process for planning, organizing, directing and controlling program operations. Management controls also include the systems for measuring, reporting and monitoring program performance.

Relevant Management Controls

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

Program Operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.

Validity and Reliability of Data – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained and fairly disclosed in reports.

Compliance with Laws and Regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

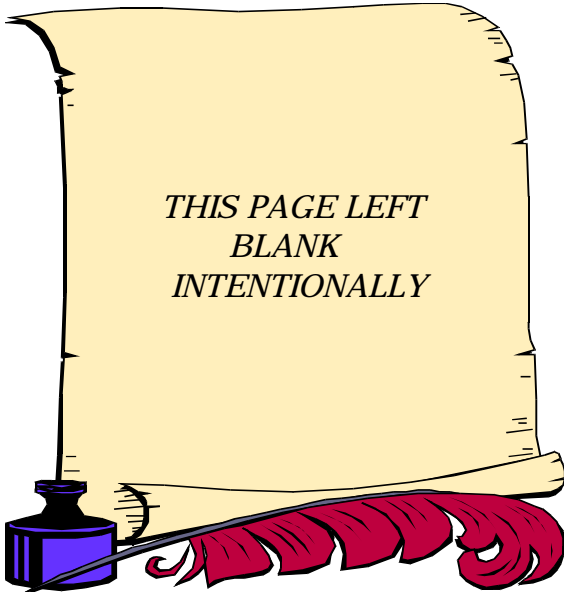
Safeguarding Resources – Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss and misuse.

We assessed all the relevant controls identified above.

It is a significant weakness if management controls do not provide reasonable assurance that the process for planning, organizing, directing and controlling program operations will meet an organization’s objectives.

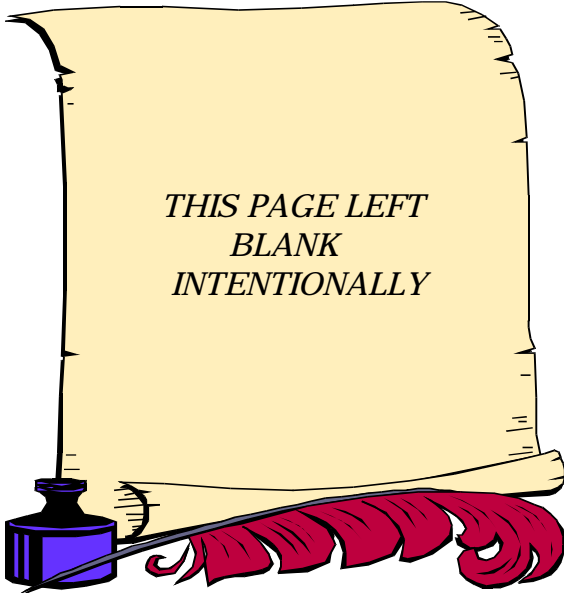
Significant Weaknesses

Based on our review, we believe that significant weaknesses exist in the areas of “Validity and Reliability of Data” (see finding 1) and “Compliance with Laws and Regulations” (see findings 1, 2 and 3).



Follow Up On Prior Audits

This was the first audit conducted by the Office of the Inspector General. An Independent Public Accountant performed prior audits of the Project for the 12-month periods ended December 31, 1998 and December 31, 1999. The reports do not contain any findings.

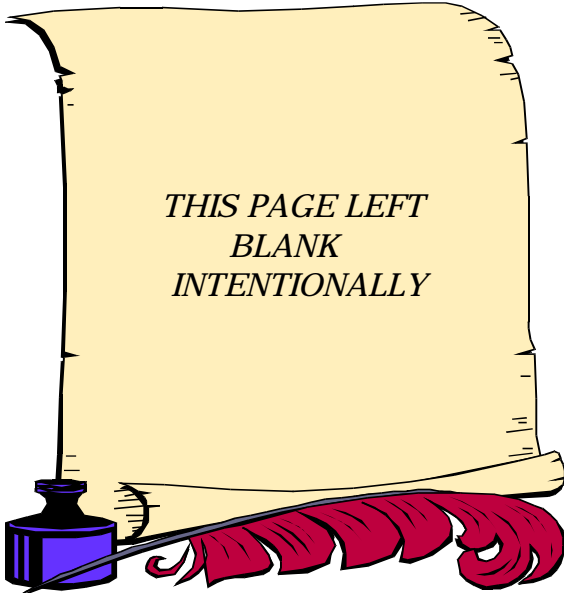


Schedule Of Ineligible and Unsupported Costs

<u>Finding</u>	<u>Ineligible 1/</u>	<u>Unsupported 2/</u>
1		\$199,205
2	\$77,000	
3	_____	<u>375,989</u>
	<u>\$77,000</u>	<u>\$575,194</u>

1/ Ineligible costs are costs charged to a HUD-financed or insured project or activity that the auditor believes are not allowable by law, contract, or Federal, State, or local policies or regulations.

2/ Unsupported costs are costs charged to a HUD-financed or insured project or activity and eligibility cannot be determined at the time of audit. The costs are not supported by adequate documentation or there is a need for a legal or administrative determination on the eligibility of the cost. Unsupported costs require a future 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.



Auditee Comments

U.S. HOUSING MANAGEMENT, INC.

**326 Third Street
Lakewood, New Jersey 08701**

**(732)367-0129
FAX (732)363-7183**

November 8, 2000

U.S. Department of Housing and Urban Development
Office of Inspector General
26 Federal Plaza
Room 3430
New York, NY 10278-0068

ATTN: Edgar Moore
Assistant District Inspector General for Audit

RE: Bay Towers Project

Dear Mr. Moore:

We are in receipt of your letter dated October 18, 2000, and have given it great consideration. On behalf of the owners and management of Bay Towers, we respectfully wish to submit this letter in reply to the findings HUD disclosed to U.S. Housing Management, Inc., ("U.S. Housing") in its letter.

Prior to addressing the three (3) HUD findings, we wish HUD to take into consideration the vast improvements the Bay Towers project has undergone in the last several years, due in no small part, to the willingness of the present ownership to invest its own capital into the project. Over the last several years, the capital contributions of the partners into Bay Towers have been in excess of 1.5 million dollars (\$1,500,000) in order to sustain project viability. Despite the contributions, the project is still recovering from the excessive debt which created the need for the Chapter 11 bankruptcy filed in 1997. Ongoing difficulties meeting operating shortfalls further led to the request to retain "Excess Income."

In light of the foregoing, the management of Bay Towers wishes to submit to HUD the following:

U.S. HOUSING MANAGEMENT, INC.

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Finding #1: Unpaid Excess Income

In April of 2000, HUD NYFO permitted the Bay Towers project to retain "Excess Income" based on the project's difficulties meeting operating expenses, the need for immediate and future repairs and completion of ongoing renovations and improvements. Verbally, it was communicated to U.S. Housing that all excess income retroactive to March 1998 could be retained. As discussed in the letter requesting the excess income, the project would be substantially impaired if not permitted to keep the excess income.

In finding #1, HUD claims that Bay Towers was improperly permitted to retain excess income under HUD Notice 99-28 since there was \$56,606 of unpaid excess income for the period from March 1998 to August 1998. The Bay Towers project regrets any misunderstanding over the filing of the excess income worksheets and any administrative problems that may have caused HUD, however, regardless of what excess income may have been owed to HUD, the Bay Towers project needs every dollar at this juncture to improve what once was a failing project. HUD NYFO gave verbal indication that it would allow the project to retain all excess income dating back to March of 1998 and, in April of 2000, HUD NYFO gave its consent to retaining excess income from October 21, 1998, to the present. We sincerely hope that the Office of the Inspector General concurs with HUD NYFO that the Bay Towers Project needs the excess income to continue the improvements the present ownership has commenced. Additionally, we would like HUD to take into consideration that since the project is still in need of funds to undertake improvements, any excess income that HUD permitted the project to retain has already been allocated and disbursed.

The Bay Towers project has been substantially improved while under its present ownership and management. More than 1.5 million dollars have been invested into the project indicating that the project short-falls have been supplemented by a substantial capital investment by owners committed to advancing the project. It is the unfortunate circumstance that the project cannot afford to pay excess income to HUD, at this time. Any revocation of a previous determination that excess income may be retained would substantially prejudice the project and its ongoing improvements.

Finding #2: Ineligible Legal Fees

HUD has found that approximately \$77,000 in legal fees which were paid were

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improperly paid out of project funds. Bay Towers does not disagree that there are circumstances where the owners may be liable for the legal fees, however, we believe that the particular circumstances of the Bay Towers project and its Chapter 11 reorganization warranted paying the legal fees out of project funds. As HUD is aware, the project was severely in debt and on the verge of failure when the Bankruptcy petition was filed. In fact, the owners, who took seriously their fiduciary duty to the project, felt that there was no alternative but to file bankruptcy. Without the protections afforded the project in bankruptcy, the project would likely have failed. In other words, without the bankruptcy, the project itself may have "folded." The legal fees which were incurred were to protect the project from failure. All the legal fees which were incurred for the bankruptcy inured to the benefit of the project and not the owners. As further indication that the project, and not the owners, benefitted from the bankruptcy is the fact that the owners contributed additional capital to the project.

Even should HUD insist that the owners are responsible for the \$77,000 in legal fees, capital contributions of approximately 1.5 million dollars more than compensate the project for the legal fees. Once again, Bay Towers and its management hope that HUD gives due consideration to the fact that the owners of this project have made every effort to advance the project, even saving the project from failure through a bankruptcy action, and should not be compelled to place additional monies into the project.

Finding #3: Write-off of an account receivable and loan payable

We find this issue very difficult to address because our only response, after investigating this account receivable, is that we have no indication that it truly exists. There is no proof, written or otherwise, that confirms this account receivable ever existed. Consequently, the project's current CPA firm has written-off the account since the project will never receive any of these apparently non-existent monies.

With regards to the loan payable, once again, there is no indication that this loan exists. HUD refers to \$60,187 payment on the loan, yet the project, its managers and accountants have no records whatsoever of the loan or any payments on the loan. It also appears that the New York City Department of Housing Preservation and Development, the lender, has no record of this loan. Had the loan been a valid, existing loan, payments would have been made pursuant to payment schedule. There does not appear to have been any payments under said loan or any other evidentiary documentation that the loan

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exists. Since there is no evidence that this particular indebtedness exists, the owners of the project should not, for practical purposes, be responsible for the loan.

Both the account receivable and the HPD loan, if they ever existed, originate more than ten (10) years ago. None of the parties involved appear to have records which date back ten (10) years. If HUD should have some record or reference which would clarify this issue for the present management, it would be appreciated since it is troublesome to have these issues outstanding. However, in the absence of any records, we respectfully submit that our auditors properly "wrote-off" these items.

In conclusion, when HUD reviews this particular project and its three (3) findings, we can only hope that the agency takes into consideration the advancements the present ownership has made with this project. We believe that the progress the project has made over the last three years is what led HUD NYFO to approve retaining the excess income. Sizeable capital contributions have been made to the project to make repairs, cover operating expenses and make improvements. The owners of Bay Towers and its management hope that the Inspector General weighs the improvements the project has made under its current ownership against its findings.

Respectfully submitted,



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President, U.S. Housing Management, Inc.

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