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November 17, 1997

Audit Related Memorandum
98-AT-212-1802

MEMORANDUM FOR: Minerva Bravo, Director, Multifamily Housing Division, 4NHM

FROM: Nancy H. Cooper
District Inspector General for Audit-Southeast/Caribbean, 4AGA

SUBJECT: Bucare Management Corporation
Management Agent
San Juan, Puerto Rico

We completed a limited review of Bucare Management Corporation's (management agent) administration of four HUD insured projects insured under Section 221 (d)(3) of the National Housing Act, as amended. The purpose of the review was to determine whether the management agent was administering the projects in compliance with the Regulatory Agreement and applicable HUD regulations.

The review primarily covered the period from January 1, 1995 to February 29, 1996. However, we extended this period when necessary to meet our objectives of the review. The field work was performed between March 1996 and June 1997.

SUMMARY

The management agent needed to improve certain practices. The agent did not maintain the projects in good repair and condition, charged a higher management fee than approved by HUD, did not fully secure or invest reserve for replacement accounts, and did not properly verify tenant income and calculate tenant rent. As a result, maintenance problems lowered the quality of living for the residents and increased HUD's risk on the mortgages. Also, project assets were not fully protected, and costs of \$4,423 were ineligible, while costs of \$15,600 were unsupported.

BACKGROUND

Bucare Management Company manages four HUD insured projects. The projects were insured under Section 221(d)3 of the National Housing Act and receive Section 8 assistance for all units. The general partner for each project is Bucare Development Corporation, which is a related party.

All project mortgages were current at the audit date. However a HUD contractor inspected the projects in 1995 and indicated the projects needed various repairs:

<u>Project</u>	<u>Inspection Date</u>	<u>Estimated Repairs</u>
Vistas De Jagueyes	8/25/95	\$ 149,280
Trujillo Alto Gardens	9/15/95	75,680
Villa Machuelo	6/21/95	undetermined
Brisas de San Alfonso	3/03/95	118,490

At Villa Machuelo, the contractor recommended additional soil and structure studies to determine causes and recommendations to resolve soil settling, cracks in floors and walls, and separation of non-bearing walls.

* * * * *

We discussed the results of our review with Angel Caban, President of Bucare Management Corporation, during the review and at an exit conference held on June 11, 1997. The management agent's written comments are briefly summarized in the report, and included as Attachment 3.

Within 60 days please furnish us a status report for each recommendation 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 as a result of the review.

We provided a copy of this report to the management agent.

Should you have any questions, please contact James D. McKay, Assistant District Inspector General for Audit, at (404) 331-3369 or Aurora Rodriguez, Senior Auditor, at (787) 766-5879.

Attachments:

- 1 - Finding and Recommendations
- 2 - Schedule of Ineligible and Unsupported Costs
- 3 - Management Agent Comments
- 4 - Distribution

FINDING AND RECOMMENDATIONS

The management agent needed to improve certain practices. The agent did not maintain the projects in good repair and condition, charged a higher management fee than approved by HUD, did not fully secure or invest reserve for replacement accounts, and did not properly verify tenant income and calculate tenant rent. As a result, maintenance problems lowered the quality of living for the residents and increased HUD's risk on the mortgages. Also, project assets were not fully protected, and costs of \$4,423 were ineligible, while costs of \$15,600 were considered unsupported.

1. Projects Not Maintained in Good Repair and Condition

The management agent did not maintain the projects in good repair and condition. Some of the deficiencies noted in previous HUD and mortgagee physical inspections had not been corrected, including some items that had been classified as emergency items. In general, the site, buildings and apartments needed maintenance and repairs.

The regulatory agreement, paragraph 10, requires the Mortgagor to maintain the mortgaged premises, accommodations and the grounds and equipment in good repair and condition. Paragraph 1.6(g) of the Housing Assistance Payment contract requires the Mortgagor, when requesting funds from HUD, to certify that to the best of the Mortgagor's knowledge and belief the dwelling units are in decent, safe, and sanitary condition.

We performed physical inspection of the four HUD insured projects from March 26 to April 2, 1996. The inspection included the common areas and at least 10 housing units per project. We noted 362 deficiencies in the 41 housing units we inspected. The deficiencies were mainly related to the conditions of the unit walls, ceilings, windows and doors, electricity, kitchen cabinets and appliances. We are providing the auditee, under separate cover, a list of all 362 deficiencies found.

In the case of Villa Machuelo, we observed soil settling and erosion, causing wall cracks in certain buildings. The most serious was in building N. The president of the management company indicated the condition of the subsoil at the project site was known before the project was built. He explained that the subsoil contains expansive material that is affected by the amount of water in the ground. This condition causes movement in the project structures resulting in cracks in non-structural walls of the buildings. He also indicated there was not much that could be done about the condition other than repairing the cracks as they appear.

Previous mortgagee and HUD inspection reports indicated the need for structural or soil studies. However, additional studies were not performed.

The following are examples of the deficiencies noted in Villa Machuelo Project:

Apartment N-1: The apartment contained 11 deficiencies including humidity, water leaks, and cracks in walls visible from the inside and outside of the unit throughout the apartment. Also, the living room sliding door was out of alignment as a result of the soil settling in the area.

Apartment G-5: There was a large crack on the outside wall of the laundry area. Soil erosion was also visible in the driveway in front of the wall and the building.

Open area between buildings F, G and H: We observed large cracks in the sidewalks and soil erosion in an open area between unit G-1 and F-3. Also, an electric meter station and two electric lamp poles were leaning backwards.

The management agent cited lack of operating funds as a reason for not completing needed repairs. We noted the management agent had not requested annual rent increases or had not submitted them on time. The president of the management company explained that the cost associated with the market study required by HUD to support the requests may be higher than the additional income the projects would receive.

The management agent also attributed part of the problem to lack of HUD approval of Maintenance and Improvement Operating Plans, and HUD delays in approving requests for disbursements from the project reserve for replacement funds to cover the required repairs.

2. The Management Agent Charged The Projects Excessive Management Fees

The management agent charged the projects a 6 percent management fee. However, HUD had not approved the fee. HUD and management agent files showed HUD had previously approved a 5 percent fee for three projects and 5.25 percent for Villa Machuelo. We estimated the agent received \$15,600 in excessive fees during the period from January 1995 to July 1996.

In May 1996, HUD instructed the management agent to discontinue charging the 6 percent fee and to charge the previously approved rates. The management agent appealed HUD's decision and submitted justification for the increased rate. HUD did not respond to the request. So, the management agent continued to charge the 6 percent rate.

3. Deposits In Reserve for Replacement Accounts Exceeding \$100,000 Were Not Adequately Secured or Invested

The management agent did not ensure that reserve for replacement accounts held by the mortgagee in excess of \$100,000 were fully invested or subject to insurance coverage of a Federal insurance agency. Therefore, the management agent had not maximized potential investment income, and some funds were not fully insured.

HUD strongly encourages project owners to invest funds held in the Reserve Fund for Replacements. HUD Handbook 4350.1, (Paragraph 4-22) authorizes mortgagees to invest funds in excess of \$100,000 in U.S. government-backed securities and to hold funds in excess of \$100,000 in institutions under the control of the Federal Deposit Insurance Corporation, National Credit Union Association or under U.S. government insurance corporations under certain conditions.

We reviewed the fund balances at February 28, 1996 and noted that in three of the four projects the balances ranged from \$112,500 to \$215,700. Thus the funds were not fully invested or insured. In April 1996 the management agent authorized the mortgagee to make short term investments of funds in excess of \$100,000. The funds were invested, and matured in August 1996. The funds could have been invested a month earlier and would have earned about \$1,884 in additional interest income. Also, according to a mortgagee official, the funds were not reinvested in August because the management agent expected HUD approval of a withdrawal from the reserve funds. The funds exceeding \$100,000 were therefore not fully invested or Federally insured.

4. Management Agent Procedures For Verifying Tenant Income and Calculating Tenant Rent Need Improvement

The management agent generally complied with HUD requirements for the selection and certification of tenant eligibility and billing of Section 8 assistance. However, the procedures for calculating the tenant portion of the rent and verifying tenant income did not meet HUD requirements.

HUD Handbook 4350.3 states:

"If a family indicates that income might not be received for the full 12 months (e.g., unemployment insurance benefit is expected to terminate), the owner should still annualize the income and advise the family to report any subsequent loss of the income so that rents may be recalculated. This way, the rent will be calculated correctly" (Paragraph 3-11.6).

"Owners must send verification forms directly to the source, not through the applicant" (Paragraph 3-31).

We reviewed seven tenant files for the Villa Machuelo project. In two of the cases the management agent had not correctly computed the tenant portion of the rent. These tenants were unemployed and the management agent computed their portion of the monthly rent using the balance of the unemployment benefits instead of the weekly benefits payable as required by HUD. This resulted in overstated Section 8 assistance of \$2,267. According to the project administrator, the situation exists in other cases.

Additionally, we noted that the verification forms were handled by the tenants. According to the project administrator, the verification forms were given to tenants to speed the certification process. The information was later confirmed by phone.

We also identified three tenants at Trujillo Alto Gardens who were employed but claimed to be unemployed. This resulted in \$2,156 of overpaid Section 8 assistance. However, nothing in the files evidenced management agent knowledge that the tenants were employed.

Management Agent Comments:

Projects Not Maintained in Good Repair and Condition

The management agent believed it had established adequate maintenance programs and taken all steps to maintain properties in conformity with HUD requirements. The agent contended the present condition of the properties is satisfactory and comparable to other projects in Puerto Rico.

The management agent believed it had taken all steps to inspect, plan, fund and complete maintenance conditions in need of repair or replacement. The management agent stated however, that HUD had taken 2 years to concur and fund a comprehensive maintenance plan. The agent said the delay forced management to postpone the commencement of planned activities which require reserve for replacement funding. He said items funded with operational funds are either completed or substantially completed.

The agent said the delay in the commencement of the plan's activities also delayed other maintenance work including exterior repainting and other administrative activities like the completion of a Comprehensive Needs Assessment report. The management agent was of the opinion that no further project inspections were warranted until the maintenance plan objectives are completed.

The management agent also said measures were taken during the construction phase to address the existing soil condition. HUD was aware of the conditions at that time. He said the owner's engineering experts have made recommendations that the management agent implemented during the ordinary course of project operations.

Excessive Management Fees

The management agent stated they had evidence supporting the adequacy of repeated requests and appeals for management fee increases. The agent requested that HUD consider management fees of all other properties in Puerto Rico and the administrative guidelines in force during the subject period.

Reserve for Replacement Accounts Not Adequately Secured or Invested

The management agent agreed.

Procedures For Verifying Tenant Income and Calculating Tenant Rent

The management agent explained that the procedures for income computation based on unemployment benefits were modified to conform with regulations. He also said they would perform a review of the cases noted.

The management agent also explained that all verifications are independently verified by project personnel and only in cases where the employer refused to reply directly to the project, were they handled through tenants.

The management agent explained that the Trujillo Alto Gardens project historically has a higher volume of income omissions, and that it is possible that some cases were not processed at the time of the auditor visit. Nevertheless, the cases will be processed in accordance with company policy.

Evaluation of Auditee Comments

We revised our draft report as appropriate based on the auditee's comments. Some issues have been dropped. The auditee disagreed with our conclusion about conditions at the projects stating that the properties are comparable to others in Puerto Rico. Regardless, our conclusion is based on comparison of the projects to HUD's mandatory Housing Quality Standards.

Recommendations:

We recommend you:

- 1A. Instruct the mortgagor and/or management agent to complete those repairs that can be covered with operating funds, and identify the methods to be used to complete non-routine repairs.
- 1B. Take steps to rectify the settling problem at Villa Machuelo to protect HUD's interests.
- 1C. Determine the reasonableness of the 6 percent management fee and advise the mortgagor and management agent accordingly.
- 1D. Require the management agent to reimburse the projects \$15,600 for unapproved management fees.
- 1E. Instruct the management agent to invest reserve funds in excess of \$100,000. If withdrawal of deposits is expected within a 3 month period, shorter term investments should be made in accordance with the liquidity requirements contained in HUD handbook 4350.1.
- 1F. Instruct the management agent to reduce the next HUD billing by \$2,267 for the overpaid Section 8 assistance for the Villa Machuelo project.

- 1G. Require the management agent to assure project managers comply with HUD requirements for independent income verifications and calculation of tenant rent.
- 1H. Instruct the management agent to reduce the next HUD billing by \$2,156 for the overpaid Section 8 assistance at Trujillo Alto Gardens.

**SCHEDULE OF INELIGIBLE AND
UNSUPPORTED COSTS**

<u>Recommendation Number</u>	<u>Ineligible¹</u>	<u>Unsupported²</u>
1D		\$ 15,600
1F	\$ 2,267	
1H	<u>2,156</u>	<u> </u>
Totals	<u>\$ 4,423</u>	<u>\$ 15,600</u>

¹ Costs not allowable by law, contract, or HUD or local policies or regulations.

² Costs which are being contested because they lack satisfactory documentation to support eligibility.

MANAGEMENT AGENT COMMENTS

This version does not contain the Management Agent Comments.
To obtain a copy of the comments, please contact the
Office of Inspector General for Audit,
75 Spring Street, SW, Room 330, Atlanta, GA 30303

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