audit report
OFFICE OF INSPECTOR GENERAL

Issue Date November 25, 1998	
Audit Case Number 99-NY-212-1003	

TO: Deborah Van Amerongen, Director, New York Multifamily HUB, 2AH

FROM: Alexander C. Malloy, District Inspector General for Audit, 2AGA
New York/New Jersey

SUBJECT: Seaview Arms Associates
Multifamily Project Operations
Project Number 012-44101
Staten Island, New York

In response to a request from Congressman Vito J. Fossella, the U.S. Department of Housing and Urban Development (HUD), New York/New Jersey District, Office of Inspector General (OIG) conducted an audit of the books and records of Seaview Arms Associates (Mortgagor) regarding Seaview Arms Apartments, Project Number 012-44101 (herein called the Project). The objectives of our review were to determine whether Project funds were used for other than reasonable operating expenses and necessary repairs and to determine whether the Project met the Housing Quality Standards (HQS) as required by HUD. The audit generally covered the period between January 1, 1997 and June 30, 1998, and where appropriate, was expanded to cover other periods. The on-site audit work was performed between July 1998 and October 1998.

Our review disclosed that the Mortgagor generally complied with HUD regulations and requirements regarding the use of Project funds for reasonable operating expenses and necessary repairs. However, our review disclosed that the Mortgagor did not comply with HUD's regulations and requirements relating to the physical condition of the Project. Specifically, our inspections of the units at the Project indicated that the Mortgagor was not maintaining the units in a decent, safe and sanitary condition, and we estimate that it will cost $533,500 to make the necessary repairs to meet HUD's requirements.

Within 60 days please give us, for each recommendation made in the report, a status report on: (1) the corrective action taken; (2) the proposed corrective action and target completion date; or (3) why the corrective action is not considered necessary. Also, please furnish us copies of any correspondence or directives issued related to the audit.

Should you or your staff have any question, please contact William H. Rooney, Assistant District Inspector General for Audit, at (212) 264-8000, Extension 3978.

Executive Summary

We audited the books and records of Seaview Arms Apartments, a Section 236 Project located in Staten Island, New York. The objectives of the review were to determine whether Project funds were used for other than reasonable operating expenses and necessary repairs and to determine whether the Project met the Housing Quality Standards (HQS) as required by HUD.

$533,500 needed to repair Project

Our review disclosed that the Mortgagor generally complied with HUD regulations and requirements regarding the use of Project funds for reasonable operating expenses and necessary repairs. However, in July 1998, the OIG in conjunction with a HUD appraiser inspected units at the Project in accordance with the HQS. The OIG appraiser inspected 57 of the 84 units, concluded that all of the inspected units failed the inspection and estimated that it would cost about $533,500 to correct all the deficiencies. We believe that this significant number of units failed the OIG inspection because the Mortgagor/Management Agent was deferring routine maintenance at the Project.

If repairs not corrected, HUD must take action

We recommend that HUD direct the Mortgagor to make the necessary repairs at the Project within a reasonable time period determined by HUD. We further recommend that HUD require the Mortgagor to provide HUD with a maintenance plan, so that HUD can be assured that the Mortgagor is performing routine maintenance. Also, we recommend that if the Mortgagor does not make the repairs to the Project within a reasonable time period, HUD should take the necessary steps to enforce the Regulatory Agreement and terminate the Housing Assistance Contract.

The results of the audit were discussed with the Mortgagor during the course of the audit and at an exit conference held on October 21, 1998, attended by:

<u>Mortgagor</u>

Samuel Pompa, General Partner
Seaview Arms Associates
Christian Pompa, Management Agent
Representative

<u>Office of Inspector General (OIG)</u>

William H. Rooney, Assistant District Inspector General for Audit
Mary Rose Michaud, Senior Auditor

The Mortgagor generally disagreed with the deficiencies mentioned in the finding. The Mortgagor's comments are summarized after the finding and included in its entirety in Appendix A.

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Abbreviations

HUD	Department of Housing and Urban Development
HQS	Housing Quality Standards
OIG	Office of Inspector General

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Introduction

The Project, Seaview Arms Apartments, was insured in January, 1972, under Section 236 of the National Housing Act, Project Number 012-44101. The initial HUD insured mortgage was in the amount of $1,870,000. The Mortgagor is Seaview Arms Associates, a New York State Partnership. Because the Project was built on a sink hole, in July, 1992, the Mortgagor obtained a second HUD insured mortgage in the amount of $987,600, the proceeds of which were used to prevent the Project from physically sinking.

Seaview Arms Apartments consists of 85 dwelling units, of which 84 are eligible for subsidy under Section 8 Housing Assistance Contract NY36-L000-059. The Management Agent for the Project is P & L Housing Management Corporation, which has an Identity-Of-Interest with the Mortgagor. The accounting books and records are maintained at the Management Agent's office located at 535 West 51st Street, New York City, New York, 10019.

Objectives

The objectives of the audit were to determine whether Project funds were used for other than reasonable operating expenses and necessary repairs and to determine whether the Project met the Housing Quality Standards (HQS) as required by HUD.

Scope and Methodology

To obtain an understanding of the Project's operations, we reviewed the Regulatory Agreement, the Management Agreement, and other applicable HUD guidelines, as follows: HUD Handbook 4350.1 REV-1, Multifamily Asset Management and Project Servicing, HUD Handbook 4370.2 REV-1, Financial Operations and Accounting Procedures for Insured Multifamily Projects, and HUD Handbook 4381.5 REV-2, Management Agent Handbook. Also, we interviewed members of the HUD Asset Management staff as well as staff members of the Management Agent and the Project.

To determine whether the Mortgagor ensured that Project costs were eligible and reasonable, we: (1) reviewed accounting records and traced transactions to supporting documentation; (2) interviewed officials of the Mortgagor and the Management Agent; and (3) interviewed HUD officials regarding the eligibility of costs.

To determine whether the Mortgagor/Management Agent properly accounted for rents and other revenues, and whether revenues were deposited into the proper accounts, we: (1) obtained and evaluated the Project's rent collection control and procedures, (2) reviewed cash receipts records and compared the amounts collected to the subsidiary ledgers; and (3) traced the total revenue collected into the bank statements.

To determine whether the Mortgagor maintained the Project in good repair and condition, we conducted 57 inspections at the Project.

Our audit covered the period from January 1, 1997 to June 30, 1998, and was extended to include prior and subsequent periods as considered necessary. The audit field work was conducted between July and October, 1998.

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

A copy of this report has been provided to the Mortgagor.

Project Not Maintained in Accordance With HUD's Requirements

When a Mortgagor signs a Regulatory Agreement and Housing Assistance Contract with HUD, it agrees to maintain the housing units in decent, safe and sanitary conditions. Our inspections of the units at Seaview Arms Apartments (Project) indicated that the Mortgagor was not maintaining the units in the required conditions and we estimate that it will cost the Mortgagor $533,500 to make the necessary repairs to meet HUD requirements.

Our review disclosed that the Project has a history of not being properly maintained. Over the past 10 years, HUD generally rated the physical condition of the Project as either below average or unsatisfactory. In June 1997, a contractor hired by HUD rated the Project as satisfactory; but in the subsequent year when OIG and HUD inspected the Project, it was again rated as unsatisfactory. We believe that these poor ratings resulted from the Mortgagor/Management deferring routine maintenance at the Project.

Criteria

Paragraph 7 of the Regulatory Agreement provides that the Mortgagor shall maintain the mortgaged premises, accommodations and the grounds and equipment in good repair and condition. Paragraph 6 (a) of the Housing Assistance Contract provides that the Mortgagor agrees to maintain the HUD assisted units and the related facilities in a decent, safe and sanitary condition. Furthermore, Title 24, Part 882.102 of the Code of Federal Regulations (CFR) defines decent, safe and sanitary housing as housing meeting the requirements of Title 24, Part 882.109 Housing Quality Standards (HQS). These HQS provide specific criteria regarding the required acceptable conditions of housing units.

OIG Inspection

In July 1998, the OIG in conjunction with a HUD Appraiser inspected units at the Project in accordance with the HQS. The OIG Appraiser inspected 57 of the 84, concluded that all the inspected units failed the HQS and estimated that it would cost about $533,500 to correct all the deficiencies. The OIG Appraiser believed that the $533,500 represented items that should have been repaired or replaced as part of the Project's normal routine maintenance program. For example, almost half of the windows at the Project are the original windows which were installed over 27 years ago. According to the OIG Appraiser, residential windows are not manufactured to last beyond 20 years. Also, the OIG Appraiser mentioned that most of the work could be completed within a few months and all the work could be completed within six months. In August 1998, we met with representatives of the Mortgagor/Management Agent and provided them with the written results of OIG's inspection.

Management Agent's fee not paid

The Mortgagor claims that the Mortgagor, through its Management Agent, loaned the Project significant amounts of money. Specifically, the Mortgagor's Identify of Interest Management Agent, has not been paid all the fees that the Management Agent is entitled to receive. Instead the fees are being accrued on the Project's books and records. According to the Mortgagor, non payment of the management fees resulted in more cash available to perform maintenance.

We do not dispute this fact because as of December 31, 1997, the Project's financial statements indicated that the Project owed its Management Agent $390,166 and the Management Agent's fee averaged $60,000 per year for the last three years. However, during our review, we observed that the Management Agent did not have a site manager at the Project to monitor the Project's day to day operations. Similarly, we observed that the Project's revenues decreased about $37,000 over the last three years (1995 to 1997) from $837,000 to $800,000 and the Project's accounts receivable from tenants and bad debt expenses increased.

We believe that not having a site manager at the Project contributed to the Project's loss of revenues. For example, the Project's tenant representative told us that because a site manager was not available, the tenants had to take a subway from the Project to the Management Agent's Office to perform their income recertifications and this was a major inconvenience for those tenants that had small children. Thus, the income recertifications were not always done in a timely manner which resulted in an increase in accounts receivable from tenants. In addition, the Project's tenant representative told us that in the absence of a site manager, the Management Agent mailed delinquent rent letters to the tenants from its Management Agent's office and the tenant representative noticed that these delinquent letters were simply discarded in the hallways of the Project. In essence, the delinquent tenants were ignoring the Management Agent's effort to collect rent. [1]

Nonetheless, if the Management Agent's fee continued to accrue on the Project's books and records and if the Management Agent aggressively collected the delinquent rents, and used the revenue generated from these rents to make the necessary repairs to the Project, we would agree that the Mortgagor/Management Agent provided some monetary resources to assist the Project. However, we believe that not having a site manager to aggressively collect rents, has jeopardized the financial stability of the Project because not only have rental revenues decreased, but the Management Agent's fee continued to accrue as a liability on the Project's books and records.

High Debt Service Cost

One objective of our review was to determine whether Project funds were used for other than reasonable operating expenses and necessary repairs. During our review we did not find indications that Project funds were used for other than reasonable operating expenses and necessary repairs. However, we noticed that over 21 percent of the Project's revenue was used for debt service (principal and interest). This is a high amount compared to the debt service cost of other projects in the area. For example, we found that the annual debt service cost for three surrounding projects ranged from five to six percent of the projects' annual revenue.

As part of our review we determined why the Project used significant amounts of its revenue for debt service. We found in 1992, that the Mortgagor obtained a $987,600 HUD insured second mortgage and the proceeds were used to prevent the Project from sinking. Apparently, in the early 1970's, the Project was built on a sink hole and as the Project was sinking, its balconies and its window frames became distorted. For the Project to survive, the Mortgagor had to stop this situation. Therefore, the Mortgagor obtained a second mortgage and used most of the mortgage proceeds to take the necessary steps to prevent the Project from sinking further. According to the latest engineering studies, the sinking has subsided.

We believe that the Mortgagor had to take this action; however, in doing so, the Mortgagor, with HUD's approval obtained a 15 year second mortgage loan at 11.5 percent. It is obvious considering

[1] Subsequent to our visit to the Project the Mortgagor/Management Agent's representative told us that Management Agent personnel are visiting the Project at least once a week to assist with recertifications and collection of delinquent rent.

today's low interest rates, that the Mortgagor should refinance this loan. However, we found that the Mortgagor's mortgage note contained a prepayment provision that prevents the Mortgagor from refinancing (prepay) the mortgage until January 2003.

As part of our review, we researched HUD's legal files and we observed that the Mortgagee holding the 11.5 percent second mortgage, signed a Mortgagee Certificate which provided that in the event of default, the Mortgagee will cooperate with HUD to take reasonable steps in accordance with prudent business practices to avoid an insurance claim. Although the Project's mortgage is not in default at this time, if the Mortgagor does not repair the Project and HUD does not renew the Housing Assistance Contract, it is likely that there will be a default. We believe that if the Mortgagor could refinance this mortgage, any savings in the debt service cost should be used for maintenance at the Project.

Conclusion

Historically, as projects age, there is a need for greater routine maintenance, and if rental revenues are not available to conduct the routine maintenance, Mortgagors are reluctant to use their own resources to assist the projects. Therefore, Mortgagors defer routine maintenance and projects eventually start to fall apart. Nonetheless, Mortgagors sign a Regulatory Agreement and a Housing Assistance Agreement agreeing to maintain projects in good repair and condition. This Project has a history of not being in compliance with HUD requirements. We observed that HUD has performed at least ten physical inspections at the Project since 1988, excluding the joint inspection by OIG and HUD, and in eight of the inspections, HUD rated the Project either below average or unsatisfactory. Consequently, we believe that if the Mortgagor does not comply with HUD's maintenance standards within a reasonable time that HUD should take the necessary steps to enforce the Regulatory Agreement and terminate the Housing Assistance Contact.

Auditee Comments

The Mortgagor contends that over the course of the last ten years it has replied to every HUD physical inspection and addressed the various findings, including the more serious and recurring items cited in some reports. Moreover, the Mortgagor notes that in June 1997, HUD rated the Project as satisfactory. Also, the Mortgagor notes that since June 1998, efforts to improve the Project have been accelerated, with virtually every recommendation and/or deficiency noted by HUD corrected or a plan to correct the problem presented to HUD. Also, the Mortgagor does not accept the OIG's cost estimate to repair the Project because the cost was based on extrapolation. Furthermore, regarding the Management Agent fee, according to the Mortgagor, it has always sent representatives to inspect and monitor the building staff. Finally the Mortgagor does not believe that refinancing is a viable option.

OIG Evaluation of Auditee Comments

The Mortgagor mentioned that in June 1997, HUD rated the Project as satisfactory. In fairness to the Mortgagor, we included this fact in the finding. However, as mentioned in the finding, the majority of the ratings by HUD over the past 10 years were either below average or unsatisfactory. More importantly, the joint HUD and OIG inspection of the units carried out in July 1998 showed that $533,500 was needed to bring the building and all the units up an acceptable living standard. The amount represents items which could be almost entirely classified as normal routine maintenance which would reasonably be expected to have been carried out over the normal course of time.

Regarding the OIG's estimated cost to correct the deficiencies, the Mortgagor objects to our use of extrapolation. We estimated the cost to repair all 84 units based upon our estimate to repair the inspected 57 units. It is immaterial to us how much it cost to make the repairs, provided that the Project meets the HQS. Finally, we believe that the Mortgagor missed the point regarding the Management Agent fee not paid. The Mortgagor said that it has always sent representatives to inspect and monitor building staff. Our issue was that the Mortgagor did not have a site manager at the Project and this contributed to a loss of revenue. Regarding the option to refinance, our recommendation is a suggestion to HUD, so that funds can be available for routine maintenance.

RECOMMENDATIONS:

We recommend that you:

1. Direct the Mortgagor to make the necessary repairs at the Project within a reasonable time period determined by your Office.

2. Require the Mortgagor to provide your Office with a maintenance plan, so that your Office can be assured that the Mortgagor is performing routine maintenance.

3. Take the necessary steps to enforce the Regulatory Agreement and terminate the Housing Assistance Contract if the Mortgagor does not make the repairs to the Project within a reasonable time period.

4. Explore the possibility of refinancing the 11.5 percent second mortgage to a lower rate and any debt service savings obtained from the refinance should be used for maintenance at the Project.

Management Controls

In planning and performing our audit, we considered the management controls of the Mortgagor and Management Agent in order to determine our auditing procedures, not to provide assurance on the 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. Also, they included 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 of 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 following areas:

- Program Operations

The Mortgagor did not ensure that the units were maintained in a decent, safe and sanitary condition.

- Compliance with Laws and Regulations

The Mortgagor did not follow the Regulatory Agreement and Housing Assistance Contract, by failing to maintain the mortgaged premises, accommodations and the grounds and equipment in good repair and condition.

Follow Up On Prior Audits

A prior audit of the Mortgagor was performed by an Independent Auditor for the twelve month period ended December 31, 1997. The report contained two findings, neither of which affected our current audit objectives.

Auditee Comments

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Director, New York Multifamily HUB, 2AH (3)
Assistant to Deputy Secretary for Field Policy and Management, SDF,
Room 7106
Director, Office of Housing/FHA, HF (Attn: Comptroller - Room 5156) (5)
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Development, CD (Room 8162)
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Director, Housing Finance Analysis Division, REF (8204)
General Partner, Seaview Arms Associates, New York, New York

Inspector General, G (Room 8256)
Public Affairs Officer, G (Room 8256)
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SAC, OIG, 2GI (Room 3430B)
AIG, OIG, GI (Room 8274)

Director, Housing & Community Development Issue Area
US GAO, 44l G Street, NW, Room 2474
Washington, DC 20548
(Attention: Judy England-Joseph)

Subcommittee on General Oversight & Investigations
O'Neill House Office Building - Room 212
Washington, DC 20515
(Attn: Cindy Sprunger)

Director, HUD Enforcement Center
1240 Maryland Avenue, Suite 200
Washington, DC 20024

Honorable Pete Sessions
Government Reform & Oversight Committee
Congress of the United States
House of Representatives
Washington, DC 20510-4305

Honorable John Glenn
Ranking Member
Committee on Governmental Affairs
United States Senate
Washington, DC 20515-4305

Honorable Dan Burton, Chairman
Committee on Government Reform & Oversight
House of Representatives
Washington, DC 20515-6143

Honorable Fred Thompson, Chairman
Committee on Governmental Affairs
United States Senate
Washington, DC 20515-4305