U.S. Department of Housing and Urban Development

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June 25, 1997

Audit Related Memorandum
No: 97-BO-111-0805

MEMORANDUM FOR: Luisa G. Osborne, Director, Multifamily Division, 1GHM

FROM: William D. Hartnett, District Inspector General, Office of Audit, 1AGA

SUBJECT: Section 8 Rent Increase
Melrose Apartments
FHA Project 013-35056
Providence, Rhode Island

This memorandum is to advise you of the lack of HUD controls over the planned repairs at Melrose Apartments.

Background

Melrose Apartments rents were raised in excess of 500 percent of Fair Market Rents to fund repairs. On November 7, 1996, the RISO granted this project a rent increase of $1,175,232 using Section 8 amendment funds. Of this amount, the approved budget allocated $1,081,981 for repairs at this 42-unit fully subsidized Section 8 project. The mechanism used to grant this increase was to convert the project from the Annual Adjustment Factor method of subsidy to a Budget-Based method.

Subsequently, on May 9, 1997, the Deputy Assistant Secretary for Multifamily Housing Programs notified you:

> *It is not appropriate for your office to increase rents for repairs or rehabilitation that places the burden of paying for an owners regulatory compliance on HUD. Your office must immediately cease this particular action and move to determine how the previous decision can be reversed. You should have reserved the right to unilaterally change the rent methodology and there should be "sunset" requirements in this case.*

On May 20, the Rhode Island State Office notified the Owner/Management Agent that rents would be reduced effective, June 1, 1997. Melrose Apartments had received $794,214 of the increased rents through May 31, 1997. Your office did not require the funds relating to repairs to be deposited into the Reserve for Replacement account as a HUD control. On May 8, 1997 you instructed the Owner/Management Agent to transfer $200,242 and any other unexpended repair funds from a savings account, to the project's Reserve for Replacement account. The Owner/Management Agent forwarded $194,941 to the Reserve account on May 14,1997 but did not forward any other repair related funds. At this time, $536,530 remains to be accounted for. According to the periodical estimates through March 31, 1997, approximately 8 percent of the work has been accomplished, however, the General Contractor was paid $298,402 including $200,000 prior to the first repair requisition.

The scope of our review included:

- Interviews of RISO staff, Owner/Management Agent officials, the General Contractor, six subcontractors, and the architect's representatives.

- A cash flow of the project's bank account for the period January 1996 to May 1997 including tracing Section 8 payments to the project books and bank account and the review of available documentation supporting project disbursements.

- Review of contracts and other records maintained by the General Contractor and the Architect, and

- Review of documents and correspondence relating to the conversion of the rent structure from AAF to Budget based and the documents supporting repairs proposed for the project.

Audit Results

Controls have not been established to assure that (1) only reasonable costs are incurred, (2) repairs will be completed within budget, (3) payments are made in accordance with contracts, and (4) funds allocated for repairs are not used for other purposes. Details on these matters are included in Attachment A.

We believe your office needs to take action to assure project funds are accounted for and controlled. We have concerns about the use of funds already provided to the Owner/Management Agent and the escalating commitments made by the 0wner/Management Agent for repairs.

We are recommending that you require the Owner/Management Agent to deposit $536,530 into the Reserve for Replacement fund until a determination as to the status of the repair work and the reasonable of the costs can be determined. In addition, we are recommending that your staff determine the qualifications, scope of work and reasonable of the fees for the General Contractor and the Architect. In addition, no releases should be made from the Reserve for Replacement fund until adequate controls are in place over the planned repairs.

Within 60 days, please provide us a status report on: (1) the corrective actions taken; (2) the proposed corrective action and the date to be completed; or (3) why action is not considered necessary. Also please furnish us copies of any correspondence or directives issued related to this audit.

If you have any questions,please contact our office at (617) 565-5259.

Finding - Controls Needed Over Section 8 Funds Committed for Repairs

The Rhode Island State Office (RISO) approved a rent increase for Melrose Apartments of $1,175,232 in additional Section 8 funds for repairs. Section 8 rents were increased in excess of 500 percent of Fair Market Rents without establishing adequate controls to assure that the additional funds would be used by the Owner/Management Agent for the purposes intended. These actions were taken although RISO's knew the project's Owner/Management Agent and its IOI management company operated with questionable management controls and received a below average rating for Management practices.

The RISO on November 7, 1996, approved the conversion of Melrose Apartments from a Annual Adjustment Factor based subsidy to a Budget Based subsidy to allow the rents to rise to a level necessary to generate the funds estimated for repairs. This one time increase was for the period September 1, 1996 to August 31, 1997.

Bedrooms	Old Rent	New Rent	FMRs	Percent of FMRs
1	$617	$2,735	$538	508%
2	$674	$2,988	$647	462%
3	$741	$3,285	$812	405%
1	$610	$2,704	$538	503%
2	$703	$3,116	$647	482%
1	$617	$2,735	$538	508%

On November 6, 1996, one day before the rent increase was approved, RISO issued the results of a Comprehensive Management Review conducted a year earlier in November 1995. This review rated the overall management as below average. Specifically, the areas of Maintenance and Security, Financial Management, Leasing and Occupancy and General Management Practices were all rated as below average. In addition 46 percent (18 or 39) units inspected failed to meet Housing Quality Standards.

The report indicated that the Owner/Management Agent was not operating efficiently and effectively. Comments from the report include:

- Major building systems such as roofs, heating systems, hot water systems and exterior siding have in most cases reached the end of their useful lives.

- Maintenance is best described as deferred, with repairs only being made on an emergency basis in response to crisis.
- No evidence of preventive maintenance measures were evidence at the real estate.
- No evidence of competitive bidding or price shopping is evidenced for the procurement of goods and services utilized by the development.
- Analysis of cash controls and safeguards in place at the time of the review indicate an unsecured environment relative to control and use of project funds.
- The present method of operation of the real estate results in numerous bills and obligations of the real estate being paid late, or unpaid altogether.
- The ownership of the real estate had failed to generate and submit Annual Audited Financial Statements for fiscal years 1994 and 1995.
- The major contributing factor to the negative cash balance at September 30, 1995 is a total inability on behalf of the management agent to effectively perform the functions of collecting tenant rent effectively and evicting those tenants who are significantly delinquent in payment of rent.

Despite the indications of the Owner/Management Agent's poor management and inadequate control systems, the RISO did not assure the establishment of controls over the costs and repairs. As of May 1997, the Owner/Management Agent has contracted for over $1.6 million in repairs without assuring a funding source was available to pay the costs and has used the repair funds for unsupported withdrawals resulting in reducing the amount available for the originally planned repairs.

Between September 1, 1996 and May 31, 1997, the Owner/Management Agent received $1,000,035 from Section 8 drawdowns and lacks an accounting for $536,530:

Section 8 Subsidies Received 9/1/96 to 5/31/97	$1,000,035
Less Subsidy for Normal Operations ($22,869 x 9 months)	$ (205,821)
Total Additional Proceeds from Rent Increase Through 5/31/97	$ 794,214
Percentage Relating to Repairs $1,081,981 $1,175,232	92.1%
Amount Allocated for Repairs	$ 731,471
Less Transferred to Reserve for Replacement Per RISO's May 8th directive	$ (194,941)
Repair Funds to be Accounted for	$ 536,530

RISO needs to gain control of the repair funds to assure that they are used only for repairs and that such repairs are performed in an economical manner. The following problem indicators have been developed:

- On July 15, 1996, the General Partner/Management Agent advised RISO that they were unable to obtain bids, *". . .due to the fact that the contractors who were designated by the Department as being capable of performing the rehabilitation work, either did not respond or were unable to perform within the time constraints imposed upon us . . . ."* Agwol, Group, Ltd. presented only one bidder to do the work. The estimates of the repairs were based on quotations received from subcontractors as submitted by Providence Construction Co., Inc. There was no evidence that competitive bids were obtained, that plans and specifications had been drafted and made available to other prospective contractors or that the General Contractor was qualified to perform the work.

- The Owner/Management Agent have not submitted any plans and specifications of the repairs to be performed even though a comprehensive set of plans and cost estimates was required by the Corrective Action Plan signed by the Owner/Management Agent November 8, 1996. On July 5, 1996, the Owner/Management Agent submitted the General Contractor's package which consisted of nine subcontractor bid proposals totalling $903,555 plus $189,747 for the General Contractor's for overhead and profit for a total of $1,093,302. All the repairs were to be done by subcontractors.

- Our inquiry at the Rhode Island Secretary of State's office disclosed that the Providence Construction Co. Inc., was created on July 1, 1996, one day before its submission of its bid of $ 1,093,302 for the repair work. RISO has no information as to the General Contractors qualifications and previous work experience. In addition, no company bank account was established until December 6, 1996 after the receipt of the first payment from the Owner/Management Agent.

- The General Contractor was paid $200,000 by February 28, 1997 prior to the processing of any subcontractor requisitions. The initial requisition for repairs covered the period ended February 28, 1997, indicated that about 4 percent of the work had been completed. The original General Contractor's contract dated August 6, 1996 provided for payments based upon a percentage of completion. According to documents provided by the General Contractor, the Owner/Management Agent amended the General Contractor's contract on February 20, 1997 to provide for the payment of $200,000 no later than March 1st 1997. *" . . . in consideration of work previously performed . . . ."* No invoices have been furnished detailing the work performed to earn such a fee.

  Since about eight percent of the work had been completed by March 31, 1997, the General Contractor should have received only $16,500. Therefore, an overpayment of $183,500 has occurred at that date.

- On November 5, 1996 the Owner/Management Agent contracted with an architect for a fee of $160,000 to provide historical consultation and contract administration services for the rehabilitation of the project. The standard architectural agreement deleted the design phase and construction document phase. In it's place, the Owner/Management Agent and the architect agreed to an Exhibit ***"A"*** which details the scope of work to be performed. We find this practice unusual for a historic preservation project in which there are no design documents consisting of drawings. As evidenced by the number of change orders approved by the Owner/Management Agent to date, it is highly questionable whether the rehabilitation costs are under control. Considering that the architect's contract does not call for detailed plans and specifications, the reasonableness of the fee is also questionable.

- One of the first Change Orders was for $ 245,200 to replace all roofs. This work was not included in the original quotations because no one realized how bad the condition of the roofs were. The $245,200 change order was approved by the General Contractor, the Architect and the Owner/Management Agent. We found that subcontractor subsequently resubcontracted the work using identical scope of work to a roofing contractor for $118,000. We believe the difference of $127,000 is questionable and needs to be reviewed.

- As shown below the Owner/Management Agent has executed contracts for substantially more than the $1,081,981 budgeted by RISO for the repair work, without any indication as to where the additional funds are coming from. In addition, change orders exceed one-third of the original quotations with no assurance that the change orders executed to date will be sufficient to complete the repairs.

Subcontractors' Original Quotes	$ 903,555
Proposed Change Orders to #8	$ 376,913
Contract With the Architect	$ 160,000
General Contractor's Fees and Overhead	$ 214,729
Total Committed to Date	$ 1,655,197
Budgeted Amount for Construction	$ 1,081,981
Amount Contracted for in Excess of Budget	$ 573,216

- Five of the seven subcontractors have not performed any work on the job through May 1997. The electrical subcontractor has been paid only for materials and at least one subcontractor has indicated his bid is no longer valid and he may be unavailable to do the work. The work originally quoted will not be accomplished within budget constraints.

- The first periodical estimate for repairs totalled $40,242 and covered work done through February 28, 1997. The requisition was paid by the Owner/Management Agent on March 18, 1997, however, the work was not certified as being completed by the General Contractor and the Architect until April 25 and 24th respectively. This is another indication of poor management practices by the Owner/Management Agent.

- The Owner/Management Agent executed a contract with the General Contractor which did not provide any contract retention as the work progressed. The lack of such a safeguard provides no protection to assure that all work is satisfactorily completed and funds will be available to correct any problems.

- The Owner/Management Agent has used repair funds to pay unpaid operating bills including excessive management fees and unsupported salaries.

Based upon the questionable procurement, contracting, and control practices of the Owner/Management Agent there is no assurance that the repairs will be done in a economical and efficient manner. The RISO needs to take immediate action to control the funds advanced for repairs.

Recommendations

We recommend that you:

1A. Require the Owner/Management Agent to immediately account for or deposit the $536,530 in Reserve for Replacement fund until a determination can be made as to the true status of the repair work and the reasonableness of the costs.

1B. Determine the qualifications, adequacy of the scope of work, and reasonableness of the fee for the General Contractor since no bids were obtained.

1C. Determine the adequacy of the scope of work and the reasonableness of the fee for the architect and

1D. Withhold any future releases from the Reserve for Replacement fund until adequate controls are in place over the planned repairs.

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