State of New York
Office of the State Comptroller
Division of Management Audit and State Financial Services

DIVISION OF HOUSING AND COMMUNITY RENEWAL

PROCESSING OF MAJOR CAPITAL IMPROVEMENT RENT INCREASE APPLICATIONS

REPORT 98-S-79

H. Carl McCall

Comptroller

State of New York
Office of the State Comptroller

Division of Management Audit and State Financial Services

Report 98-S-79

Mr. Joseph B. Lynch
Commissioner
New York State Division of
Housing and Community Renewal
Hampton Plaza
38-40 State Street
Albany, NY 12207

Dear Mr. Lynch**:**

The following is a report of our audit of the processing of Major Capital Improvement rent increase applications by the Office of Rent Administration for the period January 1, 1996 through December 31, 1998.

This audit was done pursuant to the State Comptroller's authority as set forth in Article V, Section 1 of the State Constitution and Article II, Section 8 of the State Finance Law. Major contributors to this report are listed in Appendix A.

Office of the State Comptroller
Division of Management Audit
and State Financial Services

January 7, 2000

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Executive Summary

Division of Housing and Community Renewal Processing of Major Capital Improvement Rent Increase Applications

Scope of Audit

The Office of Rent Administration (ORA), which operates within the New York State Division of Housing and Community Renewal (DHCR), administers the State's rent regulation laws applicable to approximately one million privately owned rental units. Building owners may be entitled to rent increases for making major capital improvements (MCIs) subject to ORA approval. MCIs include work such as the installation or replacement of windows, elevators, boilers and roofs.

ORA rent examiners are required to review every application for an MCI rent increase. The review process involves obtaining documentation from the building owner supporting the work performed and the cost, notifying tenants of the pending MCI and, if necessary, performing inspections to resolve disputes between owners and tenants. After the review process is completed, an order is issued either granting or denying, in whole or in part, the MCI rent increase. The increase is calculated by amortizing the approved total cost monthly over 84 months, and allocating the monthly cost to the tenants by the number of rooms they occupy.

Our audit addressed the following question about ORA's processing of MCI applications for cases closed between January 1, 1996 and December 31, 1998:

- Are controls in place to ensure that rent examiners have an adequate, documented basis for reaching a reasonable decision on the owner's MCI application for a rent increase?

Audit Observations and Conclusions

We found instances where rent examiners approved MCI applications without adequately verifying the work performed or the costs incurred. In addition, we made other observations about the processing of MCI applications where improvements are needed to ensure rent increases are justified.

ORA's Processing and Procedure Manual (Manual), which was written in 1986 and has not been updated since, required specific supporting documentation for each type of payment made by an owner for MCI-related work. During our audit, ORA officials indicated that the Manual, as it relates to the documentation necessary to support the MCI application, has been superseded by ORA Policy Statement 90-10 (Policy). In

our judgment, the Policy weakens the MCI review process by reducing the amount and kinds of documentation required to support an MCI decision.

We reviewed 26 MCI cases and found six cases where, in our opinion, the rent examiners, using their individual experience and judgment and only the minimal documentation required by the Policy, did not adequately verify costs or obtain necessary supporting documentation. In the six cases, at least one of the following conditions was a concern: contracts for MCI work were either absent or unsigned and checks were issued months after the MCI completion date. We believe that ORA officials should develop a new case processing procedure manual which will establish more reliable indicators for rent examiners to rely upon when they confirm MCI work and its costs. (See pp. 5-7)

The New York City Department of Housing Preservation and Development (HPD), through the J-51 Program, grants benefits in the form of real estate tax abatements to building owners for eligible MCI installations. ORA is required to reduce the MCI rent increase by the amount of the J-51 benefit. We found two cases where the examiners approved the MCI rent increases for the full amounts without adequately determining the status of the owners' J-51 tax abatement as stated in the MCI application so that any abatement could be deducted from the rent increase. ORA should adequately verify the existence of J-51 tax abatements before granting rent increases. (See p. 7)

ORA is also charged with responding to reported tenant complaints, whether they are MCI-related or service-related complaints. Eleven of our reviewed cases contained a total of 32 tenant complaints. The rent examiners classified 27 as service-related, and 5 as MCI-related. No inspections were conducted in response to the five MCI related complaints to determine the validity and nature of the complaints. We believe that it is essential for the rent examiner, before granting an MCI rent increase, to record the reasons for his decisions that tenant complaints were service-related and not related to the MCI under review. In addition, if the rent examiner agrees that the tenant complaint is MCI-related, he should document the reasons for approving the rent increase in light of the complaint. Documentation for such decisions for our sampled cases was not available. (See pp. 7-9)

Comments of DHCR Officials

DHCR officials stated that they will assess the audit report's findings and recommendations for possible modifications to the MCI process, especially in those areas where agency procedures were not adhered to. The officials also provided comments where they believe the report is not factually correct or does not adequately present the matters reviewed. DHCR'S complete response is included as Appendix B to this report. We have prepared an Appendix C, containing State Comptroller's Notes, which addresses comments made by DHCR in its response.

Contents

Introduction

Background

The New York State Division of Housing and Community Renewal (DHCR) is the sole administrator of the State's rent regulation laws. DHCR's stated mission is to make New York State a better place to live by supporting community efforts to preserve and expand affordable housing, home ownership and economic opportunities, and by providing equal access to safe, decent and affordable housing. DHCR's Office of Rent Administration (ORA) is responsible for regulating rents in approximately one million privately-owned rental units statewide under four laws: the Emergency Housing Rent Control Law; the Local Emergency Tenant Control Act; the Rent Stabilization Law; and the Emergency Tenant Protection Act (ETPA). These four laws are the foundation of the rent regulation systems commonly known as rent control and rent stabilization.

Rent control applies to buildings constructed before February 1947, and is in effect in New York City and various cities, towns and villages in Albany, Erie, Nassau, Rensselaer, Schenectady and Westchester counties. Rent control limits the rent an owner may charge for an apartment. In New York City, rent control operates under the Maximum Base Rent system. A maximum base rent is established for each apartment and adjusted every two years to reflect changes in operating costs. Rent stabilization applies to buildings constructed between February 1947 and January 1974, and exists in New York City and in various municipalities in Nassau, Rockland and Westchester counties. Under rent stabilization, limitations are placed on the amount of rent an owner may charge. In 1997, there were approximately 878,000 rent stabilized and 70,000 rent controlled New York City housing units and about 47,000 rent stabilized units outside the City under ORA's jurisdiction.

ORA's budget appropriation for the fiscal year ended March 31, 1999 was $27.5 million, of which $25.3 million was for personal services covering 573 positions (529 were filled) and $2.2 million was for other than personal services.

ORA is organized into six bureaus, four of which are the major case processing bureaus: Overcharge; Services, Compliance, Owner Restoration, Enforcement (SCORE); Owner Multiple (OM); and Rent Control/ETPA. The remaining two bureaus, Policy/Liaison and Management Services, provide overall legal and policy direction, public information services, automation support, and records management services to the four processing bureaus.

Building owners may receive rent increases for making major capital improvements (MCIs) subject to ORA approval. The OM Bureau, which processes the MCI applications, has four units: Docketing; OM Case Processing; Petition for Administrative Review (PAR); and Tax Abatement and Hotel Reclassification. There are 31 employees in the OM Case Processing Unit, including 15 rent examiners, and 11 employees in the PAR Unit. As of November 29, 1998, the OM Bureau listed as pending a total of 427 MCI cases.

Examples of MCIs include the installation or replacement of windows, intercom systems, elevators, boilers and roofs. Once an MCI rent increase application is received, the OM Bureau screens it to determine whether it includes support for the work performed, such as contract agreements and canceled checks. If support is included, the application is assigned a docket number, and a rent examiner is assigned to the case. The rent examiner issues notices to the tenants informing them of the pending MCI application and solicits their responses to it. The notice also indicates the number of rooms in the apartment, which is important when ORA allocates any rent increase to the tenants. The notice explains that the tenants may challenge a room count by providing "substantial evidence such as floor plans or facsimiles thereof." The pertinent tenant comments, which could result in the denial of the MCI application or a lesser rent increase, are forwarded to the owner, and the review process is initiated by the rent examiner in the OM Case Processing Unit.

A crucial step in the process is the examination and validation of supporting documents verifying the work performed and the costs associated with the MCI. If, after the documentation has been submitted, and all tenant challenges and owner rebuttals have been presented, the rent examiner cannot reach a determination, he may request an inspection. To do this, the rent examiner forwards the information to the Inspection Unit in the SCORE Bureau, which sends a notice to tenants indicating the scheduled date and time of the building inspection. The notification states that if the inspector is not granted access to the rental unit, no second opportunity will be offered, and the tenant complaint may be dismissed without further notice.

The Rent Stabilization Law requires that DHCR review MCI applications, and the Processing Procedure Manual (Manual) provides the specific review steps. The Manual, which was written in 1986 and has not been updated since, establishes that supporting documentation "… is the evidence that substantiates the information provided by the owner…" and explains how supporting documentation is utilized. For example, contracts must be reviewed in order to document the type, reasons for, and dates of installation. Canceled checks are proof of payment. Invoices serve as

proof only of payments in cash. In response to our preliminary reports of audit findings, ORA officials acknowledged that the Manual was outdated and that ORA's Policy Statement 90-10 superseded the Manual in instructing rent examiners regarding the types of supporting documentation needed to make a determination on the MCI application. Where proof is not completely substantiated by the owner, the portion of the claimed cost substantiated will be approved, and the unsubstantiated portion disallowed.

The New York City Department of Housing Preservation and Development (HPD), through the J-51 Program, grants benefits to building owners for eligible MCI installations in the form of real estate tax abatements. Although the HPD and ORA programs are independent, the same MCI could produce both a tax abatement and a rent increase for the owner. In that instance, ORA is required to reduce the rent increase by the amount of the J-51 benefit. According to the Director of the OM Case Processing Unit, the reduction is made when ORA receives a Certificate of Eligibility approving a J-51 tax abatement, either from the owner as part of the MCI application, or from HPD. The MCI application requires owners to submit the Certificate of Eligibility or the pending application for a J-51 tax abatement.

When the review process of the MCI application, including any inspection results, is completed, ORA issues an order either granting or denying (wholly or in part) the MCI increase. Any increase is calculated by amortizing the approved total cost monthly over 84 months, and allocating the monthly cost to the tenants by the number of rooms they occupy.

Audit Scope, Objectives and Methodology

We audited ORA's processing of MCI applications for cases closed between January 1, 1996 and December 31, 1998. The objectives of our performance audit were to assess whether MCI application reviews were conducted in compliance with ORA policies and procedures, and whether ORA policies and procedures were adequate to ensure that MCI rent increase application reviews resulted in reasonable decisions. We also assessed whether on-site inspections were effectively used in making decisions relative to MCI approvals. To achieve these objectives, we reviewed the ORA Manual, Policy Statements, Operational Bulletins, Advisory Opinions, and the Rent Stabilization Law. We reviewed a total of 26 MCI cases (a random sample of 25 cases and one case reviewed during the audit survey) to determine if costs were verified and if valid supporting documentation was provided by the owner. Regarding inspections, we reviewed these same cases, none of which were deemed by the rent examiners to require inspections, to determine if an inspection might have been warranted in the circumstances. In addition, we utilized

information from DHCR's Historical Update Tracking System (HUTS), a database of buildings whose rents it administers. We also discussed issues relating to laws and procedures governing the MCI process with DHCR officials.

We conducted our audit in accordance with generally accepted government auditing standards. Such standards require that we plan and perform our audit to adequately assess those operations of ORA which are included within our audit scope. Further, these standards require that we understand ORA's internal control structure and its compliance with those laws, rules and regulations that are relevant to the operations which are included within our audit scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in the accounting and operating records and applying such other auditing procedures as we consider necessary in the circumstances. An audit also includes assessing the estimates, judgments and decisions made by management. We believe that our audit provides a reasonable basis for our findings, conclusions and recommendations.

We use a risk-based approach when selecting activities for an audit. We, therefore, focus our audit efforts on those operations that have been identified through a preliminary survey as having the greatest probability for needing improvement. Consequently, by design, we use finite audit resources to identify where and how improvements can be made. Thus, little audit effort is devoted to reviewing operations that may be relatively efficient or effective. As a result, our audit reports are prepared on an "exception basis." This report, therefore, highlights those areas needing improvement and does not address activities that may be functioning properly.

Response of DHCR Officials

We provided draft copies of this report to DHCR officials for their review and comment. Their comments were considered in preparing this report and are included as Appendix B. Appendix C contains State Comptroller's Notes, which address matters contained in DHCR's response.

Within 90 days after final release of this report, as required by Section 170 of the Executive Law, the Commissioner of DHCR shall report to the Governor, the State Comptroller, and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons therefor.

MCI Case Review and Inspections

ORA's Processing and Procedure Manual (Manual), written in 1986 and not updated since, required specific supporting documentation for each type of payment made by an owner for MCI-related work. The Manual also required copies of executed contracts between the building owner and the contractor/vendor. During our audit, ORA officials indicated that the Manual, as it relates to the documentation necessary to support the MCI application, has been superseded by ORA Policy Statement 90-10 (Policy). In our judgment, the Policy weakens the MCI review process by reducing the amount and kinds of documentation required to support an MCI decision. Effective internal controls should be in place to ensure the basis of examiner judgments is adequately documented and supported.

We also made other observations as a result of our case review. We found ORA's handling of tenant complaints and scheduling of inspection appointments did not provide tenants with sufficient information to enable them to adequately prepare a challenge to an owner's MCI application. In addition, rejected MCI applications were not tracked on the HUTS data base. As a result, important evidence contained in these applications could be overlooked. Also, there was no standard in place ragarding the total processing time for MCI cases.

Case Documentation

According to the Manual, if the payment was by check, the rent examiner was required to support his decision with copies of the check (front and back) indicating payment amount, name of contractor/vendor, date written (must agree with the completion date of the installation), bank encoding and clearing stamp, and the signatures of the owner/authorized party and the contractor/vendor. If the payment was in cash, the rent examiner was required to support his decision by use of at least an invoice receipt marked "paid in full" contemporaneous with the completion of the work, a signed contract agreement, a notarized statement from the contractor showing the address of the subject building and the amount paid, and the signature of the contractor/vendor. In contrast, the Policy states that the MCI application:

> must be supported by adequate documentation which should include at least one of the following: canceled checks contemporaneous with the completion of the work; an invoice receipt marked paid in full contemporaneous with the completion of the work; a signed contract agreement; a contractor's affidavit indicating that the installation was completed and paid in full. Whenever it

> is found that a claimed cost warrants further inquiry, the processor may request that the owner provide additional documentation.

In our opinion, the Manual's requirements provided greater assurance that the MCI work was completed and the costs associated with the work were verified in order for the rent examiners to reach a reasonable decision on the owner's application for a rent increase. The Policy, in effect, weakens the MCI review process by providing insufficient assurance that the MCI work was performed and its costs verified.

As a result of the weakened internal controls of the Policy, it is our judgment that rent increase orders for 6 of the 26 reviewed cases were not adequately supported by owner submitted documentation.

In the six cases, at least one of the following conditions was a concern: contracts were either absent or unsigned and checks were issued months after the MCI completion date. ORA officials responded that their rent examiners "knew the work was done and the cost information was available." However, the internal controls outlined in the Manual, which were weakened but not nullified by the Policy, were clearly not applied in these cases. Adequate supporting documentation was not obtained and reviewed as the basis for the rent examiners' judgments.

For three of the reviewed cases, no contract documents were submitted by the building owners. One of the three MCI applications was appropriately denied when the owner failed to respond to requests for an executed contract. The other two applications were approved. ORA officials attributed this apparent inconsistency to the examiner's case-by-case exercise of judgment. In one of the applications approved without a contract, the owner disclosed a familial relationship with the contractor. Despite this additional factor, the examiner did not address the issue by requesting additional information and documentation to verify the cost and the completion of the MCI work. While we agree with ORA officials that familial relations do not preclude approval of the rent increase, we believe that in these cases a more intensive review by the examiner is warranted to verify the cost and work involved. Inconsistent decisions are a direct result of the Policy, which minimizes the need for adequate supporting documentation.

Contracts were submitted but not signed for three MCI applications we reviewed. In none of these cases did the documentation (canceled checks) used by the examiner clearly establish an adequate connection between the work supposedly performed, and the payment. This is contrary to

effective internal controls because a canceled check cannot, in and of itself, serve as proof that it was in payment for the specific MCI work.

According to the Policy, canceled checks supporting payments for MCI work must be contemporaneous with the completion of the work to match the payments with the work. In three cases, payment dates ranged from 3 to 15 months after MCI work completion. The examiners did not question this issue nor request follow-up documentation to confirm that the payments were for the MCI work indicated on the application. The only explanation offered was that examiners are primarily concerned with the amounts on the checks, not the dates. This seems inconsistent with the Policy.

ORA officials acknowledged that they are considering updating the Manual, but they stressed that examiners need the flexibility to exercise their judgments. We agree with the need for such flexibility, provided that effective internal controls are in place to ensure the bases of such judgments are adequately documented and supported. We believe that the rent examiner should be pro-active in acquiring the documentation sufficient to verify the work completed and the amount paid. The situations we found in our review underscore this principle.

J-51 Tax Abatements

In two cases, the owners indicated on the application that the improvements were done with J-51 tax abatements. However, the owners did not submit the actual Certificates of Eligibility. Instead of requesting the required documentation from the owners, the examiners approved the MCI rent increases for the full amounts. In response to our preliminary audit findings, ORA officials stated that they believed the owners meant that they had applied for, but had yet to receive a tax abatement. They indicated that "if a J-51 comes through, the owners are directed to refund the difference in a lump sum payment." We believe that ORA should take the initiative in verifying the owners' statements on the MCI applications that they received tax abatements, rather than requiring tenants to pay up front for a full rent increase and receive refunds later.

Tenant Complaints

ORA is also charged with responding to reported tenant complaints, whether they are MCI-related or service-related complaints. MCI complaints could affect the rent examiner's decision on the owner's application. In addition, ORA policy requires inspections when tenants make service-related complaints.

Eleven of our reviewed cases contained a total of 32 tenant complaints. The rent examiners classified 27 as service-related, and 5 as MCI-related.

No inspections were conducted in response to the 5 MCI-related complaints to determine the validity and nature of the complaints. We believe that it is essential for the rent examiner, before granting an MCI rent increase, to record the reasons for his decisions that tenant complaints were service-related and not related to the MCI under review. In addition, if the rent examiner agrees that the tenant complaint is MCI-related, he should document the reasons for approving the rent increase in light of the complaint. Documentation for such decisions for our sampled cases was not available.

An illustration of the issue of classification of tenant complaints is found in one of our sampled cases. The case file describes how a tenant complained of water leaks after a new roof had been installed. The examiner accepted the owner's contention that the leaks were not related to the roof work. He advised the tenant to file a service complaint, rather than arranging for an inspector to visit the premises to determine the cause of the leak and provide the examiner with support for his decision to grant or deny the rent increase. Again, there was no documentation in the case file to support the examiner's decision.

After classifying complaints as service-related, the Case Processing Unit does not transmit them directly to the Inspections Unit. Instead, they are returned to the tenants with instructions to submit them to the Inspections Unit. In effect, tenants are asked to submit their complaints to ORA a second time. In one case, where the MCI in question was a heating system, three tenants complained of sporadic heat in their apartments. However, the tenants were directed to file a service complaint. This requirement that the tenants resubmit their complaints may discourage them from filing valid complaints. ORA officials maintain that it is unreasonable to burden the examiners with making direct referrals to the inspectors. They also stated that tenants are first required to notify the owner and then complete an ORA form before an inspection is ordered to look into the problem. We believe that in these situations, the tenants are responding to the MCI application notice they received which allows them to directly submit their complaints about the MCI to ORA. Even if the examiner accurately determined the complaint to be service-related, and support for that determination is on file, we believe that ORA should send the appropriate form directly to the tenant. This action would save tenants a needless step and demonstrate a measure of ORA responsiveness to their concerns.

When an inspection is scheduled, it is preceded by a notice to the tenants indicating the scheduled date. Although officials informed us that tenants can contact ORA to reschedule inspections if the time is inconvenient, this

is not indicated on the notice. Tenants may therefore have missed opportunities to address their concerns through inspections.

In 11 of the 26 sampled cases, a total of 37 tenants filed room count challenges. No inspections were performed to resolve them, and complaints were disregarded if floor plans were not submitted. The MCI notice informs the tenant of the room count reported by the owner, but does not provide the definition of a room. The notice lists a floor plan as an example of acceptable substantiating information, rather than as required support for a challenge. As a result, invalid room count challenges could be avoided if tenants had a clear concept of the definition of a room and the evidence required for a challenge. Two of the sampled cases referred to tenant room count challenges which were dismissed for lack of floor plans or other substantiating information. We suggested that an addendum defining a room and specifying the necessity of floor plans be included with the notice. ORA officials maintained that both the definition of a room and the evidential requirements of room count challenges are already defined clearly enough on the notice. They said that to require addenda to the notice would involve an endless volume of additional detail. In re-reading the tenant notice, we could find no definition of a room nor an indication that a floor plan was the only supporting documentation required of the tenants. In our opinion, a relatively simple clarification on the notice of the rules for challenging the application could minimize unsupported challenges, saving time and effort for all parties.

Rejected Applications

During the survey phase of our audit, we reviewed an application that was resubmitted after initial rejection. The processor did not assign a docket number to the initial application, because the Manual does not require docket numbers for rejected applications. In addition, there is no official listing of rejected applications in HUTS. This case was only identified as having previously been rejected because the examiner recalled the previous submission. The examiner showed us that some of the dates on the resubmission had been altered, and conflicted with the original application. The Director of the Case Processing Unit also informed us that rejections are not shown on any ORA report. The Director manually records rejection data unofficially, but only retains this information temporarily. Without an official document to track rejected MCI cases, ORA could overlook important evidence in its possession, allowing an owner to alter dates or amounts to ensure a better chance of having an application approved. ORA officials explained that since these cases are missing so much substantial information, they do not even warrant a review by the examiners. We believe some logging of rejected applications would help rent examiners obtain valuable information.

Processing Standards

The Rent Stabilization Law originally required DHCR to fully review MCI applications within 90 days of filing. However, a 1988 Appellate Court decision voided the section of the law that included the 90-day processing requirement. This same section of the voided law also contained many of the essential elements that define MCIs. For example, it listed the improvements that qualified as MCIs. ORA adopted, as policy, much of what the law contained, but did not retain the 90-day provision, even though the court decision did not specifically address the 90-day processing requirement.

ORA officials indicated that it was unrealistic to expect cases to be processed within 90 days. In their view, a more realistic expectation was 120 days. They emphasized that they considered this a goal, rather than a standard. In their response to our preliminary audit findings, ORA officials claimed that the 90-day requirement had only applied to the appeal process. After reviewing the original law, we note that there is a section requiring action on an appeal within 90 days, but there had also been another section pertaining to an initial 90-day review of MCI cases.

To determine the actual processing time, we analyzed cases opened and closed between January 1, 1996 and December 31, 1998, utilizing data from ORA's HUTS files. On average, the 3,378 such cases in that period required 134 days to close. Fifty percent of these cases were not closed within 90 days, and 38 percent were not closed for more than 120 days. Six percent of the cases took over a year to close.

We also analyzed 475 cases filed after December 31, 1995, but not yet closed by December 31, 1998. This group had remained open for an average of 211 days, and 25 percent of these cases had remained open for over a year.

Recommendations

1. Improve internal controls by developing a new case processing procedure manual which will establish more reliable indicators for rent examiners to rely upon when they confirm MCI work and its costs.

2. Recommendation deleted.

3. Require owners to submit copies of J-51 tax abatement certificates, when the owners indicate on the MCI application that they have been granted tax abatements.

4. Recommendation deleted.

5. Clarify on the tenant notice the distinction between MCI-related and service-related complaints.

6. Send tenants, as an attachment to the MCI application notice, the appropriate form and instructions for filing a service-related complaint.

7. Include instructions for rescheduling an appointment on the inspection notice.

8. Provide a specific definition of a room on the MCI application notice to the tenants and explain what is specifically required to contest a room count.

9. Track rejected MCI applications.

10. Establish time standards for closing cases.

11. Recommendation deleted.

Major Contributors to This Report

Kevin McClune
Howard Feigenbaum
Stuart Dolgon
Michael Miller
Keith Murphy
Mostafa Kamal
Frank Torres
Huanan Zhang
Paul Bachman

George E. Pataki
Governor

Joseph B. Lynch
Commissioner

New York State Division of Housing and Community Renewal
Hampton Plaza
38-40 State Street
Albany, NY 12207

October 22, 1999

Mr. Kevin McClune
Office of the State Comptroller
270 Broadway
New York, New York 10007

Dear Mr. McClune:

Attached are DHCR comments regarding OSC audit number 98-S-79, "Processing of Major Capital Improvements Rent Increase Applications". DHCR has provided a number of comments where we believe the report is not factually correct or does not adequately present the matters reviewed. In addition, there appears to be a presumption that if there is any means an internal control may be strengthened, that it should be done. * Note 1 * Note 2

In fulfilling its responsibilities, DHCR must make judgments to assess the expected benefits and related costs of control procedures. The objectives of these control procedures are to provide DHCR with reasonable, but not absolute, assurance that operations are in accordance with expectations, whether that be meeting legal/regulatory requirements or performance goals. In several areas DHCR is criticized for modifying or not increasing its controls. We believe this is misguided, based on the results of this audit. * Note 2

During the period covered by this audit the average processing time for MCI's decreased from about 3 years to less than a year (over 75% are now processed in less than 6 months). No mention of this is made in the report. DHCR assessed the MCI process, including the internal controls, and made the adjustments needed to ensure that MCI applications were processed in a more timely manner while giving reasonable assurance that operations were performed in an acceptable manner. Some of this was accomplished by eliminating or modifying certain processes and procedures. Based on this report's findings it appears that these efforts were successful, as the auditors did not find any cases where there were improper MCI approvals. * Note 3 * Note 2

In suggesting that additional processing steps be taken, the auditors have offered no assessments or determinations regarding the impact of their recommendations as to the increased costs and additional time which would need to be added to the processing time line. Nor has there been any compelling rationale offered as to how this will improve the quality of the MCI determinations * Note 2

that are made. However, recognizing that there are always opportunities for improvement, we will assess the audit report findings and recommendations for possible modifications to our MCI process, especially in those areas where agency procedures were not adhered to.

* Note 2

We appreciate the opportunity to respond to this report.

Sincerely,

John J. Solodow

John J. Solodow
Internal Control Officer

Attachment
cc: Joseph B. Lynch, Commissioner
Nancy Reuss, DOB
Paul Roldan
Paul Fuller

*See State Comptroller's Notes, Appendix C

DHCR comments on OSC audit number 98-S-79

(1) On page 4, the auditors, report "...we observed apparent conflicts between the law and ORA procedures...". In fact, the report documents no instances of such conflicts. The statement should be modified.

* Note 4

(2) On page 5, OSC states that Policy Statement 90-10 requiring proof of payment for MCIs weakens the standard for such proof as stated in the examiner's manual from 1986. We disagree. The standards in 90-10 are sufficient to make a determination of whether expenditures took place as required, or to permit the examiner to pursue the matter further. OSC completely overlooked the fact that there is now sufficient case law accepting the 90-10 standard. Furthermore, 90-10 was created in 1990 because prior standards did not work. They were cumbersome and time-consuming. It has broad recognition as an appropriate standard. OSC has not demonstrated any cases where the use of this standard has resulted in the improper grant of an MCI.

* Note 5

(3) On page 5, the report states that ORA's handling of the scheduling of inspection appointments reflected a lack of responsiveness to tenants. This is incorrect. OSC does not understand the significance of service reduction complaints and how an inspection fits with such a complaint. Inspections are not the first step in resolving a complaint of service reduction, neither in an MCI proceeding nor in a pure service reduction complaint. In a MCI proceeding, the agency looks to whether or not the installation resulted in granting of a city or municipal permit which necessarily represents a review with a higher level of expertise than DHCR can or should provide. For instance, the review of a boiler or electrical installation should be done by agencies with specific expertise in those areas. In the case of a pure service reduction complaint, the inspection is always preceded by notification to the owner which allows the owner an opportunity to correct. The report fails to recognize that due process of law precludes this agency from taking action prior to proper notification.

* Note 6

(4) On the same page, the report finds it problematic that rejected MCI applications are not given docket numbers and this is as it should be. This recommendation cannot be accepted because docketing creates legal rights for the parties which are not appropriate under the circumstances. We recommend that the auditors review the procedural requirements on proceedings before DHCR and Petitions for Administrative Review as they appear in the Rent Stabilization Code. The rights which accrue under those regulations would inappropriately come into play for a MCI application which is not complete. Not only would the OSC's suggestion create unwanted complaints, it would also be a tremendous waste of taxpayers money to address the legal aftermath of such spurious applications.

* Note 7

(5) The remainder of page 5 and top of page 6 again discusses the kinds of proof that should be required for payments on MCI work. This has been addressed elsewhere. However, the Comptroller's states "In our *opinion* the manual's requirements provide greater assurance..." than the current policy as stated in 90-10. As agency staff are required to attest to in the representation letter that OSC requires, this agency is required to provide "reasonable assurance" and we believe our system does. DHCR is responsible for assessing effectiveness in developing the MCI internal control system. Nothing in the report indicates that the controls over the MCI process do not provide reasonable assurance, or are ineffective.

* Note 5

* Note 2

*See State Comptroller's Notes, Appendix C

DHCR's experience was that the procedure in the manual did not work because it was cumbersome; it was quickly superceded by Policy Statement 90-10. As stated earlier, the current 90-10 has been broadly applied and has been legally sustained.

(6) On page 6 and again on page 7, the report refers to staff accepting as proof of payment checks which were "...issued months after the MCI completion date." Perhaps the authors of the report are unfamiliar with standard contracting procedures. It is a widely accepted and typical practice that some or all of the payments called for in a construction contract are withheld until the contractor completes what is called "punch list" items. This is a prudent practice and is generally the only way the building owner can insure full compliance by the contractor. It may be helpful for the OSC and DHCR to discuss a time guideline after which questions might be raised as to why a payment is late. However, such a guideline should allow a sufficient number of months for "punch list" items to be addressed.

* Note 8

(7) On page 7 the report faults DHCR for not issuing J-51 tax abatement offsets at the same time as it issues an MCI rent increase. This is a misunderstanding of how processing occurs. The great majority of MCI applications are processed more quickly at DHCR than the companion J-51 can be processed at HPD. Accordingly, the J-51 certificate does not exist when the MCI order is issued. In the relatively small number of situations where the certificate does exist, examiners should, and do, make the rent offset in the MCI order.

* Note 9

(8) On page 9 the Comptroller's report faults the method by which DHCR addresses room count complaints. DHCR used to include a definition but decided that it was more effective to replace the definition with language with the need to submit floor plans or facsimilies thereof. The wording of the auditor's finding is very specific and strongly implies, when it says "there are invalid room count challenges that could be avoided," that the majority of such complaints are in fact invalid. It should also be noted that room count complaints have no effect on the total MCI, and no impact on the total rent roll.

* Note 10

(9) On the bottom of page 9 and top of page 10, the report discusses the need to docket rejected applications. This has already been addressed. However, this section of the report goes on to state that DHCR "could overlook important evidence in its possession." However, no example of such important information is cited. Furthermore, the recommendation overlooks the fact that an incomplete or incompetent application should not be in our possession because it would create legal rights inappropriately for the filing party.

* Note 7

(10) In discussing processing standards, the report refers to the requirements in the Rent Stabilization Law that the application be determined in 90 days. Despite at least two meetings to clarify this matter, OSC erroneously reports that this requirement is in law. It is not. Nor is it in the rent stabilization regulations. Indeed, it was once proposed but invalidated by a court. Accordingly, the 90 day standard is null and void and has no source of authority whatsoever.

* Note 11

Moreover, the report makes no reference to the fact that the agency has improved MCI processing times from an average of approximately 36 months to issuance to the current time of six to eight months to issue, with most being issued within six months.

* Note 3

*See State Comptroller's Notes, Appendix C

Finally, DHCR is still bound by the requirement of due process. Sending required notices to the opposing parties [i.e, the tenants] as well as the service of their responses on the applicant and associated counter-serving alone can exceed 90 days.

(11) On page 11 the report states that there are no reports which can be used to detect cases experiencing long delays. This, also, is in error. There are both automated and manual reports which do this, including the Case Aging Report, the Check List Control Sheet and the Report of Cases by Examiner. All of these reports provide information about the progress a case is making or not making and can be used to identify problem cases.

* Note 12

(12) Several of the specific recommendations made on pages 12 and 13 were current practice at the time of the audit and their appearance in the report is unnecessary. On a quarterly basis, HPD's J-51 Unit mails DHCR copies of recently issued Tax Abatement Certificates. These are then routinely researched by staff to find matching MCI dockets and this becomes the basis for opening of Tax Abatement cases. Recommendation number 10 regarding time standards is already in place and number 11 regarding tracking is also already in place.

* Note 13

(13) Additionally, certain specific recommendations cannot properly be implemented and should not be part of the report in their current form. Recommendation number 6 regarding inspections and number 9 regarding the docketing of rejected MCIs are in this category, as well as number 3 regarding interaction of J-51s to MCIs.

* Note 14

*See State Comptroller's Notes, Appendix C

State Comptroller's Notes

1. We met with DHCR officials following receipt of their response to our draft audit report, to seek clarification and additional information on matters in disagreement. Consequently, we have amended our report where appropriate.

2. Contrary to DHCR's assertion, we did not presume that if there is any means by which an internal control should be strengthened, that it should be done. Based on our audit of DHCR's procedures for processing MCI rent increase applications, we observed weaknesses in the process which could affect the decisions by rent examiners to approve or disapprove an application. Hence, we made recommendations for DHCR management to consider. In our judgment, implementing our recommendations would not add appreciably to the cost or timeliness of the MCI approval process. Further, while the scope of our audit did not include a determination of whether rent examiners properly approved MCI rent increase applications, we have identified instances where, in our judgment, rent examiners may have been advised to collect additional information to make more informed decisions. As stated by DHCR officials, they recognize that there are always opportunities for improvement, and they will assess the report's findings and recommendations for possible modifications in the MCI approval process.

3. As stated in our report, the scope of our audit addressed whether controls are in place to ensure that rent examiners have an adequate, documented basis for reaching decisions on MCI rent increase applications. We did not analyze the average processing time of MCI rent increase applications.

4. We modified the language in our report to clarify that we discussed issues relating to laws and procedures governing the MCI process with DHCR officials.

5. We maintain that the Manual was more definitive and expansive in the extent of documentation that the rent examiner was required to obtain. Further, the case law states, "Whenever it is found that a claimed cost warrants further inquiry, the processor may request that the owner provide additional documentation." In our judgment, rent examiners could have obtained additional information to make more informed decisions. Additionally, as stated in note 2 above, the scope of our audit did not include a determination of whether rent examiners properly approved MCI rent increase applications.

6. We have modified our report to state that ORA's handling of tenant complaints and the scheduling of inspection appointments does not provide tenants with sufficient information to enable them to adequately prepare to challenge the owner's MCI application. However, we maintain that DHCR should require its rent examiners to document in the case files the reasons for their decisions to categorize complaints as service-related rather than MCI-related. Whether or not another government agency has granted a permit is not relevant. It is the responsibility of the rent examiner to document his or her decision on a complaint before approving an MCI rent increase.

7. We have modified our report with respect to docketing of rejected MCI applications. However, in our judgment and to the extent possible, DHCR should use the information that is in its possession to make informed decisions concerning MCI rent increase applications.

8. DHCR's Policy includes canceled checks contemporaneous with the completion of the work among the types of documentation that can support an MCI application. In this regard, DHCR needs to establish its own time guideline, to guide rent examiners in making determinations that checks were, in fact, contemporaneous with the completion of work.

9. We agree with DHCR that, in most cases, MCI determinations have been completed in advance of HPD's granting of J-51 certificates. We have amended our report accordingly, including deleting recommendations 2 and 4. However, we continue to recommend that rent examiners require owners to submit copies of J-51 tax abatement certificates, in those instances where the owners have indicated on their MCI rent increase application that they have been granted a tax abatement.

10. We do not imply that the majority of complaints involving room count challenges are invalid. While DHCR is correct that room count complaints have no effect on the total MCI and no impact on the total rent roll, room count challenges can affect an individual tenant's proportionate share of an MCI rent increase. We therefore maintain that DHCR officials should provide a clear definition of a room on the MCI application notice to tenants.

11. Our report does not state that the Rent Stabilization Law requires DHCR to process MCI applications in 90 days. We state that the section of the law that included the 90 day requirement was voided by a 1998 Appellate Court decision. Hence, DHCR has no formal policy guidance with respect to the timeliness of processing of MCI rent increase applications. Therefore, we recommend that DHCR establish time standards for closing cases.

12. At our meeting with DHCR officials following receipt of their response to our draft report, we verified that DHCR has reports providing tracking information on the progress of individual MCI cases. Therefore, we have amended our report accordingly, including deleting recommendation 11.

13. We have modified recommendation 10 and, as stated in note 12, deleted recommendation 11.

14. As indicated in note 9, we have deleted recommendations 2 and 4, pertaining to J-51 tax abatements. However, we maintain our recommendation 3 that a rent examiner should verify the owner's statement on the MCI rent increase application that the work was partially paid for by a J-51 tax abatement, by requiring a copy of the J-51 certificate. We have modified recommendation 6 as it pertained to forwarding complaints to another ORA unit. We have retained recommendation 9 since it does not address the docketing of rejected applications. As indicated in note 7 above, we believe that DHCR should track all such applications in order to make informed decisions concerning subsequent re-submissions by the owners.