Baldwin Creek Apartments, Fort Wayne, IN

Section 223(f) Multifamily Insurance Program

Office of Audit, Region 5
Chicago, IL

Audit Report Number: 2016-CH-1010
September 30, 2016

To:	Daniel J. Burke, Director of Multifamily Midwest Region, 5AHMLA
From:	**//signed//** Kelly Anderson, Regional Inspector General for Audit, 5AGA
Subject:	The Owner and Former Management Agent for Baldwin Creek Apartments, Fort Wayne, IN, Did Not Always Operate the Project in Accordance With HUD's Requirements and the Regulatory Agreement

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of Baldwin Creek Apartments.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, section 8M, requires that OIG post its publicly available reports on the OIG Web site. Accordingly, this report will be posted at http://www.hudoig.gov.

If you have any questions or comments about this report, please do not hesitate to call me at 312-353-7832.

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The Owner and Former Management Agent for Baldwin Creek Apartments, Fort Wayne, IN, Did Not Always Operate the Project in Accordance With HUD's Requirements and the Regulatory Agreement

Highlights

What We Audited and Why

We audited Baldwin Creek Apartments as part of the activities in our fiscal year 2016 annual audit plan. We selected the project based on our analysis of risk factors related to multifamily projects in Region 5's jurisdiction.[1] Our objective was to determine whether the project's owner and management agents operated the project in accordance with the U.S. Department of Housing and Urban Development's (HUD) requirements and the regulatory agreement.

What We Found

The project's owner and former management agent did not always operate the project in accordance with HUD's requirements and the regulatory agreement. Specifically, the project's owner or former management agent (1) inappropriately provided rent-free housing to two households, (2) did not always properly support transactions charged to the project for purchases, (3) did not always maintain the project's security deposit account at a level to fully cover deposit obligations, and (4) failed to submit the required audited financial statements to HUD in a timely manner. As a result, (1) the project lost $8,210 in rental revenue for two units and (2) HUD lacked assurance that $1,442 in additional rental revenue was not lost or that $6,608 was appropriately used for the project's units.

What We Recommend

We recommend that HUD require the project's owner to (1) reimburse the project from nonproject funds $8,210 for the lost rental revenue, (2) support that additional revenue was not lost or reimburse the project from nonproject funds $1,442 for the two units as appropriate, (3) provide documentation supporting the distribution or allocation of the purchased appliances to the appropriate project units or reimburse the project $6,608 from nonproject funds, and (4) implement adequate procedures and controls to address the findings cited in this audit report.

[1] Region 5 includes the States of Illinois, Indiana, Michigan, Minnesota, Ohio, and Wisconsin.

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Background and Objective

The U.S. Department of Housing and Urban Development's (HUD) Section 223(f) program insures mortgage loans to facilitate the purchase or refinancing of existing multifamily rental housing. These projects may have been financed originally with conventional or Federal Housing Administration[2]-insured mortgages. Properties that require substantial rehabilitation are not eligible for mortgage insurance under this program. HUD requires completion of critical repairs before endorsement of the mortgage and permits the completion of noncritical repairs after the endorsement for mortgage insurance. This program insures lenders against loss on mortgage defaults.

Under the Section 223(f) program, the project's owner has to follow HUD's requirements and a regulatory agreement. The regulatory agreement entered into as of August 1, 2010, outlined terms and conditions for the HUD-insured mortgage, including concerning: (1) required written HUD approval for permitted use of the project, (2) disbursements from the reserve for replacement account, (3) maintenance of the security deposit account, (4) audited financial statements, and (5) calculation of and distributions from project surplus cash during the year.

Baldwin Creek Apartments is a 168-unit multifamily project located in Fort Wayne, IN. In August 2010, HUD insured the project's mortgage of more than $4 million under section 223(f) of the National Housing Act. The project is owned and operated by AD-Hobson, Limited Partnership, and has been managed by Evert Kramer of Professional Housing Management since October 1, 2015.[3]

The project was in a non-surplus-cash position from 2012 through 2015. Paragraph 6(b) of HUD's regulatory agreement with the project's owner states that without the prior written approval of HUD's Secretary, the owner must not assign, transfer, dispose of, or encumber any personal property of the project, including rents, or pay out any funds except from surplus cash, except for reasonable operating expenses and necessary repairs. Based on our review of the project's check register and bank statements, no distributions were made to the project's owners in 2014 and 2015.[4]

Our objective was to determine whether the project's owner and management agents operated the project in accordance with HUD's requirements and the regulatory agreement.

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[2] The National Housing Act, as amended, established Federal Housing Administration (FHA), an organizational unit within HUD. FHA insures multifamily loans originated by FHA approved lenders for the construction, substantial rehabilitation, and acquisition and refinancing of apartments.

[3] The project was owner managed by AD-Hobson, Limited Partnership from August 7 through September 30, 2015. Before August 2015, the project was managed by RLJ Management Company, Inc.

[4] On August 4, 2015, the project's owner made a nonmortgage loan of $30,000 to the project for operations and to assist the project with making repairs after the basement flooded in June 2015. Based on our review of the project's check register and bank statements, no payments had been made on this loan as of December 31, 2015.

Results of Audit

Finding: The Owner and Former Management Agent Did Not Always Operate the Project in Accordance With HUD's Requirements and the Regulatory Agreement

The project's owner and former management agent did not always operate the project in accordance with HUD's requirements and the regulatory agreement. Specifically, the project's owner or former management agent (1) inappropriately provided rent-free housing to two households, (2) did not always properly support transactions charged to the project, (3) did not always maintain the project's security deposit account at a level to fully cover deposit obligations, and (4) failed to submit the required audited financial statements to HUD in a timely manner. These weaknesses occurred because the project's owner lacked adequate oversight of the management of the project to ensure compliance with HUD's requirements and the regulatory agreement. As a result, (1) the project lost $8,210 in rental revenue for two units, and (2) HUD lacked assurance that $1,442 in additional rental revenue was not lost or that $6,608 was appropriately used for the project's units.

The Project Lost Rental Revenue by Providing Two Households Rent-Free Housing

Contrary to paragraph 6(h) of HUD's regulatory agreement, the project's owner and former management agent allowed the use of the project's dwelling accommodations for a purpose other than originally intended. The multifamily project's application for mortgage insurance (form HUD-92013) stated that the project's 168 units were revenue-generating units. However, two of the project's units were used to provide two households rent-free housing from August 2015 through February 2016, with the rents totaling more than $8,000.

For the first rent-free unit, the project's site manager said the tenant was a former maintenance employee of the project who was hired directly by the owner on August 7, 2015. Although the former maintenance employee's employment had ended in November 2015, he continued to reside in the unit rent-free until February 2016 without evidence of an executed lease. Therefore, the project lost $3,760 in rental revenue. Further, based on the former maintenance employee's employment application, he resided at the project before his employment. The project owner, and the former and current management agents were unable to support when the former maintenance employee moved into the unit and whether the $490 rent expense for July 2015 was lost rental revenue. According to the project's owner, no one employed at the project had an agreement to live in a unit rent free.

For the second rent-free unit, the household moved into and lived in the unit rent free for 7 months. Therefore, the project lost $4,450 in rental revenue. Further, the project lacked sufficient documentation to support that the household paid delinquent rental charges of $952 before moving into the unit.

The project lost $8,210 ($3,760 + $4,450) in rental revenue by allowing the two households to inappropriately live in two of the project's units rent free for 7 months (August 2015 through February 2016) and lacked sufficient documentation to support that $1,442 ($490 + $952) in additional rental revenue was not lost. As a result of our audit, the two households no longer resided at the project as of March 1, 2016.

Unsupported Transactions Were Charged to the Project

For the period January 1, 2014, through December 31, 2015, there were five disbursements totaling $146,488 from the project's reserve for replacement account. We reviewed an invoice from each of the five disbursements, which totaled nearly $66,000, for adequate support. Contrary to paragraph 4-15(A) of HUD Handbook 4350.1, REV-1, for one invoice in the amount of $6,608 for the purchase of 13 appliances, the project's owner or management agent was unable to provide support identifying the specific locations, such as the dwelling units or common areas, that received the purchased appliances. The project's former management agent stated that purchased appliances normally were tracked according to which units they were purchased for but on this occasion, a large number of appliances were purchased quickly for many vacant units so the appliances were not tracked.

The Project's Security Deposit Account Was Underfunded

The project's former management agent did not always maintain the project's security deposit account at a level to fully cover deposit obligations. Paragraph 2-12(A)(2) of HUD Handbook 4370.2, REV- 1, states that the balance of the security account must not at any time be less than the aggregate of all outstanding obligations under the account for security deposits. The following table shows the underfunded and overfunded project's security deposits for the sample months reviewed.

Sample month reviewed	Account balance	Outstanding obligations	(Underfunded) / Overfunded
January 2015	$23,031	$31,008	($7,977)
April 2015	29,599	30,519	(920)
May 2015	29,594	31,167	(1,573)
July 2015	25,584	28,847	(3,263)
October 2015	24,823	22,042	2,781
November 2015	25,324	26,091	(767)
December 2015	25,326	25,491	(165)

The project's former management agent stated that when it became the management agent in March 2013, the cash security deposit account was underfunded. The project's former management agent also stated that households' security deposit funds were included in the project's operating cash account to cover expenses such as utility bills because the project did not have sufficient funds. Since March 2016, when the project's current management agent took over the financial accounting,[5] which included the project's operating and security bank accounts, the project's security deposit account had been fully funded.

Required Financial Statements Were Not Submitted to HUD in a Timely Manner

Contrary to paragraph 9(e) of HUD's regulatory agreement,[6] the project's owner did not always submit audited financial statements to HUD in a timely manner. The project's fiscal yearend was December 31, 2015, and its 2015 audited financial statements were due to HUD on February 29, 2016. The project's audited financial statements were not submitted to HUD until April 2016. The project's owner stated that the untimely submission of the audited financial statements was due to changes that occurred, including the replacement of the former management agent and the departure of the owner's chief financial officer, who was the primary point of contact for the audit.

The Project's Owner Lacked Adequate Oversight of the Management of the Project

The project's owner lacked adequate oversight of the management of the project. According to the project's owner, the former management agent did not (1) properly manage the project and (2) always inform him of actions taken. For example, the project's owner stated that he was unaware that households resided at the project rent free. Although the project owner contracts the services of management agents to manage the project, he is (1) ultimately responsible for the project[7] and (2) expected to monitor the performance of management agents to ensure compliance with HUD's regulations and requirements.

In October 2015, the project owner hired a new management agent to oversee the project.

Conclusion

The project's owner lacked adequate oversight of the management of the project to ensure compliance with HUD's requirements and the regulatory agreement. As a result, (1) the project lost $8,210 in rental revenue for two units and (2) HUD lacked assurance that $1,442 in additional rental revenue was not lost or that $6,608 was appropriately used for the project's units.

Recommendations

We recommend that the Director of HUD's Multifamily Midwest Region require the project's owner to

1A. Reimburse the project from nonproject funds $8,210 for the lost rental revenue.

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[5] The owner managed the project's financial accounting from August 7, 2015 through February 29, 2016.

[6] Paragraph 9(e) of the regulatory agreement requires the project's owner to submit an annual financial report to HUD within 60 days following the end of each fiscal year.

[7] paragraph 1.6(a) of HUD Handbook 4381.5, REV-2

1B. Support that additional revenue was not lost or reimburse the project from nonproject funds $1,442 for the units that were provided to two households as rent-free housing as appropriate.

1C. Provide documentation supporting the distribution or allocation of the purchased appliances to the appropriate project units or reimburse the project $6,608 from nonproject funds.

1D. Implement adequate procedures and controls to ensure that (1) rental revenue was not lost and that lease agreements are executed before households are permitted to live in the units, (2) the project's records are properly maintained, (3) the project's security deposit account equals or exceeds the total outstanding obligations associated with the account at all times, and (4) annual audited financial statements are submitted to HUD in a timely manner.

Scope and Methodology

We performed our audit work from January through July 2016. We conducted onsite work at Baldwin Creek Apartments' office at 2020 Hobson Road, Fort Wayne, IN; and RLJ Management Company's office at 3021 East Dublin-Granville Road, Columbus, OH. The audit covered the period January 2014 through December 2015 and was expanded as determined necessary.

To accomplish our objective, we reviewed

- Applicable laws; HUD's regulations at 24 CFR (Code of Federal Regulations) Parts 200 and 207; HUD Handbooks 4350.1, REV-1, CHG-9; 4370.1, REV-2; 4370.2, REV-1, CHG-1; and 4381.5, REV-2; and HUD's regulatory agreement with the project's owner.

- The project's audited financial statements for 2014 and 2015, financial records, and management agent agreements and project data in HUD's Integrated Real Estate Management System.

- HUD's files for the project and the project's organizational chart.

In addition, we interviewed employees of the previous and current management agents and HUD's staff. We also communicated with the project's owner and point of contact.

Of the project's five disbursements from the reserve for replacement account totaling $146,448 from January 1, 2014, through December 31, 2015, we selected for review one invoice from each of the five disbursements to the project totaling nearly $66,000. We primarily focused on high-dollar invoice amounts from the replacement reserve request and the type of services or products provided by the vendor in the HUD approved request as higher risk. We used non-statistical samples since we knew enough about the population to identify a relatively small number of items of interest that were likely to be misstated or otherwise have high risk. The results of our testing applied only to the disbursements reviewed; therefore, we do not intend to project our results.

We reviewed the project's tenant security deposit bank statements and the project's monthly rent roll reports for January 2014 through December 2015. We selected a nonrepresentative sample of 7 months to determine whether the owner's management agents maintained the project's security deposits appropriately. Due to the independent public accountant's finding on security deposits in the project's 2014 audited financial statements,[8] we focused on the project's security

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[8] Dauby O'Connor & Zaleski, LLC, the independent accounting firm, cited in the project's 2014 audited financial statements that at December 31, 2014, the security deposit account did not have adequate funds to cover the obligations associated with the account. This was also a finding cited in the project's 2013 audited financial statements.

deposits maintained after the December 31, 2014. We selected a nonrepresentative sample because we knew enough about the population to identify the months that were likely high risk. The results of the sample testing was limited to the population reviewed and cannot be projected to the universe.

We relied in part on data maintained in the project's systems. Although we did not perform a detailed assessment of the reliability of the data, we performed a minimal level of testing and found the data to be adequately reliable for our purposes.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective(s). We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Internal Controls

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined that the following internal controls were relevant to our audit objective:

- Effectiveness and efficiency of operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.

- Reliability of financial reporting – 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 applicable laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiency

Based on our review, we believe that the following item is a significant deficiency:

- The project's owner lacked adequate oversight of the management of its project to ensure compliance with HUD's requirements and the regulatory agreement (finding).

Appendixes

Appendix A

Schedule of Questioned Costs

Recommendation number	Ineligible 1/	Unsupported 2/
1A	$8,210	
1B		$1,442
1C		$6,608
Totals	**$8,210**	**$8,050**

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

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.

Appendix B

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation **Auditee Comments**

Baldwin Creek Apartments

Office of Inspector General
U.S. Department of Housing and Urban Development

Re: HUD audit report response

We are in receipt of the referenced report and have the following information to add for context and consideration.

Comment 1

1) *Non-revenue generating occupancy.* The report references two units that were not in compliance for a short period of time. As discussed in detail during the audit, the prior property management company caused via their negligence a large amount of damage to the property. Upon the immediate replacement of the management company, Ownership, when learning of the units out of compliance, promptly removed the tenants and have subsequently brought the units back into compliance.

Comment 2

2) *Responsibility of lost revenue to be borne by Owner.* The property received no benefit, and incurred no damage as a result of the units being occupied. At the time, a large percentage of the units were in process of eviction and/or unoccupied. Occupancy fell approximately 40% during the time when Ownership terminated the previous management company and needed to remove the problem tenants. It was practically and virtually impossible for the leasing agents to lease up that number of units such that the improperly occupied units were the cause of any lost revenue. In fact, to this day, nearly a year later the project has yet to achieve full occupancy.

Comment 3

3) *Report does not acknowledge the contributions.* If there was lost revenue, the audit does not disclose the significant contributions made by Ownership towards stabilizing the project. To date in contributions and loans, in excess of $1,300,000.00 has been provided to the project in the form of contributions, loans, and work in place.

Best,

Tyson Jacobsen
Member
A.D. Hobson LLC

OIG Evaluation of Auditee Comments

Comment 1 For the first unit that was occupied by the former maintenance employee, the project owner and management agents were unable to provide an executed lease agreement or evidence that they actively pursued rent collection between July 2015 and February 2016. Further, based on the project's records, the second unit was vacant. However, we determined that it was occupied. As a result of our audit, according to the project's assistant property manager, the tenants were told to either pay rent or move out.

Comment 2 According to the project's application for mortgage insurance with HUD, all of the project units were revenue generating. So, in spite of the percentage of unit occupancy or whether no damage was incurred for the two occupied, rent-free units, the project owner failed to execute lease agreements before the tenants moved into the units. Therefore, the project lost rental revenue totaling more than $8,000 for 7 months. Further, for one of the two units, the project's management agent was unable to provide documentation showing that the delinquent rent of $952 for a prior unit was collected from the household. The household lived in the new unit rent free. We understand that a project does not always achieve full occupancy; however, it does not have any bearing on the rent that should have been collected for occupied units.

Comment 3 Owner contributions were not the focus of our audit. Therefore, we cannot attest to contributions and loans made by the owner to stabilize the project. The project owner should work with HUD to resolve the recommendations regarding the lost revenues cited in this report.