Issue Date July 30, 2009
Audit Report Number 2009-FW-1014

TO: Brenda L. Waters
Acting Director, Kansas City Multifamily Hub, 7AHM

Henry S. Czauski, Acting Director, Departmental Enforcement Center, CV

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FROM: Gerald R. Kirkland
Regional Inspector General for Audit, Fort Worth Region, 6AGA

SUBJECT: Cypress Ridge Apartments, Oklahoma City, Oklahoma, Owner's Agent Received and Paid More Than $742,000 Contrary to HUD and Regulatory Requirements

HIGHLIGHTS

What We Audited and Why

In response to a request from the U. S. Department of Housing and Urban Development (HUD), we audited Cypress Ridge Apartments' (Cypress) use of HUD-insured mortgage loan proceeds and property operating funds governed by a regulatory agreement.[1]

The audit objective was to determine whether the management agent/general contractor[2] (agent) used project and operating funds consistent with the regulatory agreement and HUD regulations. Specifically, we wanted to determine whether the agent (1) used loan proceeds for other than reasonable project expenses, (2) used operating funds to pay other than reasonable operating expenses and necessary repairs, and (3) paid distributions from other than surplus cash.

1 HUD and ownership officials executed the regulatory agreement on December 14, 2005.
2 Williams Commercial Property Management, Inc. was the owner's management agent for the property and the HUD-approved general contractor for the rehabilitation project.

What We Found

The agent obtained and used funds contrary to the regulatory agreement. It received loan proceeds totaling $356,400 without construction cost documentation to support the release of proceeds. From the operating account, it paid related entities and others $386,007 without required justification for payments. This condition occurred because the agent commingled property funds with the funds of other properties it managed without an accounting and justification of transactions. As a result, the agent drew and paid out amounts without assurances that it used the funds for legitimate expenditures. This condition put HUD at a greater risk of loss on the mortgage loan insured by the Federal Housing Administration (FHA), which later defaulted with a resulting loss to FHA of $3.75 million.

What We Recommend

We recommend that the Acting Director of the Office of Multifamily Housing, Kansas City hub, require the owner to either support or repay HUD more than $356,000 for loan proceeds it received and support or repay HUD more than $386,000 paid out of the operating account. We also recommend that HUD's Acting Director of the Departmental Enforcement Center take appropriate actions against the ownership and management agent for violating the project's regulatory agreement.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

On July 1, 2009, we provided a discussion draft report to the ownership of Greystone Apartments with written comments due by July 22, 2009. On July 8, 2009, we held an exit conference with HUD and the ownership. At the exit conference, the ownership stated that it could not respond in writing to the findings and recommendations by July 22, 2009. The ownership did state that it eventually could support the costs reported and it intends to hire a certified public accountant to gather and present the support. On July 20, 2009, an attorney for the ownership requested an extension to respond by September 30, 2009. We denied the request and issued the report without comments.

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BACKGROUND AND OBJECTIVE

Cypress Ridge Apartments (Cypress) is a 256-unit garden-style apartment complex in Oklahoma City, Oklahoma. Greystone Apartments, Inc., the property owner, was the project sponsor and borrower. Williams Commercial Property Management, Inc., (agent) was the management agent that operated the property for the ownership. It also was the U. S. Department of Housing and Urban Development (HUD)-approved general contractor for the property's rehabilitation project. William L. Sharpe, the president of Greystone Apartments, and a principal shareholder and contact person for the ownership, owned Williams Commercial Property Management. On November 17, 2003, eight individuals purchased controlling stock in the ownership entity with plans to rehabilitate the property with funds from a Federal Housing Administration (FHA)-insured loan. On December 14, 2005, Harry Mortgage Company[3] (lender) and the owner entered into a nonrecourse $5.87 million mortgage agreement that FHA insured under Section 221(d)(4) of the National Housing Act. FHA provides insurance to protect lenders against loss from defaults on mortgage loans made to rehabilitate housing units for moderate-income and displaced families.

On December 14, 2005, HUD and the ownership executed a regulatory agreement that limited property payments to reasonable operating expenses and necessary repairs and project payments to amounts ordinarily paid for services, supplies, or materials in the area where the user purchased the services or the supplies and materials. It also required the owner to keep at all times books, contracts, records, documents, and other papers relating to the operations of the mortgaged property and the execution of the project in a condition for audit.

On October 1, 2007, 22 months after obtaining the loan, the owner defaulted on its FHA-insured mortgage loan. The agent had completed only 57 percent of the rehabilitation. Comparably, contractors usually complete substantial rehabilitation within 12 months. In the appraisal, the contractor estimated that it would take nine months to complete the rehabilitation.

The lender assigned the note to HUD, and HUD recorded the assignment on November 28, 2007. HUD paid more than $4.2 million to settle the lender's claim. On June 26, 2008, HUD sold the mortgage loan for $484,376, a net loss of more than $3.75 million to the FHA insurance fund.

The audit objective was to determine whether the agent (1) used loan proceeds to pay reasonable project expenses, (2) used operating funds for reasonable operating expenses and necessary repairs, and (3) paid distributions from other than surplus cash. This is the second report on Cypress, with the first report[4] addressing processing and underwriting by the lender.

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3 HUD had approved Harry Mortgage Company to process loans under its multifamily accelerated processing program.

4 Harry Mortgage Company, Oklahoma City, Oklahoma, Overstated the Financial Wherewithal of the Owner and General Contractor When Underwriting the Cypress Ridge Apartments' $5.87 Million Loan under the Multifamily Accelerated Processing Program, Report Number 2009-FW-1010, dated June 26, 2009.

RESULTS OF AUDIT

Finding: The Agent Paid and Obtained More than $742,000 Contrary to HUD and Regulatory Requirements

The agent with the dual roles of management agent and general contractor did not fulfill its responsibility to provide support for more than $742,000 in property operating funds disbursed and project loan proceeds drawn. The lack of support occurred because the agent did not keep required documentation to justify expenditures charged to the property and the project. As a result, the agent had no assurances that it used operating funds for legitimate expenditures and drew amounts to reimburse eligible rehabilitation costs. This condition put HUD at a greater risk of loss on the FHA-insured mortgage loan, which later defaulted with a resulting loss to FHA of $3.75 million.

The Agent Did Not Provide Support for More Than $356,000 of the Construction Costs Reimbursed

The project did not have documentation to support construction draws totaling $356,400, or 31 percent, of the $1.1 million that the owner received for the agent's rehabilitation work.[5] Examples of missing support for construction draws included payrolls without time sheets that supported all hours charged, payments to MasterCard without receipts to show what the agent purchased, billings for overhead and general requirements without explanation, and payments to vendors without an invoice or other billing documents. The following table shows by draw that the agent did not have sufficient support for eight of 11 draws.

[5] The lender wrote the checks to the owner, and the owner paid the agent, which deposited the payments into its construction bank account.

Supported and unsupported construction costs paid			
Draw[6]	**Paid**	**Supported**	**Unsupported**
Draw #2	$ 15,729	$ 16,156	($ 427)
Draw #3	96,099	91,545	4,554
Draw #4	91,780	83,307	8,473
Draw #5	105,175	54,927	50,248
Draw #6	151,429	46,565	104,864
Draw #7	197,278	197,284	(6)
Draw #8	89,975	58,441	31,534
Draw #9	127,537	65,484	62,053
Draw #10	113,664	115,034	(1,370)
Draw #12	70,827	27,244	43,583
Draw #13	84,070	31,176	52,894
Totals	**$1,143,563**	**$787,163**	**$356,400**

Property Bank Account Payments Included Questionable Expenditures of More Than $386,000

A review of the property bank account disclosed unsupported payments totaling $386,007, including $374,194[7] paid to related entities. We classified the payments as follows:

Operating account unsupported payments	
Expenditure	**Amount**
Related entities	
Payroll	$174,706
Williams Commercial Property Management.	176,000
Other properties managed by the agent	10,988
Owner	12,500
Total related entities	**374,194**
Other	
Unknown payee	6,152
Landscaping	2,500
Bank of Oklahoma	3,161
Total other	**11,813**
Total	**$386,007**

6 Draws 1 and 11 did not contain construction costs.
7 This represents the gross amount paid to related entities.

This condition occurred because the agent did not keep documentation that justified expenditures charged to the property as required by the regulatory agreement.

The Agent Did Not Provide an Accounting of Commingled Funding of Properties It Managed

Payments to and proceeds from related properties showed that the agent commingled funds[8] of properties it managed without a proper accounting. It made payments from the property's bank account to related parties and deposited proceeds from related parties into the owner's bank account without documentation to justify transactions and account for the funding.

Thereby, the agent did not fulfill the provision of the regulatory agreement that requires a contract agent to maintain records and documents in a reasonable condition for proper audit. Although the property and project had separate bank accounts, the agent wrote checks from the property and project bank accounts to related properties and paid related party bills without documenting the justification for the transactions. For example, the agent wrote checks to Golden Oaks Apartments, for $1,750 on December 29, 2005, and $2,500 on July 5, 2006. For both checks, the agent could not support the payments. On May 15, 2006, it wrote a $4,000 check to Hillcrest Residence Apartments without an explanation in the files. Altogether, the agent paid $5,900 to Hillcrest Residence Apartments without support.

The Unjustified Use of Funding Put HUD at Greater Risk of Loss on the Insured Mortgage Loan

The unjustified use of funds from the property and the rehabilitation project put HUD at a greater risk of loss on its FHA-insured mortgage loan by not having assurance that use of funding was prudent. This condition could result in less funding to pay suppliers and subcontractors, resulting in liens on the property. For this project, the agent did not complete the rehabilitation and defaulted on the mortgage loan, which the lender eventually assigned to HUD. HUD lost more than $3.75 million.

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8 HUD permits the use of a centralized operating account as long as deposits to and disbursements from the account are clearly traceable and the actual cash position of each and every project in the centralized account is easily identifiable at all times. In this instance, the entities maintained separate operating bank accounts. Thus, for the purposes of this report commingling refers to the payment of expenses for the project and the related parties without regard for the source of the funds or restrictions on the use of the funds.

Conclusion

The agent violated the regulatory agreement in obtaining loan proceeds and using operating funds. This condition occurred because the agent commingled funds with the funds of other properties it managed without a proper accounting and documented justification. As a result, the agent had no assurances that it obtained and paid out more than $742,000 for eligible rehabilitation costs and legitimate expenditures. This put HUD at a greater risk of loss on the FHA-insured mortgage loan from which FHA lost more than $3.75 million.

Recommendations

We recommend that the Acting Director of the Office of Multifamily Housing, Kansas City hub

1A. Require the owner to either support or repay HUD $356,400 for loan proceeds it received.

1B. Require the owner to either support or repay HUD $386,007 paid out of the operating account.

We further recommend that the Acting Director of HUD's Departmental Enforcement Center

1C. Take appropriate actions against the ownership and management agent.

SCOPE AND METHODOLOGY

The audit covered agent draws and Harry Mortgage Company releases of loan proceeds and agent payments from the property operating and project bank accounts. To accomplish the objective, we carried out the following:

- Reviewed requirements to draw project funds and pay out property operating funds,
- Reviewed agent disbursement procedures,
- Reviewed support for all of the more than $1.1 million in loan proceeds paid to the owner for reimbursement of project costs,
- Scanned the bank statements and payment register for curious and unusual payments that warranted in-depth review to establish the propriety of the payment,
- Reviewed a nonstatistical sample of $492,778 of the more than $1 million paid from the property's operating account from December 2005 through March 2008,
- Interviewed the president of the property corporate owner,[9] and
- Interviewed the HUD Director and her staff at the multifamily program center in Oklahoma City, Oklahoma.

We conducted the audit from August 2008 to May 2009 at the agent's office located at 3033 Northwest 63rd Street, Suite 155, Oklahoma City, Oklahoma, and at the HUD multifamily program center office in Oklahoma City, Oklahoma. The review period was December 14, 2005, the date the parties executed the regulatory agreement, through March 31, 2008.

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. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

[9] He is also the president of Williams Commercial Property Management, Inc., the management agent and general contractor for the project.

INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that the following controls are achieved:

- Program operations,
- Relevance and reliability of information,
- Compliance with applicable laws and regulations, and
- Safeguarding of assets and resources.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. They 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 objectives:

- Controls over disbursements of operating funds to ensure compliance with HUD and regulatory requirements.
- Controls over the drawdown of mortgage loan proceeds.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weaknesses

Based on our review, we believe that the following items are significant weaknesses:

- Controls over disbursements of operating funds were overridden and ineffective.
- Controls over the drawdown of mortgage loan proceeds did not ensure that the general contractor had sufficient construction costs to support the amount of the drawdown.

APPENDIX

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Unsupported 1/
1A	$356,400
1B	386,007
Total	$742,407

1/ 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.