



Baker Tower Apartments, LLC Denver, CO

Section 223(f) Multifamily Insurance Program



To: Tom Azumbrado, Regional Director, West Multifamily Region, 9AHMLAP

//signed//

From: Ronald J. Hosking, Regional Inspector General for Audit, 8AGA

Subject: Baker Tower, Denver, CO, Incorrectly Disbursed Funds and Did Not Correctly Administer the Project's Security Deposit Account

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of Baker Tower Apartments, LLC. 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 website. 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 913-551-5870.



Audit Report Number: 2017-DE-1003
Date: September 21, 2017

Baker Tower, Denver, CO Incorrectly Disbursed Funds and Did Not Correctly Administer the Project's Security Deposit Account

Highlights

What We Audited and Why

We audited Baker Tower Apartments, LLC (corporation), located in Denver, CO, based on data showing that the corporation had taken more than \$3.4 million in owner distributions since 2013 and scored poorly on its most current Real Estate Assessment Center physical property inspection. The objective of our audit was to determine whether the corporation complied with the regulatory agreement and U.S. Department of Housing and Urban Development (HUD) regulations when it paid out owner distributions and disbursements and while maintaining the property's security deposit account.

What We Found

The corporation did not always comply with its regulatory agreement or HUD regulations when it paid out distributions and disbursements and it did not properly maintain its security deposit account. Specifically, the corporation paid out an ineligible distribution that was \$242,634 more than the surplus cash computation reported to HUD, improperly used project funds to pay \$15,000 for its refinance application fee, held a \$0 balance on its security deposit account from August to November 2016, and deposited all security deposit transactions directly into the project's operating account.

What We Recommend

We recommend that the Regional Director of HUD's West Region, Office of Multifamily Housing Programs, require the corporation to develop and implement controls over owner contributions and owner distributions to ensure compliance with its regulatory agreement and HUD regulations, complete HUD-approved training regarding owner contributions and owner distributions, repay its project's operating account for the ineligible \$15,000 disbursement from non-project funds, perform an analysis of all security deposits and ensure that the security deposit account is fully funded, and develop and implement procedures to maintain the project's security deposit funds separately from all other accounts by depositing and disbursing all security deposit funds directly into and from the security deposit account.

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Background and Objective

Baker Tower Apartments is located in Denver, CO. It is a profit-motivated multifamily project with 125 apartment units. Baker Tower is owned by Baker Tower Apartments, LLC, and has been managed by Maxx Properties since November 13, 2011. The corporation and the U.S. Department of Housing and Urban Development (HUD) entered into a regulatory agreement for mortgage insurance on the multifamily rental apartments. The amount of the mortgage insurance was \$10 million and was insured under Section 207, according to Section 223(f) of the National Housing Act. Section 207/223(f) insures mortgage loans to facilitate the purchase or refinancing of existing multifamily rental housing. Properties requiring 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.

HUD insurance on the loan was conditional upon the owners' assurance that \$3.3 million would be available for the completion of noncritical repairs deferred until after endorsement of the note. The lender of the mortgage loan, Walker & Dunlop, LLC, managed the escrow until the corporation completed all noncritical repairs. Subject to the prior written approval of HUD, Walker & Dunlop released funds from the escrow for completed work.

Under the regulatory agreement, a distribution means any disbursement, conveyance, or transfer of any portion of the mortgaged property, including the segregation of cash or assets for later withdrawal as surplus cash, other than in payment of reasonable operating expenses, or any other disbursement, conveyance, or transfer provided for in the regulatory agreement. The regulatory agreement outlines the requirements for actions requiring the prior approval of HUD, maintenance of the security deposit and reserve for replacement accounts, and how to properly take distributions from restricted accounts and owners' distributions from surplus cash. Baker Tower is shown in the picture to the right.



Our audit objective was to determine whether the corporation complied with the regulatory agreement and HUD regulations when it paid out owner distributions and disbursements and while maintaining the property's security deposit account.

Results of Audit

Finding 1: The Corporation Paid Out an Ineligible Distribution and Paid for an Ineligible Expense

The corporation paid out an ineligible owner distribution and paid for an ineligible expense. This condition occurred because the corporation did not have adequate controls and was unaware that finance application fees were not eligible property expenses. As a result, HUD lacked assurance that the property had sufficient operating funds, and the \$15,000 used for an ineligible application fee was not available for project operations.

The Corporation Paid Out an Ineligible Distribution and Paid for an Ineligible Expense

The corporation did not always comply with its regulatory agreement or HUD regulations when it paid out a more than \$3 million owner distribution and used \$15,000 for an ineligible application fee. On November 19, 2015, the corporation paid out an owner distribution of more than \$3 million. However, the June 2015 midyear surplus cash amount was approximately \$2.7 million, resulting in an unauthorized distribution of more than \$242,000. The December 2015 annual surplus cash amount was \$520,553, indicating that the property most likely would have had more than \$3 million cash available if the corporation had waited until after the yearend computation. The funds from the \$3 million owner distribution came from the proceeds received from an escrow agreement for deferred noncritical repairs. The escrow agreement withheld \$3.3 million from a cashout refinance. However, the corporation deposited the funds into its operating account, which HUD considers an owner contribution. Therefore the transaction either required HUD approval for the corporation to recapture those funds from its operating account or the property needed to be in a surplus cash position to recapture the funds. Additionally, in August 2016, the corporation used project funds to pay \$15,000 for an application fee to refinance the project. Costs related to refinancing were not eligible property expenses; therefore, the \$15,000 was an ineligible project expense.

The Corporation Lacked Controls Over Contributions and Distributions

The corporation did not have controls for owner contributions into and distributions from the project's operating account and was unaware that finance application fees were not eligible property expenses. With no controls over owner contributions or owner distributions, the corporation was unaware that when it deposited the proceeds from its escrow agreement into its operating account, the funds were considered an owner contribution and were subject to HUD's rules when it tried to recapture those funds as a distribution.

Conclusion

At the time of the more than \$3 million distribution, HUD lacked assurance that the property had sufficient funds to cover the more than \$242,000 above the previous surplus cash position.

Additionally, the \$15,000 used for the application fee was not available for the operations of the project.

Recommendations

We recommend that the Regional Director of HUD's West Region, Office of Multifamily Housing Programs, require the corporation to

- 1A. Develop and implement controls over owner contributions and owner distributions to ensure compliance with its regulatory agreement and HUD regulations.
- 1B. Complete HUD-approved training regarding owner contributions and distributions.
- 1C. Repay its project's operating account for the ineligible \$15,000 disbursement from non-project funds.

Finding 2: The Corporation Did Not Properly Maintain Funding in the Project's Security Deposit Account

The corporation did not properly maintain funding in the project's security deposit account. This condition occurred because the corporation did not implement adequate controls. As a result, HUD lacked assurance that the project's security deposit account was fully funded at all times.

The Corporation Did Not Properly Maintain Funding in the Project's Security Deposit Account

The corporation did not maintain the project's security deposit account in accordance with its regulatory agreement when it zeroed out the account and deposited security deposits directly into the project's operating account. The corporation's regulatory agreement requires it to maintain security deposit funds in a separate account. In August 2016, the corporation zeroed out its security deposit account, and in November, 2016, it redeposited the same amount into the account and made an additional deposit to the account. The corporation stated that the account was mistakenly zeroed out while it was closing unused bank accounts for its many properties.

Additionally, the corporation deposited all security deposits directly into the project's operating account and reimbursed tenants' security deposit funds from the operating account. It reconciled the project's operating account for the tenants' security deposits on a quarterly basis to determine the total liability to the tenants. If the liability was higher than the dollar amount in the security deposit account, the corporation transferred funds from the project's operating account into the security deposit account to fund the liability.

The Corporation Did Not Follow Existing Procedures

The corporation did not follow existing procedures to ensure that security deposit funds were deposited or disbursed from a separate security deposit account. The corporation has its own policies which contain language that, if followed, complies with the regulatory agreement. It states, "Security deposits collected from residents of the Premises shall be deposited and maintained in an account separate and apart from all other funds in the name of the project." However, the corporation did not follow this procedure and instead deposited security deposit funds directly into its operating account.

Conclusion

HUD lacked assurance that the corporation's security deposit account was fully funded at all times, putting the project at risk of not being able to cover the tenants' security deposit account refunds.

Recommendations

We recommend that the Regional Director of HUD's West Region, Office of Multifamily Housing Programs, require the corporation to

- 2A. Perform an analysis of all security deposits and ensure that the security deposit account is fully funded.

- 2B. Implement controls to ensure existing procedures are followed to maintain the project's security deposit funds separately from all other accounts by depositing and disbursing all security deposit funds directly into and from the security deposit account.

Scope and Methodology

Our audit work covered Baker Tower Apartments, LLC's records from 2014 to 2016. We performed our work between May and July 2017 at Baker Tower Apartments located at 330 Acoma Street, Denver, CO.

To accomplish our objective, we

- interviewed HUD staff in charge of the project;
- interviewed various staff members of Baker Tower Apartments, LLC;
- reviewed applicable laws and regulations and background information;
- reviewed audited financial statements and financial records for 2014, 2015, and 2016 from HUD's Integrated Real Estate Management System;
- reviewed tenant security deposit accounts;
- reviewed tenant historical payment ledgers and security deposit reports;
- reviewed the project's operating fund accounts;
- reviewed all bank statements and check registers for Baker Tower Apartments;
- reviewed the reserve for replacement account;
- reviewed the transaction history of the escrow agreement for deferred noncritical repairs; and,
- reviewed supporting documentation for disbursements.

The corporation made 2,601 disbursements totaling more than \$12.7 million between 2014 and 2016. We selected the 6 months of November to December 2014, October to November 2015, and July to August 2016, which had the highest amount of disbursements from our review period. There were 436 disbursements totaling \$4.7 million during those months. We selected a nonstatistical sample to allow us to focus on any disbursements made directly to the owners or any disbursements made to vendors outside the project's normal operations. To select our sample, we reviewed the six monthly bank statements for any disbursements that met the above criteria and identified 11 disbursements that were not clearly related to the operations of the project. For those 11 expenditures, we obtained supporting documentation from the corporation. The supporting documents included invoices from the respective companies, bank statements, descriptions of services performed, and check registers. The results of this audit apply only to the items tested and are not projected to the universe of disbursements.

For tenant security deposits, we reviewed 100 percent of the security deposit transactions that occurred during the 4 months when the security deposit account was zeroed out by the auditee, which was August to November of 2016. We selected these 4 months because we considered them to be at a high risk as all funds had been removed from the account. There were 67

security deposit transactions for a total of \$20,843 during the 4-month period. We tied the amounts from the ledger directly to the supporting documents in the tenant files to ensure that the information on the ledger was reliable. The results of this audit apply only to the items tested and are not projected to the universe of the security deposit account transactions.

We relied in part on computer-processed data for our audit. We obtained supporting documentation from HUD and the auditee to support our audit conclusions. We performed data reliability testing on the security deposit data summary provided to us by the corporation to determine whether the data accurately matched the source documentation. We traced a sample of the data records to the tenant files to determine whether the security deposit summary data accurately reflected the documents. Based on our analysis, we determined that we could rely on the security deposit summary data received from the corporation.

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

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:

- Controls to ensure that the owner's distributions were authorized and taken at the appropriate time.
- Controls to ensure that disbursements were for eligible project operating expenses.
- Controls to ensure that the security deposit account was maintained in a separate account and at an amount equal to the outstanding obligations of the security deposit account.

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 Deficiencies

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

- The corporation lacked controls to ensure that the owner's distributions and eligible expenses were administered properly (finding 1).

- The corporation lacked controls to ensure that existing procedures were followed regarding security deposit transactions being maintained within a separate security deposit account (finding 2).

Appendixes

Appendix A

Schedule of Questioned Costs

| Recommendation number | Ineligible 1/ |
|------------------------------|----------------------|
| 1C | \$15,000 |
| Totals | 15,000 |

- 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.

Appendix B

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments



Ronald Hoskings
Regional Inspector General Audit
Office of Audit Region 8
1670 Broadway, 23rd floor,
Denver, CO 80202

Re: **Draft Audit Report Number: 2017-DE-XXXX Baker Towers LLC**

Sent via email to CGagon@hudoaig.gov

September 11, 2017

Mr. Hoskings,

We offer the following written response to the above reference draft audit regarding Baker Towers LLC.

Comment 1

1A With respect to the audit finding that the project paid out an alleged ineligible distribution of \$242,634, it was demonstrated and evidenced by the Owner that all distributions came from excess refinance proceeds. These refinance proceeds are not considered project funds. All Owner distributions came from Owner funds. The refinancing proceeds were deposited into the projects operating account. The Owner does have controls over contributions and distributions, however in the future such funds will be deposited into a separate account instead of the property operating account. We ask that HUD consider this substance over form.

Comment 2

1B Relates to 1C below. The Company is very familiar with eligible and ineligible property expenses.

Comment 3

1C The \$15,000 application fee was paid in conjunction with a planned Section 221(a) 7 refinance of the project which was not completed because of interest rates. Furthermore, the fee application was also paid from Owner funds that resided in the project's operating account (excess refinancing proceeds) but has since been repaid back to Baker to eliminate any further concern.

Baker LLC takes exception your contention that the corporation does not maintain adequate controls over contributions and distributions and recommends the draft report

**Ref to OIG
Evaluation**

Auditee Comments

Comment 4

be amended to focus on the use of the operating account for deposits and distributions of refinancing proceeds.

2A On July 14, 2017, the Corporation fully complied with the Regional Director's following requests related to tenant security deposits: Ellie Hockstad

"I would like to request the following security deposit ledger information listed below so I can accurately account for the security deposit fees. An electronic or a paper copy would work, if you have a paper copy just let me know and I will stop by and pick it up. Thanks for your assistance with this matter and have a great day! "

- The years 2014, 2015, and 2016
- How much and when tenants paid for the security deposit when they moved in
- How much and when tenants were paid when they moved out

Of the 664 tenant security deposits audited by HUD, there were zero exceptions noted by your audit.

Comment 5

2B The Corporation does maintain controls over its tenant security deposits. The tenant security deposits are maintained in a separate account.

Baker Towers LLC takes exception to the allegations that it does not maintain adequate controls over its security deposit accounts as evidenced by HUD's own audit findings over a 3 year period and thousands of transactions. Your draft reports further states that HUD audited 100% of the 4 months the security deposits were in another deposit account, and no exceptions were discovered. The Corporation respectfully request that the draft report be amended regarding the general contention of a lack of controls over its accounting for its security deposits.

Respectfully yours,



John Colardi
Chief Financial Officer

OIG Evaluation of Auditee Comments

- Comment 1 The corporation stated the funds taken were from excess owner refinance proceeds and agrees the corporation deposited the funds into the projects operating account. Any funds deposited into the project's operating account are considered owner contributions to the project and cannot be withdrawn from the project without prior written approval from HUD or unless the project meets the requirements in the regulatory agreement for surplus cash distributions. In this instance, the corporation neither obtained prior HUD approval to remove the funds nor did it have sufficient surplus cash at the time of the distribution. We believe the fact that the owner did not seek HUD approval prior to taking the distribution and that the distribution was in excess of the previous surplus cash contribution, demonstrates a lack of controls over the processing and accounting for owner contributions and distributions.
- Comment 2 We changed the wording for recommendation 1B from requiring the corporation to obtain HUD approved training regarding eligible property expenses to requiring the corporation to obtain HUD approved training regarding owner contributions and owner distributions.
- Comment 3 The corporation states that the refinance fee was paid for with Owner funds that resided in the project's operating account. Refer to comment 1 above regarding owner contributions and owner distributions. The corporation additionally stated it has since repaid the project to eliminate any further concerns. The corporation will need to provide evidence of the repayment to HUD during the audit resolution process to clear the recommendation.
- Comment 4 We appreciate the cooperation provided by the corporation's staff in providing the requested documents during our review. As explained in our scope and methodology section of the report, we did not review 664 security deposit transactions for the entire audit period of 2014 to 2016. We did, however, review 100 percent of security deposits from August to November of 2016 which totaled 67 security deposit transactions. The corporation is incorrect in its statements that we found no exceptions in our testing. While we did find that the corporation ensured the security deposit account was adequately funded on a quarterly basis, we identified the exception that the corporation violated its regulatory agreement by depositing security deposit funds directly into its operating account.
- Comment 5 We disagree that the corporation has adequate controls over its security deposit account. We do agree that the corporation maintains a separate security deposit account and reconciles that account on a quarterly basis with security deposit funds it deposits directly into the projects operating account. However,

depositing funds directly into the projects operating account directly violates the regulatory agreement and the corporations own management agreement with its owner controlled management company. That agreement states, “All funds collected in the operation of the Premises, except security deposits, shall be deposited in the Operating Account.” It goes on to state, “Security deposits collected from residents of the Premises shall be deposited and maintained in an account separate and apart from all other funds in the name of the project.” The corporation needs to develop and implement controls to ensure all security deposits are deposited and maintained separate from all other project funds.