

**U.S. Department of Housing and Urban Development**

**Office of Inspector General**

**Pacific/Hawaii**

**450 Golden Gate Avenue, P.O. Box 36003  
San Francisco, California 94102-3448**

March 8, 1996

AUDIT RELATED MEMORANDUM  
96-SF-212-1804

MEMO TO: William F. Bolton, Director, Multifamily Housing Division, Sacramento Area Office,  
9GHM

FROM: David A. McCargar, Assistant District Inspector General for Audit, 9AGA

SUBJECT: Peach Tree Terrace Apartments  
Multifamily Mortgage Operations  
Yuba City, California

We completed a review of Peach Tree Terrace Apartments to identify instances of assets used in violation of the regulatory agreement governing project operations. We found that loan repayments exceeding surplus cash were made to the general partners.

### **BACKGROUND**

Peach Tree Terrace (FHA project 136-35617) is a multifamily housing development located in Yuba City, California. The mortgage loan is insured by HUD under Section 221(d)4 of the National Housing Act. HUD gave final endorsement to the project in 1981. The project is owned by Peach Tree Terrace General Partnership. FPI Management, Inc., located in Sacramento, California, manages the project. Project operations are governed by a regulatory agreement with HUD in consideration of the mortgage insurance.

### **PURPOSE AND METHODOLOGY OF REVIEW**

We made this review to determine if project assets were used in violation of the regulatory agreement. For our principal methodologies, we:

- ✓ analyzed the project's audited financial statements for fiscal years 1992 to 1994,
- ✓ interviewed HUD staff, the managing general partner, and management agent staff,
- ✓ reviewed HUD's asset management files, project records maintained by the management agent, and records provided by the managing general partner, and
- ✓ gained an understanding of the internal control structure. We did not conduct tests to determine control effectiveness because it was not necessary for the limited objective of our review.

The review covered activities from January 1992 to August 1995. We did the field work in September 1995.

## FINDING

### REPAYMENTS TO PARTNERS WERE MADE WHEN THE PROJECT LACKED SURPLUS CASH.

During the three years ended December 31, 1994, project funds were used to repay \$69,677 of the partner's loans to the project. These repayments violated HUD's requirements by being premature and exceeding allowable limits by \$17,495. Thus, the repayments increased the risk that assets would not be available to properly maintain the project or service the HUD-insured loan. The managing general partner claimed he was unaware that HUD requirements were violated.

**LIMITATIONS ON REPAYMENTS.** Repayments of notes payable to partners may only be made from surplus cash or with the prior approval of HUD. In consideration for mortgage insurance, the owner agreed to abide by paragraph 8(b) of the regulatory agreement which states:

"Owners shall not without the prior permission of the Secretary 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."

Repayment of advances is not considered to be an operating expense. HUD handbook 4370.2 REV-1, chapter 2-11, explains the requirements on advances. It stipulates:

"Advances made for reasonable and necessary operating expenses may be paid from surplus cash at the end of the annual or semi-annual period. . . . Repayment of owner advances when the project is in a non-surplus cash position will subject the owner to criminal and civil monetary penalties."

Thus, repayments of any owner loans or advances to the project should not exceed the available surplus cash.

**REPAYMENTS MADE TO PARTNERS.** The general partners advanced the project \$508,346 between 1983 and 1991. After 1991, the partners were repaid a portion of these advances. These repayments occurred when the project had surplus cash deficiencies or exceeded the surplus amount as shown below.

Fiscal Year Ended	Surplus Cash Balance (Deficiency)	During Fiscal Year	Loan Repayments to Partners	Repayments in Excess of Available Surplus Cash
1991	\$(1,477)	1992	\$14,000	\$14,000
1992	4,150	1993	42,650	38,400
1993	(4,468)	1994	13,027	13,027
1994	(23,089)			

Although the repayments were disclosed in the audited financial statements, the public accounting firm performing the audits failed to disclose the repayments as a compliance finding.

**REPAYMENTS INCREASED THE SURPLUS CASH DEFICIENCY.** If the excess repayment of \$14,000 in 1992 had not been made and subsequent repayments were limited to surplus cash, the allowable repayments would have been \$18,150 for 1993 and \$34,032 in 1994. Thus, the net total of excessive repayments would be \$17,495 (\$69,677 less \$52,182). If the excess repayments had not been made, the surplus cash deficiency would have been reduced from \$23,089 to \$5,594.

Because of subsequent cash shortfalls, the partners advanced \$5,000 on August 16, 1995 at the request of the management agent. Based on the unaudited trial balance as of December 31, 1995,

the surplus cash deficiency grew slightly during 1995 even though the partners had advanced the \$5,000.

On August 10, 1995, HUD requested that excess distributions be reimbursed to the project. The managing general partner's reply showed that he was unaware that the repayment of advances required surplus cash. No further repayments have been made since HUD notified the owner that loan repayments require surplus cash or be approved by the Department.

## **RECOMMENDATIONS**

We recommend that you:

- A. Require the partners to return \$12,495 (\$17,495 less \$5,000 advance in 1995). If the partners do not return the funds in a timely manner, advise us so that other avenues can be explored to recover the funds.
- B. Inform the accounting firm that performed the audits about HUD's regulations dealing with the repayment of advances and the firm's responsibility to report any violations as a finding.

Within 60 days, please furnish us a status report on the recommendations stating (1) the corrective action taken, (2) the proposed clearance action and the date to be completed, or (3) why action is not considered necessary. Also, please furnish us copies of any correspondence or directives issued that are related to the review.

We received written comments from the project owner's managing general partner. The partner said that he informed the accounting firm about HUD's requirements governing advances and that the excess repayments would be repaid within 90 days. The partner's response begins on the next page.

If you have any questions, please call senior auditor Mark Pierce at (415) 436-8101.

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## AUDITEE COMMENTS



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