

This scoring notice will publish in the Federal Register on February 23, 2011. The published notice will establish the deadline for submission of public comments. No comments should be submitted nor will they be accepted prior to publication of the notice in the Federal Register.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR-5094-N-04]

**Changes to the Public Housing Assessment System (PHAS):
Financial Condition Scoring Notice**

AGENCY: Office of the Assistant Secretary for Public and Indian Housing, HUD.

ACTION: Notice.

SUMMARY: This notice provides additional information to public housing agencies (PHAs) and members of the public about HUD's process for issuing scores under the financial condition indicator of the Public Housing Assessment System (PHAS) rule, published elsewhere in today's Federal Register. This notice includes threshold values and associated scores for each financial subindicator derived from generally accepted accounting principles (GAAP)-based financial information. This notice updates and clarifies the audit flags and tier classification chart.

DATES: Effective Date: **[Insert date 30 days after date of publication in the FEDERAL REGISTER].**

Comment Due Date: **[Insert date 60 days after date of publication in the FEDERAL REGISTER].**

ADDRESSES: Interested persons are invited to submit comments on this notice to the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, 451 7th Street, SW, Room 10276, Washington, DC 20410-0500.

Communications must refer to the above docket number and title. There are two methods for submitting public comments. All submissions must refer to the above docket number and title.

1. Submission of Comments by Mail. Comments may be submitted by mail to the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, 451 7th Street, SW, Room 10276, Washington, DC 20410-0500.

2. Electronic Submission of Comments. Interested persons may submit comments electronically through the Federal eRulemaking Portal at www.regulations.gov. HUD strongly encourages commenters to submit comments electronically. Electronic submission of comments allows the commenter maximum time to prepare and submit a comment, ensures timely receipt by HUD, and enables HUD to make them immediately available to the public. Comments submitted electronically through the www.regulations.gov website can be viewed by other commenters and interested members of the public. Commenters should follow the instructions provided on that site to submit comments electronically.

Note: To receive consideration as public comments, comments must be submitted through one of the two methods specified above. Again, all submissions must refer to the docket number and title of the rule.

No Facsimile Comments. Facsimile (FAX) comments are not acceptable.

Public Inspection of Public Comments. All properly submitted comments and communications submitted to HUD will be available for public inspection and copying between 8 a.m. and 5 p.m. weekdays at the above address. Due to security measures at the HUD Headquarters building, an advance appointment to review the public comments must be scheduled by calling the Regulations Division at 202-402-3055 (this is not a toll-free number). Individuals with speech or hearing impairments may access this number via TTY by calling the Federal Information Relay Service, toll-free, at 800-877-8339. Copies of all comments submitted are available for inspection and downloading at <http://www.regulations.gov>.

FOR FURTHER INFORMATION CONTACT: Claudia Yarus, Department of Housing and Urban Development, Office of Public and Indian Housing, Real Estate Assessment Center (REAC), 550 12th Street, SW, Suite 100, Washington, DC 20410 at 202-475-8830 (this is not a toll-free number). Persons with hearing or speech impairments may access this number through TTY by calling the toll-free Federal Information Relay Service at 800-877-8339. Additional information is available from the REAC Internet site at <http://www.hud.gov/offices/react/>.

SUPPLEMENTARY INFORMATION:

I. Purpose of this Notice

The purpose of this notice is to provide information about the scoring process for PHAS indicator #2, financial condition, under the PHAS interim rule published elsewhere in today's Federal Register. The purpose of the financial condition indicator is to measure the financial condition of each public housing project.

II. Background

A. Financial Condition Indicator Regulatory Background

To reflect a shift from a PHA-wide based assessment to one that is property based, HUD is revising the Financial Assessment Sub-System for public housing (FASS-PH) Financial Data Schedule (FDS) and financial condition scoring process. Project-based management is defined in 24 CFR 990.115 as “the provision of property management services that is tailored to the unique needs of each property.” PHAs must also implement project-based budgeting and project-based accounting, which are essential components of asset management. Project-based accounting is critical to a property-based assessment of financial condition, because it mandates the submission of property-level financial data. Accordingly, under the interim rule published

elsewhere in today's Federal Register, PHAs will now be scored at a property level, using the already designated projects as the basis for assessment.

HUD will assess the financial condition of projects. Project financial performance will be scored and averaged across the PHA, weighted according to unit count. The projects within a PHA will be evaluated and scored based on the project's performance relative to industry standards.

B. Comparable Scoring Systems

The financial condition subindicators are not unique to public housing. The subindicators included in the financial condition indicator scoring process are common measurements used throughout the multifamily industry to rank properties and identify the properties that require further attention.

III. Transition to Asset Management and Frequency of Financial Condition Submissions

The number of units in a PHA's Low-Rent program and the PHAS designation for small PHAs will determine the frequency of financial condition submissions during and after the transition to asset management. Pursuant to § 902.13(a) of the PHAS interim rule, the deregulation of small PHAs provides that PHAs with fewer than 250 public housing units will receive a PHAS assessment, based on its PHAS designation, as follows:

- (1) A small PHA that is a high performer will receive a PHAS assessment every 3 years;
- (2) A small PHA that is a standard or substandard performer will receive a PHAS assessment every other year; and
- (3) All other small PHAs will receive a PHAS assessment every year, including a PHA that is designated as troubled or Capital Fund troubled in accordance with § 902.75.

In the first year of implementation of the interim PHAS rule, the baseline year, every PHA will receive an overall PHAS score and in all four of the PHAS indicators: physical condition; financial condition; management operations; and Capital Fund program. This will allow a baseline year for the small deregulated PHAs.

IV. Subindicators

A. Subindicators of the Financial Condition Indicator

There are three subindicators that examine the financial condition of each project. The values of the three subindicators, derived from the FDS submitted by the PHA, comprise the overall financial assessment of a project. The three subindicators of the financial condition indicator are:

- Quick Ratio (QR);
- Months Expendable Net Assets Ratio (MENAR); and
- Debt Service Coverage Ratio (DSCR).

B. Description of the Financial Condition Subindicators

The subindicators are described as follows:

Subindicator #1, QR. This subindicator is a liquidity measure of the project's ability to cover current liabilities. It is measured by dividing adjusted unrestricted current assets by current liabilities. The purpose of this ratio is to indicate whether a project could meet all current liabilities if they became immediately due and payable. A project should have available current resources equal to or greater than its current liabilities in order to be considered financially liquid. The QR is a commonly used liquidity measure across the industry. Maintaining sufficient liquidity is essential for the financial health of an individual project.

Subindicator #2, MENAR. This subindicator measures a project's ability to operate using its net available, unrestricted resources without relying on additional funding. It is computed as the ratio of adjusted net available unrestricted resources to average monthly operating expenses. The result of this calculation shows how many months of operating expenses can be covered with currently available, unrestricted resources.

Subindicator #3, DSCR. This subindicator is a measure of a project's ability to meet regular debt obligations. This subindicator is calculated by dividing adjusted operating income by a project's annual debt service payments. It indicates whether the project has generated enough income from operations to meet annual interest and principal payment on long-term debt service obligations.

V. GAAP-based Scoring Process and Elements of Scoring

A. Points and Threshold

The financial condition indicator is based on a maximum of 25 points. In order to receive a passing score under this indicator, a project must achieve at least 15 points, or 60 percent of the available points under this indicator.

B. Scoring Elements

The financial condition indicator score provides an assessment of a project's financial condition. Under the PHAS financial condition indicator, HUD will calculate an overall score based on the unit weighted average score for each project. In order to compute an overall financial condition score, an individual project financial condition score is multiplied by the number of units in each project to determine a "weighted value." The sum of the weighted values is then divided by the total number of units in a PHA's portfolio to derive the overall PHAS financial condition indicator score. The three subindicator scores are produced using

GAAP-based financial data contained in the FDS. The minimum number of points (zero) and the maximum number of points (25) can be achieved over a range of values.

Subindicators	Measurement of	Points
QR	Liquidity	12.0
MENAR	Adequacy of reserves	11.0
DSCR	Capacity to cover debt	2.0
Total		25.0

QR

A project will receive zero points when its QR is less than 1.0. If its QR equals 1.0, it will receive 7.2 points. If its QR is greater than 1.0 and less than 2.0, it will receive greater than 7.2 points but less than 12.0 points, on a proportional basis. A project will receive the maximum of 12.0 points when its QR is equal to or greater than 2.0.

QR Value	Points
<1.0	0.0
1.0	7.2
>1.0 but <2.0	>7.2 but <12.0
≥2.0	12.0

MENAR

A project will receive zero points when its MENAR is less than 1.0. If its MENAR equals 1.0, it will receive 6.6 points. If its MENAR is greater than 1.0 and less than 4.0, it will receive greater than 6.6 points but less than 11.0 points, on a proportional basis. A project will receive the maximum of 11 points when its MENAR is equal to or greater than 4.0.

MENAR Value	Points
<1.0	0.0
1.0	6.6
>1.0 but <4.0	>6.6 but <11.0
≥4.0	11.0

DSCR

A project will receive zero points when its DSCR ratio is less than 1.0. If its DSCR equals at least 1.0 but less than 1.25, it will receive 1 point. A project will receive the maximum of 2.0 points if its DSCR is equal to or greater than 1.25 or if it has no debt at all.

DSCR Value	Points
<1.0	0.0
≥1.0 but <1.25	1.0
≥1.25	2.0
No Debt Service	2.0

VI. Audit Adjustment

Pursuant to § 902.30, HUD calculates a revised financial condition score after it receives audited financial information. The revised financial condition score, which is based on the audited information, can increase or decrease the initial PHA-wide score that was based on the unaudited financial information. The audited score reflects two types of adjustments. The first type is based on audit flags and reports the result from the audit itself. Significant deficiencies and material weaknesses are considered to be audit flags, alerting the REAC to an internal control deficiency or an instance of noncompliance with laws and regulations. The second adjustment type addresses significant differences between the unaudited and audited financial information reported to HUD pursuant to § 902.30.

Audit Opinion and Flags

As part of the analysis of the financial health of a PHA, including assessment of the potential or actual waste, fraud, or abuse at a PHA, HUD will look to the Audit Report to provide an additional basis for accepting or adjusting the financial component scores. The information collected from the annual Audit Report pertains to the type of audit opinion; details of the audit opinion; and the presence of significant deficiencies, material weaknesses, and noncompliance.

If the auditor's opinions on the financial statements and major federal programs are anything other than unqualified, points could be deducted from the PHA's audited financial score. The REAC will review audit flags to determine their significance as it directly pertains to the assessment of the PHA's financial condition. If the flags have no effect on the financial components or the overall financial condition of the PHA as it relates to the PHAS assessment, the audited score will not be adjusted. However, if the flags have an impact on the PHA's financial condition, the PHA's audited score will be adjusted according to the seriousness of the reported finding.

These flags are collected on the Data Collection Form (OMB approval number 2535-0107). The PHA completes this form for audited submissions. If the Data Collection Form indicates that the auditor's opinion will be anything other than unqualified, points can be deducted from the financial condition score. The point deductions have been established using a three-tier system. The tiers give consideration to the seriousness of the audit qualification and limit the deducted points to a reasonable portion of the PHA's total score.

Audit Flag Tiers

Audit flags are assigned tiers, as stated in the following chart.

<u>Audit Flags and Tier Classifications</u>		
Audit Flags	Tier Classification	Comments
Financial Statement Audit Opinion(s):		
1. Unqualified opinion(s)	None	
2. Qualified opinion(s) <ul style="list-style-type: none"> • Departures from GAAP not significant enough to cause an adverse opinion(s) • Limitations on the scope of the audit (regardless of cause) not significant enough to cause a disclaimer of opinion 	Tier 2	<i>Deduction only if the departure includes the Low Rent or Capital Fund programs</i>

<u>Audit Flags and Tier Classifications</u>		
Audit Flags	Tier Classification	Comments
3. Adverse opinion(s) regardless of reason(s)	Tier 1	
4. Disclaimer of opinion(s) regardless of reason(s)	Tier 1	
Opinion(s) on Supplemental Information (Statement of Auditing Standard (SAS) 29 “in relation to” type of opinion):		<i>Applies to the FDS</i>
1. Fairly stated	None	
2. Fairly stated except for:	Tier 2	
3. No opinion	Tier 1	
4. Incomplete or missing	Tier 1	
Report on Internal Control and Compliance and Other Matters Noted in an Audit of the Financial Statement performed in accordance with Government Auditing Standards (GAS) (Yellow Book):		<i>Deduction applies only if the internal control deficiency and/or noncompliance relates to the Low Rent or Capital Fund programs</i>
1. Control deficiencies <ul style="list-style-type: none"> • Significant deficiencies • Material weakness 	Tier 3	
2. Material noncompliance	Tier 3	
3. Fraud	Tier 3	
4. Illegal acts	Tier 3	
5. Abuse	Tier 3	
Report on Compliance with Requirements Applicable to Major Federal Programs and Internal Control over Compliance with OMB Circular A-133 <u>Opinion on compliance with each major federal program requirements</u>		
1. Unqualified opinion(s) on compliance with Low Rent program and Capital Fund program major federal requirements	None	
2. Qualified opinion(s) on compliance with Low Rent Program program and Capital Fund program major federal requirements (regardless of cause)	Tier 2	

<u>Audit Flags and Tier Classifications</u>		
Audit Flags	Tier Classification	Comments
3. Adverse opinion(s) on compliance with Low Rent program and Capital Fund program major federal requirements (regardless of cause)	Tier 1	
4. Disclaimer of opinion(s) on compliance with Low Rent Program and Capital Fund program major federal requirements (regardless of cause)	Tier 1	
<u>Internal Controls and Compliance</u>		
1. Control Deficiencies: <ul style="list-style-type: none"> • Significant deficiencies in internal controls over compliance with Low Rent program and Capital Fund program requirements • Material weakness in internal controls over compliance with Low Rent program and Capital Fund program requirements 	Tier 3	
2. Material noncompliance with Low Rent program and Capital Fund program requirements	Tier 3	
Other Consideration:		
1. Significant change penalty deduction applies only if the significant change(s) relate to the Low Rent or Capital Fund programs	Tier 2	
2. Going concern	Tier 1	
3. Management Discussion and Analysis and other supplemental information omitted	Tier 2	
4. Financial statements using basis other than GAAP	Tier 1	

Each tier assesses point deductions of varying severity. The following chart illustrates the point schedule:

Tier	PHAS Points Deducted
Tier 1	Any Tier 1 finding assesses a 100 percent deduction of the PHA's financial condition indicator score.
Tier 2	Any Tier 2 finding assesses a point deduction equal to 10 percent of the unadjusted financial condition indicator score.
Tier 3	Each Tier 3 finding assesses a 0.5 point deduction per occurrence, to a maximum of 4 points of the financial condition indicator score.

Review of Audited Versus Unaudited Submission

The purposes of comparing the ratios and scores from the unaudited FDS submission to the ratios and scores from the audited submission are to:

- Identify significant changes in ratio calculation results and/or scores from the unaudited submission to the audited submission;
- Identify PHAs that consistently provide significantly different data from their unaudited submission in their audited submission; and
- Assess or alleviate penalties associated with the inability to provide reasonably accurate unaudited data within the required time frame.

This review process will be performed only for the audited submissions.

Significant Change Penalty

HUD views the transmission of significantly inaccurate unaudited financial data as a serious condition. Therefore, projects are encouraged to assure that financial data is as reliable as possible for their unaudited submissions.

A significant change penalty will be assessed for significant differences between the unaudited and audited submissions. A significant difference is considered to be an overall financial condition score decrease of three or more points from the unaudited to the audited submission. A significant change penalty is considered a tier 2 flag and will result in a reduction of 10 percent of the total audited financial condition score.

The PHAS system automatically deducts the significant change penalty from the audited

score, and this reduction triggers the REAC analyst's review. REAC may waive the significant change penalty if the project provides reasonable documentation of the significant difference in its submission.

Dated: February 1, 2011

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Sandra B. Henriquez
Assistant Secretary for Public and Indian Housing

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