CHAPTER 1.        INTRODUCTION

1-1. PURPOSE

This Handbook provides procedures for reviewing annual and monthly financial statements submitted on multifamily projects. The procedures are designed exclusively for Asset/Loan Management staff to use in reviewing financial statements submitted by owners of projects with HUD-insured, co-insured, or HUD-held mortgages.

1-2. SCOPE

This Handbook explains how to use annual and monthly financial statements to determine if a project has complied with HUD requirements and the terms of any mortgage relief or subsidy contracts, check for diversion of project assets, and assess a project's past performance and future needs. The Handbook also provides procedures for checking the accuracy and completeness of the statements and for managing the process of obtaining and reviewing the statements. Not all the review steps included in this Handbook will need to be completed on every financial statement. Chapter 2, Section 1 gives the Asset/Loan Management Branch Chief discretion to vary the scope of the review according to the condition of the project and the performance of the project owner, management agent, accountant, and Cooperative Board of Directors.

This Handbook does not advise owners or accountants how to prepare financial statements. Guidance on these topics is provided in the publications mentioned in the Foreword to the Handbook.

1-3. LEGISLATIVE AUTHORITY

A. Sections 207, 213, 220, 221, 223, 231, 232, 236, 241, 242, and Title XI of the National Housing Act as Amended, Section 8 of the U.S. Housing Act of 1937, and Section 202 of the Housing Act of 1959. Provisions of these acts include the following:

1. HUD provides direct long term loans to eligible, private or public not-for-profit sponsors to finance rental or cooperative housing facilities for occupancy by elderly or handicapped persons (Section 202).

2. HUD insures mortgages made by private lending institutions to build or rehabilitate multifamily rental or cooperative housing a) for moderate income or displaced families (Section 221); b) suited to the needs
of the elderly or handicapped (Section 231); c) to accommodate 20 or more patients requiring skilled nursing care and related medical services (Section 232); d) for the treatment of persons who require medical care furnished only, or most effectively, by hospitals (Section 242); e) for group practice medical facilities to relieve overburdened hospitals and nursing homes (Title XI); and f) by private or public developers that contain at least five dwelling units (Section 207).

3. HUD insures loans made by private lending institutions to pay for improvements to apartment projects, nursing homes, hospitals, or group practice facilities that carry HUD-insured mortgages (Section 241).

4. HUD insures mortgages to purchase or refinance existing projects originally financed with or without Federal mortgage insurance (Section 223(f)).

5. The secretary is authorized to make periodic interest reduction payments on behalf of the owner of a project designed for lower income families (Section 236).

6. Public Housing Agencies (PHAs) administer programs to assist low-income families obtain safe and affordable housing. The PHA selects landlords to rehabilitate properties to meet certain safety and sanitation standards. HUD then subsidizes the rental payments for eligible tenants. The various assistance programs authorized under Section 8 include Lower Income Rental Assistance, Existing Housing Voucher, Certificate programs, New Construction, Substantial Rehabilitation, Special Allocations (Loan Management Set Aside), Farmer's Home (515), and Section 202/8 programs. Of these, this Handbook applies only to projects whose mortgages are insured or held by HUD.

B. Sections 2 and 4 of the Inspector General Act of 1978. The HUD Inspector General (IG) has the statutory responsibility to

conduct, supervise, and coordinates audits and investigations relating to HUD's programs and operations. The IG also provides leadership and recommends policies designed to promote economy, efficiency, and effectiveness and to prevent fraud and abuse.

C. Section 108 of the HUD Reform Act of 1989. The Secretary may impose a monetary penalty on any owner of a multifamily property who has agreed to use nonproject income to pay
project liabilities or to make cash contributions for payment due under the mortgage but who fails to do so. A monetary penalty may also be imposed for any violation of the regulatory agreement, including failure to maintain books and accounts of the project according to requirements prescribed by the Secretary.

D. Section 42, Internal Revenue Code of 1986, as amended Low Income Housing Credits. This section authorizes tax credits for low income housing meeting certain criteria. Current and prospective owners may not receive excessive profits or subsidies or create undue mortgage insurance risks by combining Low Income Housing Tax Credits (LIHTC) with other HUD programs. HUD requires a review of all cases that use LIHTCs.

E. Sections 416 and 421 of the Housing and Community Development Act of 1987, Misuse and Diversion of Funds. These sections impose specific sanctions and penalties for the misuse and diversion of funds and for the violation of regulatory agreements and other applicable regulations. Penalties may include 1) a fine of up to $250,000 or imprisonment for up to five (5) years, or both, or 2) requesting the U.S. Attorney General to recover any assets or income of the violator.

1-4. GOALS OF FINANCIAL ANALYSIS

Effective financial statement analysis can assist the Department in achieving the goals of asset management (loan servicing). The objectives of financial analysis as related to asset management in general are discussed below.

A. Financial health of project. The financial health of a project is determined by its stability and the quality of service it provides. To provide stability, rents must be set at levels sufficient to

cover debt service on the loan, the cost of operating a project, and allow a reasonable return on equity (distributions) to owners when permitted. As inflation pushes up operating expenses, rents must be increased. The Asset Management (Loan Management) staff's objective is to keep rent increases to necessary amounts and to minimize the impact of the increase on lower-income residents. The staff does this in many ways. This handbook describes analyses of financial statements. When analyzing a project's financial data, the Asset Management staff must determine which projects need subsidies and recommend scarce subsidies in accordance with the relative needs of the projects. Once HUD has allocated subsidies to a project,
Asset/Loan Management staff must monitor the project to make sure it is fully using the subsidies. HUD reallocates funds among projects as necessary to ensure full usage of limited subsidy funds.

Providing quality housing is as important as providing affordable housing. While low rents enable more people to afford housing, the housing must be of adequate quality. The Asset Management staff contributes to this end by assisting or permitting owners to achieve a sufficiently high rent potential to maintain the project by ensuring that money is not being diverted for expenses not essential to the operation of the project. To provide more operating funds, the staff also may help the owner obtain a rent increase or a mortgage relief.

B. Protect the FHA Insurance Fund. When projects with HUD-insured loans fail to make their payments, the mortgagee may decide to assign the mortgage to the Secretary. When this happens, HUD must use Federal funds to pay the mortgagee the balance due on the FHA-insured loan (with certain adjustments). The Asset/Loan Management staff can help protect the FHA insurance fund by monitoring the project's physical and financial status and providing solutions to current and anticipated physical and financial problems. When assignment claims cannot be avoided, the Asset/Loan Management staff can still help reduce government losses by quickly negotiating a workout or repayment plan with the project owner. A workout plan can enable the owner to pay back to HUD the amount due under the note and mortgage. The staff can also recommend timely foreclosure so that HUD can acquire and resell the project and minimize its losses in that way.

C. Ensure that rental revenue and federal subsidies are used properly. If funds are used for other than necessary and reasonable expenses of operating the project, the tenants will not fully benefit from HUD's housing programs. If funds are diverted for unauthorized purposes, there may not be sufficient remaining funds to maintain the project, or tenants' rents may be set higher than they should be. Asset/Loan Management staff can help avoid these situations by reviewing the financial statements carefully to identify instances where funds have been diverted improperly or are not being used in compliance with previous agreements.

D. Compliance with Regulatory Agreement and subsidy contracts. Compliance with regulatory agreements and specific subsidy contracts is essential to providing decent, safe, and affordable
housing to all eligible tenants and maintaining a financially sound project with the ability to sustain future operations. To ensure compliance with such agreements and contracts, the Asset/Loan Management staff must:

1. Review the auditor's Report on Compliance to ascertain if any compliance deficiencies were noted.

2. Perform tests of the financial statements and accompanying notes to assess an owner's compliance with HUD requirements and controlling agreements with respect to:
   - funded reserves,
   - security deposits,
   - residual receipts,
   - management fees,
   - excess rental charges,
   - property maintenance,
   - ownership of the project,
   - Flexible Subsidy assistance, and
   - Other subsidies, such as Section 8.