
 CHAPTER 2. REVIEWING ANNUAL STATEMENTS

SECTION 1. Managing the Review Process

2-1. INTRODUCTION

The Asset/Loan Management Branch Chief is responsible for managing the annual review process described in the following sections of this chapter. The Branch Chief must ensure that:

- o The automated Multifamily Information Processing System (MIPS) is used to monitor the receipt and review of financial statements.
- o Workload is appropriately distributed among staff.
- o Both the timeliness and the quality of the review are monitored.
- o Full reviews are performed when necessary.
- o Appropriate follow-up actions are taken.

This handbook is intended to provide guidance to HUD staff for reviewing annual and monthly financial statements of mortgagors with projects under the following HUD programs:

- o 202 Direct Loans for Housing for the Elderly or Handicapped
- o 207M Mobile Home Courts
- o 207 Multifamily Rental Housing, Pre-War Legislation and formerly HUD-held mortgages sold with insurance
- o 207/223(c) Formerly HUD-owned projects
- o 213S Sales and Investor Cooperatives
- o 213M Management Cooperatives
- o 213(i) Consumer Cooperatives
- o 220 Urban Renewal/Declining Area Rental Housing
- o 221(d) (3) Market Rate, Moderate Income Families
- o 221(d) (4) Market Rate, Moderate Income Families
- o 221(d) (5) Below Market Interest Rate ("BMIR")
- o 221(h) Rehab. Sales Projects
- o 223(e)/220 Rehab./Refinance Existing, Declining Neighborhood
- o 223(f)/207 Purchase/Refinancing Existing Housing
- o 231 Housing for the Elderly
- o 232 Nursing Homes, Intermediate Care Facilities
- o 233 Experimental Housing

- o 236 Housing for Lower Income Families
- o 241 Supplemental Loans (Capital

- o 242 Improvement/Equity Takeout)
- o 242 Hospitals
- o Title XI Group Practice Facilities

2-2. SUBMISSION REQUIREMENTS

HUD Handbooks 4370.2 and 4350.1 provide detailed guidance as to which owners must submit financial statements and the type of statements that are required. If prior to the expiration of the fiscal year established, the project is opened and enjoys occupancy for a period of 30 days or longer, the first annual statements are prepared as of the end of that fiscal period. If there is no occupancy or if the initial occupancy occurs less than 30 days prior to the end of the fiscal year, the annual statements are not required until the end of the next fiscal year.

- A. Generally, unless another date is approved by HUD, the reports are due no later than 60 days following the end of each fiscal year. Branch Chiefs may extend the submission date, but should do so only when the delay was caused by circumstances beyond the control of the owner (e.g., If owner can show that it could not get an IPA because of tax season conflict. This would not be an acceptable reason if the project's fiscal year ends 12/31). When an extension is granted, the new deadline must be entered into the MIPS Application 5.3a, "Financial Statement Date Tracking." Extensions should not be approved when the delay is due to the owner's failure to maintain adequate records or to obtain the services of a CPA and execute engagement letters early on. Owners should execute engagement letters well in advance of the end of the fiscal year and should specify a delivery date prior to the 60-day submission deadline.
- B. Appendix 1 contains a sample letter that may be used in notifying owners of requirements for the first annual statements, including any special statements required. Appendix 2 contains a sample letter that may be used to remind owners of approaching submission dates.

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2-3. TIMEFRAMES FOR HUD REVIEWS

Ideally, all financial statements should be reviewed within 60 days of receipt. Unfortunately, since most projects operate on a calendar fiscal year and the majority of their statements are due February 28, the 60-day goal is not always reasonable. If the Field Office cannot review all statements within the 60-day timeframe, the Branch Chief should ensure that statements are reviewed at least within the following timeframes:

- A. All reports must be checked for completeness, in accordance with the steps in Section 2 of this chapter, within 30 days of receipt of the report.
- B. Financial statements submitted on troubled projects must be analyzed within 60 days of receipt of the report.
- C. Financial statements submitted on non-troubled projects must be analyzed within 120 days of receipt of the report.

2-4. MONITOR SUBMISSION AND REVIEW TIMEFRAMES

Appendix 3 shows MIPS output reports the Branch Chief should use to monitor the receipt and review of the annual statements. The reports will identify projects which have statements coming due during the quarter, financial statements which are past due, and financial statements which have been received but not reviewed. MIPS contains a data element to track follow-up activities related to the review of the annual statements (See MIPS Application 5.3a, "Financial Statement Date Tracking"). Appendix 4 contains a sample follow-up letter that may be used for overdue statements.

2-5. SCOPE OF REVIEW

The following sections of this chapter provide detailed procedures for reviewing annual statements for completeness, compliance, and performance. In some instances, every procedure may not need to be performed. In such cases, the Branch Chief may reduce the scope of the review if the reduced level of review will not jeopardize the Secretary's interests.

- A. The following review procedures must be completed on every set of financial statements.

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1. Completeness check. Does it contain all required statements, supplemental data, an auditor's opinion in proper form and the Owner/Management Agent Certification?
 2. Review of financial statements and auditor's report to determine basis of accounting. Is the accrual basis of accounting used?
 3. Review of auditor's opinion, report and supplemental data, particularly the auditor's comments on the internal control structure and compliance with HUD's requirements. Has the auditor reported any internal control problems, any diversions, any noncompliance with HUD requirements?

4. Independent completion or check of the IPA's Computation of Surplus Cash, Distributions and Residual Receipts. Have distributions been paid in excess of the amount permitted by the regulatory agreement? Is a residual receipts deposit required? Is the amount of accrued distributions accurate?
 5. Review of financial statements for unauthorized distributions to owners or loans to individuals, related projects, or other businesses.
 6. Review of rent collection effort, liquidity and bottom line cash throw-off. Is the revenue earned sufficient to cover operating expenses incurred or expenses anticipated for the coming year? Does the project have enough cash to meet its accrued obligations as they become due?
- B. The compliance and diversion checks may not be reduced when:
1. The IPA has detected excess distributions or major diversions,
 2. The owner, management agent, or both have a record of diversions or major noncompliance with HUD requirements on this or other projects, or

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3. The mortgage is in default or has been chronically delinquent.
- C. Checks for compliance and diversions may be reduced only if the audit:
1. Has been performed by an IPA whose audit work, on this and other projects, has consistently been accurate, and
 2. Has been performed in compliance with HUD requirements and AICPA auditing standards.
- 2-6. QUALITY CONTROL
- The Branch Chief should establish and maintain a supervisory review system which monitors the quality of the IPA's annual reports and the Asset/Loan Management staff's analysis of the reports.
- A. IPA's annual reports that contain obvious errors or that appear

lacking in professionalism should be suspect. If a reasonable standard of care is not taken in the report preparation, the underlying work may reflect a similar lack of quality. The converse, however, is not necessarily true; fancy covers and cosmetically perfect statements do not guarantee quality. The Field Office should establish an IPA monitoring file and place in that file copies of the IPA's substandard work and any correspondence discussing that work. (See Chapter 4 of this handbook for more information about monitoring IPA's.)

- B. The scope or intensity of the supervisory review may vary according to the:
- o Grades and experience of the HUD staff.
 - o Condition of the projects.
 - o Past experience of the owner and the management agent.
- C. The supervisory review should be designed to ensure that:
1. Asset/Loan Management staff have completed the level of review mentioned in this Section.

2. Asset Management staffs findings are consistent with the facts in the financial statements, the IPA's opinion and supplemental data, the MIPS flags, and other information in the servicing file (especially Office of Inspector General (OIG) audits and on-site reviews).
3. Asset Management staff's recommendations are appropriate to the problems noted; that is, the recommended actions will get to the cause of the problems and bring about corrective action.
4. The severity of enforcement actions is commensurate with the violation.
5. Tickler files are established to ensure timely monitoring of required follow-up actions.

SECTION 2. Evaluating Adequacy of Statements

2-7. INTRODUCTION

The first step in the review process is to determine if the financial statements are complete. Incomplete statements not only violate the regulatory agreement, but also give the reviewer a distorted or inadequate picture of the financial stability of the project. A simple checklist will indicate immediately the completeness of the

statements. Before the statements are reviewed, it is necessary to load the project's revenue and expense data to update the MIPS system. Updated reports from MIPS should be used by the Asset/Loan Management staff in the review process.

2-8. CHECK TO SEE IF THE STATEMENTS ARE COMPLETE

The statements must be signed and must contain the basic financial statements and supplemental data required by HUD Handbook 4370.2, Financial Operations and Accounting Procedures for Insured Multifamily Projects. The Asset/Loan Management staff may use Form HUD-93484, "Annual Financial Statement Completeness Checklist", to document the completeness review. Form HUD-93484 is shown in Appendix 5.

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A. Basic Financial Statements. Before any meaningful review of the financial statements can begin, the report must contain the following basic financial statements:

- o Statement of Financial Position (also known as Balance Sheet), including a Statement of Changes in Owner's Equity.
- o Statement of Income (Form HUD-92410)
- o Statement of Cash Flows
- o Statement of Retained Earnings

NOTE (1): If the change in the owner's equity account consists only of the net profit or loss of the project during the year, the change may be noted on the Balance Sheet in lieu of including a separate Statement of Changes in Owner's Equity. If, however, the owner has made contributions or taken distributions during the year covered by the statement, a separate Statement of Changes in Owner's Equity should be included with the financial statements.

NOTE (2): The basic financial statements have notes which contain explanatory information relative to the owner organization and policy changes affecting the preparation of financial statements and account balances, as well as significant accounting policies that have been followed in the preparation of the financial statements by the owner's accountant. In addition, the notes should indicate the type of Section 8 project, if applicable, and the basis for computation of any distributions shown.

B. Supplemental Data. The following list identifies the

supplemental data (Schedules) that the owner is normally required to include with the financial statements. The supplemental data provides support and detail for the specific accounts shown on the basic financial statements. (See Handbook 4370.2, Chapter 3 for a description of the supplemental data listed below.)

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- o Accounts and Notes Receivable (other than from regular tenants)
- o Delinquent Tenant Accounts Receivable
- o Owner Escrow Deposits
- o Tenant Deposits
- o Reserve Funds
- o Accounts Payable (other than Trade Creditors)
- o Notes Payable (other than mortgage)
- o Surplus Cash, Distributions and Residual Receipts
- o Accrued Taxes
- o Compensation of Partners or Officers
- o Unauthorized Distribution of Project Income
- o Changes in Fixed Asset Accounts
- o Stock Activity Reports (initial report only)
- o Listing of Identity of Interest Companies and Activity
- o Donations, Subsidy Payments, Founders Fees (Nonprofit Elderly Housing only)

The Asset/Loan Management staff uses the supplemental data when reviewing the financial statements for compliance with HUD agreements and for possible diversion of project assets, as well as when evaluating the project's performance over the past year.

1. When reviewing the supplemental data for completeness, the Asset Management staff should be aware that supplemental data normally included as a separate statement or schedule may be included elsewhere in the financial statements - i.e., in the notes to the financial statements or in the auditor's findings on compliance and internal controls.
2. To review effectively a financial statement from a compliance as well as a performance perspective, Asset Management staff should have available all of the supplemental data required. However, certain checks for compliance or diversions are not contingent upon all the schedules being included in the supplemental data. For example, while the staff would not need the "Schedule of Delinquent Tenants Accounts Receivable" to review the owner's compliance in the handling of

tenant security deposits, the staff would need this schedule to evaluate the rent collection procedures of the project. In addition, the supplemental data is not needed when reviewing the auditor's opinion. Although missing schedules in the supplemental data should always be requested from the owner, the Asset/Loan Management staff should not stop or delay the review of the financial statements until the missing schedules(s) are received.

The missing data should be requested by using procedures detailed below.

- C. Owner/Management Agent Certification. The financial statements must contain a certification, signed by the owner, and management agent if applicable, stating that the owner and management agent have reviewed the financial statements and consider them to be complete and accurate. The management agent's certification should identify the individual, as well as the company responsible for management. The management agent is required to certify the financial statements so that the Department can identify any affiliations, interests or relationships that the agent may have with the owner or other management firms that do business with the Department. In addition to the management agent, if applicable, the following persons must certify the financial statements:
1. If the project is owned by an individual, the owner must certify.
 2. If the project is a corporation, two officers, one of which must be the president, must certify.
 3. If the project is a cooperative, two members of the Board of Directors, including the president, must certify.
 4. If the project is a limited partnership, two or more general partners must certify if there is more than one general partner.
 5. If the project is a general partnership, all joint venturers or partners must certify.

6. If the project is owned by a trust, the trustee and appropriate beneficiaries must certify.

- D. Accountant's Certification. The auditor's report must be manually signed by the firm (or individual practitioner) responsible for the audit; the auditor's name must not be simply printed or typed on the report. The auditor must be an Independent Public Accountant (IPA). An IPA is a Certified Public Accountant (CPA) or a licensed or registered public accountant (licensed or registered on or before December 31, 1970). In states that do not regulate the use of the title "public accountant", only Certified Public Accountants may be used to make these audits. The IPA must have no business relationship with the owner or management agent except for the performance of the audit, systems work and tax preparation. Opinions or reports signed by the project's bookkeeper, whether a CPA or licensed public accountant, are not acceptable. The whole purpose of an audit is to have an independent, objective third party determine whether the owner's financial statements are accurate; a project's bookkeeper does not qualify as an independent party.

2-9. MISSING COMPONENTS OF FINANCIAL STATEMENTS

Form HUD-93484, "Annual Financial Statement Completeness Checklist", may be used to determine if any part of the financial statements is missing. If the financial statements are incomplete Asset/Loan Management staff should follow the steps below.

- A. Complete the form letter in Appendix 6 (page 1 of 2) and send it to the owner. A copy should also be sent to the management agent. A copy of the form letter should be placed in a tickler file so that appropriate follow-up will take place after the 15 working days allowed for a response.
- B. If no response is received after 15 working days, the Asset Management staff should prepare a follow-up letter which may state that unless the missing schedules are received within 10 working days of the letter, future requests for financial relief or releases from the Replacement Reserve Fund will be denied. A sample follow-up letter is included in Appendix 6 (page 2 of 2).

- C. If the missing schedules are not received within the 10 day period, the matter should be referred to the staff supervisor

who may consider the imposition of sanctions as discussed in Section 8 of this chapter.

2-10. UPDATE MIPS

Upon receipt of the complete annual financial statements, the Asset Management staff should record its receipt using MIPS Application 5.3a, "Financial Statement Date Tracking".

2-11. MIPS REPORTS

A. MIPS Application 5.3b, "Data Entry and Performance/Risk Analysis", allows the Asset Management staff to:

1. Input Financial Statement Data - Initiates display of a series of screens that prompts user to enter data directly from the Financial Statement.
2. Edit Financial Statement Data - Allows user to view and change financial data resident in the database.
3. Review Financial Statement Data - Allows user to review financial records resident in the database.
4. Reports - Allows user to display and generate financial reports.
5. Enter Supplemental Data for Analysis/Reports - Allows user to enter supplemental data which will be provided for the Risk analysis and Summary reports.

B. After financial data has been entered into MIPS, the Asset Management staff should:

1. Review the data for arithmetic errors, possible duplicate entries, and account classification errors.

2. Generate reports:

Computerized 92410, "Statement of Income"
Computerized 92558, "Income and Expense
Analysis"

Refer to Appendix 3 for a complete list of reports that can be generated by MIPS.

SECTION 3. Reviewing Financial Statements and Schedules

2-12. PROJECT SERVICING FILE

In preparation for the review of the annual financial statements, the Asset/Loan Management staff should review the Project's Servicing File to become familiar with both current and past aspects of the project's operation. Repeated reference to the servicing file may be necessary during review of the statements. Familiarity with the following areas will provide the background needed to properly analyze the annual statements.

A. Previous Year's Financial Statements.

What was the project's financial condition at the end of the last fiscal year? Consider tenant receivables, operating accounts payable, cash balance, and mortgage status.

1. Were the financial statements submitted in an acceptable form?
2. Was the project in a surplus cash position the previous year? What, if any, was the required deposit to the residual receipts account?
3. What were the problem areas, if any, on last year's statement? Were all issues resolved?
4. Was any repayment to project funds required as a result of last year's review? Was the required repayment received?

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B. Physical Inspection.

1. What was the physical condition of the project at the time of the last physical inspection or on-site management or occupancy review?
2. Can the project anticipate unusual or extraordinary expenses at this time?
3. Has the owner responded to the last inspection report?

C. Occupancy Review (if applicable).

1. Were there any areas of noncompliance noted in the last review that related to security deposits, unauthorized fees, or tenant files?
2. Has the owner responded to the review?

D. Management Review.

1. What was the overall management rating?
 2. What were the major management concerns?
 3. Did the review disclose any major weaknesses in the area of financial management?
 4. Has the owner responded to the review?
- E. Monthly Accounting Reports (Forms HUD-93479/80/81, if applicable).
1. What was the status of the project in recent months, covering the period after the end of the fiscal year?
 2. Is there a current cash flow problem?
 3. Is there a vacancy, collection, or liquidity problem?

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- F. Current Rent Schedule (Form HUD-92458).
1. What is the maximum gross potential rent approved by HUD?
 2. What was the effective date of the last rental increase?
- G. Relief Tools (e.g., Mortgage Modification, Flexible Subsidy).
1. Is the project currently under some form of mortgage relief? If so, for what time period?
 2. Is the project current under the terms of the relief agreement?
 3. What cash contribution, operating changes, waivers of distributions or other special concessions did the owner agree to in the management relief contract?
- H. OIG Audit (if applicable).
1. Has HUD requested an OIG Audit or Investigation on this project?
 2. Are there any outstanding findings?
- I. General Correspondence.
1. Are there any matters in the general correspondence

file which need to be addressed during the review of the annual statements?

2. Have tenant complaints focused on any particular area?

J. Experience with the Independent Public Accountant (IPA).

1. Did the IPA who prepared this year's statement prepare the previous year's statement on this project? Has the IPA prepared statements on other projects in your field office's portfolio?

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2. Has the IPA's past work been acceptable on this project and on other projects?

2-13. REQUIRED REPORTS

The following reports are required to be submitted along with the financial statements:

- A. Auditor's Report on Financial Statements
- B. Auditor's Report on the Internal Control Structure
- C. Auditor's Report on Compliance

The following reports also are required but they may be submitted independently from the financial statements:

- D. Auditor's Management Letter or Schedule of Findings and Questioned Costs
- E. Auditor's Comments on Audit Resolution Matters
- F. Auditee's Response or Corrective Action Plan

2-14. AUDITOR'S FINANCIAL REPORT LAYOUT

The auditor shall audit the books and records of the owner and shall furnish an opinion on the annual financial statements. HUD requires that the financial statements be prepared using the only accrual basis of accounting. The accrual basis of accounting is the method of accounting in which revenue is recognized when earned (regardless of when cash has been received) and expenses are recognized when incurred (regardless of when cash has been paid). If the owner or management agent has prepared the financial statements using a basis of accounting other than the accrual basis (i.e., cash basis or tax basis), the auditor should make the necessary accruals to convert the financial statements to the accrual basis so that they will be

acceptable for HUD's purposes.

The auditor's report must be in the form of a letter signed by the auditor. The body of the standard auditor's report should include

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paragraphs discussing the scope of the audit, generally accepted auditing standards and government auditing standards, and the opinion rendered on the statements and supporting data.

Components of the Auditor's Report on the Financial Statements

- o Title that reads "Independent Auditors Report".
 - o Introductory Paragraph that identifies the financial statements that were audited.
 - o Scope Paragraph that describes the nature and objective of an audit.
 - o Opinion Paragraph on Financial Statements that expresses the auditor's opinion as to whether the statements are fairly presented in all material respects, in conformity with GAAP.
 - o Opinion Paragraph on Supplemental Data that expresses the auditor's opinion as to whether the supplemental data is fairly presented in relation to the financial statements taken as a whole.
- A. In the scope paragraph(s), the auditor states that generally accepted auditing standards (GAAS), as well as government auditing standards (GAS) were observed in the performance of the audit.
1. GAAS refer to the ten auditing standards that have been approved and adopted by the members of the AICPA. GAAS are divided into three groups: (1) general standards, (2) standards of fieldwork, and (3) standards of reporting.
 2. GAS (which are issued by the U.S. General Accounting Office (GAO)) are standards for audits of government organizations, programs, activities, and functions, and of government funds received by contractors, nonprofit organizations, and other nongovernment organizations. GAS pertain to the auditor's professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports.
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It is important to realize that GAAS and GAS are only minimum guidelines for the performance of an audit engagement and therefore the auditor must constantly exercise professional judgment.

- B. In the opinion paragraph(s), the auditor states that:
1. The financial statements present fairly, in all material respects, the entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles (GAAP). GAAP are broad rules adopted by the accounting profession as guides in measuring, recording, and reporting the financial activities of a business.
 2. The supporting (supplemental) data has been subjected to the same auditing procedures applied to the basic financial statements and are presented fairly in all material respects in relation to the basic financial statements taken as a whole.

Refer to HB 4370.4, "Basic Accounting Desk Reference for HUD Loan Servicers" for an expanded explanation of GAAP and GAAS.

2-15. REVIEW OF AUDITOR'S REPORT ON FINANCIAL STATEMENTS

Asset/Loan Management staff should review the following items and document the results of the review on the Form HUD-93485, "Annual Financial Statement Review Worksheet", shown in Appendix 7.

- A. Scope. To be acceptable, this section must state that the auditor has audited each of the basic financial statements of the project for the period(s) indicated, in accordance with GAAS and GAS. Be alert to the following problems.
1. Unaudited Financial Statements - "The accompanying (statements) were not audited by us/me" followed by "I/we do not express an opinion on them", or similar wording such as "compiled by us", indicates unaudited financial statements. In these cases the statements have not been audited at all, but have merely been compiled

by the accountant who signed the report. (A compilation of financial statements is an accounting service in which an accountant prepares the financial statements without expressing any assurance that the statements are accurate and complete or are in conformity with GAAP.) Sometimes the reason, such as lack of independence, will be given. Financial statements that have been compiled, not audited, do not conform to HUD requirements. Furthermore, an auditor that has performed write-up work (bookkeeping) for the owner is not considered independent and therefore should not perform the audit.

2. Omission of Financial Statements - To be complete, the introductory paragraph should refer at least to the Balance Sheet, Statement of Income, Statement of Retained Earnings, and Statement of Cash Flows. If all of these are not included, the statements are incomplete and, therefore, do not conform to HUD requirements. The Statement of Changes in Owner's Equity may be incorporated into the Balance Sheet or the Notes to the Financial Statements, and, as such, are not always presented as a separate statement; therefore, its reference in the auditor's report is not always necessary.
3. Scope Limitation - In this situation, the auditor says that, for some stated reason, it was not possible to follow GAAS and GAS in all respects and, hence, the auditor's ability to express an opinion on the statements is limited. It's important to note that a scope limitation refers to the IPA's opinion about the financial statements and not the statements themselves. Audit reports containing scope limitations must be reviewed individually, not arbitrarily rejected. In most cases the limitation cannot be removed, so the statements presented are the best ones available. The most common example of a scope limitation in a HUD project occurs when some or all accounting records for the year are not complete and available. In this instance, an audited Balance Sheet is usually possible despite the IPA's scope limitation. However, if the scope limitation was caused by poor or missing records

Inspector General (OIG) to audit the project's records or, depending on the type of scope limitation involved, request the owner to ask the IPA to perform a special examination or further tests of selected account balances, statements, or schedules.

B. Opinion. Four types of audit opinions may be issued by the auditor: unqualified, qualified, adverse, or disclaimer. A qualified, adverse, or disclaimer of opinion is issued when deficiencies are encountered during the audit that prevent the issuance of the standard (unqualified) opinion. Deviation from this "standard" or "clean" opinion may be acceptable, but must always be explained in the auditor's report. The explanation, if not contained in the scope paragraph, may be usually given as a separate explanatory paragraph between the scope and opinion, and should be read carefully for its effect on the reliability of the statements.

1. Unqualified opinion is one in which the IPA states that the financial position of the owner entity at (date) is presented fairly.

When an unqualified report is issued, the auditor makes the following assurances:

- a. Accounting principles selected by the client have general acceptance.
- b. Accounting principles used are appropriate for the client.
- c. Disclosures, such as financial statement notes, are adequate to allow the user to use, understand, and interpret the financial statements.
- d. Data presented in the financial statements are classified and summarized in a reasonable manner.

- e. Underlying events and transactions, within a range of acceptable limits, are reflected in the financial statements.
- f. The financial statements have not been materially affected by changes in accounting principles.

Uncertainly. In the case of an uncertainty, an unqualified opinion may be issued and the auditor will modify the standard audit report by adding an

explanatory paragraph.

- o Uncertainty Related to Going Concern arises when the auditor concludes that there is substantial doubt about an entity's continued existence.
- o Uncertainty Unrelated to Going Concern arises when an auditor cannot collect sufficient competent evidence to support management's accounting estimates (i.e., there may be pending litigation or a question of cost recoverability for a particular project or investment).

The effects of an uncertainty on the auditor's report depends upon the probability of a material loss occurring, or the likelihood that the entity will cease to exist.

Lack of Consistency. Inconsistent treatment of an item from one year to the next, distorting comparability by a stated amount. An example of this would be the changing of liability accrual policies.

Where there is a material lack of comparability caused by a change in accounting principle, an explanatory paragraph follows the opinion paragraph, which remains unqualified.

An example of an unqualified opinion is shown in Exhibit 2-1.

2. Qualified opinion is issued when one of the following circumstances has a material impact on the financial statements:
 - a. Scope Limitation. Sufficient evidence cannot be collected because of engagement circumstances or restrictions imposed by the client. For example, poor or unavailable records for part or all of the year.
 - b. Departure from GAAP. Disagreement between auditor and management about the treatment or amount of an item, such as reserve for bad debts. An auditor cannot dictate the treatment of an item, therefore, if management disagrees, the auditor can only comment upon it in the report.

When a qualified opinion is expressed, the auditor's report should include an explanation that describes the reasons for the qualified opinion, including the effects or potential effects of the qualification on the financial statements. If the effects are fully described in a note(s) to the financial statements, they can be incorporated in the auditor's report by reference to the note(s). The opinion paragraph will say that statements are fairly presented "except for..." or "with the exception of.." the explanation(s) noted. An example of a qualified opinion is shown in Exhibit 2-2.

Exhibit 2-1: Independent Auditor's Report - Unqualified Opinion

To the Partners
ABC Partnership
Anytown, U.S.A.

We have audited the accompanying balance sheet of ABC Partnership, HUD Project No. 0xx-44007LD (a limited partnership), as of (date), and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Partnership at (date), and the results of its operations and its cash flows and its analysis of net worth for the year then ended in conformity with generally accepted accounting principles.

Our audit was conducted for the purpose of forming an opinion on the financial statements taken as a whole. The supporting information included in the report (shown on pages XX to XY) are presented for the purposes of additional analysis and are not a required part of the basic financial statements of the ABC Partnership. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly presented in all material

respects in relation to the financial statements taken as a whole.

Anytown, U.S.A.
(date)

XYZ and Company
Certified Public Accountants

Note: Comparative financial statements are encouraged. Guidance is provided at AU 508.74-83.

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Exhibit 2-2: Independent Auditor's Report - Qualified Opinion

To the Partners
ABC Partnership
Anytown, U.S.A.

We have audited the accompanying balance sheet of ABC Partnership, HUD Project No. 042-44998 (a limited partnership), as of (date), and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Our audit included such tests of the accounting records and other auditing procedures as we considered necessary in the circumstances with the exception of Accounts Receivable - Prior Agent. We were denied access to the prior Agent's records for (date) and are unable to verify the amount of the receivable reflected on the statement of position and as explained in Note 2 to the financial statements. ABC Partnership terminated the management contract with the prior Agent as of (date).

In our opinion, except for the effects of such adjustment, if any, as might have been determined to be necessary had we been able to determine the validity of Accounts Receivable - Prior Agent, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Partnership on (date), and the results of its operations and its cash flows and its analysis of net worth for the year then ended in conformity with generally accepted accounting principles.

Our audit was conducted for the purpose of forming an opinion on the financial statements taken as a whole. The supporting information included in the report (shown on pages XX to XY) are presented for the purposes of additional analysis and are not a required part of the basic financial statements of the ABC Partnership. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements, and in our opinion, except for the effects of such adjustment,

if any, regarding Accounts Receivable - Prior Agent, as discussed above, are presented fairly in all material respects in relation to the basic financial statements taken as a whole.

Anytown, U.S.A.
(date)

XYZ and Company
Certified Public Accountants

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3. Adverse opinion is one in which the IPA states that the financial statements do not present fairly the financial position of the entity at the date of the audit. In this situation, the departure from GAAP is so material that the financial statements taken as a whole cannot be relied upon. When an adverse opinion is issued, an explanatory paragraph should be included in the report and should (1) describe the reason(s) for the issuance of the adverse opinion, (2) describe the effects on the financial statements of the departure from GAAP, if determinable, and (3) expressly note if the effects cannot be determined. The report should explicitly state that the financial statements are not prepared in accordance with GAAP. Adverse opinions generally indicate that the client is in violation of HUD accounting requirements. An example of an adverse opinion is shown in Exhibit 2-3.
4. Disclaimer of opinion is one in which the IPA is unable to provide an opinion because sufficient evidence could not be collected or there is substantial doubt about an entity's continued existence. The evidence may not have been collected because:
 - a. the client limited the scope of the engagement,
 - b. it was not possible to collect the evidence based on the engagement circumstances, or
 - c. an uncertainty precluded the collection of necessary information. (See 1. above for a further discussion of uncertainties and when an unqualified opinion may be expressed.)

Under these conditions, assuming the effects are so material that it would be inappropriate to issue a qualified opinion, the auditor should disclaim an opinion on the financial statements.

A disclaimer of opinion begins the first introductory paragraph with the phrase "We were engaged to audit.....". An explanatory paragraph should be included

that describes the reasons for disclaiming an opinion. In

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addition, if material deviations from GAAP or the inconsistent application of accounting principles was discovered during the engagement, an additional explanatory paragraph should be added to the disclaimer to describe these deficiencies. Finally, the opinion paragraph should refer to the scope limitation or uncertainty described in the explanatory paragraph and should state explicitly that no opinion is expressed on the financial statements. An example of a disclaimer of opinion is shown in Exhibit 2-4.

While qualified, adverse or disclaimed opinions generally indicate serious problems, a departure from a "clean" opinion applies only to the items described in that opinion. Exactly the same audit procedures should be followed on all accounts not affected by the disclaimer or qualification. Accordingly, the reliability of all other account balances is the same as for "clean" opinions and the Asset/Loan Management staff should not necessarily expect audit costs to be lower when disclaimed or qualified opinions are rendered than when unqualified opinions are given.

- C. Opinion on Supplemental Data. Supplemental (supporting) data is included in all HUD financial statements and is referred to in the auditor's report. The usual wording is: "supporting data... are presented fairly in all material respects in relation to the basic financial statements taken as a whole."

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Exhibit 2-3: Independent Auditor's Report - Adverse Opinion

To the Partners
ABC Partnership
Anytown, U.S.A.

We have audited the accompanying balance sheet of ABC Partnership, HUD Project No. 093-44007NP (a limited partnership), as of (date), and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on

these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As disclosed in Note 12 to the financial statements, the Partnership presents fixed assets at estimated market value. In our opinion, generally accepted accounting principles require that fixed assets be presented at cost. As a result of these departures from generally accepted accounting principles, fixed assets are overstated by \$28,318.

In our opinion, because of the effect of the matter discussed above, the financial statements referred to above and the related supporting data do not present fairly, in conformity with generally accepted accounting principles, the financial position of ABC Partnership as of (date) or the results of its operations or its cash flows and its analysis of net worth for the year then ended.

Anytown, U.S.A.
(date)

XYZ and Company
Certified Public Accountants

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Exhibit 2-4: Independent Auditor's Report - Disclaimer of Opinion

To the Partners
ABC Partnership
Anytown, U.S.A.

We were engaged to audit the accompanying balance sheet of ABC Partnership, HUD Project No. 093-44007NP (a limited partnership), as of (date), and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Partnership's management.

No lease for commercial space was on file, nor was revenue from commercial space included on the appropriate supporting documentation. Revenues for commercial space were stated in the accompanying financial statements at \$120,000. We were unable to apply sufficient alternative procedures to the Partnership's rental records.

Since we were not able to apply alternative auditing procedures to satisfy

ourselves as to rental revenue, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements referred to above, or on the related supporting data.

Anytown, U.S.A.
(date)

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Certified Public Accountants

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- D. Opinions on Cash Basis and Tax Basis Financial Statements. Financial statements are usually prepared in accordance with GAAP and the auditing and accounting standards are written with this in mind. However, in some situations, financial statements are prepared in accordance with a comprehensive basis of accounting other than GAAP; for example the cash basis or tax basis.
1. Cash basis (or modified cash basis)
 - a. A basis of accounting related to cash receipts and disbursements, or a modification to the cash basis with recorded depreciation on fixed assets and accrued income taxes.
 - b. The cash basis is generally considered useful for small nonpublic companies for which the cost of GAAP financial statements is not beneficial in relation to the needs of likely users.
 - c. The cash basis is not suitable for HUD projects.
 2. Tax basis
 - a. A basis of accounting that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements.
 - b. The income tax basis of accounting is based on the rules and regulations for accounting for transactions under the Internal Revenue Code.
 - c. Tax basis financial statements are suitable when statement users are primarily interested in the tax aspects of their relationship with the entity (for example, tax-shelter limited partnerships), but want more information and detail than would be provided by receipt of a copy of the entity's tax return.
-

d. The tax basis is not suitable for HUD projects.

Cash basis or tax basis financial statements may be prepared by project owners for other users or for other purposes, but such statements are not acceptable for HUD's purposes.

When reporting on cash basis or tax basis financial statements, the auditor will express an opinion as to the fairness of the financial statements with respect to the cash or tax basis of accounting. The standard auditor's report (unqualified opinion) should include paragraphs discussing the scope of the audit, generally accepted and government auditing standards, the basis of accounting used, and the opinion rendered on the statements and supporting data.

The introductory paragraph uses the word "audited" to identify more precisely the type of service being provided by the auditor, and provides brief descriptions of management's and the auditor's responsibility for the financial statements. In addition, the titles of the financial statements are modified to show that they are not intended to present the financial position, results of operations, or cash flows in conformity with GAAP. For example, if the financial statements are prepared on a cash basis, the Balance Sheet might be entitled: Statement of Assets and Liabilities Arising from Cash Transactions.

The explanatory paragraph states the basis of accounting and refers to the note in the financial statements that describes the basis. While the note should describe how the presentation differs from GAAP, it is not necessary to quantify the effects of the differences between GAAP and the basis of accounting used. An example of a cash basis and tax basis auditor's report (unqualified opinion) is shown in Exhibits 2-5 and 2-6, respectively. Refer to Exhibits 2-2, 2-3, and 2-4 for examples of how a cash or tax basis auditors report would be structured when a qualified, adverse, or disclaimer of opinion is issued.

When reviewing cash basis or tax basis financial statements, Asset/Loan Management staff should:

- o Pay particular attention to financial statement disclosures, notes to the financial statements, and the summary of significant accounting policies which should discuss the basis of accounting used and how it differs from GAAP.
- o Be satisfied that the financial statement names reflect the basis of accounting used and do not use terminology typically used in GAAP basis financial statements.
- o Ask the owner to submit audited financial statements that meet HUD's requirements.

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Exhibit 2-5: Independent Auditor's Report - Unqualified Opinion
Cash Basis Financial Statements

To the Partners
ABC Partnership
Anytown, U.S.A.

We have audited the accompanying statements of assets and liabilities arising from cash transactions of ABC Partnership, HUD Project No. 075-44001 (a limited partnership), as of (date), and the related statements of revenue collected and expenses paid for the year then ended. These financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1, these financial statements were prepared on the basis of cash receipts and disbursements, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities arising from cash transactions of ABC Partnership as of (date), and its revenue collected and expenses paid during the year then ended, on the basis of accounting described in Note 1.

Our audit was made for the purpose of forming an opinion on the financial statements taken as a whole. The supporting data included in the report (shown on pages XX to XY) are presented for the purposes of additional analysis and are not a required part of the financial statements of the ABC Partnership. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly presented in all material respects in relation to the financial statements taken as a whole.

Anytown, U.S.A.
(date)

XYZ and Company
Certified Public Accountants

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Exhibit 2-6: Independent Auditor's Report - Unqualified Opinion
Tax Basis Financial Statements

To the Partners
ABC Partnership
Anytown, U.S.A.

We have audited the accompanying statements of assets, liabilities and capital - income tax basis of ABC Partnership, HUD Project No. 075-44001 (a limited partnership), as of (date), and the related statements of revenue and expenses - income tax basis for the year then ended. These financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1, these financial statements were prepared on the basis of accounting the Partnership uses for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and capital of ABC Partnership as of (date), and its revenue and expenses for the year then ended, on the basis of accounting described in Note 1.

Our audit was made for the purpose of forming an opinion on the financial statements taken as a whole. The supporting data included in the report (shown on pages XX to XY) are presented for the purposes of additional analysis and are not a required part of the financial statements of the ABC Partnership. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly presented in all material respects in relation to the financial statements taken as a whole.

Anytown, U.S.A.
(date)

XYZ and Company
Certified Public Accountants

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2-16. AUDITOR'S REPORT ON THE INTERNAL CONTROL
STRUCTURE

In accordance with GAAS and GAS, the IPA shall obtain an understanding of the project's internal control structure and shall furnish a written report on their understanding of the entity's internal control structure and the assessment of control risk made as part of a financial statement audit. This report may be included in either the auditor's report on the financial audit or a separate report. The independent accountant must justify any material departure from the language as illustrated in Exhibit 2-7.

2-17. AUDITOR'S REPORT ON COMPLIANCE

In accordance with GAAS and GAS, the IPA should prepare a written report on the tests of compliance with applicable laws and regulations. This report, which may be included in either the report on the financial audit or a separate report should contain a statement of positive assurance on those items which were tested for compliance and negative assurance on those items not tested. The IPA's test of compliance with applicable laws and regulations should include tests to the extent necessary to comply with GAAS, GAS, and GAAP. The report on compliance should include all material instances of noncompliance and all instances or indications of improper acts which could result in criminal prosecution. The report shall also include compliance with requirements applicable to nonmajor HUD program transactions. The independent accountant shall justify any material departure from the language as illustrated in Exhibit 2-8.

2-18. OTHER REPORTS

As recommended by GAAS, the following reports are prepared by an auditor and they also are to be submitted to HUD:

A. Auditor's Management Letter, or Schedule of Findings and Questioned Costs. When the auditor identifies a finding, the following information should be provided to HUD to permit timely and proper corrective action to be taken. The auditor should attempt to identify:

- o condition (the nature of the problem)
- o criteria (what the owner/management agent should be doing)

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- o effect (what happened as a result of the problem)
- o cause (why the problem exists)

The auditor's Management Letter, or Schedule of Findings and Questioned Costs, may be attached to the auditor's report on compliance. An illustration of a Management Letter appears in Exhibit 2-9.

B. Auditor's Comments on Audit Resolution Matters. This report, which may be included in the Auditor's Management Letter, identifies whether a project owner has taken corrective actions on findings from the prior audit report. The auditor should provide the project name, prior audit report number, a brief description of the finding, and the status of the corrective action on the finding. This report also includes findings contained in program review reports, and state agency reports. An example of "Auditor's Comments on Audit Resolution Matters" is illustrated in Exhibit 2-10.

C. Auditee's Response or Corrective Action Plan. Although not a part of the annual audited financial statements this report must be prepared by the auditee. The report should provide a statement of agreement or disagreement with the findings and recommendations proposed by the auditor in the Auditor's Management Letter. If the auditee disagrees with a finding, specific information should be provided as to why the finding is considered to be incorrect. The auditee should also provide detailed actions taken or planned to correct the deficiencies noted in the report.

The concept of the auditor's "schedule of findings and questioned costs" and the auditee's "corrective action plan" is very similar to an auditor's management letter to the client and the client's response to the management letter which are recommended by GAAS. Although the purpose of an audit engagement is to formulate an opinion on the financial

statements, auditors are often requested to prepare a management letter at the conclusion of the study and evaluation of the internal accounting control system. The management letter often identifies weaknesses in the accounting system, operational inefficiencies, and noncompliance with applicable laws and regulations discovered by the auditor. The client is requested to respond in writing to the auditor's management

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letter citing agreement or disagreement with the auditor's findings and proposing actions to correct the noted deficiencies.

An example of an "Auditee's Response or Corrective Action Plan" appears in Exhibit 2-11.

2-19. MATERIALITY

In reviewing the financial statements the Asset/Loan Management staff should keep in mind the concept of materiality. The concept of "materiality" is used by the IPA in determining whether or not an item is important enough to require the auditor to issue a qualified, adverse, or disclaimer of opinion in the auditor's report. The auditor's assessment of materiality determines whether the auditor will issue:

- A. an unqualified opinion because the matter is immaterial;
- B. a qualified opinion because the matter is material;
- C. a disclaimer of opinion because an uncertainty is so material that its potential effect on the financial statements is pervasive; or
- D. an adverse opinion because a deliberate disregard of GAAP pervades the fairness of presentation.

The IPA has no obligation to make any disclosures which are not significant to the review of the statements by a knowledgeable reader. For example, the IPA may disagree with the classification or the amount of certain maintenance expenses shown on the Form HUD-92410. However, the auditor may not consider the error "material" enough to disclose in the financial statements since, in the auditor's judgment, it does not impair the reliability of the financial statements taken as a whole or the usefulness of the statements for HUD. See Exhibit 2-12 for a matrix of variations from the standard auditor's report.

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Exhibit 2-7: AUDITOR'S REPORT ON THE INTERNAL CONTROL STRUCTURE

To the Partners
ABC Partnership
Anytown, U.S.A.

We have audited the financial statements of (the Entity) as of and for the year ended June 30, 199X, and have issued our report thereon dated date of report . We have also audited the Entity's compliance with requirements applicable to major HUD-assisted programs and have issued our report thereon dated date of report .

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audits for the year ended June 30, 199X, we considered the (Entity's) internal control structure in order to determine our auditing procedures for the purpose of expressing our opinions on the (Entity's) basic financial statements and on its compliance with requirements applicable to major programs and not to provide assurance on the internal control structure.

In connection therewith, we have also obtained an understanding of those internal accounting control and administrative control procedures comprehended in the U.S. Department of Housing and Urban Development (HUD) Consolidated Audit Guide for HUD Programs issued October 1991. Our study included tests of compliance with such procedures.

The management of the Project is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgements by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles and that Federal financial assistance programs are managed in compliance with applicable laws and regulations. Because of inherent limitations in any internal control structure, errors, irregularities or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories (identify internal control structure categories).

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and determined whether they have been placed in operation and we assessed control risk.

We performed tests of controls to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance. Our procedures were less in scope than would be necessary to render an opinion on internal control structure policy and procedures. Thus, we do not express our opinion on those policies and procedures.

We noted certain matters involving the internal control structure and its operations that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgement, could adversely affect the organization's ability to administer Federal financial assistance programs in accordance with applicable laws and regulations.

(Include paragraph to describe the reportable conditions noted.)

A material weakness is a reportable condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of the (Entity) in a separate communication dated September 8, 199X.

This report is for the information of the mortgagor, management, and the Department of Housing and Urban Development. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

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Anytown, U.S.A.
(Date)

XYZ and Company
Certified Public Accountants

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Exhibit 2-8: AUDITOR'S REPORT ON COMPLIANCE

We have audited the financial statements of (Entity) as of and for the year ended June 30, 199X and have issued our report thereon dated (date of report). In addition, we have audited the (Entity's) compliance with the common and specific program requirements that are applicable to each of its major HUD-assisted programs, for the year(s) ended June 30, 199X. The management of the (Entity) is responsible for compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about the (Entity's) compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

The results of our audit procedures disclosed instances of noncompliance with the requirements referred to above, which are described in the accompanying schedule of findings and questioned costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.

In our opinion, the mortgagor complied, in all material respects, with the requirements described above that are applicable to its major HUD-assisted programs for the year ended June 30, 199X.

(Signature)

(Date)

Exhibit 2-9: AUDITOR'S MANAGEMENT LETTER OR SCHEDULE OF FINDINGS
AND QUESTIONED COSTS
(May be Attached to Auditor's Report on Compliance)

When the auditor identifies a finding, this schedule must include the following information for each finding, where applicable (a) the size and corresponding dollar value of the population; (b) the size and dollar value of the sample tested; and (c) the size and dollar value of the instances of noncompliance.

The Government Auditing Standards state that well-developed findings generally consist of the following attributes:

- o Statement of condition - the nature of the deficiencies, e.g., a regulation not being followed, a control procedure not followed or one which is inadequate.
- o Criteria - what the auditee should be doing, e.g., the specific regulation, a prudent management practice, or an internal control procedure.
- o Effect - what happened as a result of the condition; this should be monetized in all possible instances and described as thoroughly as possible.
- o Cause - why the condition exists, e.g., the auditee was unaware of the regulation or internal control was not a high priority of the auditee.
- o Recommendation - what the auditee should do to correct the condition, normally address the cause, e.g., develop procedures to implement regulation or follow established procedures.

The auditor should attempt to identify the condition, criteria, effect, and cause to provide sufficient information to HUD officials to permit timely and proper corrective action. These findings may also serve as a basis for HUD to conduct additional work. In addition, as part of the finding, the auditor is required to make a recommendation for corrective action to the auditee. As part of this report, the auditor is required to include the auditee's summary comments on the findings and recommendations in the report. In addition, the auditee is responsible for developing a separate corrective action plan (see Example G) based on the auditor's findings and recommendations and including the plan when submitting the auditor's report. If corrective action is not necessary, a statement by the auditor describing the reason it is not should accompany the audit report.

Exhibit 2-10: AUDITOR'S COMMENTS ON AUDIT RESOLUTION MATTERS

The Project has not taken corrective action on findings from prior audit report, number and title:

Finding No. 1 The required documentation with regard to eligibility was not obtained for tenants receiving rent supplements.

 Status The Project has not obtained the required documentation from third- party sources nor has the Project reimbursed the appropriate programs for the amount of the recommended disallowance, \$15,350.

Finding No. 2

 Status

 This includes all prior audits, program review reports and state agency reports.

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Exhibit 2-11: AUDITEE'S RESPONSE OR CORRECTIVE ACTION PLAN

Name and Number of Project _____

Auditor/Audit Firm _____

Audit Period _____

The following is a recommended format to be followed by auditees for submitting a corrective action plan:

Section I - Internal Control Structure Review

A. Comments on Findings and Recommendations

The auditee should provide a statement of concurrence or nonconcurrence with the findings and recommendations. If the auditee does not agree with a finding, specific information should be provided by the auditee to support its position. If the information is voluminous, an appendix may be attached to the submission.

B. Actions Taken or Planned

The auditee should detail actions taken or planned to correct deficiencies identified in the report. Appropriate documentation should be submitted for actions taken. For planned actions, auditees should provide projected dates for completion of major tasks. Officials responsible for

completing the proposed actions should also be identified. If the auditee believes a corrective action is not required, a statement describing the reasons should be included.

C. Status of Corrective Action or Prior Findings

The auditee must comment on all prior findings whether or not corrective action has been completed. The auditee should provide a report on the status of corrective actions taken on prior findings that remain open. An update should be included on dates for completion of major tasks and responsible officials for any actions not completed. In addition, documentation should be submitted for any actions the auditee considers completed.

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Section II - Compliance Review

- A. Comments on Findings and Recommendations
(See Section I.A. above.)
- B. Actions Taken or Planned

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Exhibit 2-12: Variations from the Standard Auditor's Report

	TYPE OF OPINION		
CAUSE OF VARIATION	UNQUALIFIED (variation does not effect clean opinion)	QUALIFIED	DISCLAIMER ADVERSE
Departures from GAAP	o	o	
Uncertainties	* o		* o

Scope limitation

o o

Lack of consistency

**
o

* An uncertainty may result in an unqualified or a disclaimer of opinion.

** Where there is a material lack of comparability caused by a change in accounting principle, an explanatory paragraph follows the opinion paragraph, which remains unqualified.

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SECTION 4. Compliance with Agreements and Commitments

2-20. INTRODUCTION

The Asset/Loan Management staff should determine if the owner has complied with the project's basic controlling documents--i.e., the Regulatory Agreement, the Mortgage Note and Mortgage (and any modifications), the Management Certification, any financial relief contracts (e.g., workout agreements, flexible subsidy contracts), any subsidy contracts, and the HUD Code of Federal Regulations. As part of the audit, the IPA performs necessary tests regarding the internal control structure and the owner's compliance with the controlling documents and reports on any material weaknesses and noncompliance as appropriate. The absence of IPA findings on reportable conditions, however does not mean that no problems exist. The reliability of the supplemental data will vary according to the IPA's diligence and knowledge of HUD program requirements. Asset Management staff must determine to what extent the IPA's report can be relied upon and tailor the intensity of the compliance review accordingly. A list of Compliance Checks appears below.

Compliance Checks

Security Deposits
Funded Reserves
Residual Receipts
Management Fees
Commercial Facilities
Owner contributions and advances
Excess Rental Charges

Unapproved Charges Assessed
Acquisition of Long-Term Liability
Commingling of Funds
Physical Condition of Project
Other Compliance Areas
Summary of Compliance Checks

2-21. COMPLIANCE WITH HUD REQUIREMENTS

In instances where the Asset/Loan Management staff deem it necessary to perform additional review of the internal control structure and compliance, the following steps are useful. (A summary of compliance checks is included as Exhibit 2-13 on Page 2-57. Asset

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Management staff should document the review of compliance with HUD agreements on the Form HUD-93485, Annual Financial Statement Review Worksheet.)

- A. Security Deposits. Deposits paid by a tenant at the time a unit is rented. The deposit is placed into an account specifically for tenant deposits and held until the tenant vacates the unit. A security deposit may be applied to pay for any damages caused by the tenant.
1. Funding Level. From the Balance Sheet, determine if the account balance for Tenants' Security Deposits Held in Trust (Account No. 1191) equals or exceeds the liability for such deposits (Account No. 2191). The liability includes all accrued interest as required by law.
 2. Proper Handling. Review the auditor's comments made in the supplemental data section of the report to ensure that security deposits are held in a separate federally insured bank account in the name of the project.
- B. Funded Reserves.
1. Replacement Reserve. The Replacement Reserve account provides cash to assist in the replacement of major capital items. Generally, these items are appliances, plumbing, cabinets, roofing, sprinkler system, etc. The reserve is not intended to pay for routine maintenance costs, such as painting of common areas. The regulatory agreement establishes the requirements for the Replacement Reserve account.
 - a. Check the "Analysis of the Replacement Reserve

Account" in the supplemental data or notes to the financial statements to see if the required number and amount of monthly deposits were made; and

- b. Check to see if any lump sum deposit to the reserve for replacement account required by a special agreement or contract has been made. An example of a lump sum payment is the payment to the account from flexible subsidy funds. Any such deposit should be shown on the

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Statement of Cash Flows and on the supplemental schedule, "Analysis of Replacement Reserve Fund".

- c. Check to see if the Reserve funds are invested and determine how any interest earned is handled. On Section 8 new construction and substantial rehabilitation projects on which the "Agreement to Enter Into a Housing Assistance Payments Contract" was executed after 11/5/79 and 2/20/80, respectively, regulations require that the Reserve funds be invested and that any interest earned be deposited in the Reserve account.
2. General Operating Reserve (GOR) Cooperatives. To provide for contingencies that a nonprofit cooperative organization would not otherwise be able to meet without making a special assessment on its membership, the regulatory agreement generally requires that monthly payments be made a GOR.
- a. Check the supporting data or Statement of Cash Flows to see if the required deposits have been made in the proper amount to the GOR account. The monthly contribution of GOR is at least 3 percent of the monthly carrying charges. However, when the GOR account reaches 15 percent of the annual carrying charges of the coop, the monthly accrual rate may be reduced to 2 percent. When the balance in the GOR account exceeds 25 percent of the annual carrying charges, accruals may be discontinued until the account is reduced below 25 percent.
 - b. Check the supporting data or Statement of Cash Flows for withdrawals from the GOR account. Disbursements totalling less than 20 percent of

the total balance in the reserve (Account No. 1365) as of the close of the preceding annual reporting period may be made without Field Office approval. Any disbursements in excess of

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the 20 percent limit can be made only after Field Office approval.

3. Other Required Reserves. If the owner has agreed to establish and maintain other reserves (i.e., capital improvements reserve), use procedures similar to those described "Compliance with HUD Requirements: Funded Reserves" for replacement reserves to check owner compliance. Determine monthly and lump sum deposits due and check to see if the deposits were made. Check to see if withdrawals were approved by HUD, if required, or if they were used as specified in agreements between the owner and HUD.
- C. Residual Receipts. This refers to any cash remaining at the end of a semi-annual or annual fiscal period after deducting from surplus cash the amount of all distributions.
1. Determine if a deposit to the residual receipts account should have been made during the period covered by the financial statements. To determine this, review the "Computation of Surplus Cash, Distributions and Residual Receipts" prepared for the prior year's statements. See Section 6 of this chapter if additional guidance is needed on this computation.
 2. Check to see if the mortgagee received the amount required to be deposited in the residual receipts account as a result of the prior year's operation. The deposit should be shown in the disbursement section of this year's Statement of Cash Flows. The IPA should have confirmed in writing the receipt of the funds with the mortgagee and provided the date of the deposit in the footnotes to the statements. If the IPA did not confirm the deposit, call the mortgagee to determine if the funds were received. Also, note this as a deficiency in the IPA's work (See Chapter 4, Section 4, on Monitoring Independent Public Accountants).
 3. On Section 8 new construction and sub. rehab. and Section 202/8 projects on which the "Agreement to Enter Into a Housing Assistance Payment Contract" was executed after 11/5/79 and 2/20/80, respectively,

regulations require that the residual receipts funds be invested and that any interest earned be deposited in the residual receipts account. If the residual receipts are invested, check to see if any interest earned was credited to the residual receipts account. To do so, use the analysis of the residual receipts account and breakdown of interest provided in the notes to the statements.

- D. Management Fees - Account 6320. The management fee is a fee paid to the person or entity approved by HUD to manage the project. The management fee earned by the agent is based on an agreed upon percentage of rental revenue actually collected during the year. The percentage used in the calculation will vary depending on whether a miscellaneous or special fee is being calculated.

Due to the inherent differences between accrual accounting and cash basis accounting, it is not possible for Asset/Loan Management staff to make an exact recalculation and comparison of the management fee payable, management fee expense, and management fee earned without expending a substantial amount of effort to obtain necessary figures. Therefore, the Asset Management staff should rely on the IPA's testwork to obtain assurance as to the validity of management fees.

- E. Commercial Facilities are facilities, buildings, or areas of a building, devoted to commercial activities such as operation of a laundry. Asset Management staff should check to see if revenue from commercial space has been included on the latest rental schedule, Form HUD-92458. A copy of the Form HUD-92458 is included in Appendix 10.

- F. Owners Contributions and Advances. Cash or other assets provided to the project by an owner. The assets are used for operation of the project. Contributions generally become a permanent part of the project equity whereas advances may be made to the project for a limited time. In other words, advances are repaid and contributions are not.

1. Check to see if any contribution required of the owners was deposited in the project account. Failure to make

such a contribution may subject the owner to civil money penalties. (See Appendix 8). A contribution may have been required by a transfer of physical assets (TPA), or a flexible subsidy or mortgage relief contract. The contribution would appear on the Statement of Cash Flows.

2. If a contribution was made, check to see if the contribution was properly recorded on the project books. The flexible subsidy contract, TPA approval, or mortgage relief contract may have specified that the contribution be considered a non-refundable contribution to capital. If so, the contribution should not be included as a liability (i.e., amounts/loans due owners) on the Balance Sheet.
3. Determine if repayments of owner advances were made. Repayments would be shown on the Statement of Cash Flows and in the notes to the financial statements. If repayments were made, determine if the payments were made in accordance with HUD requirements.
 - a. Owner's 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 is generally not considered an owner distribution. Repayment of owner advances when the project is in a nonsurplus cash position may subject the owner to criminal and civil money penalties. See Appendix 8.
 - b. To encourage owners to make advances to projects in critical situations, the Department may approve, on a case-by-case basis, requests to make advances and for repayment of such advances on a monthly basis. Such repayments are not considered owner distributions.
 - 1) Approval for scheduled repayment can be made only for short-term operating advances made on behalf of the welfare of the tenants (e.g., necessary emergency

repairs, security measures) or to avoid a claim by the lender for insurance benefits

or default by the owner under the mortgage or in the payment of a project operating expense (e.g., taxes, utility bills).

- 2) Advance HUD approval is required for an owner to receive repayment on a monthly basis.
- 3) The scheduled repayment may not be made if it will bring the project into default. If the project is already in default, the repayment may not be made if it would have an adverse effect on an existing workout agreement.

c. "Advances" made by owners to obtain a workout agreement, a TPA, etc., will generally not be repaid since these are usually treated as equity contributions.

G. Excess Rental Charges. The regulatory agreement provides that project owners may not charge rents over those approved on the latest HUD "Approved Rental Schedule", Form HUD-92458.

Hence, actual rental revenue (Account No. 5120 on Form HUD-92410) should not exceed the annual rent potential authorized on Form HUD-92458. In making this comparison, Asset Management staff should be sure to use a rent potential which excludes non-revenue producing units.

If actual rental revenue exceeds the rent potential approved by HUD, the owner may be collecting rents in excess of those approved on Form HUD-92458. If this is the case, Asset/Loan Management staff should discuss the matter with the owner and review collection records or tenant leases and files during the next on-site review. (Depending on the type of project, excess rental collections must be remitted monthly to HUD, or accounted for separately and made available for deposit to the residual receipts account with the mortgagee. See Handbook 4370.2, "Financial Operations and Accounting

Procedures for Insured Multifamily Projects", Chapter 2 for further guidance.)

H. Unapproved Charges Assessed. Unapproved charges are charges levied against tenants for services not approved on the Rental Schedule, Form HUD-92458. The regulatory agreement stipulates that project owners may not assess and

collect charges for services and equipment if those charges have not been approved by HUD.

1. Check the project file for correspondence and Management or Occupancy review comments on findings related to unapproved fees.
 2. Review Account 5190 - Miscellaneous Rental Revenue. If this amount is material and is not itemized in the footnotes to the financial statements, a breakdown of revenue sources and amounts should be requested from the owner. If the statement is footnoted or when supplemental information is received from the owner, reconcile revenue sources and amounts with the charges approved on the Rental Schedule or elsewhere in the file. If accounts are not in accordance with agreements, Loan Management staff should notify the owner and follow-up to resolve any discrepancies.
- I. Acquisition of Long-Term Liability. The regulatory agreement stipulates that the owner may not, without prior HUD approval, incur any liability other than for current operating expenses. (A liability is an economic obligation to convey assets (usually cash) or to render services in the future, or stated differently, a liability is a claim against an entity by outside parties resulting from past or current transactions and requiring future settlement. An example of a long-term liability is a three-year bank loan obtained to correct deferred maintenance on the project.)
1. All long-term liabilities for the project must be fully described in the notes to the financial statements.

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2. In evaluating the impact of noncompliance by the owner in this matter, Asset/Loan Management staff should determine whether the project's future liquidity will be jeopardized by incurring the long-term debt. To make such a determination, the staff needs to determine the payment terms and assess whether the project can meet these terms while still covering the mortgage payments and other operating expenses. Are payments to be made monthly, quarterly, or annually? Are payments required routinely or only if certain events occur (i.e., surplus cash is generated or the project is sold)?
- J. Commingling of Funds. As a general rule, all cash receipts, including collections by management agents, must be deposited in a separate account in the name of the project in a financial institution that is federally insured so that all funds of a

mortgagor are federally insured. However, under certain circumstances, such as for ease of administration when several small projects are competently managed by one agent, funds from more than one project may be deposited into one bank account. This concept is known as commingling of funds. Commingling of funds is permissible only with the advance approval of HUD and when the management agent's accounting system has the capacity to identify all receipts and disbursements to a particular project at all times. This requirement also includes the capacity to produce financial statements for each individual project. Commingling of funds in an agent's transfer account is an acceptable practice if approved in advance by HUD and if the agent can identify the exact amount of funds that belong to a particular project at all times. This is a privilege and may be revoked at any time.

Results of transactions involving a project shall be recorded in the books of accounting using an accounting system that identifies the project to which the transaction applies. Under no circumstances should an accounting system that cannot identify the project to which a transaction applies be used. If an accounting system does not provide for identification of transactions by project, the auditor should disclose the condition as a violation of the Internal Control Structure and Compliance reviews. The auditor will also make the disclosure whenever HUD has not approved commingling of project funds.

Asset/Loan Management staff should review the auditor's reports on the internal control structure and compliance with applicable laws and regulations, the notes, and applicable supplemental data to determine if the auditor has made any disclosures regarding commingling of funds.

- K. Physical Condition of Project. The regulatory agreement stipulates that owners maintain the mortgaged premises, accommodations and the grounds and equipment in good repair and condition. A physical inspection is required to be performed by the mortgagee every calendar year and by Field Office personnel on a scheduled basis to assess the project's buildings, grounds and mechanical systems. Form HUD-9822, "Physical Inspection Report" is completed upon every inspection and is intended to determine whether preventive and corrective maintenance are being performed on a timely basis.
1. Review Form HUD-9822 to determine the overall condition of the project. Is the project well-maintained? Has the owner responded to the last inspection report?

2. Check the amount of maintenance expense (Account number series 6500 on Form HUD-92410). Does the amount expensed for maintenance of the project appear reasonable considering the physical condition of the property? How does the amount of maintenance expense compare with that of the previous year? Investigate any material fluctuations.
 3. Review the tenant complaint file to determine whether complaints have been filed regarding maintenance and upkeep of the project and physical security of the project.
- L. Other Compliance Areas. In addition to the compliance areas listed above, the owner is responsible for complying with HUD requirements regarding:
1. Mortgage Status
 2. Tenant application, Eligibility, and Recertification
 3. Management Functions

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Exhibit 2-13. Summary of Checks for Compliance with Agreements and Commitments.

- A. Securely Deposits
1. Balance Sheet account number 11.91 should equal or exceed account number 2191.
 2. Deposits must be held in a separate account in the name of the project.
- B. Funded Reserves
1. Check to see if all required monthly deposits and any lump sum deposit to the reserve for replacement account required by a special agreement has been made.
 2. Check to see that withdrawals did not exceed those permitted by HUD.
 3. Are the reserve funds invested? Is any interest income properly recorded?
- C. Residual Receipts
1. Determine if any residual receipts deposit, required as a result of the previous year's operation, was deposited with the mortgagee.

2. Check to see if any interest earned on the residual receipts account was credited to that account.

D. Management Fees

Rely on the IPA's testwork to obtain assurance as to the validity of management fees.

E. Commercial Facilities

Compare Commercial Revenue (account number 5140) from Form HUD-92410 with potential revenue in the commercial leases. Is the commercial space supporting itself?

F. Owner Contributions and Advances

1. Check to see that all payments required by mortgage relief and flexible subsidy contracts were received.

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2. Check to see that the terms for repayment of any advance or loan are properly shown on the financial statements.

G. Excess Rental Charges

Compare rental revenue from the Statement of Income (account number 5120) to the HUD-approved Rental Schedule.

H. Unapproved Charges Assessed

1. Review Miscellaneous Revenue on Form HUD-92410 (account number 5190) for any unapproved charges.
2. Request breakdown of miscellaneous revenue sources and amounts, if necessary.

I. Acquisition of Long-Term Liability

1. Review long-term liability section of the Balance Sheet for any new notes receivable or notes payable.
2. Check payment terms of any loans/advances and assess the effect of those payments on the project's future liquidity.

J. Commingling of Funds

Check for disclosure made by the auditor in the notes, the supplemental data to the financial statements, or in the Internal Control Structure and Compliance Reports.

K. Physical Condition of Project

1. Review Form HUD-9822 to determine the condition of the project.
2. Check amount of maintenance expense (account number series 6500) for propriety. Analyze fluctuations, if any, between current and prior year.
3. Review tenant complaint files for information regarding condition of project.

L. Other Compliance Areas. Reviews should include Mortgage Status, Tenant Application, Eligibility and Recertification, and Management Functions.

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SECTION 5. Potential Diversions of Project Assets

2-22. INTRODUCTION

The regulatory agreement provides that project assets and revenue may only be used for purposes directly related and essential to the operation of the project. Hence, use of project assets (e.g., cash, security deposits, equipment, supplies, etc.) for other than necessary and reasonable operation of the project or for payment of authorized distributions to owners constitutes a violation of the regulatory agreement. Such diversions of project assets can cause defaults in mortgage payments and may also be violations of Federal law. Appendix 8 contains excerpts from some of the more important Federal laws applicable to the diversions of project assets. Other handbooks contain restrictions on owners' distributions and repayment of advances. In addition to this Section, see also "Use of Enforcement Tools" and Exhibit 2-23, of this Handbook; Handbook 4370.2; and 4350.1, Chapter 8, Enforcement of Owner Requirements.

While the IPA is required to disclose any diversions detected during the audit, the IPA's work is performed on a test basis and, without an extension of the examination scope, even a competent IPA may not detect some diversions of project assets. The purpose of an audit is to express an opinion as to the fairness of the financial statements; not to detect improper acts or fraud on the part of the client. Generally, if the auditor can prove that the engagement was conducted in accordance with GAAS and GAS the auditor will not be held liable for failing to detect diversions of project assets. Even though the IPA is responsible for detecting material irregularities and improper acts with a direct and material effect on the financial statement line items, IPA's are by training and experience not equipped to spot violations of every applicable law and regulation.

2-23. CHECKING FOR DIVERSIONS

This paragraph provides steps for the Asset/Loan Management staff to use in reviewing financial statements for possible diversions of project assets. These steps are listed below and summarized in Exhibit 2-14 on page 2-68.

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Types of Diversions

Unauthorized loans to individuals, related projects or other businesses

Repayment of construction costs from operating funds

Unauthorized Distributions to Owners

Reduction in long-term loans and notes payable without HUD approval

Diversions from Unreported Revenue

Purchase or Disposal of Major Assets without HUD Approval

Overstatement of Tenant Accounts Receivable

Overstatement of Bad Debts

A. Unauthorized loans to individuals, related projects or other businesses. The regulatory agreement for the project prohibits the owner or management agent from using project revenue to engage in any other business or activity not related and essential to the operation of the project. Simply stated, the project should not be in the business of lending project funds to individuals or other business enterprises, including other related projects.

1. The first place the Asset/Loan Management staff should look for unauthorized loans or advances to individuals or other business entities is the Balance Sheet under Accounts or Notes Receivable (accounts 1140 and 1150). Any accounts receivable (other than from tenants) or notes receivable should be explained in the supplemental data submitted with the financial statements. If the supplemental data is not included or adequately explained, additional information should be requested from the owner or the management agent.

2. The Asset Management staff may also use the

Statement of Cash Flows to detect unauthorized notes or accounts receivable. The disbursement of project

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funds which created the receivable or represented payment on the note would be shown on the Statement of Cash Flows.

3. The Asset Management staff should examine the supplemental data or schedule to determine the propriety of any account or note receivable. Any loan or advance to officers, employees of the project or others not approved by HUD indicates an unauthorized distribution and the staff should require immediate repayment from the owner or the management agent.
 4. Unauthorized loans are more likely to occur when either an identity-of-interest relationship exists between the project owner, the management agent or some individuals/principals of the ownership or management entity, or when the owner or agent owns or operates other HUD-insured projects. The Loan Management staff should be particularly alert to such loans and transfers when these conditions exist.
- B. Repayment of Construction Costs from Operating Funds. With the exception of nonprofit mortgagors, project income earned through the cost certification cut-off date is treated as a recovery of the project's cost. Whenever construction-related disbursements or accounts payable appear on a project's financial statements, the Asset/Loan Management staff should determine whether the construction costs will be or were paid from operating funds. Usually, construction related items will appear only on financial statements covering the early years of a project's operation or when residual receipt notes, executed to permit eventual repayment of construction costs or advances remain outstanding.

In the first annual financial statement period, whenever construction costs remain unpaid after final endorsement, two Statements of Cash Flows are required.

- o One shall apply to project construction cost transactions during the first annual statement period.

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- o The second shall apply strictly to project rental operations from the day following the cost certification cut-off date to the end of the fiscal year.

If operating funds were used to pay construction costs, the staff should discuss the matter with the project owner and request return of the operating funds to the rental account.

1. Determine if payments have been made on construction items. Check the Statement of Cash Flows or compare the present balance on a construction loan with the balance due at the end of the prior fiscal year. If the balance has been reduced, payments may have been made.
2. If payments were made for construction costs, determine if operating funds were used to make those payments.
 - a. Were residual receipts, Allowance to Make Project Operational (AMPO) Funds, or Supplemental Management Funds released by HUD to cover these payments?
 - b. Were construction loan proceeds released during the fiscal year covered by the statements greater than or equal to the amount paid out for construction costs during the same fiscal year?

If the answer to both of these questions is "no", project operating funds may have been used to pay construction costs.

- C. Unauthorized Distributions to Owners. Before completing this step, it is important to note the different forms of owner distributions, the limitations imposed upon distributions in limited dividend projects, and the "Computation of Surplus Cash, Distributions and Residual Receipts" worksheet, as shown in Appendix 11.
 1. Determine if the project was in a surplus cash position at the end of the prior annual fiscal period. Use the

surplus cash computation prepared using the prior year's Balance Sheet.

2. Determine the amount of distributions paid during this fiscal year. Check the Owner's Equity section of the Balance Sheet or the separate Statement of Changes in Owner's Equity (if applicable), to determine the amount the auditor has reported as distributions. Also check the Statement of Cash Flows. Be sure to include officer salaries or other payments to owners not approved by HUD as necessary to the operation of the project.
 3. Compare the amount of distributions paid during the period covered by the annual statements with the amount of surplus cash available and with the additional dollar limitations imposed upon limited dividend owners. Keep in mind the following:
 - a. No distributions are permitted on nonprofit owned projects.
 - b. Limited dividend owners may pay both the annual distribution earned (i.e., the 6 or 10% permitted by the regulatory agreement) plus distributions unpaid from previous years, but only up to the amount of surplus cash available.
 - c. Distributions may not be paid in excess of the surplus cash available as of the end of the prior fiscal year, except as justified in the section related to semi-annual distributions.
 - d. Distributions may not be paid when a project is in default under the mortgage, when the owner has agreed to waive payment of distributions, when the project is in a non-surplus cash position, or if the project is not in "good repair and condition (Regulatory Agreement requirement), based on a mortgagee physical inspection or a HUD management review or physical inspection.
- D. Reduction in Long-Term Loans and Notes Payable Without HUD Approval (other than mortgage principal payments).

Loans for the purpose of paying current operating expenses, can be paid back without HUD approval as long as the project is not in default. A reduction in loan and notes payable for purposes other than current operating expenses must have the prior approval of HUD. See "Compliance with HUD Requirement" in this handbook for the policy on repayment of owners' advances. That policy is also stated in

Handbook 4370.2, "Financial Operations and Accounting Procedures for Insured Multifamily Projects" (See Chapter 2).

- E. Diversions from Unreported Revenue. This type of diversion is generally the most difficult to detect. Sources of revenue which sometimes are not reported include laundry revenue and revenue from commercial space and parking. The following steps should be performed to find indicators of possible unreported revenue.
1. Review the latest "Rental Increase Worksheet", "Rental Schedule" or Form FHA-92264 "Project Income Analysis and Appraisal", to determine if commercial space, laundry facilities, etc., are included in the makeup of the project. Check Form HUD-92410, "Statement of Income" to determine if revenue from these sources is reported. If so, Asset/Loan Management staff should contact the owner or management agent for an explanation. It is possible that such revenue is being used as petty cash (not an impropriety in itself, but poor internal control) or is being diverted.
 2. When possible, review leases for commercial space to determine the approximate amount of revenue that should be generated. If the project should have commercial revenue and it is reflected in the statements, are the amounts that are reported reasonable?
 3. Using your personal knowledge of the project's occupancy and the latest Management Review Report, determine if the vacancy factor is within acceptable limits. If the vacancy loss seems out of line, it could be possible that rental receipts from tenants are not being reported.

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- F. Purchase or disposal of major assets without HUD approval. All large changes in major asset accounts should be explained in detail. Asset/Loan Management staff should be alert both for the purchase of non-project related assets with project revenue as well as the possibility that funds from disposal of project assets were not credited to the project.
1. Determine if there were any changes in major assets during the past fiscal year. This can be done in two ways. Both methods are recommended because a reconciliation can be performed if both methods are used.
 - a. Compare the 1400 accounts on this year's

Balance Sheet with the 1400 accounts on the prior year's Balance Sheet. Any large changes in these accounts should be explained.

- b. Determine the change in fixed assets for the current year by reviewing the supplemental data, Schedule of Changes in Fixed Assets. Compare this amount with that computed in (a) above to ensure that the two amounts agree.
- G. Overstatement of Tenant Accounts Receivable. Tenant Accounts Receivable appears as a current asset on the Balance Sheet, account number 1130. The balance in account 1130 should agree with the amount shown in the supplemental data, "Schedule of Delinquent Tenant Accounts Receivable". Large amounts of receivables may indicate poor collection procedures by the project manager or they may be associated with diversions of project rental revenue for personal use. Diversions of project revenue may occur when poor internal control measures (e.g., acceptance of cash and not using prenumbered rental receipts) are used.

If tenant receivables are more than 10% of one month's rent potential or if the latest management review indicates poor internal control, the Asset/Loan Management staff should consider an examination of the individual tenant ledger cards at the next on-site review.

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- H. Overstatement of Bad Debts. Check to ensure that the amount expensed for bad debts (account number 6370) on Form HUD-92410 is not excessive (i.e., more than 1% of the gross rent). This account is intended to adjust gross potential revenue for revenue which is not collected. The account, however, can be manipulated by overstating the bad debt expense and diverting rental receipts from normal project uses to unauthorized uses. If this is suspected, the Asset/Loan Management staff may request from the owner or management agent a list of bad debts that were written off and confirm these amounts in writing.

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Distributions to Owners.

- A. Unauthorized loans to officers, related projects or other business entities' activities.
 - 1. Review Balance Sheet accounts 1140 and 1150 for loans not authorized by HUD.
 - 2. Review supplemental data to financial statements and Statement of Cash Flows to detect advances or loans not shown on the Balance Sheet.
 - 3. Be particularly alert for loans to individuals or business entities having an identity-of-interest with the owner or management agent, or loans to projects operated by the same management agent or principals of the owner entity.

- B. Repayment of Construction Costs from Operating Funds
 - 1. Compare Balance Sheet account 2320, Long-Term Liabilities, to the balance on the prior year financial statement.
 - 2. Review Statement of Cash Flows for payment of construction items from rental revenue. Determine if construction funds were sufficient to cover these payments.

- C. Unauthorized Distributions to Owners
 - 1. Determine if the project was in a surplus cash position as of the end of the previous fiscal year. See surplus cash computation prepared using prior year's Balance Sheet.
 - 2. Compare distributions paid during this fiscal year with surplus cash available at the end of the prior fiscal year or, if permitted by the regulatory agreement, at the end of the semi-annual period of the current fiscal year.
 - 3. If distributions were paid in excess of surplus cash or in excess of the amount earned the previous fiscal year plus any distributions unpaid from previous years, the excess must be refunded to the project.
 - 4. Distributions may not be paid when the project is in default under the mortgage, when the owner has agreed to waive payments of distributions (e.g., as part of a flexible subsidy contract, workout agreement, etc.), when

the project is in a non-surplus cash position, or if the project is not in good repair and condition.

D. Reduction in Long-Term Loans and Notes Payable without HUD Approval

Determine whether reductions in long-term loans or notes payable (other than mortgage payments) were from surplus cash and had HUD approval.

E. Diversions from Unreported Revenue

1. Review rental schedules and leases to determine if other revenue should be shown on the Statement of Income.
2. Check to see if the vacancy factor is within the acceptable limit.

F. Purchase or Disposal of Major Assets without HUD Approval

Check amount of changes in fixed assets from the supplemental data and compare with items shown in 1400 account number series on the Balance Sheet.

G. Overstatement of Tenant Accounts Receivable

Determine whether the level of tenant accounts receivable is acceptable (i.e., not greater than 10% of monthly rent potential).

H. Overstatement of Bad Debts

Check to see that account 6370, Bad Debts, is not excessive (i.e., greater than 1% of the gross rental revenue).

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SECTION 6. Surplus Cash, Distributions, and Residual Receipts

2-24. SURPLUS CASH

Basically, surplus cash is the cash remaining after all necessary and reasonable expenses of the project have been paid or funds have been set aside for such payment and all reserve requirements have been met. A more specific definition of surplus cash is provided in each project's regulatory agreement. Appendix 11 contains a worksheet for computing surplus cash and independently verifying the computation of surplus cash made by the IPA. Surplus cash is important because it represents a source of funds for paying project owners a return on their equity or meeting special needs of the project.

- A. Surplus cash is computed as of the end of an annual or semi-annual period. For profit-motivated projects, all surplus cash is available for distribution to project owners. For nonprofit projects, for which distributions are not permitted, the regulatory agreement requires that all surplus

cash available as of the end of an annual fiscal period be deposited in the residual receipts account within 60 days after the end of the project's fiscal year. For limited dividend projects, the regulatory agreement provides that surplus cash be used first to pay distributions (up to the amount specified in the project's regulatory agreement, and that any remaining surplus cash be deposited in the residual receipts account.

- B. Profit motivated and limited dividend owners receiving Flexible Subsidy must agree that any surplus cash generated during a fiscal year overlapping the term of the Flexible Subsidy Financial Assistance Contract, or a fiscal year ending during the one-year period following the contract term will be returned to HUD as repayment of the Flexible Subsidy provided. The owner also must agree that no distributions will be paid during or at the end of these same fiscal periods.

2-25. DISTRIBUTIONS TO OWNERS

A distribution is any withdrawal or taking of cash or any assets of the project other than for the payment of reasonable expenses necessary to the operation and maintenance of the project. The term distribution includes, for example, supervisory fees paid to general partners and any salaries or other fees paid to the sponsor or owner, unless those

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salaries or fees have been approved by HUD as essential to the operation of a project. One example of such an exception would be a management fee approved by HUD and paid on an owner-managed project; such a fee would not be considered a distribution. The classification of these payments depends on the financial condition of the project and decisions made by the HUD Office. Guidance on the treatment of these payments is provided in Handbook 4350.1, "Insured Project Servicing Handbook".

- A. Distributions may not be made in the following circumstances:

- o from borrowed funds,
- o prior to completion of the project,
- o when a project is in default,
- o when a project is in a non-surplus cash position,
- o under some modification agreements,
- o under a forbearance agreement, or
- o by nonprofit owners.

Owners who take distributions when the mortgage note is in default or when the project is in a non-surplus cash position are subject to civil or criminal penalties (See Appendix 8).

In addition, the first year's distribution may not be paid until all required cost certification submissions have been made. Distributions are earned beginning with the day following the cost certification cut-off date used for cost certification purposes. On limited dividend (LD) or profit-motivated (PM) projects, the regulatory agreement provides that distributions can be paid without prior HUD approval only:

- o if paid from surplus cash, or
- o if paid after the end of an annual fiscal period or, if specified in the regulatory agreement, a semi-annual fiscal period.

In effect, surplus cash generated at the end of one fiscal period is not available for distribution until the next fiscal period. Phrased differently, distributions paid out early in fiscal year 1992, for example, may not exceed surplus cash available as of the end of fiscal year 1991.

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- B. On projects owned by profit-motivated (PM) entities, distributions may be paid up to the amount of surplus cash available. For certain Section 8 projects and projects owned by limited dividend (LD) owners, distributions are subject to an additional restriction. In any one year, distributions may not exceed the amount earned that year (e.g., 6% or 10% of initial equity permitted in the regulatory agreement) plus any distributions unpaid from previous years. As indicated by the use of the word "additional" in the second sentence of this paragraph, Section 8 and LD owners are subject to both this limitation and the surplus cash limitation. Exhibit 2-15 contains general rules as to the numerical limitations imposed on distributions by project type.

The above policy on distributions can change when an owner agrees to accrue/waive payment of distributions and to use all surplus cash to repay flexible subsidy assistance. Nearly all flexible subsidy contracts contain such clauses. Even if the project did not receive flexible subsidy monies, the owner may still agree to accrue/waive payment of distributions in return for HUD's approval of other forms of mortgage relief (e.g., provisional workout, modification, etc.). Be sure to review any modifications or workout agreements for such clauses. Distributions that are made in spite of prohibitions under such agreements would subject the owner to civil or criminal penalties.

- C. Some regulatory agreements permit distributions to be paid out

of surplus cash available as of the end of a semi-annual period. If an owner paid distributions following the end of the first six months of the fiscal year covered by the statements, a surplus cash computation reported as of the end of that semi-annual period must be submitted with the annual statements. This computation would be in addition to the computation required as of the end of the fiscal year.

- D. Determining Initial Owner's Equity. On limited distribution projects, the annual distribution earned is computed by multiplying the distribution rate cited in the regulatory agreement by the initial owner's equity. The initial owner's equity is calculated by the Mortgage Credit Branch; the initial equity is shown in Schedule 3 on the reverse side of Form FHA-2580, "Maximum Insurable Mortgage." The initial owner's equity figure is determined at the time of cost certification and should not be

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confused with the balance in the Owner's Equity section which is reported annually on the project's Balance Sheet.

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Exhibit 2-15

Distributions Earned by Type of Project

Type of Project	Annual Distribution Earned
1. Section 8 - New Construction projects whose notification of selection was issued before 11/5/79 and Section 8 Substantial Rehabilitation projects whose notification of selection was issued before 2/20/80.	Surplus Cash
2. Section 8 - New Construction projects whose notification of selection was issued on or after 11/5/79 and Section 8 Substantial Rehabilitation projects whose notification of selection was	

issued on or after 2/20/80.

- | | |
|---|--|
| a. Nonprofit | No distribution permitted |
| b. Small projects (under 50 units) and partially assisted projects (i.e., projects with more than 50 units and less than 20% assistance). | Surplus Cash |
| c. Elderly projects | 6% of initial equity investment |
| d. Non-elderly | 10% of initial equity investment (usually) |
| 3. Other projects. | |
| a. Profit motivated (PM) | Surplus Cash |
| b. Limited dividend (LD) | 6% of initial equity investment |
| c. Nonprofit (NP) | No distribution permitted |

Note: (1) Above represents general rules. Always check the amount specified in the regulatory agreement and other original processing documents.

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(2) Owners may have waived their rights to accrue or pay distributions in return for subsidies or mortgage relief. Be sure to check subsidy and mortgage relief contracts for such clauses.

2-26. RESIDUAL RECEIPTS

The regulatory agreement provides that any deposit due the residual receipts account must be deposited with the mortgagee or other HUD-approved depository within 60 days after the end of the fiscal period in which the receipts were generated. Funds may be withdrawn from the residual receipts account only with prior HUD approval.

For certain Section 8 New Construction/Substantial Rehabilitation projects, reductions of residual receipts, other than by withdrawals, normally occur when a project's Section 8 contract is terminated or expires and is not renewed. At this time, HUD may require any balance of residual receipts to be transferred back to HUD, which may represent a loss contingency to the owner. In this case, the likelihood that residual receipts will be transferred back to HUD is reasonably possible (i.e., the chance of the future event or events occurring is more than remote but less than likely) and the amount should be recorded. In accordance with FASB No. 5, if the amount of the loss can be reasonably estimated, then this amount may be accrued by a charge (debit) to income.

In addition, any amounts transferred to the Residual Receipts account should be debited to that account and credited to the General Operating account. The notes to the financial statements should include a discussion of residual receipts account activity and a disclosure that use of residual receipts account funds is contingent upon HUD's prior written approval. In addition, any funds transferred to or from the residual receipts account must be separately displayed in the Statement of Cash Flows.

Exhibit 2-16(A and B) gives annotated examples of available distributions and required deposits to residual receipts for limited dividend owners.

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Exhibit 2-16A

Examples of Distributions to Owners and Required Deposits to Residual Receipts

EXAMPLE A

1.	Surplus Cash		\$11,000
2a.	Annual Distribution Earned During Fiscal Period Covered by Statements	\$14,000	
b.	Distribution Accrued and Unpaid at the End of the Prior Fiscal Period (NOTE 1)	\$21,000	
c.	Distribution Paid During Fiscal Period Covered by Statements (NOTE 2)	(\$17,000)	
		<hr/>	
3.	Amount to be Carried on Balance Sheet as Distribution Earned but Unpaid Line 2(a) + 2(b) - 2(c)	\$18,000	
4.	Amount Available for Distribution Next Year	<hr/>	\$11,000
			<hr/>
5.	Deposit Due Residual Receipts		\$ 0
			<hr/>

NOTE 1:

Accrued Distribution

NOTE 2:

Distribution Paid 1/18/9X

\$ 9,000

due 12/31/9X	\$ 7,000	Distribution Paid 7/3/9X	\$ 8,000
Distribution Earned 199X	\$14,000	(semi-annual)	
TOTAL Accrued and Unpaid	<u>\$21,000</u>	TOTAL Distribution Paid	<u>\$17,000</u>

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Exhibit 2-16B

Examples of Distributions to Owners and Required Deposits to Residual Receipts

EXAMPLE B

1.	Surplus Cash		\$19,000
2a.	Annual Distribution Earned During Fiscal Period Covered by Statements	\$14,000	
b.	Distribution Accrued and Unpaid at the End of the Prior Fiscal Period (NOTE 1)	\$15,000	
c.	Distribution Paid During Fiscal Period Covered by Statements (NOTE 2)	<u>(\$14,000)</u>	
3.	Amount to be Carried on Balance Sheet as Distribution Earned but Unpaid Line 2(a) + 2(b) - 2(c)	<u>\$15,000</u>	
4.	Amount Available for Distribution Next Year		<u>\$15,000</u>
5.	Deposit Due Residual Receipts		<u>\$ 4,000</u>

NOTE 1:

Accrued Distribution due 12/31/9X	\$ 1,000
Distribution Earned 199X	\$14,000
TOTAL Accrued and Unpaid	<u>\$15,000</u>

NOTE 2:

Distribution Paid 1/18/9X	\$10,000
Distribution Paid 7/3/9X (semi-annual)	\$ 4,000
TOTAL Distribution Paid	<u>\$14,000</u>

SECTION 7. Performance Analysis

2-27. INTRODUCTION

After the Asset/Loan Management staff has reviewed the statements for completeness, compliance and possible diversions, the staff should use the statements to analyze the project's past performance and determine if any remedial or preventive action is needed. When assessing performance, the staff should follow the steps summarized in Exhibit 2-20 and discussed in the remainder of this Section. Appendix 7 contains an "Annual Financial Statement Review Worksheet." This worksheet may be used to assist the analysis of financial statements. If it is used, the Performance Section of the worksheet provides space for documenting any deficiencies noted or conclusions drawn while carrying out these steps.

2-28. SUFFICIENCY OF PROJECT REVENUE

To determine if project revenue was sufficient to support debt service required by the mortgage and necessary operating expenses, check the Net Cash Throw-Off amount computed by MIPS. Basically, this amount is computed by subtracting principal and replacement reserve payments required to be paid during the fiscal year from net operating income. ("Net operating income" is the difference between the revenue earned and expenses incurred, excluding depreciation and "non-cash" expenses.) It is important to note that the computation uses the principal and reserve payments required by the mortgage or regulatory agreement rather than any lower or higher payments required by a workout plan or actually paid by the owner. Use of the mortgage terms enables the Asset/Loan Management staff to assess the project's ability to support routine operations. Negative amounts for net cash throw-off indicate that expense, debt service and reserve needs exceeded revenue and immediate action is needed to cure the deficit. Revenue must be increased, expenses decreased, or some combination of the two. While positive amounts mean revenue earned was greater than expense, debt service and reserve needs, as noted below, positive amounts do not always preclude problems or eliminate the need for the staffs attention. For example:

- A. If cash throw-off was small (generally less than 5 percent of rent potential) or significantly less than in previous years, it may mean that a rental increase is needed. If the net cash throw-off exceeds 15 percent of rent potential, rents may be

higher than needed or deferred maintenance may exist. The generation of the net cash flow Flag by MIPS showing lower than normal operating expenses would reinforce the staff's suspicion of deferred maintenance.

- B. The positive cash throw-off may have resulted from an infusion of a Flexible Subsidy monthly operating subsidy. If so, the current rent schedule will not be sufficient to cover project expenses when the Flexible Subsidy assistance terminates.
- C. Since the net cash throw-off is calculated using the accrual method of accounting employed on Form HUD-92410, expenses included in the computation may not have been paid. Funds may have been used to pay expenses incurred in prior years and new payables may exist, or funds may have been diverted for unauthorized use.

2-29. ASSESSMENT OF NEGATIVE CASH THROW-OFF

To assess the seriousness of any negative cash throw-off, consider the ratio of the net cash throw-off to the total cash requirement. This ratio is called the Default Risk Ratio and is calculated by MIPS. The ratio will be negative whenever the net cash throw-off was negative. The absolute amount of the ratio indicates the size of the cash throw problem. Generally, the larger the negative ratio the greater the potential problem. For example, a negative cash throw-off of \$1,000 will be more serious for a project with a cash requirement of \$10,000 (ratio of -10) than for a project with a cash requirement of 100,000 (ratio of -1).

- A. Ratios between negative 99.99 and negative 06.00 indicate High Default Risk. This rating indicates that during the previous year the project experienced severe cash flow difficulties which resulted in severe financial problems in the current year. Projects in this rating call for immediate attention so that specific causes of the project's problems can be identified and corrective servicing actions can be developed and implemented.
- B. Ratios between negative 05.99 and zero indicate Moderate to Potentially High Default Risk. This rating indicates that during the previous year the project did not generate sufficient cash flow from operations to cover its cash requirements. However, the shortfall the project is facing may or may not be indicative

of impending default in the current year. Other factors the

Asset/Loan Management staff should consider include the following:

- o The project's available funds.
 - o An improvement or decline in the project's vacancy and collection rates.
 - o Timing and seasonal variance in operating costs.
 - o Management's latest efforts to reduce operating costs.
 - o Impact of any rental increase implemented just prior to or after the end of the fiscal year.
- C. Ratios between zero and positive 99.99 indicate Low Default Risk. This rating indicates that during the previous fiscal year the project's cash flow was sufficient to meet its operating and financial expenses. Projects within this category are not likely to be facing impending default.

2-30. EVALUATE PROJECT'S LIQUIDITY

After assessing the project's ability to meet routine, recurring operating expenses, the Asset/Loan Management staff should evaluate the project's ability to meet the short-term obligations it has accumulated. To do so, the staff should compute the Net Available Funds and Mortgage Payment Coverage computations explained in Exhibit 2-17. In addition, the staff should compute other ratios such as the Current Ratio and the Acid Test (Quick) Ratio which provide a more general evaluation of a project's short term liquidity. The staff should also consider the availability of any reserve funds or special escrows.

- A. Compute Net Available Funds. Net available funds are a stringent measure of the resources available to the project after its past obligations are settled. It shows the project's ability to meet short-term cash demands, usually due within the next 30 - 60 days. Net available funds consist of available funds less cash obligations. A more detailed definition is given in Exhibit 2-17 and a sample calculation is shown in Exhibit 2-18.

-
1. If net available funds is negative, it should be bracketed It represents a deficiency and a severe liquidity problem. The project cannot even meet its past obligations, and, unless recent relief (e.g., rent increase) has been obtained, the project clearly is in short-term financial difficulty.

2. If net available funds is positive, it should be compared to the amount of a monthly mortgage payment including all escrows. A healthy project will have at least enough to pay a full mortgage payment including any required escrow, so that it is not "living hand to mouth" by needing the next month's rent to meet that month's required payment.
- B. Compute the Mortgage Payment Coverage Ratio. The mortgage payment coverage ratio is defined as net available funds divided by the current mortgage payment, including escrows. A ratio of .70 tells you, for example, that net available funds equal 70% of upcoming cash obligations. In the absence of other known information (e.g., deferred maintenance needs, operating expense trends, etc.), the following general guidelines can be used in reviewing the mortgage payment coverage ratio. An example of this calculation is shown in Exhibit 2-18.
1. If the ratio is positive but less than approximately 0.7, the project should be able to meet its past obligations but without much "cushion" and will probably need a portion of the next month's rent to meet the required mortgage payment. The project may not appear to be in short-term difficulty but should be termed "Marginal". The Asset/Loan Management staff may consider requesting monthly accounting reports for projects falling in this category.
 2. If the ratio is greater than 1.0, the project has an adequate cushion of resources and appears "healthy".

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Exhibit 2-17

NET AVAILABLE FUNDS consists of Available Funds less Cash Obligations with:

- (1) Available Funds defined as:

Unrestricted cash - exclude any deposit due the residual receipts account.

HUD receivables - clearly valid and immediate claims (e.g., amounts due on subsidy vouchers).

Investments of unrestricted cash - savings deposits, certificates of deposit, and marketable securities.

Any other current assets clearly and routinely convertible to

available cash within 30 days. These could include items such as refunds or claims receivable, if they would be readily acknowledged by their payee and are being processed for immediate payment, and

- (2) Cash Obligations defined as all current liabilities, except accrued liabilities related to (but not including) mortgage escrows.

MORTGAGE PAYMENT COVERAGE RATIO equals:

$$\frac{\text{Net Available Funds}}{\text{Monthly Mortgage Payment}^*}$$

* Per note and including escrows

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Exhibit 2-18

Sample Computation of Net Available Funds and
Mortgage Payment Coverage Ratio

Unrestricted cash	\$10,000	
HUD Receivables	4,000	
Investments (unrestricted)	1,000	
Other current assets	500	

Available Funds		\$15,500
Accounts Payable	\$ 5,800	
Short-term note payable	1,500	
Prepaid rents	500	
Other payables	1,000	

Total Current Liabilities		\$ (8,800)

Net Available Funds		\$ 6,700

Monthly Mortgage and Escrow Payments		\$10,100

Mortgage Payment Coverage Ratio		.66

In this example, there is a \$3,400 deficiency between Net Available Funds and the Monthly Mortgage and Escrow Payments. The project,

therefore, is not financially healthy and is "living hand to mouth" since it needs the next month's rent to meet this month's required payments. One emergency expenditure could cause a default under the mortgage.

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- C. The Current Ratio is the relationship of a project's current assets to current liabilities. The current ratio provides an analysis of the working capital (current assets less current liabilities) structure of a project. The current ratio is computed by dividing a project's current assets by its current liabilities. The resulting ratio can be used to evaluate a project's working capital position. The formula for calculating the current ratio is as follows:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \text{Current Ratio}$$

As a general rule, a 2 : 1 ratio is considered to be an adequate index in many industries.

- D. The Acid Test Ratio or quick ratio is the relationship between a project's quick assets to current liabilities. Quick assets are those assets which can easily be converted to cash (e.g., cash, short-term investments, and accounts receivable). The acid test ratio provides an analysis of what the project's current assets are composed of.

The acid test ratio is computed by adding up the quick asset balances and dividing the sum by current liabilities. The acid test ratio measures the immediate solvency or debt-paying ability of a project. (Traditionally, short-term notes receivable is considered a quick asset and is included in the numerator of the acid test ratio. However, for purposes of this discussion, short-term notes receivable has been excluded from the ratio because generally projects do not have notes receivable.) The formula for calculating the acid test ratio is as follows:

Cash + short-term investments + accounts receivable = total quick assets.

$$\frac{\text{Total Quick Assets}}{\text{Current Liabilities}} = \text{Acid Test Ratio}$$

As a general rule, a 1 : 1 ratio is considered to be an adequate index in many industries.

- E. Check the Balance in the Project's Reserve Funds. Balances in the Replacement Reserve or Residual Receipts Fund are not

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included in the above liquidity computations because these funds are not used to cover normal operating expenses. These funds do, however, significantly affect both short-term and long-term liquidity assessments.

1. The Residual Receipts Fund represents a cash cushion for the project. With HUD approval, the owner can use residual receipts for a wide variety of project needs which cannot be met using normal operating revenue.
2. Few projects can pay replacement costs out of their normal operating budgets. A project's need for reserve funds will vary according to the age of the project, the quality of maintenance provided and the quality of the equipment installed. Handbook 4350.1 provides more guidance on analyzing the adequacy of the reserve. If the reserve balance or monthly deposits are inadequate, the Asset/Loan Management staff should discuss with the owner the feasibility of increasing the monthly deposits to the reserve.

2-31. OTHER FINANCIAL RATIOS

In addition to the liquidity ratios, other types of financial ratios include, Profitability Ratios which provide insight about how effectively a project is being managed, and Activity Ratios which measure how effectively an entity is using its resources.

A. Profitability Ratios include:

- o Profit Margin on Rental Revenue, and
 - o Return on Partners'/Owner's Capital
1. Profit Margin on Rental Revenue Ratio is a ratio which evaluates how effectively a project is being managed. Profit Margin on Rental Revenue is calculated as follows:

$$\frac{\text{Net Profit Before Depreciation}}{\text{Rental Revenue}} = \text{Profit Margin on Rental Revenue}$$

If profit margin is comparatively low, either the project's rental revenue is relatively low, or cost is relatively high, or both.

2. Return on Partners'/Owner's Capital Ratio is a ratio which evaluates the project's ability to provide owners with a return on their investments. Return on Partners'/Owners Capital Ratio is calculated as follows:

$$\frac{\text{Net Profit Before Depreciation}}{\text{Partners'/Owner's Capital}} = \text{Return on Owners' Capital}$$

If return on partners'/owner's capital is comparatively high, they are either enjoying relatively high profits, or relatively low personal investment in the project.

B. Activity Ratios

1. The Average Collection Period is a useful Activity Ratio which measures accounts receivable turnover. This ratio is a valuable tool in evaluating a project's rent collection procedures. The Average Collection Period is calculated as follows:

$$\frac{\text{Total Rental Revenue Per Year}}{360 \text{ Days}} = \text{Rental Revenue Per Day}$$

$$\frac{\text{Accounts Receivable}}{\text{Rental Revenue Per Day}} = \text{Average Collection Period}$$

If the average collection period is relatively high, it indicates a possible problem in the collection area, as there simply is too much cash not being collected, and there are a high number of accounts overdue.

2. The Percentage of Uncollected Rent is a second activity ratio which indicates the percentage of potential uncollected rent revenue for a given period. The percentage is calculated as follows:

Compute percentage of rent potential that was not collected. This ratio should not exceed 7%.

$$\frac{\text{Vacancy Loss + Bad Debt Expense}}{\text{Rent Potential}} = \text{Percentage of Uncollected Rent}$$

A related indicator of the adequacy of the rent collection effort is the level of accounts receivable. Generally, receivables should not exceed 10% of the monthly rent potential. Carefully examine if the amount exceeds 10%.

See Exhibit 2-21 on page 2-92 for a Ratio Analysis Worksheet that can be used to calculate the financial ratios discussed above.

2-32. COMPUTE SURPLUS CASH, DISTRIBUTIONS AND RESIDUAL RECEIPTS

Use the instructions and form provided in Appendix 11. The availability of surplus cash usually means the project is healthy. It usually means that the project has been able to pay all of its expenses, set-aside funds to pay expenses coming due within 30 days, and still have funds left over to pay a distribution to the owners or deposit in the residual receipts account.

The Asset/Loan Management staff should be alert for cases where surplus cash is generated by not incurring expenses for needed services (e.g., by deferring needed maintenance). Flexible subsidy funds should be excluded from the surplus cash computation. See Handbook 4355.1, "Flexible Subsidy Handbook".

2-33. EVALUATE PROJECT EXPENSES

While auditors will verify the accuracy of the amounts spent on operating expenses, they will usually spend little time assessing their reasonableness as compared to other projects. For example, if a project shows maintenance payroll as consisting of two individuals paid \$25,000 each for the year, the IPA will perform tests to verify that the employees did exist, that they were paid those amounts, and that those amounts were reported on the applicable payroll tax returns. The IPA will not, except in extreme cases, make judgments as to whether a maintenance staff of two was appropriate for that

project, or whether the salaries paid were appropriate for the skills required of the individuals.

The Asset/Loan Management staff can complete such reasonableness checks using their knowledge of the project, the management plan, file review data, and the MIPS flag ratios and percentage change

calculations.

- A. The Asset Management staff should check two aspects of expenses: trends and absolute levels.
1. Trends. Trends are determined by comparing current year's expenses with prior year's expenses on the same project. MIPS percentage change figures measure trends. In a period of high inflation, some upward trend in expenses is almost unavoidable. However, management can exert some control over upward trends. By bulk purchasing, taking advantage of discounts for paying early and shopping for the best deal, management can hold the line on increases in operating expenses. The standard management agreement requires agents to take such actions.
 2. Levels. The reasonableness of a project's expense level is determined by comparing the project's current year expenses with expenses of similar projects for the same year. Projects to be compared should be similar with respect to type of construction, layout, location, tenant body and, if possible, size. To minimize distortions caused by economies of scale associated with size, comparisons should be made in terms of per unit per month (PUPM) accounts. MIPS facilitates the review of expense levels by providing PUPM figures and by flagging deviations from expenses of comparable projects. In MIPS, the comparable projects are the projects included in the flag base. An explanation of MIPS ratios and flags is included in Appendix 12. Establishment of standards of reasonableness is not straight-forward or mechanical. In many Area Offices, "average" expense levels are not necessarily reasonable, but on the other hand few projects can approach the standards of the "most efficient" ones. A reasonable

range of operating expenses, rather than an absolute number, should be developed.

- B. The review for reasonableness can initially focus on the MIPS expense categories (i.e., administrative, maintenance, operating, utilities and financial), rather than on individual line items. An in-depth review of line items should be completed if:
1. The overall review indicates an abnormal level or trend of expenses;

2. The project shows other signs of difficulty (e.g., poor physical condition, deferred maintenance, financial insolvency); or
 3. Impropriety by the owner or manager is suspected.
- C. The Asset Management staff should determine the cause of any MIPS flag or abnormal level or trend in project revenue and expenses. To determine the most probable causes of the variations from the "normal" or "efficient" operation, staff should:
1. Keep in mind the purpose of the flag and determine which specific line item expenses have increased or decreased and are most likely to have caused the flag to occur.
 2. Determine the most likely cause of the specific line item expense increase or decrease. To do this, review the data collected during the file review, especially any on-site review data, monthly accounting reports, correspondence, supplemental data, and the auditor's opinion.

See Exhibit 2-19 on page 2-91 for MIPS Performance Indicators.

- D. High costs or increases in costs in excess of amounts justified by inflation can indicate one or more of the following situations:

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- o Special circumstances which necessitate the excess expenditures;
- o Management inefficiency such as overstaffing, poor maintenance capability, or poor purchasing;
- o Management or owner abuse, such as paying excessive amounts to identity-of-interest firms or in conflict-of-interest situations.

The burden of proof should be on management and ownership to prove that high costs are due to special circumstances rather than to inefficiency or abuse. Regulatory agreements require that the owner provide for management which is satisfactory to HUD and that "at the request of the Commissioner, his agents, employees, or attorneys, the owner shall ... give specific answers to questions upon which information is desired relative to the income, assets,

liabilities, contracts, operation, and condition of the property . . ." A request for details of outside contracts is often appropriate.

- E. The Asset Management staff must be careful not to confuse classification differences with substantive ones. For example, if a small project shows a very high administrative cost per unit but a very low maintenance cost, it may only be that a resident manager, classified as administrative, performs most of the maintenance. In this case, no real divergence from the norm has been found. The staff should also recognize that projects which are similar in terms of construction, location and tenant body may legitimately have different operating costs. If, for example, an agent has recently assumed management of a project and is correcting deferred maintenance, maintenance expenses may temporarily be higher than in similar projects.

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Exhibit 2-19

MIPS PERFORMANCE INDICATORS
Evaluators' Samples

Performance Indicators	Internal Review	Possible Action Needed
Administrative Expense Ratio	Flag appears due to high audit fees. Scanned management Review. Noted comment that agent is not posting books regularly and promptly. CPA reports the same finding in the Audit.	Written communication with the owner requesting that books be established and maintained on current basis.
Ratios	The review of ratios indicates that almost all expenses increased in line with similar type projects. Reviewed project budgets, management review and physical inspection for possible reduction in expenses.	Written recommendation to the management agent and owner that they review the budgets and consider need for rent increase.
Trend :	Review budget and rent	Enforce Management

Net Cash Throw-Off Reduction from Previous Years	schedule for possible adjustment. Last rent increase: 3 years ago. New agent is using contracted maintenance but has same number of on-site staff as previous agent.	Agent's "shopping clause" to reduce maintenance expenses. Recommend training of on-site staff.
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Vacancy Loss	Vacancy rate appears excessive given the type, age and location of the project.	Seek information as to the maintenance of waiting lists, marketing program, general condition of vacant units, a time required to repair vacant units.
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2-34. FINANCIAL STRENGTH OF THE PROJECT

Asset/Loan Management staff should attempt to answer the following questions as a final step in the evaluation of the project's performance:

- o Is the project getting stronger?
- o Have project liquidity and cash flow improved over recent years?
- o Are any changes in on-site management procedures having a favorable impact on the project?
- o Is the project meeting the benchmarks assumed in long-term projections underlying mortgage workouts or relief plans?

Be sure to consider how any mortgage relief, flexible subsidy or owner contributions affected the financial indicators used in the analysis.

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- Step 1. Check cash flow. Was revenue sufficient to cover project expenses?
- o Check net cash throw-off calculated by MIPS.
 - o Complete surplus cash computation using worksheet in Appendix 11.
- Step 2. Check project's liquidity. Does the project have the ability to meet its future cash obligations?
- o Compute Net Available Funds.
 - o Compute Mortgage Payment Coverage Ratio.
 - o Compute Current Ratio.
 - o Compute Acid Test Ratio.
 - o Evaluate Adequacy of Reserve Funds.
- Step 3. Check project's profitability and activity.
- o Compute Profit Margin on Rental Revenue
 - o Compute Return on Partners'/Owner's Capital
 - o Compute Average Collection Period
 - o Compute Percentage of Uncollected Rent
 - o Compute level of Accounts Receivable
- Step 4. Evaluate reasonableness of expense levels. Are the levels reasonable? Is the project operating as efficiently as possible?
- o Review expense categories for reasonableness. Use MIPS flags and ratios. Consider trends and absolute levels.
 - o Determine trends by comparing current year amounts with the amounts for prior years for the same project.

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- o Determine reasonableness of Project A's expense levels by comparing Project A's current year expenses with expenses of comparable projects for the same year, preferably on a per unit per month (PUPM) basis.
 - o Determine the cause of any MIPS flag, or abnormal level or trend in project revenue or expenses. Refer to data

collected in review of the project file (especially reports of on-site visits), the auditor's report and supplemental data as necessary.

- o Consider a more in-depth review of line items if:
 - categorical review indicates an abnormal level or trend of expenses;
 - MIPS flags exist;
 - the project shows other signs of difficulty (e.g., poor liquidity, high rent loss, deferred maintenance); or
 - impropriety by owner or management agent is suspected.

Step 5. Is the project getting stronger?

- o Have net available funds, mortgage payment ratios, or cash flow improved over recent years?
- o Are any changes in on-site management procedures having a favorable impact on the project?
- o Is the project meeting the benchmarks assumed in long-term projections underlying mortgage workouts or relief plans?
- o Be sure to consider how any mortgage relief, flexible subsidy or owner contributions affected the financial indicators used in the analysis.

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Exhibit 2-21. Ratio Analysis Worksheet

LIQUIDITY RATIOS

1. Net Available Funds

Current Assets _____

Current Liabilities (_____)

Net Available Funds _____

2. Mortgage Payment Coverage Ratio

Net Available Funds _____

Monthly Mortgage Payment + _____

	Mortgage Payment Coverage Ratio	_____
3.	Current Ratio	
	Current Assets	_____
	Current Liabilities	+ _____
	Current Ratio	_____
4.	Acid Test Ratio	
	Quick Assets	_____
	Current Liabilities	+ _____
	Acid Test Ratio	_____

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PROFITABILITY RATIOS

5.	Profit Margin on Rental Revenue	
	Net Profit Before Depreciation	_____
	Rental Revenue	+ _____
	Profit Margin on Rental Revenue	_____
6.	Return on Partner's/Owner's Capital	
	Net Profit Before Depreciation	_____
	Partners'/Owner's Capital	+ _____
	Return on Partners'/Owner's Capital	_____

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ACTIVITY RATIOS

7.	Average Collection Period	
	Total Rental Revenue Per Year	_____
		+ 360 Days

Rental Revenue Per Day	_____
Accounts Receivable	_____
Rental Revenue Per Day	+ _____
Average Collection Period	_____
8. Percentage of Uncollected Rent	
Vacancy Loss	_____
Bad Debt Expense	+ _____
Subtotal	_____
Rent Potential	+ _____
Percentage of Uncollected Rent	_____

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SECTION 8. Required Actions

2-35. INTRODUCTION

If no adverse conditions or trends were detected during the review of the statements and no corrective action is needed of the owner, the Asset/Loan Management staff need to document the scope of the review and conclusions drawn as to the acceptable condition of the project. The Annual Financial Statement Review Worksheet (Appendix 7) may, at the option of the Asset/Loan Management Branch Chief be used for this documentation. If the review disclosed adverse conditions or compliance problems or if clarification of materials in the report is required, the Asset Management staff must communicate those findings to the owner, seek any necessary clarifications, recommend corrective action, and follow-up to ensure implementation of corrective action. See Handbook 4350.1, "Insured Project Servicing Handbook," for rules to follow when communicating with owners about deficiencies. This will help the Department in seeking civil and criminal penalties against owners, when necessary. Many owners and agents will respond to the report and implement the necessary corrective actions with little coaxing from HUD. When owners do not implement actions necessary to protect the Secretary's interest or stabilize the project, the Field Office may need to use enforcement tools available to the Department. (See further references in this section, Appendix 8, and Handbook 4350.1, Chapter 8.)

2-36. CONVEY RESULTS OF REVIEW TO OWNER

On most projects, the statement of findings and recommended or required corrective actions should be communicated in writing. Only rarely will verbal discussions suffice (e.g., when expenses are reasonable, no compliance problems exist and the owner merely needs to be told to examine the need for a rent increase). It is recommended to confirm verbal discussions in writing as soon as possible. The letter should be mailed to the owner with a copy to the agent. The report should propose a corrective action for each finding and should specify a response date. Exhibit 2-21 lists some corrective actions that might be needed. Appendix 13 contains a sample letter to an owner related to the annual financial statement review.

2-37. UPDATE MIPS

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After the findings have been conveyed to the owner or the "no problem" review documented, the MIPS system should be updated to reflect completion of the review. Refer to MIPS application 5.3a, Financial Statement Date Tracking.

2-38. REQUEST WRITTEN RESPONSE

If the owner does not respond within 15 working days, the Asset/Loan Management staff should prepare a follow-up letter. If the owner does not respond within 10 days of the follow-up letter, the staff may withhold other processing actions (e.g., release of replacement reserves, approval of mortgage relief, final approval of a rental increase).

2-39. RESOLUTION OF PROBLEMS

Depending upon the type of action needed, the Asset Management staff should follow-up as necessary to obtain corrective action.

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Exhibit 2-22

POSSIBLE CORRECTIVE ACTIONS

TYPE OF CONDITION

POSSIBLE HUD OFFICE ACTION

Owner noncompliance, diversions, or failure to use nonproject funds for certain needs of the project as part of agreement with HUD in return for mortgage relief, TPA or flexible subsidy contract

- Require owner to repay the project for any unauthorized disbursements or to provide nonproject funds as agreed.
- Request OIG audit or independent review of limited items in the owner's records if uncertain as to exact amount diverted.
- Seek civil or criminal penalties through recommendations to Regional Counsel.

Performance Problems

- Conduct on-site inspections (occupancy, management, physical) earlier than originally planned
- Process rent increase
- Consider financial relief
- Increase replacement reserve deposits
- Change management agent or procedures
- Request monthly accounting reports
- Request budget or quarterly reports on budget

IPA's work does not comply with AICPA and OIG standards (failure to report major diversions, improper opinions)

- Refer through Regional Inspector General to State licensing board
- Request owner to obtain a new IPA for future audits
- Request Office Director to impose Temporary Denial of IPA Participation

2-40. USE OF ENFORCEMENT TOOLS

If owners will not take the actions needed to resolve performance problems or if violations of HUD rules or instances of noncompliance by the owner/agent or IPA are so numerous or serious that continued participation would jeopardize the Secretary's interest, the HUD Office should consider imposing administrative sanctions. Exhibit 2-22 identifies major administrative sanctions available and who can recommend or approve each action. The HUD Office must exercise care in using enforcement tools or leverage and must be careful not to aggravate existing problems or to create new ones by imposing harsher penalties than needed. Remedies should be focused on the

party at fault (i.e., the owner, the agent, or the IPA). While specific procedures to be used in imposing these sanctions are included in HUD Handbook 4350.1, Insured Project Servicing Handbook, IG Handbook 2003.3A, Audit and Investigation Activities, and HUD Handbook 4080.1, Compliance Handbook for Housing, limited guidance on more common problems is provided below and in Chapter 5 of this Handbook. Relevant excerpts from the United States Code are included in Appendix 8.

- A. All cases where the Asset/Loan Management Branch has been unsuccessful in recovering unauthorized distributions of project assets should be referred to the Chief Counsel for administrative action.
- B. The Housing and Community Development Act of 1987 (Section 254 of the National Housing Act) requires that when the project mortgage note is in default or the project is in a non-surplus cash position, whoever willfully uses any part of the rents, assets, proceeds, or other funds derived from the property for any purpose other than to meet actual or necessary expenses shall be subject to a fine or imprisonment. As required by Handbook 2003.3A, violations of this nature should always be referred to the Regional Inspector General for Investigation or to the Regional Counsel for Prosecution.
- C. If there is reason to believe that the program participant willfully violated HUD regulations or refuses to make restitution of misused funds, the matter should be referred to the Regional Inspector General for Investigation. The participant may be subject to civil money penalties provided under the National Housing Act. (See Appendix 8.)

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- D. IPA firms who consistently disregard HUD's reporting requirements or produce financial statements that are judged to be substandard work for the profession should be referred to the Office of Inspector General for appropriate action (e.g., debarment, Temporary Denial of Participation, possible referral to local and State licensing boards). See Chapter 5, Imposing Sanctions on Independent Public Accountants, for further information.
- E. There may be cases where an immediate threat to Departmental programs is posed by the unrestricted continued operations of an IPA or program participant who is being recommended for suspension or debarment. In such cases, the Asset/Loan Management Branch Chief should seriously consider recommending that the HUD Office Manager impose Temporary Denial of Participation in addition to the submission of the suspension/debarment recommendation in

order to protect the public interest and the interests of the Department while the recommendation is being processed at Headquarters.

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Exhibit 2-23

Enforcement Actions

ACTION	PLAYERS
2530 Denial.	HUD Office Manager can deny participation.
Audits or Investigations.	HUD Office Manager recommends to Regional Inspector General Staff.
Limited Denial of Participation.	HUD Office Director can approve.
Suspension or Debarment.	HUD Office Manager recommends to Assistant Secretary for Housing who decides if action is warranted.
Referral to State/Local Accounting Licensing Boards.	HUD Office Manager recommends to Regional Inspector General Staff.
Prosecution (civil and criminal penalties). See Appendix 8 for listing of criminal and civil codes.	HUD Office Manager passes recommendation to Regional Counsel.

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