CHAPTER 3: PROJECT ACCOUNTING, FINANCIAL AND REPORTING REQUIREMENTS

Section 1. Owner's Accounting and Recordkeeping Responsibilities

3-1. GENERAL. The coinsurance regulations and the regulatory agreement require that project owners establish and maintain the books and accounts of the mortgaged property in accordance with the requirements of the Secretary and the lender. This section sets forth HUD's accounting and recordkeeping requirements. While lenders have authority to establish additional requirements, lenders should seldom need to do so as HUD's requirements are well-accepted and comprehensive.

3-2. UNIFORM CHART OF ACCOUNTS. Coinsured projects must establish and maintain their accounts in conformance with HUD's Uniform Chart of Accounts. This system is described in HUD Handbook 4370.2, Financial Operations and Accounting Procedures for Insured Multifamily Projects. Adherence to this system will ensure that the records and reports of coinsured projects will be comparable with those of insured projects and compatible with HUD's automated data systems. Implementation of the Uniform Chart of Accounts will also facilitate HUD's reviews of the lender's financial analysis and rent increase processing and any necessary General Accounting Office or Inspector General audits of the project. If a project needs accounts that are not included in the chart, the owner should establish and classify those accounts in accordance with accepted accounting principles and the categories used in the chart.

3-3. OWNER'S FINANCIAL RECORDKEEPING REQUIREMENTS. The project's books and accounts must be kept current and in a reasonable condition for proper audit. All records related to the project's purchase of goods and services must be maintained for three years or such longer periods as may be prescribed by the lender. This records retention requirement applies to all records related to project operations, regardless of who (e.g., project owner, management agent, lender or identity-of-interest supplier or contractor) holds the records. The regulatory agreement requires that, upon request, all such records must be made available during normal business hours for examination and inspection by the lender, the Secretary, the Inspector General of HUD and the Comptroller General of the United States.

3-4. TENANT SECURITY DEPOSITS. Any funds collected as security deposits must be maintained in a trust account separate and apart from all other funds of the project. This trust account must be held in the name of the project and the balance in the account must at all times equal or exceed the project's liability for residents' security deposits. The owner must comply with any State or local laws regarding investment of security deposits and distribution of any interest or other income earned thereon. If the owner is not required to deposit investment income in the security deposit account or to distribute such income to tenants, the owner must deposit the investment income in the project operating account.

Section 2. Owner's Financial and Occupancy Reporting Responsibilities

3-5. MONTHLY FINANCIAL REPORTS. The regulatory agreement gives the lender authority to require the owner to submit monthly reports on the project's financial operations.

a. When Required. Generally, the lender should require monthly financial reports:

(1) during the first six months following endorsement;

(2) when the project is experiencing occupancy, financial or management problems; or

(3) during the period of any workout, forbearance agreement, or other temporary mortgage relief program.

b. Report Format. While a lender may prescribe a different format, lenders will often require owners to use the monthly report forms described in HUD Handbook 4370.1 REV.1, Reviewing Annual and Monthly Financial Reports. The Handbook 4370.1 reports consist of the three schedules listed below:

(1) Monthly Report for Establishing Net Income (Form HUD 93479, Appendix 9);

(2) Schedule of Disbursements (Form HUD-93480, Appendix 10);

(3) Schedule of Accounts Payable (Form HUD-93481, Appendix 11);

3-6. ANNUAL FINANCIAL REPORTS. The owner must annually provide both the lender and the HUD Field Office with a report on the project's financial operations. The owner must submit the report within 60 days after the end of the project's fiscal year.

a. Contents. The report must be prepared in the form required by HUD Handbook IG 4372.1, Audit Guide for Mortgagors Having HUD Insured or Secretary-Held Multifamily Mortgages for use by Independent Public Accountants. The principal parts of the report are listed below. Owners should read HUD Handbook IG 4372.1 for a more complete and detailed listing of the required contents for financial reports.

(1) Balance Sheet

(2) Statement of Profit and Loss (Form HUD-92410, Appendix 12)

(3) Statement of Changes in Financial Position

(4) Computation of Surplus Cash, Distributions and Residual Receipts (Form HUD-93486, Appendix 13). NOTE: If an owner elects to collect distributions on both a semi-annual and annual basis,

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the annual financial report must include two surplus cash computations -- i.e., one for each semi-annual period.

(5) Supplemental Notes and Schedules

(6) The owner's certification that he/she has reviewed the financial statements and considers them to be complete and accurate.

b. First Report. If less than three months will elapse between the date of cost certification (or endorsement, if no cost certification was required) and the end of the project's fiscal year, no report is required 60 days after the first fiscal year end date. However, the owner must include this period in the report the owner submits at the end of the first full fiscal year. If three or more months elapse between the date of cost certification (or endorsement, if no cost certification was required) and the end of the project's fiscal year, the owner must submit a report on that period within 60 days after the end of the project's fiscal year. Even though the report covers only a partial fiscal year, the report must contain all of the schedules and notes required by Paragraph 3-6.a. and HUD Handbook IG 4372.1.

c. Audit Requirement. The annual financial reports must be audited by a certified public accountant or an independent public accountant (IPA) licensed on or before December 31, 1970. The auditor must have no business relationship with the project owner except for performance of the audit, systems work and tax preparation.

3-7. ANNUAL OCCUPANCY REPORTS. Project owners must annually prepare and submit a Civil Rights Tenant Characteristics Occupancy Report (Form HUD-949). This Form is shown in Appendix 14. HUD uses this information to determine the extent of women's and ethnic minorities' participation in HUD's programs. Executive Order 11063 and Title VIII of the Civil Rights Act of 1968 require HUD to make such assessments. Instructions for preparing Form HUD-949 are provided on the back of the form. The project owner or management agent must annually submit the original and one copy of this report in time to reach the local HUD Field Office's Fair Housing and Equal Opportunity Division no later than the third Friday in October. The owner must retain a copy of the report for three years after the date the report was due. The Fair Housing and Equal Opportunity Director of each HUD Field Office must ensure that owners and managers prepare this report accurately and submit it on time.

3-8. OTHER REPORTS. The regulatory agreement provides that upon request of the lender, the owner must submit operating budgets, occupancy, accounting and other reports; properly certified copies of minutes of meetings of the directors, officers, shareholders, or beneficiaries of the mortgagor entity; and specific answers to questions raised from time to time by the lender relative to income, assets, liabilities, expenses, contracts, operations, actual cost of repairs and improvements, disposition of mortgage funds, conditions of the project and the status of the mortgage.

Section 3. Use of Project Funds

3-9. GENERAL. The regulatory agreement provides that the owner may not obligate the project to pay for costs other than those reasonable and necessary to the operation and maintenance of the project. The owner may use project funds only to:

a. pay amounts required by the mortgage;

b. make required deposits to the replacement reserve;

c. pay reasonable amounts for expenses necessary to the operation and maintenance of the project;

d. make any owner distributions permitted under the regulatory agreement; and

e. repay owner advances as allowed by Paragraph 3-13.

3-10. SHOP FOR BEST DEAL. The regulatory agreement requires the owner/agent to obtain contracts, materials, supplies and services, including the preparation of the annual audit, on terms most advantageous to the project and at costs not in excess of amounts ordinarily paid for such contracts, materials, supplies and services in the area in which such services are rendered or supplies and materials furnished. All goods and services purchased from individuals or companies having an identity-of-interest with the owner or its managing agent must be at costs not in excess of the costs that would be incurred in making arms-length purchases on the open market. The owner/agent must solicit oral or written cost estimates as necessary to assure compliance with the provisions of this paragraph.

3-11. EXCESSIVE COSTS. If the lender determines that the amounts charged to the project exceed the amounts ordinarily paid for supplies, services and materials of similar quality and/or that the charges levied by identity-of-interest companies exceed those that would be incurred in making arms-length transactions and notifies the owner of such determination, the lender should require the owner to immediately discontinue charging the project for any amounts the lender deemed excessive. If the excessive charges resulted from the owner's failure to solicit bids and/or compare or take advantage of available discounts, the lender should also require the owner to refund to the project excessive amounts already paid.

3-12. DEPOSIT AND INVESTMENT OF PROJECT FUNDS. The regulatory agreement requires that the owner/agent deposit all rents and other receipts of the project in the name of the project in accounts which are fully insured as to principal by an agency of the Federal government. Project funds in excess of those needed to meet short-term project operating expenses may be invested in Treasury securities or in securities issued by a Federal agency or a Federally sponsored agency. (See Paragraph 5-2 of this Handbook for guidance on permitted forms of investment.) All

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interest earned on the operating account must be retained in the operating account.

3-13. REPAYMENT OF OWNER ADVANCES. Repayments of funds which owners advanced to cover necessary and reasonable operating expenses are not subject to the surplus cash rules set forth in the regulatory agreement and Section 4 of this Chapter. Owners may repay such advances if the conditions set forth below are met.

a. If the project is current under the mortgage, advances made for reasonable and necessary operating expenses may be repaid from project income without the lender's prior approval. Project management, however, must exercise prudent judgment as to the timing of the repayment. Advances may not be repaid when the repayment would cause a delinquency or default under the mortgage or impose a financial hardship on the project.

b. If the project is delinquent under the mortgage, loans and advances made by the owner to meet necessary and reasonable operating expenses may be repaid from project income only with the prior written approval of lender. If the mortgage is in default, generally the lender should consider authorizing repayments of advances only if the project is under a workout or reinstatement plan (see Chapter 9) and is current in the payments required under that plan.

Section 4. Surplus Cash, Owner Distributions

and Residual Receipts

3-14. SURPLUS CASH. Surplus cash must be computed in accordance with the procedures set forth on Form HUD-93486, Computation of Surplus Cash, Distributions and Residual Receipts. This Form is shown in Appendix 13. 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. Surplus cash must be computed as of the end of the fiscal year. If the owner elects to collect distributions semi-annually, the owner must also compute surplus cash as of the end of each semi-annual fiscal period.

a. For profit-motivated projects, all surplus cash is available for distribution to project owners.

b. For non-profit projects, distributions are not permitted. All surplus cash available as of the end of an annual fiscal period must be deposited in the residual receipts account. This deposit requirement is discussed in Paragraph 3-16, below.

c. For limited-distribution projects, surplus cash is used first to pay distributions (up to the amount specified in Paragraph 3-15.e., below). Any surplus cash remaining after distributions have been paid or funds have been set aside for their payment must be deposited in the residual receipts account.

3-15. DISTRIBUTIONS TO OWNERS. A distribution is any withdrawal or taking of cash or any assets of the project, other than for the payment of debt service, payment of reasonable expenses necessary for the operation and maintenance of the project, or repayment of owner advances as authorized by Paragraph 3-13. The term distributions includes, for example, supervisory fees paid to general partners and any salaries or other fees paid to the sponsor or mortgagor, unless those salaries or fees have been approved by the lender as essential to the operation of a project. For example, a management fee approved by the lender and paid on an owner-managed project would not be considered a distribution. Distributions are subject to the following restrictions.

a. Distributions for coinsured projects are earned beginning with the cost certification date, unless a cost certification was not required. If cost certification was not required, distributions are earned beginning with the date the mortgage was endorsed for insurance.

b. Owners may collect distributions only after they have completed all repairs or rehabilitation and submitted any cost certification required by HUD Handbook 4566.1.

c. Owners may collect distributions only from surplus cash that existed as of the end of an annual or semi-annual fiscal period.

d. Owners may collect distributions only after the end of the fiscal period in which the surplus cash is generated. In effect, surplus cash generated during one fiscal period is not available for distribution until the next fiscal period. For example, if a project uses a calendar fiscal year, distributions paid out early in fiscal year 1982 may not exceed surplus cash available as of the end of fiscal year 1981.

e. Owners of non-profit (NP) projects may not take distributions. For projects owned by profit-motivated (PM) entities, distributions may be paid up to the amount of available surplus cash. For projects owned by limited distribution (LD) mortgagors, distributions may not exceed the lesser of (1) surplus cash or (2) the sum of the amount earned that year (i.e., the percentage of initial equity specified in the regulatory agreement) and any distributions unpaid from previous fiscal periods.

f. No distribution may be paid from borrowed funds or when payments due under the note, mortgage, or regulatory agreement have not been made.

g. If any of the conditions listed below apply, the owner may distribute surplus cash only after obtaining the lender's written approval.

(1) The owner has not satisfactorily responded to any lender management review, physical inspection report, annual financial statement correspondence or any other correspondence that requires the owner to implement corrective action, and that was received

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at least 30 days before the end of the fiscal period for which the surplus cash computation is made.

(2) The lender determines that the project has significant uncorrected physical deficiencies.

(3) There is a default, other than a fiscal default, under the regulatory agreement.

3-16. RESIDUAL RECEIPTS. As described in Paragraph 3-14, this account is established out of all or part of the surplus cash that is generated by non-profit and limited distribution projects. While the residual receipts account is held by the lender, the account must remain at all times under HUD's control. The lender may release residual receipts only after obtaining written approval from the HUD Field Office.

a. Deposit Requirements. Residual receipts must be deposited with the lender within 60 days after the end of the annual or semi-annual fiscal period in which the receipts were generated.

b. Investment of Residual Receipts. The regulatory agreement requires the project owner to invest residual receipts and to add all earnings on such investments to the residual receipts account. Residual receipts may be invested only in the accounts and securities listed in Paragraph 5-2.a. of this Handbook. While the regulatory agreement gives HUD control of the residual receipts account, HUD allows the project owner to select among the authorized forms of investment as long as the owner exercises due care and attempts to maximize earnings to the extent consistent with the project's liquidity needs. The lender may charge a fee for administering the invested residual receipts so long as the fee meets the conditions set forth in Paragraph 5-3 of this Handbook.

c. Procedures for Releasing Residual Receipts. The owner may request the release of residual receipts funds for purposes which will benefit the project or protect HUD's interest in the project. Requests for releases must be prepared and processed in accordance with the following procedures:

(1) The owner must submit its request to the lender. The owner's request must clearly describe the purposes for which the funds are being requested. The owner's request should include an explanation as to why project operating funds cannot or should not be used for the purposes requested.

(2) The lender must evaluate the owner's request, taking into consideration the following:

(a) the project's current financial condition;

(b) the condition of the reserve for replacements, including recent and anticipated withdrawals; and

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(c) the physical and financial needs of the project.

The lender must forward the request with its evaluation and recommendation to the Loan Management Branch of the HUD Field Office. The lender's submission must report the current balances in the replacement reserve and residual receipts accounts and current monthly replacement reserve deposits.

(3) The HUD Field Office will review the request and the lender's recommendation. If HUD approves all or part of the request, it will notify the lender and the owner of the amount approved and the purposes for which the funds may be used. If HUD disapproves part or all of the request, it will notify the lender and the owner of the amount disapproved and the reasons for the disapproval.

d. Owner Use of Residual Receipts. The project owner may use residual receipts funds only for the purposes for which HUD authorized their release.

Section 5. Lender Review of Project Financial Reports

3-17. IMPORTANCE OF TIMELY SUBMISSION. The lender should impress upon the owner the importance of the annual financial report. Prompt submission of the financial statement will enable the lender to process requests for rent increases in an expeditious manner and to deal effectively with impending problems before they threaten the viability of the project. The lender must establish a process for identifying when statements are due and must promptly follow-up when statements are not submitted by the date due.

a. Lender Follow-up on Past Due Reports. If the lender has not received a project's annual financial statement within 60 days after the end of the project's fiscal year, the lender must give the owner a written demand for the financial statement. The lender must send a copy of this letter to the HUD Field Office. The lender's letter must remind the owner that: (1) failure to submit the report within 60 days after the end of the project fiscal year is a violation of the regulatory agreement; and (2) if the owner fails to submit its annual financial report within 60 days of the due date or any later date agreed to in writing by the lender, the lender may retain a certified public accountant to prepare the report and assess the project for the cost of the report. The CPA must be independent of both the owner and the lender. The lender may hire a CPA for this purpose only after the lender has given the owner 30 days written notice of its intent to do so.

b. Extension of Time to Furnish Reports. The lender may approve an extension of time for submission of the annual financial report, but should do so only when the delay was caused by circumstances beyond the control of the owner. The lender may not extend the due date beyond 60 days after the original due date, since the usefulness of

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the required statements diminishes the longer the report is delayed, and late submissions could be used to hide diversions of cash or other violations of the regulatory agreement. The lender may not approve an extension if the delay is needed because of the owner's failure to maintain adequate records or to engage an accountant before the end of the fiscal year.

3-18. LENDER REVIEW OF ANNUAL FINANCIAL REPORTS. HUD Handbook 4370.1 provides detailed guidance for HUD Field Offices to use in reviewing and evaluating annual financial statements. Lenders should adopt similar review procedures. While lenders are not required to follow these procedures step-by-step, lenders should employ prudence and discretion and tailor the scope of the review to the condition of the project and the performance of the project owner, management agent and accountant. Generally, the review must include the steps summarized below.

a. Check for Completeness. Does the report contain all the required statements, supplemental schedules and an auditor's report? Are these in the form required by HUD Handbook IG 4372.1?

b. Review Auditor's Report. Does the auditor's work comply with AICPA, IG and GAO Standards? Has the auditor reported any internal control problems, any diversions or unauthorized distributions, or any noncompliance with HUD requirements?

c. Check for Compliance. Has the IPA/owner accurately computed surplus cash, the amount available for distribution, and the amount required to be deposited to residual receipts? Have distributions been paid in excess of surplus cash or amounts earned? Has the mortgagor complied with other HUD requirements on the use of project funds? Have project assets been used for purposes other than the necessary and reasonable operation of the project (e.g., loans to individuals, related projects or businesses)?

d. Analyze Project Performance. The lender should use the financial report to analyze the project's past performance and determine if any remedial or preventive action is needed. This includes assessing the reasonableness of the project's expenses, evaluating the effectiveness of management's rent collection practices, and analyzing the project's liquidity and cash flow. Is the approved rent potential sufficient to cover debt service and operating expenses anticipated for the coming year? Does the project have enough cash to meet its accrued obligations?

3-19. LENDER REVIEW OF MONTHLY ACCOUNTING REPORTS. HUD Handbook 4370.1 provides a checklist which the lender may find useful in reviewing and evaluating monthly financial reports. The lender should adapt the review to the purpose for which the reports were requested and to the past performance of the owner or agent.

3-20. INITIATION OF CORRECTIVE ACTIONS. If the lender's review of the annual or monthly financial report discloses adverse conditions or compliance problems, or if the auditor's work is deficient, the lender must communicate these findings to the owner and pursue any necessary corrective actions.

a. Notification of Findings and Corrective Actions Needed. The lender should notify the owner in writing of any adverse findings and recommended or required corrective actions. The letter should be mailed to the owner with a copy to the management agent. Exhibit 3-1 lists some examples of corrective actions that may be needed.

b. Follow-up. If the owner does not respond by the date specified in the letter, the lender should prepare a follow-up letter. The regulatory agreement requires the owner to furnish a response to the lender's written inquiries regarding annual or monthly financial statements no later than 30 days after receipt of the inquiry. Until a response is obtained, the lender may suspend other processing actions (e.g., approval of withdrawals from the reserve for replacements, approval of rent increases, etc.)

3-21. USE OF ENFORCEMENT TOOLS. If the owner refuses to implement actions necessary to protect the lender's and the Secretary's interests, the lender may need to use the enforcement tools embodied in Section C of the Regulatory Agreement and/or request HUD to impose administrative sanctions. These administrative sanctions are listed in Exhibit 3-2. Limited guidance regarding use of these sanctions is provided in HUD Handbook 4370.1. Specific policies and procedures for imposing these sanctions are included in HUD Handbook IG 2003.3A, Audit and Investigation Activities, and HUD Handbook 4080.1, Compliance Handbook for Housing.

3-22. REPORTING TO HUD. The lender must send the HUD Field Office copies of all correspondence regarding an owner's failure to comply with this Chapter's requirements, project operating problems detected during the review of the financial statement and plans for resolving those compliance or performance problems. This includes letters to and from owners, management agents and/or auditors. The lender also must report promptly to HUD's Office of Inspector General all information or allegations indicating possible fraud.

3-23. FINANCIAL RECORDS RETENTION REQUIREMENTS. The lender must keep copies of the annual and monthly monthly financial reports and related correspondence for three years after the date each report was due.

EXHIBIT 3-1.

POSSIBLE CORRECTIVE ACTIONS

TYPE OF CONDITION	POSSIBLE ACTION
Owner Non-Compliance or Diversions	o Require mortgagor to repay any unauthorized disbursements.
	o Request OIG audit or independent review of limited items in the owner's records if uncertain as to exact amount diverted.
Performance Problems	o Conduct on-site inspections earlier than originally planned.
	o Process rent increase.
	o Increase replacement reserve deposits.
	o Require owner to change the management agent or operating procedures.
	o Request monthly accounting reports.
	o Request budget and/or quarterly reports on budget.
IPA's work not complying with AICPA, IG, and GAO standards - especially failure to report major diversions, improper opinions	o Refer through Regional Inspector General to State licensing board.
	o Require owner to obtain a new IPA for future audits.
	o Request Field Office Manager to impose Temporary Denial of IPA Participation.

EXHIBIT 3-2.

HUD ADMINISTRATIVE ENFORCEMENT ACTIONS

ACTION	PLAYERS
Temporary Denial of Participation	Field Office Manager can

	approve.
Suspension or Debarment	Field Office recommends to Assistant Secretary for Housing who decides if action is warranted.
Prosecution	Field Office Loan Management staff initiates and passes recommendation to Field Counsel. Regional Inspector General available to assist in documenting facts.
Referral to State/Local Accounting Licensing Boards	Field Office recommends to Regional Inspector General staff.
Audits or Investigations	Field Office recommends to Regional Inspector General staff.