



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
OFFICE OF AFFORDABLE HOUSING PRESERVATION

February 19, 2009

Name
Address ALL M2M AND DEMO OWNERS
Address
Address

SUBJECT: 2009 M2M and DEMO Accounting Q&As
Full Restructuring Financial Reporting and Post Closing Portfolio Management
Compliance

Dear Owner/Agent and/or Owner's Accountant

HUD's new Post-Closing Portfolio Manager (PCPM), MBI Consulting Inc. (MBI), has improved the processes and procedures for the annual surplus cash analysis. OAHP and MBI expect to make significant progress in the coming year towards eliminating the backlog and becoming current with the annual reviews.

We have often been asked why we perform surplus cash analyses. HUD's experience has been that fiscal performance improves when there are established standards of accountability, review, and monitoring. The PCPM surplus cash analysis review is a key component for meeting our fiduciary responsibility to Congress and to taxpayers. Since our last accounting Q&A letter in November 2007, we have received many new questions and comments from experienced owners and accountants and from those new to M2M transactions. We have compiled these questions and answers for this 2009 Accounting Q&A Letter. We encourage you to review the full library of past M2M accounting letters at: <http://www.hud.gov/offices/hsg/omhar/mhrowner.cfm>.

If you have other questions, please send an email to the OAHP Resource Desk at resourcedeskweb@oahp.net. Your questions will be answered by our OAHP portfolio management staff. Our experienced team is directed by Linda Field and managed by Jo Anne Garrison, Mike Murphy and Bev Rudman. You may contact any of them by calling 202-708-0001.

The PCPM surplus cash review is calculated using the information filed in the annual financial statements (AFS) in the Financial Assessment Subsystem (FASS) at HUD. FASS is managed by HUD's Real Estate Assessment Center (REAC) and you can direct your filing questions by phone to 888-245-4860, or by email to REAC_TAC@HUD.gov. You may also find answers to your questions on the REAC Technical Assistance Center website at: <http://www.hud.gov/offices/reac/support/tac.cfm>.

Sincerely,

Theodore K. Toon
Deputy Assistant Secretary
Office of Affordable Housing Preservation

CC: Project Accountants Identified in FASS
HUD PMs, DEC and REAC staff
MBI Consulting, Inc.

1. How can an owner obtain information on the current M2M mortgage account balances? The accountant needs this to prepare the AFS.

Dynaxys, HUD's multifamily notes servicing contractor, can provide this information upon receipt of a written request from the owner. For self-service access to up-to-date account information on HUD-held M2M and DEMO notes, information is also available on the Dynaxys Mortgage Loan Servicing Website at <https://www.dynaxys.com/mlsw/>. Click on "New User" to gain access to information on a property. The FHA loan number and owner's tax ID number must be entered. Authorized users can view the following information:

- Mortgage confirmation
- Payments applied to accounts
- Current balances
- Accrued interest details
- Tax payments
- Reserve balances

Some owners may provide their accountants with access to the website information for a period of time.

2. If the Final Surplus Cash Analysis (FSCA) for a prior fiscal year determined that an additional payment is due on the M2M note and required specific accounting adjustments, what is the process for making these required adjustments?

The PCPM addresses necessary adjustments and the required sources of funding for additional payments in the FSCA in Section I, Issues and Recommendation. Pay special attention to specific guidance given by the PCPM regarding required sources. If, after reviewing Section I, these requirements are not clear, please contact the PCPM analyst directly.

On the next monthly billing statement following issuance of the FSCA, HUD's multifamily notes servicing contractor (Dynaxys) will bill for the additional amount and the PCPM will review the sources of repayments in the next year's financial statements. If the next year's financial statements do not show appropriate adjustments and repayments as detailed in the FSCA, enforcement action may be initiated. The HUD project manager (HUD PM or PM) may request additional documentation to demonstrate compliance with the findings in the FSCA. If so, please respond directly to the PM.

3. Where can I look-up/confirm HUD account numbers to be used in FASS? Account numbers are not numerically ordered within the FASS templates; it is difficult to determine the appropriate account numbers.

Owners and accountants should review the FASS User Guide for help finding appropriate HUD account numbers. See Chapter 13 of REAC's Industry User Guide for the Financial Assessment Subsystem - Multifamily Housing (FASSUB 7.0).
http://www.hud.gov/offices/reac/products/fass/fassmf_guide.cfm.

4. FASS created a new account, FASS 2114, titled “Incentive Performance Fee Payable”. When should it be used and what does it replace?

The new FASS account 2114 was created in 2007. FASS account 2114 should be used to report the Incentive Performance Fee (IPF) that is earned in the current year and payable in the subsequent year. The amount in FASS account 2114 should match the calculated IPF reported in FASS account S1300-203 on the Computation of Surplus Cash and the amount reported as IPF earned in FASS account 7115 on the Statement of Profit and Loss. This supersedes prior guidance given in Question #7 in the 2004 Accounting Q&A Letter.

NOTE: If the IPF is not paid in the year subsequent to the year it is earned, then the owner loses the right to take it. An IPF should never appear on the Computation of Surplus Cash as an obligation.

5. Where do I report the interest expense for the Mortgage Restructuring Note (MRN) and Contingent Repayment Note (CRN), collectively “M2M notes”, on the Statement of Profit and Loss? Should the interest be reported in FASS account 6825, “Interest on Other Mortgages” (a project account) or in FASS account 7142, “Interest on Mortgages Payable” (an entity account)?

Interest due on the M2M notes should be reported in FASS account 6825, “Interest on Other Mortgages.”

6. If the FY 2006 FSCA disallowed “Repairs and Maintenance” expenses that should have been reimbursed from the R4R account and the HUD PM agreed to allow reimbursement of the FY 2006 expenses during FY 2008, how should the delayed reimbursement request be shown in the FY 2008 AFS? What if the reimbursement is not received until FY 2009?

Typically expenditures, requests for reimbursement associated with those expenditures, and the associated reimbursements themselves all occur in the same year. When this does not occur, special rules apply as shown in the following example.

EXAMPLE: In August 2008, HUD issued the FY 2006 FSCA to the owner, disallowing Repairs and Maintenance expenses of \$100,000 because the expenses should have been reimbursed from the Reserves for Replacement account (R4R). This caused an additional payment to be due on the MRN. The owner was billed for the additional amount due in September 2008 (\$75,000, assuming a 75%/25% split applied to the \$100,000 disallowed expenses). In October 2008, the owner promptly paid the \$75,000 owed from non-project funds and submitted a request for release of \$100,000 from the R4R for reimbursement of those FY 2006 expenses. The owner received reimbursement from the R4R in December 2008. Scenario A below responds to this example. See Scenario B below for the accounting treatment required if payment and reimbursement occur in different fiscal years.

Scenario A – If payment to HUD and reimbursement from R4R occur in the same fiscal year, handle as follows:

1. An entity payable account is established to recognize the owner's out-of-pocket payment on the MRN.
2. HUD approves the reserve release. Thereafter, \$100,000 is transferred from the R4R account to the operating account and will appear on the 2008 Statement of Cash Flows as a source of operating cash in FASS account S1200-250.
3. \$75,000 is paid back to the owner from the operating account to extinguish the entity payable.
4. The remaining \$25,000 of the reserve release may remain in the operating account and becomes part of the surplus cash calculation as of 12/31/2008 OR it may be returned to the

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owner as the owner's share of surplus cash, provided the owner is entitled to distributions (i.e., if all preconditions were met for that period).

5. The 2008 Statement of Cash Flows shows the receipt and repayment of the owner advance in FASS account S1200-455 (Entity Financing Activities) and the principal and interest payments on the MRN, CRN, or DEMO notes in FASS accounts S1200-361 and/or S1200-181. If the owner distributes the remaining \$25,000 it is shown as a distribution in FASS account S1200-420. The Notes to the Financial Statements for 12/31/2008 must fully disclose the details of these transactions.

Scenario B – If payment to HUD was made in the fiscal year prior to when the owner received reimbursement from the R4R, handle as follows:

1. An entity payable account is established to recognize the owner's out-of-pocket payment on the MRN.
2. The audited financial statements for 12/31/**2008** disclose the entity payable in FASS account 2113 – "Accounts Payable – Entity," and the Statement of Cash Flows shows the \$75,000 cash receipt from the owner in FASS account S1200-455 and shows principal and interest payments on the MRN in FASS accounts S1200-181 and S1200-361. The Notes to the Financial Statements for 12/31/2008 must fully disclose the details of these transactions. The \$75,000 entity payable **CANNOT** be shown as an obligation on the 12/31/2008 Computation of Surplus Cash.
3. The 12/31/**2009** financial statement discloses the \$100,000 withdrawal from the R4R account and the Statement of Cash Flows show the \$75,000 repayment of the owner advance in FASS account S1200-455 - "Entity/Construction Financing Activities." The remaining \$25,000 of the reserve release may remain in the operating account and become part of the surplus cash computation as of 12/31/2009 OR be returned to the owner as the owner's share of surplus cash, provided the owner is entitled to distributions (i.e., if all preconditions were met for that period).
4. The Notes to the Financial Statements for both years, 12/31/2008 and 12/31/2009, must fully disclose the details of these transactions in order to prevent the owner from being cited for unauthorized distributions.

NOTE: In this example, if the FY 2006 FSCA had warned that certain expenses should be reimbursed from the R4R but did not "disallow" them, the delayed reimbursement should promptly be requested from the PM and should be accounted for in the next reporting period. The late submission of the reimbursement request to HUD and related FSCA comments should be described in the notes to the AFS.

7. **HUD denied certain repairs and maintenance type expenses for a property in the FY 2006 FSCA because they should have been reimbursed from the Reserve for Replacement Account (R4R). The HUD PM says they may not approve 'old' R4R reimbursements, even though those reimbursements are addressed by OAHP in the FY 2006 FSCA. Can OAHP grant a waiver in order to allow the reimbursement?**

No, OAHP cannot grant a waiver. HUD Headquarters multifamily staff advises that PMs have discretion in approving old reimbursement requests, especially if ineligible repairs and maintenance expenses were not previously cited by the PCPM in the SCA. HUD Handbook 4350.1 says "Owners should make reimbursement requests during the same (project) fiscal year in which the expenditure occurred, preferably at least sixty days prior to the close of the project's fiscal year". **However, if a request for reimbursement is submitted within a reasonable time of being notified by OAHP and the PCPM, such delayed reimbursement requests may be considered by the PM.** Submit Form 9250 at once when notified by OAHP and the PCPM contractor, and include documentation explaining the delayed submission to the HUD PM and requesting special consideration for the late submission. Prior year adjustments,

including any reimbursement requests denied by the PM, must always be fully documented in the Notes to the Financial Statements.

8. How and when am I billed for payments that are due on the MRN, CRN or DEMO loan?

Loan payment notices for the M2M notes are generated and mailed to you by Dynaxys, HUD's multifamily notes servicing contractor. Your filing of the Annual Financial Statements (AFS) identifies the required loan payment for that period. The required payment amounts as well as the receipt of any payments are transmitted to Dynaxys and are incorporated into the regular monthly billing cycle. If the FSCA (mailed to you by the PCPM) reflects an adjustment to the loan payment amount, that adjustment is then relayed to Dynaxys and is incorporated into the next monthly billing statement. If full payment has not been made, that billing statement will reflect an amount due HUD. To assure your payments are applied promptly and correctly, please include the following information with your payment: the M2M/DEMO loan number, the project name, and the purpose of the payment (for example, surplus cash payment for FYE 12/31/08, or settlement adjustment for FYE 12/31/08, etc.).

9. Each year the PCPM asks some owners for supplemental information related to entity transactions, capital recovery payment (CRP) and incentive performance fee (IPF) for each property in their portfolio. These questions arise although the accounting for CRP and IPF in the financial statements complies with generally accepted accounting principles (GAAP). How should this entity accounting be handled in order to achieve transparency in FASS?

This situation occurs with a few owners who consider the partnership the owner of the property (instead of the individual partners) and are treating CRP and IPF as "return of capital" and then rolling CRP and IPF into a net distribution in lieu of using the prescribed FASS accounts for each. This accounting approach generally provides a net distribution amount with no detail on how the net figure was reached, resulting in questions each year from the PCPM. Owners must provide sufficiently detailed accounting data in FASS in order for HUD to determine whether the IPF and CRP were accrued and paid appropriately and in the correct amounts since those payments directly affect the computed payment due to HUD on any M2M notes. To facilitate HUD's review, the following accounting treatment is recommended:

Each type of entity payment (whether CRP, IPF, or distributions) needs to be shown individually, in lieu of netting, and the owner must use the specified FASS accounts for CRP and IPF with adjusting entries reflected in the Entity accounts:

- The AFS must contain a supplemental schedule detailing all receipts and disbursements from the entity cash account(s) including beginning and ending balances of said account(s).
- If the ownership entity chooses to treat any IPF payment as a return of capital, the full amount of any IPF that is earned must still be shown in FASS account 7115 on the Statement of Profit and Loss and as an accrued liability on the balance sheet using FASS account 2114 – "Incentive Performance Fee Payable." Then the ownership entity should use FASS account 7190 for any adjusting entries (this account requires detail in FASS account [7190-010 or -020]). See #4 above for further IPF discussion.
- If the ownership entity chooses to treat any CRP payment as a return of capital, the full amount of any CRPs that are earned must still be shown in FASS account S1200-417 – "Principal Payments on Capital Recovery Payment (M2M)" and FASS account S1200-195 – "Interest on Capital Recovery Payment (M2M)" in the Statement of Cash Flows. The ownership entity must use FASS account 7190 for any adjusting entries (this account requires detail in FASS account [7190-010 or -020]).
- CRP payments made during a fiscal year are reported on the Statement of Cash Flows

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- in FASS accounts S1200-417 (principal portion) and S1200-195 (interest portion).
- At the end of a fiscal year, the loan will have a remaining principal balance. Some of the remaining balance is to be paid within twelve months and is shown as a current liability in FASS account 2179, with the balance being a long term liability shown in FASS account 2329.
 - If any payments have become due but have not been paid as of fiscal year end, there will also be accrued interest payable, which should be shown in FASS account 2139 – “Accrued Interest Payable – Capital Recovery Payment (M2M)”.
 - In the Statement of Cash Flows, payment of the cash flow “split” from the prior year’s surplus cash must be reflected in FASS account S1200-420 – “Distributions” for the owner portion of the split. The ownership entity must use FASS account 7190 for any adjusting entries (this account requires detail in FASS account [7190-010 or -020]).

10. Must an owner respond to the PCPM’s questions about expenses when there will be negative surplus cash regardless of whether the questioned expenses are allowed?

Yes, HUD takes seriously the agreements the owner made at the time of the M2M restructuring and a failure to respond violates those terms and conditions. HUD must confirm the calculation of surplus cash (even if it is negative) and doing so requires an analysis of the individual line items. In addition, it is important for the SCA to be based on complete and correct information each year, as the current year will form the basis for reviews in future years. If an owner is non-responsive to the PCPM’s requests for information, HUD may issue a management finding which is deemed a default under the Regulatory Agreement and would result in forfeiture of the IPF and CRP (or owner distributions in a DEMO restructuring) for the current and/or future years. Unresolved findings could impact the principals’ 2530 approval, result in fines, and ultimately lead to acceleration of the M2M/DEMO notes.

11. How may an extension of the FASS filing deadline be granted if an owner does not want to lose out on eligibility for IPF because of a late filing or late payment?

Extension requests must be submitted online in the FASS system and are approved or denied by HUD’s Real Estate Assessment Center (REAC). Extension requests must be submitted before the due date. HUD’s policy is that extensions will be approved only for circumstances deemed to be beyond the owner’s control (i.e., natural disasters, deaths, database problems caused by HUD personnel). See also Question #25 in the 2007 Accounting Q&A Supplemental Letter.

12. How does an owner re-file a financial statement for a prior year to correct an error that was made? For example, what if the AFS filing reflects a payment due to HUD but the amount is incorrect.

Resubmission requests must be submitted online in the FASS system and are approved or denied by REAC. REAC can be reached by phone at 888-245-4860, or by email to REAC_TAC@HUD.gov.

HUD generally discourages owners from re-filing a prior period AFS, unless it is materially misstated (e.g. the balance sheet, profit and loss, or statement of cash flows is incorrect). If there are problems with supporting schedules (e.g., Computation of Surplus Cash) HUD usually requests that a revised schedule be submitted in hard copy form to the HUD Project Manager (PM) and those changes be entered in the footnotes of the project’s next AFS along with an explanation as to why the revised calculation was required. The AFS footnote should summarize all correspondence from HUD addressing adjustments to prior year AFSs, including findings from prior year FSCAs.

13. Are payments due on DEMO and M2M notes within 10 days of the AFS due date or within 10 days of filing the AFS? If an AFS is filed before the filing deadline, is there an earlier payment due date?

Payments are ALWAYS due ten (10) days after the date that the AFS is due to HUD. If an AFS is filed before or after the filing deadline, the payment due date does not change.

14. Are project accountants routinely provided with copies of the FSCA that was completed by the PCPM?

No, the FSCA is not transmitted to accountants by HUD or its contractor; this is the owner's responsibility. Since the FSCA may address project operations and accounting adjustments to be made in the AFS for the subsequent filing period, it is important that project-specific FSCAs be provided by the owner to the project accountants. Failure to address prior year corrections may result in management findings in the subsequent year, impacting owner eligibility for cash flow distributions (including the CRP, IPF, and owner distributions).

15. If the meaning of any of the comments made in the FSCA is not clear to an owner or to the HUD PM; who should be contacted for clarification?

Please contact the PCPM Help Desk at pcpmhelpdesk@mbicfs.com to seek clarification. For further questions, contact the PCPM Project Manager, Rick Copeland, by phone at 301-986-1595, extension 108 or by email at rcopeland@mbicfs.com. If you continue to have questions after contacting the PCPM Help Desk and the PCPM Project Manager, please contact the OAHP Portfolio Management staff (see cover letter for contact names and phone number).

16. What is the "Baseline" that the PCPM refers to, and why is it important if an expense exceeds it?

The Baseline refers to the operating expense levels determined during the M2M underwriting process. The owner and the M2M underwriters agreed on those expense levels in the M2M restructuring process and the property should be operating reasonably at or near the Baseline expense amounts, adjusted annually for the operating cost adjustment factor (OCAF). Expenses that exceed the Baseline decrease the operating cash and could jeopardize the financial stability of the property. Alternatively, expenses that are lower than the Baseline could signal a decrease in services.

17. Why are Baselines not being adjusted? Won't the variances keep growing, triggering more and repeated questions in the surplus cash analysis?

The M2M baseline was developed after an extensive analysis by the M2M underwriters and through negotiations and agreement with the owner. Circumstances change and some changes are long-lasting, but the SCA process does not include the same extensive underwriting and collaborative process as occurred during the M2M restructuring process. After a variance has been explained by the owner and the variance accepted by HUD, the PCPM will take that explanation into consideration in the following years. An owner may be asked to confirm that there is no change in the reason for particular expense variances, but OAHP and the PCPM are aiming to avoid unnecessarily repeating questions on specific line items in future years.

18. Do OAHP and the PCPM prepare FSCAs after a property is sold to a Qualified Non Profit (QNP) with debt relief? Where should questions regarding HUD AFS reporting requirements after a Transfer of Physical Assets (TPA) and QNP debt relief be directed?

No, OAHP and the PCPM do not review the AFS or prepare an FSCA for operations subsequent to the completion of QNP debt forgiveness or debt assignment. Draft versions of

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the seller's partial year AFS are reviewed during the TPA/QNP review process. Formal submission of the seller's partial year AFS in FASS is still required and subject to standard review by MF and REAC.

The QNP's AFS (for the partial year and subsequent reporting periods) should be prepared in accordance with standard HUD accounting requirements. Non M2M AFS questions should be directed to the HUD PM or to the REAC Technical Assistance Center (TAC) via email at REAC_TAC@HUD.GOV .