
CHAPTER 3. FINANCIAL REPORTS AND SUPPORTING DATA**3-1. INTRODUCTION**

This chapter discusses the submission of reviewed financial statements and the IPA's report on those statements, the report on the internal control structure, the report on the compliance with applicable laws and regulations and the supplemental data reports required by HUD.

The mortgagor is responsible for submitting the annual financial statements as required by HUD and the IPA audits the reports and furnishes an opinion on the financial statements. The owners are expected to maintain books and records in accordance with Generally Accepted Accounting Principles (GAAP) and the auditor must thoroughly review these records using Generally Accepted Auditing Standards (GAAS) and Government Auditing Standards (GAS). The IPA must also use the audit guide: IG 2000.4, Consolidated Audit Guide for Audits of HUD Programs.

GAAP are broad rules adopted by the accounting profession as guides in measuring, recording, and reporting the financial activities of a business. 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 field work (3) standards of reporting. GAS (which are issued by the U.S. General Accounting Office (GAO) are standards for audits of government organizations, programs, activities and functions of government funds received by contractors, nonprofit organizations, and other nongovernmental organizations.

The purpose of an audit is to have the IPA render a professional opinion on the reliability of the financial statements as an accurate reflection of the project's condition and performance.

Project owners should use competitive bidding processes when procuring the services of an IPA. These processes could vary depending upon the size and the needs of the project from a simple telephone bidding (of at least three auditors) to a

comprehensive invitation for bids (IFB)/request for proposal (RFP) process.

Once an auditor's proposal is accepted, the proposal in effect becomes a contract between the auditor and the mortgagor. The auditor's proposal/engagement letter should include the following:

- o objective of the audit
- o a description of the work to be done and the approach, including that the performance of the audit will be in accordance with GAS and IG Handbook 2000.4
- o auditor's proposed staffing plan for the audit
- o discussion of professional time and fees (in IFBs/RFPs, cost issues are separately bound and reviewed)
- o the auditor, or audit firm's qualifications
- o Finally, the engagement letter must allow for duly authorized agents of the Secretary to examine the IPA's working papers supporting the audit report.

Projects which have audits performed using OMB Circular A-133, Audits of Institutions of Higher Education and Other Non-Profit Institutions should ensure that those audits comply with the guidelines defined in this handbook.

In addition, the project owners should consider the following IPA issues relating to the preparation of the audited statements:

- A. Independent Public Accountants (IPAs) that perform bookkeeping services for a project, are prohibited from performing audits of the project.
- B. To the extent permitted by GAS or GAAS, IPAs may rely on physical inspections of projects made by HUD or mortgagees.
- C. The mortgagor's records include prior year IPA audits, HUD Management Reviews, HUD/Mortgagee physical

inspection reports and HUD-OIG audits. This information should be provided to IPAs and should be stated in the IPA engagement letter.

- D. When conducting compliance tests for Affirmative Fair Housing Market Action Plans, in addition to verifying that such a plan exists, if required by the Regulatory Agreement, IPAs should sample some items, (e.g., advertising expenses) to verify compliance.

- E. Tests that the IPA might make regarding the adequacy of Reserve Fund balances should normally be limited to testing that involves the nature of a "going concern" basis of the mortgagor.

3-2. AUTHORITY

HUD Regulations, regulatory agreements, and other documents through which the Secretary exercises control over the mortgagor, require the submission of various financial reports and supporting data. Such reports shall be prepared at an interim date or as of the end of the annual accounting period to supply HUD and project management with a full disclosure of the results of operation, as well as the financial condition of the project.

- A. From the Regulatory Agreement, the requirement for an annual report states: "Within 60 days following the end of each fiscal year, the Secretary shall be furnished with a complete annual financial report based upon an audit of the books and records of the mortgagor, prepared in accordance with the requirements of the Secretary, certified to by an officer or responsible 'Owner' and, when required by the Secretary, prepared and certified by a Certified Public Accountant, or other person acceptable to the Secretary".

In other words, the mortgagor is responsible for preparing the required financial statements and certifying that the statements are accurate. However,

an Independent Public Accountant examines the financial statements to express an opinion.

- B. The Regulatory Agreement also contains an option to require monthly occupancy reports: "At the request of the Secretary, his agents, employees, or attorneys, the Owners shall furnish monthly occupancy reports and shall give specific answers to questions upon which information is desired from time to time relative to the revenue, assets, liabilities, contracts, operation, and condition of the property and the status of the insured mortgage."
- C. Under certain circumstances, special operating (revenue) statements must be submitted.

1. When occupancy occurs during the construction period, an operating (revenue) statement is required covering the period from the date of first occupancy to the cutoff date for inclusion of interest. At the option of the mortgagor, the statement may cover the period from the date of first occupancy to the last day of the month in which the final Inspection Report was signed. If this election is made, interest, taxes, insurance, and mortgage insurance premiums will also be cut off (i.e. treated as capital costs) as of the month-end date used for the statement.
2. In the rare instance when more than three months intervene between the cost certification cutoff date and the first principal payment as originally scheduled, an income statement is required, covering all operating revenue and expenses during the period, for an advanced amortization determination. This requirement does not apply to investor-sponsor or nonprofit mortgagors, or to any project wherein the mortgage does not exceed \$200,000.

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- 3-3. REQUIREMENTS OF FINANCIAL REPORTS. The following requirements pertain to all controlled projects except cooperative housing:
- A. Financial reports shall be based on data obtained from separate books and records established for and relating solely to the project. Particular care must be taken in cases where an individual person owns and operates additional projects. In other words, each project's books must be separate and distinct. There are instances where other projects have similar officers or identity of interest management firms managing the property.
 - B. Reports must cover the project's entire fiscal period under review. A financial report is required even if any fiscal period is less than a full year.
 - C. The Annual Financial Statements must be prepared on an accrual basis, after making all year-end adjustments. Since the report is based on an examination of books and records of and related to the mortgagor, or entity, the mortgagor shall advise the mortgagee, at least 30 days prior to the end of the mortgagor's fiscal year, that

a statement reporting the escrow, and various reserve fund balances is required as of the date on which the fiscal year ends. As part of the annual audit, the IPA will ask the mortgagee to confirm the amounts of all funds under its control and that they are Federally insured as to principal.

- D. The Report shall be audited by an Independent Public Accountant (IPA) who is a Certified Public Accountant (CPA) or a licensed or registered public accountant having no business relationship with the mortgagor except for the performance of audit, systems work and tax preparation. IPAs who are not Certified Public Accountants must have been licensed or registered by a regulatory authority of a State or other political subdivision of the United States on or before 12/31/70. In states that do not regulate the use of the title "public

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accountant," only Certified Public Accountants may be used to make these audits.

3-4. PREPARATION OF FINANCIAL REPORTS

TYPES OF REPORTS AND REPORT CONTENT: The financial statements, except for cooperative housing projects, must contain the following reports, as applicable:

- A. A Statement of Financial Position (Balance Sheet including a Statement of Changes in Owners/Partners Equity. (Appendix 4). The Balance Sheet shows the financial position of an entity at a specified point in time.

The Balance Sheet must reflect all prepaid and deferred items. For nonprofit elderly housing projects only, if founders' fees, life membership contracts or similar funds are received, the Balance Sheet must show:

1. In appropriately titled Fund (Asset) accounts, the aggregate of such cash on hand at the end of the fiscal year, and
2. In appropriately titled Deferred Income (Liability) accounts, any portions of such cash received but not earned at the end of the fiscal year. If there are differences in the conditions under which the funds were received, a separate account shall be established for each class. For example, separate accounts are

required if certain classes of funds are refundable, either in whole or in part, while others are not.

- B. A Statement of Income for the year under review. (Appendix 5). The Statement measures the results of operations for the year under review. This must conform to the following requirements:

1. It must be submitted on Form HUD-92410.

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2. It must show Gross Potential Income less vacancies to arrive at a Net Rental Income.
3. Any apartments or commercial space occupied but not producing revenue must be shown as an expense under the applicable expense classification, and a supporting schedule must be submitted listing the names of such occupants and their connection with the project. If no such revenue applies, it shall be so indicated on the statement.

For Section 221 and Section 236 nonprofit projects only:

4. If gross potential unit rental revenue reported differs from that shown on the Form HUD-92458, Rental Schedule and Information on Rental Project (see Appendix 6), then in effect, a detailed statement accounting for the difference must be attached.
5. Any expenses reported for salaries or other compensation to supervisory or administrative employees, officers, directors, or stockholders must be supported by a schedule showing duties, salary paid, and date of prior written HUD approval.
6. A full explanation is required concerning any receipts from charges for facilities or services, other than reimbursement for breakage or damage by tenants.

For nonprofit elderly housing projects only:

7. Receipts from donations, subsidy payments, portions of founders' fees, life membership contracts, and similar funds earned during the

current year, etc., shall be reported and fully identified.

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- C. A Statement of Retained Earning (Appendix 8). This shall include an explanation of changes in the account other than net income or loss for the operating period.
- D. A Statement of Shareholders' Equity or Partners' Capital (Appendix 9). This shall include a full explanation of origins, additions, and deductions during the operating period. This statement could also be shown as part of the Statement of Financial Position (Balance Sheet).
- E. Statement of Cash Flows, (Appendix 10) shall include funds provided and applied for all cash and certain non-cash expenses (e.g. depreciation) to reflect net increase/decrease in cash during the operating period. The statement shall include no less detail than that shown in Appendix 10 and may include footnotes, if applicable. It shall be prepared using the Direct Method and shall include all receipts, i.e., rental revenue, concessions, commercial property, advances by owner, releases from the Reserve for Replacements, etc. It shall also include all disbursements, whether by check or in cash. In addition, a schedule of funds in the bank must be attached showing each depository by name, account title, and balance, including funds held in the Reserve Fund for Replacements and the Residual Receipts Accounts whether these accounts are maintained by a mortgagee or by the mortgagor.
- F. Notes to Financial Statement includes notes relative to the mortgagor 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 statement by the mortgagor's accountant. In addition, the notes should indicate the type of project and basis for computation of distributions shown.
- G. Supporting Data, in the form of explanatory comments or appropriate schedules. See Appendix 11 Supporting Data for samples of the reports required by HUD. This must include the following:

1. Accounts and Notes Receivable. A complete, detailed analysis shall be included of any accounts or notes receivable other than regular tenant accounts, including date acquired, original amount, terms, name of borrower and balance due.
2. Delinquent Tenant Accounts Receivable. A summary analysis shall be made of delinquent tenant accounts, including the number of tenants and amounts delinquent for 30 days, 30-60 days, 60-90 days, and over 90 days.
3. Mortgagor Escrow Deposits. A breakdown shall be made of the items making up the total amount on deposit with the mortgagee in anticipation of future disbursements for mortgage insurance premiums, taxes, property insurance, etc. This amount shall be confirmed in writing by the mortgagee.
4. Tenant Deposits. A complete, detailed analysis shall be included of funds maintained in any regular tenant accounts such as security/pet deposits.
5. Reserve Funds. An analysis shall be made of all required reserve funds, including:
 - a. A statement as to the amount required. If more than one fund is required to be established, a separate statement must be submitted for each fund.
 - b. A statement as to the form in which these funds are provided. If funds are in cash, the names of the depository of each fund are required, if invested in securities, full details are required.

- c. A statement of any withdrawals during the year, including the purpose of and authority for such withdrawals.

6. Change in Fixed Asset Accounts. A schedule shall be included, showing full details and explanations of any Changes in Fixed Asset Accounts.
7. Accounts Payable. A list shall be included of accounts payable, other than trade creditors, segregated by those payable within 30 days, 30-60 days, and more than 60 days, with detailed analysis of the latter group, to include date incurred, original amount, purpose, terms, creditor, and balance due. Accrued expenses shall be shown separately from accounts payable.
8. Accrued Taxes Payable. A statement shall be attached supporting any accrued taxes shown, including each type of tax, basis for the accrual, and date due.
9. Notes Payable (Other than Mortgage). Details shall be included of loans or notes payable, other than the insured mortgage, including date incurred, original amount, purpose, terms, creditor, and balance due.
10. Stock Actively Reports - Initial Submission. In the initial report (the first report submitted on the project), full details shall be included concerning the issuance of all stock and/or investments, including names of stockholders or individuals interested, proportionate interest of each and whatever consideration is received by corporate or noncorporate projects (considerations shall be itemized to show amount of cash, land, services, etc.). Initially, a list shall be furnished consisting of officers, directors, and individuals having a financial

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interest in the project. Thereafter, details shall be furnished of any changes in these positions occurring during the year. If no changes have occurred, it should be so noted.

11. Distributions to Owners or Stockholders. If any dividends were paid or if other distributions were made to owners or stockholders (including purchase or redemption of any stock of the corporation), the amount declared on each class

of stock shall be shown along with the period for which it was declared, the date of declaration, and the date of payment. For limited distribution mortgagors, a statement is required as to both the cumulative and the current (fiscal year) amount of return on equity earned.

12. Unauthorized Distribution of Project Revenue. If any unauthorized distribution of project revenue is revealed during the audit, a separate schedule must be prepared detailing the amounts involved, date of distribution and any other relevant information.
13. Comments on Statement of Position (Balance Sheet) Items. Comments on and explanations of all other Balance Sheet items not fully explained by the title of the account shall be a part of the report.
14. Residual Receipts. For all projects required to make deposits to a residual receipts fund, a computation shall be included showing the amount of any such receipts at the end of the fiscal year and the date of their deposit to the fund. An analysis of this fund and the computation are required regardless of whether or not residual receipts have actually been generated.

15. Donations, Subsidy Payments, Founders Fees, etc. for Non-Profit Elderly Housing Only. In the initial report (the first report submitted on the project) for nonprofit elderly housing only, full details shall be reported concerning any and all donations as well as subsidy payments, founders' fees, life membership contracts or similar funds, etc., including original amounts and purposes for which expended. In subsequent reports, full details must be given concerning such amounts received, due, and expended during the year.
16. Compensation of Partners or Officers. If a project is owned by a corporation or partnership, a statement detailing the Compensation of Officers or Partners is required. If no compensation was paid, a

statement to that effect will suffice.

17. Listing of Identity of Interest Companies and Activity. A listing of identity-of-interest (as defined below) companies doing business with the mortgagor and/or management agent of the project, along with a breakdown of services rendered and amounts received, shall be required if the payments for services performed for the project totalled \$1,000 during the operating period.

HUD assumes an identity of interest to exist between the project staff and the lender/vendor when (1) the project staff member, or (2) any officer, owner, or director of the project, or (3) any person who directly or indirectly controls 10 percent or more of the project's voting rights is also (1) an officer, owner, or director of the lender/vendor, or (2) a person who directly or indirectly controls 10 percent or more of the lender/vendor's voting rights, or (3) directly or indirectly owns 10 percent or more of the lender/vendor. A vendor is any individual or

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establishment that provides goods or services of any kind to the project for compensation or remuneration.

3-5. TYPES OF SUBMISSION

This paragraph highlights report submission requirements for projects operating under the following situations.

- A. The Partial-Year Financial Statement, covering the period from cost certification cut-off through the end of the fiscal year established by the mortgagor, shall contain the same statements and supporting data required in the annual financial report. Partial-year financial statements also may be required as a result of a Transfer of Physical Assets (TPA) which occurs before the end of the current fiscal period as described in HUD Handbook 4350.1, Insured Project Servicing Handbook.
- B. The Statement Covering the Period of Occupancy During Construction must show gross rents received, excluding security deposits and actual operating expenses incurred during the period. In certain cases,

accrued expenses may be included.

1. Additional allowable operating expenses for this purpose may include:

- a. advertising expense,
- b. rental commissions customary for the type of project, if any,
- c. a reasonable management fee (excluding salaries paid to officers of sponsor or mortgagor), and
- d. electricity, gas, water and operating salaries (maintenance, cleaners, gardeners, elevator operators, etc.) to the extent they are not included in

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construction costs on Form HUD-92330 or Form HUD-92330A.

2. Disallowable Expenses include the following Occupancy costs:

- a. Depreciation
- b. Interest
- c. Taxes
- d. Property Insurance Premiums
- e. Mortgage Insurance Premiums (MIPs)

3. If this statement shows an excess of revenue over operating expenses, as defined, the excess shall be treated as a recovery of construction costs (line 15 of Form HUD-92330), except in nonprofit-mortgagor cases.

- a. A copy of the statement, signed by the mortgagor, must be attached to Form HUD-92330.
- b. In nonprofit-mortgagor cases, net income shall not be treated as a recovery of cost, but transferred at final closing to a residual receipts account

for future project needs. The operating (revenue) statement, however, must be reviewed to determine if any expense items shown in the statement were paid from Allowance to Make a Project Operational (AMPO) funds or otherwise included in cost certification items. If so, the net income reflected in the statement shall be adjusted accordingly; and a requirement made that such adjusted net income be

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transferred to the residual receipts accounts.

4. If operating expense exceeds revenue, no entry is made on Form HUD-92330. In this case, the recognized excess of expense over revenue may be carried over as a reduction of net income.
 - a. The statement shall also include information on net income or loss, cash flows, accounts receivable, and accounts payable. It shall be accompanied by a certification of the accountant.
- C. The Statement Covering the Period Between Cost Certification Cutoff Date and First Scheduled Principal Payment. Although rarely needed, the income statement covering the period between the cost certification cutoff date and the first scheduled principal payment requires special preparation.
 1. When final closing is scheduled after the close of the accountability period, the statement shall be submitted at or before final closing. When final closing is scheduled prior to the expiration of the accountability period, the mortgagor must agree in writing:
 - a. To furnish within 30 days after its expiration an income and expense statement for the required period.
 - b. To apply immediately such portion of the net operation revenue as the Secretary may require as a mandatory prepayment to the mortgage.

2. All rents received, exclusive of security deposits, shall be included as revenue. All expenses for operation, including taxes, insurance, mortgage insurance premium, interest and reasonable management fees (but not officers' salaries or

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depreciation), may be deducted in determining net income for this purpose. If the income statement submitted at cost certification reveals an excess of expense over income, to the extent recognized by the Secretary, such excess may be carried forward as "Unrecovered Expense--Prior Period" to the operating (revenue) statement required by this paragraph.

3. The amount and the handling of the prepayment of the mortgage required under this paragraph are subject to the following:
 - a. In no case shall the required payment exceed the amount that would have been due in cumulative principal payments if the first payment had been scheduled on the first of the month following the month in which the accounting period started.
 - b. Prepayment is required only to the extent that the amount of the net income permits payment of one or more full monthly principal payments as scheduled.
 - c. If the circumstances are such that the operating (revenue) statement is submitted before final endorsement, the mortgagee and mortgagor may elect to have the mortgage endorsed for less than the face amount by a sum equal to that which would have been required as a mandatory prepayment.
4. The statement shall also include information on net income or loss, cash flows, accounts receivable, and accounts payable. It shall be accompanied by a certification of the mortgagor, as well as an accountant.

3-6. REPORTS TO BE ISSUED BY IPA'S

- A. Financial Statement Audit. An independent public accountant shall examine the books and records of the mortgagor and shall furnish an opinion on the annual financial statements in accordance with GAAS and GAS. The independent accountant shall justify any material departure from the "unqualified opinion" language as illustrated in Appendix 12.
- B. Internal Control Structure. In accordance with GAAS and GAS, an independent public accountant 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 on the internal control structure shall disclose all internal control weaknesses considered to be reportable conditions, including material weaknesses, as defined by Government Auditing Standards, published by the Comptroller General of the United States. This report may be included in either the auditor's report on the financial audit or a separate report. The independent accountant shall justify any material departure from the language as illustrated in Appendix 13.
- C. Compliance with applicable laws and regulations. In accordance with GAAS, independent public accountants shall prepare a written report on their tests of compliance with applicable laws and regulations in accordance with IG Handbook 2000.4. This report, which may be included in either the report of the financial audit or a separate report shall include all material instances of noncompliance. The independent accountant shall justify any material departure from the language as illustrated in Appendix 14.

The following additional reports, which may be included in either the report of the financial audit or issued as separate reports, are recommended by GAAS, required by GAS, and are also to be prepared and submitted. Samples of these reports

are included in Appendix 15.

D. Auditor's Schedule of Findings and Questioned Costs. When the auditor identifies a finding, the following information should be provided to HUD officials 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)
- o effect (what happened as a result of the problem)
- o cause (why the problem exists)

The findings reported by an auditor may serve as a basis for HUD to perform additional reviews.

The auditor's "Schedule of Findings and Questioned Costs" should be attached to the auditor's report on compliance.

E. Auditor's Comments on Audit Resolution Matters. This report 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 findings and the status of the corrective action plan. This report also includes findings contained in program review reports, and state agency reports.

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3-7. MORTGAGOR'S CERTIFICATION.

A. The annual financial report shall include: (1) a certification by the mortgagor, when the project is owned by an individual; (2) by two or more partners (including at least two general partners if there are two or more general partners), when it is owned by a limited partnership; (3) by two officers one of which must be the president of the corporation, when it is owned by a corporation; (4) all joint venturers or partners, when the project is a general partnership; or (5) trustee and appropriate beneficiaries, when it is owned by a trust.

B. The following language shall be used:

"I/we hereby certify that I/we have examined the accompanying financial statements and supplemental data of (mortgagor's name) and, to the best of my/our

knowledge and belief, the same is complete and accurate."

- C. The report also shall include the Employer Identification Number (EIN) assigned to the project by the Internal Revenue Service when the project is owned by a partnership or a corporation or any entity having an EIN. The EIN must be entered below the partner or corporate signatures.

3-8. MANAGING AGENT'S CERTIFICATION.

In instances where there is a management agent for the project, a certification of the financial statements is required which shall identify the individual, as well as the company responsible for management. The Managing Agent's Certification should take the form of the Mortgagor's Certification. Note: This certification is not the Management Certification required for management of the project as described in HUD Handbook 44381.5, Management Documents, Agents, and Fees.