CHAPTER 1

INTRODUCTION

1-1 Purpose

This Handbook is designed as a self-instructional guide. It can be used as a desk reference to provide loan management staff with the accounting knowledge necessary to perform their duties regarding the review of annual and monthly financial statements. This guide helps the loan management staff use accounting information more effectively and offers a better understanding of basic accounting concepts. More specifically, the guide cross references other Handbook sources which aid in the data tracking and analysis of financial reports. In addition, a discussion of MIPS (Multifamily Information Processing System), is found in the guide which highlights the benefit of automated data processing as it relates to the functions of the loan management staff.

Evaluating the asset management of a project is a critical function of the Loan Management/Asset Management Branch. Asset management is of vital importance to the stability and financial health of projects with mortgages insured or held by HUD. Asset management includes the safeguarding of financial assets, real property and personal property. Often times management agents are hired by owners to perform asset management functions such as:

- o designing the procedures and systems needed to keep the project running smoothly,
- o recruiting, hiring and training project personnel,
- o monitoring project operations,
- o informing project owners of project operations, and
- o analyzing project problems and developing and implementing solutions to those problems.

This guide provides information necessary for loan management staff to review the financial statements from the following HUD projects:

- o 202 Direct Loans for Housing for the

		Elderly or Handicapped
o	207M	Mobile Home Courts
o	207	Multifamily Rental Housing, Pre-War Legislation (Exception, Formerly HUD-held mortgages sold with insurance)
o	207/223(c)	Formerly HUD-held Mortgages and HUD-owned Projects
o	213S	Sales and Investor Cooperatives
o	213M	Management Cooperatives
	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/Refinance Existing Housing
o	231	Housing for the Elderly
o	232	Nursing Homes, Intermediate Care, Board and Care Facilities
o	233	Experimental Housing
o	234	Condominiums
o	236	Housing for Lower Income Families
o	241	Supplemental Loans (Capital Improvement/Equity Takeout)
o	242	Hospitals
o	Title XI	Group Practice Facilities

1-2
Scope

The guide will focus on the terms and principles that underlie the four primary financial statements. Each of the statements will be the subject of detailed in depth discussion which includes the following:

- o what it is,
- o what it does,
- o what its major components are,

- o why it is important,
- o examples,
- o its relationship to other financial statements, and
- o how it is used.

How to use the guide

Before reading the guide the Loan Management staff should assess their current accounting knowledge by taking the self-test included in Chapter 1. Individuals who have accounting degrees or are CPAs may already have the requisite accounting aptitude necessary for performance of the Loan Management staff's functions. These individuals may skip the self-test and concentrate on those areas of the guide that discuss accounting as it relates to HUD Multifamily projects.

Organization of the guide

Chapter 2 is an overview of the accounting process which includes an introduction to the four primary financial statements, discussion of cash versus accrual accounting and a description of the accounting process and the use of a Chart of Accounts. Chapters 3 through 6 highlight the details of the Statement of Financial Position, the Statement of Income, the Statement of Retained Earnings and the Statement of Cash Flows. Chapter 7 covers auditing concepts. The Appendices contain examples of financial statements that might be used on an actual HUD project. Also included is a glossary, a listing of acronyms and a key word index.

1-3 Legislative Authority

A. Sections 207, 213, 221, 223, 231, 232, 233, 236, 241, 242, and Title XI of the National Housing Act as Amended, Section 8 of the U.S. Housing Act of 1937, and Section 202 of the Housing Act of 1959. Provisions of these Acts include the following:

1. HUD insures mortgages made by private lending institutions to build or rehabilitate multifamily rental or cooperative housing a) for moderate income or displaced families (Section 221); b) suited to the needs of the elderly or handicapped (Section 231); c) to accommodate 20 or more patients requiring skilled nursing care and related medical services (Section 232); d) for the treatment of persons who require medical care furnished only, or most effectively, by hospitals (Section 242); e) for group practice medical

facilities to relieve overburdened hospitals and nursing homes (Title XI); f) for experimental housing projects (Section 233) and g) by private developers or governmental entities that contain at least five dwelling units (Section 207).

2. HUD provides direct long term loans to eligible nonprofit sponsors to finance rental or cooperative housing facilities for occupancy by elderly or handicapped persons (Section 202).

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

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

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

6. Public Housing Agencies (PHAs) and HUD administer programs to assist low-income families in obtaining decent, safe, and sanitary housing by selecting landlords to lease properties that meet certain safety and sanitation standards (Section 8). The various assistance programs authorized under this Section include Lower Income Rental Assistance, Existing Housing Voucher, Certificate Programs, New Construction, Substantial Rehabilitation, Special Allocations (Loan Management Set Aside), Farmer's Home (515), and Section 202/8 programs. Of these, this handbook applies only to projects whose mortgages are insured or held by HUD.

B. Sections 2 and 4 of the Inspector-General Act of 1978. The

HUD Inspector General (IG) has the statutory responsibility to conduct, supervise, and coordinates audits and investigations relating to HUD's programs and operations. The IG also provides leadership and recommends policies designed to promote economy, efficiency, and effectiveness and to prevent fraud and abuse.

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

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

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

1-4 Goals of Financial Analysis

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

A. Financial health of project. The financial health of a project is determined by its stability and the quality of service it provides. To provide stability, rents must be Set at levels sufficient to cover debt service on the loan, the cost of operating a project, and allow a reasonable return on equity (distributions) to owners when permitted. As inflation pushes up operating expenses, rents must be increased. The Asset Management (Loan Management) staff's objective is to keep rent increases to necessary amounts and to minimize the impact of the increase on lower-income residents. The staff does this in many ways. This handbook provides various concepts and terms used in accounting that are essential for analysis, understanding, and interpretation of financial statements.

B. Protect the FHA Insurance Fund. When HUD-insured mortgages fall into unremedied default, the mortgagee, under the contract of mortgage insurance, may elect to receive mortgage insurance benefits. This involves either an assignment of the mortgage to the Secretary or an election by the mortgagee to foreclose and convey title to the project. When this happens, HUD must use Federal funds to pay the mortgagee the balance due on the FHA-insured loan (with certain adjustments). The Asset/Loan Management staff can help protect the FHA insurance fund by monitoring the project's physical and financial status and providing solutions to current and anticipated physical and financial problems.

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

D. Compliance with Regulatory Agreements and subsidy contracts. Compliance with regulatory agreements and specific subsidy contracts is essential to providing decent, safe, and affordable housing to all eligible tenants and maintaining a financially sound project with the ability to sustain future operations.

1-5 Accounting Knowledge Quiz

Introduction: The following questions are designed to help you assess your accounting knowledge as it applies to HUD projects. You will be asked to read one or more of the chapters of this guide depending upon how well you answer the questions.

Directions: Please answer the following questions to the best of your knowledge. The answers to each question are located at the end of the chapter and include a reference where further explanations are provided. The Asset/Loan Management staff person should read the chapters referenced that apply to questions answered incorrectly or not fully understood.

If you find the entire test too difficult don't be alarmed. The guide is designed to provide you with basic accounting knowledge and assist you in the performance of your duties as a Loan Management staff member. Read the entire guide, paying particular attention to the terms and concepts, and you will gradually obtain the knowledge that will allow you to become a competent reviewer of financial statements.

CHAPTER 1

ACCOUNTING KNOWLEDGE QUIZ

1. Place a check mark next to the items listed below that are "assets" of a HUD project.

_____(a) Rental revenues
_____(b) Prepaid expenses
_____(c) Depreciation
_____(d) Mortgagee escrow deposits
_____(e) Rent supplement contracts
_____(f) Mortgage on the property
_____(g) Checking account balance
_____(h) Accounts receivable

2. Give two ways the Owner's Equity account on the Balance Sheet is established or increased.

____
____
____
____

3. If utility bills totaling $61,000 are paid during the first year of a project's operation, unpaid bills at the end of the year total $16,000 and unbilled usage is $8,000, what is the total utility expense for the year under the cash basis of accounting? $__________

What is the total utility expense for the year under an accrual basis? $ __________

Which basis of accounting is acceptable to HUD?

(a) cash

(b) accrual

(c) both

4. If goods or services have been accepted but a billing statement has not been received, does a liability exist under a pure accrual basis?

   ____ Yes ____ No

   Why or why not? ____

5. Place a check mark next to the following activities that are shown on the Statement of Cash Flows.

   _____(a) Cash withdrawals by owners
   _____(b) Additional capital contributions
   _____(c) Fixed asset purchases
   _____(d) Payments of mortgage principal
   _____(e) Proceeds from borrowing

6. If accounting is purely historical, of what use can it be, particularly to HUD projects?

7. When a tenant "skips" owing $300 in rent and $1,250 for legitimate damages, does a $1,550 receivable exist?

   ____ Yes ____ No

8. What are the arguments for including prepaid expenses and mortgagee escrow deposits as current assets?

9. If a mortgage balance is $10 million, but three payments (totaling $200,000 of interest and $100,000 of principal) are delinquent, what is the total mortgage payable amount to be shown on the Statement of Position? $ __________

10. Is the value of apartments used as employees' rent-free residences and as project offices properly considered a vacancy loss? If not, how is this rental loss accounted for?

11. How is the principal portion of mortgage payments made during the year properly categorized on the Statement of Income?

12. What is the effect and purpose of accelerated depreciation?

Effect:

Purpose:

13. Can a project show continuous net losses and still survive without additional capital contributions?

____ Yes ____ No

ANSWERS

1. You should have checked: b, d, g, h. The others are not assets. (See Chapter 3)

2. By an owner contribution or by net income. (See Chapters 3 and 4)

3. Cash basis: $61,000
   Accrual basis: $85,000 (See Chapter 2)

   (b) Accrual Basis. HUD does not accept financial statements which use the cash basis since it is not based on generally accepted accounting principles.

4. Yes. Under the accrual basis of accounting, liabilities are recorded when incurred. On a cash basis, liabilities are recorded when billed. (See Chapter 2)

5. You should have checked all of them. (See Chapters 2 and 5)

6. It gives the Loan Management staff the ability to evaluate the financial performance of the project, and provide advance warning of financial problems. (See Chapter 2)

7. Yes, but if it is unlikely to be collected, an allowance for doubtful accounts should be set up. (See Chapter 3)

8. A) They will be of benefit during the coming year.
   B) Because the economic benefits will not expire until some later time. (See Chapter 3)

9. $10 million. The delinquency does not change the Unpaid Principal Balance, it only describes its status. The $200,000 would be shown as delinquent interest payable. (See Chapter 3)

10. This use is not a vacancy loss. It can properly be shown as revenue with an offsetting expense, or as reduced rent potential. (See Chapter 4)

11. It is not shown on the Statement of Income at all, rather it is treated as a reduction of the mortgage liability. Accordingly, it appears only on the Statement of Cash Flows and can also be derived at by comparing the Statement of Position for the beginning of the year with that at the end of the year. (See chapters 4 and 5)

12. A) The effect is to allocate more of the cost of the asset to the early years of its depreciable life, or match the expense with revenue generated over the life of the assets.
    B) The purpose can be to match depreciation expense with corresponding revenue, but is used most often to reduce the owner's taxable income. (See Chapter 4)

13. Yes. The net losses may be due primarily to depreciation expenses. Depreciation is an expense that can be deducted from income, but does not require the outlay of cash. It is a noncash expense. (See Chapter 4)

CHAPTER 2

THE ACCOUNTING PROCESS

2-1 ORIENTATION

Four primary statements are used to record and present financial information:

- o Statement of Financial Position (Balance Sheet),
- o Statement of Income,
- o Statement of Cash Flows, and
- o Statement of Retained Earnings.

This chapter will familiarize you with these four statements.

Objectives of this chapter

At the completion of this chapter, you will be able to:

1. Describe and explain the functions of the four primary financial statements.

2. Explain how the four primary financial statements interrelate.

3. Define the following terms:

   - o assets,
   - o liabilities,
   - o income,
   - o cash flows,
   - o expenses, and
   - o owner's equity.

4. Explain the differences between cash and accrual accounting.

Learning advice

This chapter is only an introduction to the financial statements. You are not expected to learn all of the details in this chapter. Chapters 3, 4, 5, and 6 will give you a detailed explanation of the four primary statements. This chapter will give you an idea of what is to come.

2-2 INTRODUCTION

Financial statements provide historical information for measuring and evaluating the financial performance of a project and can help detect financial problems before they occur. The information contained in these statements is used to monitor housing projects whose mortgages are insured or held by HUD.

The Multifamily Insurance Processing System (MIPS) is the HUD computerized system used to track the submission and review of financial statements. The MIPS system monitors the receipt of financial statements and the review of those statements; it records historical information relating to the statement. The major objective of MIPS is to facilitate the review of financial statements. This review process is a critical tool used to evaluate the historical life of HUD projects and assess their stability and potential for growth. The reviews of financial information are to be conducted within specified timeframes. These timeframes are included in MIPS applications. The Loan Management staff should be aware of these time frames and review MIPS reports and flags to ensure that mortgagee submissions are timely. For more information on MIPS, consult User Manuals, "Application 5.3a, Financial Statement Date Tracking," and "Application 5.3b, Data Entry and Performance/ Risk Analysis."

2-3 TYPES OF FINANCIAL STATEMENTS

According to Generally Accepted Accounting Principles (GAAP), a complete set of financial statements includes at least the following:

- Statement of Financial Position (Balance Sheet),
- Statement of Income,
- Statement of Cash Flows, and
- Statement of Retained Earnings.

These four statements must be supplemented by Notes to the Financial Statements that detail any aspects of the financial operations and reporting which are not evident from the statements themselves, but which would provide useful information to the reader.

How they are used

The Asset Management/Loan Management staff uses these statements to perform the following tasks:

- check to see if the project is in compliance with HUD requirements,
- evaluate the financial efficiency of the operations,
- assess the financial needs of the project, and
- determine the annual increase or decrease in owner's equity.

Relationships between the statements — The primary financial statements and their notes are interrelated. While they cannot, in practice, be analyzed completely independently of one another, they do display different aspects of the financial performance of the project. Therefore, they can be discussed individually with respect to their basic purposes and emphasis.

Note — All of the reviewed financial statements are a reflection of individual transactions that have occurred throughout the accounting period. There are many techniques used when accounting for these transactions. The basic tool used to maintain account balances is the general ledger. This ledger provides control over the entire accounting process from a projects inception. Subordinate to the general ledger is the various subsidiary ledgers. These ledgers account for items such as individual customer listings for accounts receivable or accounts payable. Daily journals are also maintained which detail the transactions which effect the various accounts. Most companies and businesses use a uniform system for numbering the various accounts in the general ledger, This is known as a chart of accounts. The auditor who audits the financial statements will look closely at the chart of accounts to ensure that activity is being properly recorded and that posting of similar transactions is consistent. The auditor should also be aware of items that may be inappropriately posted to an account, when proper classification of the transaction would result in an adverse condition. A HUD Chart of Accounts can be found in Handbook 4370.2, Financial Operations and Accounting Procedures for Insured Multifamily Projects" and Handbook 4370.3, "Uniform System of Accounts for Cooperatives Using Computer and Manual Systems".

2-4 STATEMENT OF FINANCIAL POSITION BALANCE SHEET

What it is — The Statement of Financial Position (Balance Sheet) is a written summary of a project's financial status at a given point in time.

What it does — It documents what a project owns and what it owes as of a specific date.

Why it is — The Balance Sheet is an important tool used for important — evaluating the financial condition of the project and its ability to continue operations as an ongoing concern as of a particular point in time. In addition, it provides a means of evaluating the project's short term ability to meet ongoing expenses and future obligations.

The elements of the Balance Sheet — The Balance Sheet has three main elements:

- o assets,
- o liabilities, and
- o owner's equity.

The following discussion will cover each of the components of the Balance Sheet and introduce its details.

Assets

Definition — Assets are probable future economic benefits obtained or controlled by a project as a result of past transactions or events. They have monetary value and are of present or future benefit to the project.

Examples — Assets include physical properties and intangible rights. For HUD projects, physical properties mean land, buildings, equipment and furniture. Intangible rights include things like patents, goodwill, copyrights, leaseholds and trademarks. Rent owed by tenants, note receivables and the unexpired portion of an insurance policy are intangible in nature but are classified as current assets on the Balance Sheet.

How they are measured — Assets are measured in dollars on the basis of the original cost to acquire the asset. Assets are generally not recorded at either current market value or replacement cost.

What they do — Assets reflect (the dollar value of) the economic resources of the project.

Why they are important — Assets are important to the Loan Management staff because they represent the collateral for the mortgage. The Loan Management staff must make a determination of a project's ability to remain financially stable. There are several ratios (mathematical computations) that use assets to weigh the financial position of a project. These will be discussed in more detail in Chapters 3 and 4. In addition, assets measure the project's ability to provide decent, safe and sanitary housing services. The Loan Management staffs assessment of the adequacy of these assets is an integral part of evaluating the project's ability to repay its debts.

Types of Assets

Assets on HUD projects include the following types:

- current assets;
  - deposits held in trust,
  - prepaid expenses,
- restricted deposits and funded reserves; and
- fixed assets.

Example

An example of the Asset section of a Balance Sheet is shown in Exhibit 2-1. Note that the terms listed here will be clarified in Chapter 3.

Comment

To illustrate the structure of each financial statement, we have left off the dollar amounts. Of course, all financial statements will show figures which reflect the financial status of the entity. The appendices to this Handbook contain examples of completed financial statements.

Exhibit 2-1.
Sample Statement of Financial Position (Balance Sheet)

ABC Partnership
Statement of Financial Position (Balance Sheet) as of (date)

Assets

CURRENT ASSETS		
Petty Cash		XXX
Cash in Bank		XXX
Tenant Accounts Receivable	XXX	
Accounts Receivable - Other	XXX	
Less Allowance for Doubtful Accounts	(XXX)	
Net Accounts Receivable		XXX
Notes Receivable - Other		XXX
Notes Receivable - Stockholders, Officers	XXX	
Less Reserve for Doubtful Notes Rec	(XXX)	
Net Collectable Receivables		XXX
Accrued Receivables	XXX	
Investments (short term)	XXX	
Miscellaneous Current Assets	XXX	
Total Current Assets		XXX

DEPOSITS HELD IN TRUST

Tenant Security Deposits	XXX	
Other Deposits	XXX	
Total Deposits Held in Trust		XXX
PREPAID EXPENSES		
Property Insurance	XXX	
Mortgage Insurance	XXX	
Taxes	XXX	
Miscellaneous	XXX	
Total Prepaid Expenses		XXX
RESTRICTED DEPOSITS AND FUNDED RESERVES		
Mortgagee Escrow Deposits	XXX	
Reserve for Replacements	XXX	
Residual Receipts Reserve	XXX	
Construction Escrow	XXX	
Total Deposits		XXX

FIXED ASSETS		
Land	XXX	
Buildings	XXX	
Building Equipment - Fixed	XXX	
Building Equipment - Portable	XXX	
Furniture	XXX	
Furnishings	XXX	
Total Fixed Assets	XXX	
Less Accumulated Depreciation	(XXX)	
Subtotal		XXX
Total Assets		XXX

Liabilities

Definition

Liabilities are claims (probable future sacrifices) against the project by outside parties, They are economic obligations to other organizations or persons of the project to transfer assets or provide services in the future which are the result of past transactions or events.

Examples

o Mortgages.

- Taxes.
- Money owed due to unpaid bills (Accounts Payable).

What they do Liabilities are recorded at dollar value and measure the project's economic obligations.

Types of liabilities Liabilities can be divided into three categories:

- current liabilities,
- deposit and prepayment liabilities, and
- long term liabilities.

Why they are important Liabilities are an integral factor in both the short and long term solvency of the project. They place a dollar value on a project's future economic obligations. Your determination of the project's ability to meet these financial obligations depends heavily upon your understanding of the size and timing of its liabilities. There are several ratios (mathematical computations) that use liabilities to weigh the financial position of a project. These will be the subject of more detailed discussion in later chapters.

Example An example of the Liabilities section of a Statement of Financial Position (Balance Sheet) is shown in Exhibit 2-2.

Exhibit 2-2.
Sample Statement of Financial Position (Balance Sheet)

ABC Partnership
Statement of Financial Position as of (date)

Liabilities

CURRENT LIABILITIES		
Accounts Payable	XXX	
Accounts Payable - HUD	XXX	
Accrued Wages Payable	XXX	
Accrued Interest Payable	XXX	
Accrued Taxes	XXX	
Notes Payable (short term)	XXX	
Miscellaneous Current Liabilities	XXX	
Mortgage Payable - Current Portion	XXX	
Total Current Liabilities		XXXX
DEPOSIT AND PREPAYMENT LIABILITIES		
Tenant Security Deposits (contra)	XXX	
Other Deposits	XXX	

Rent Deferred Credits	XXX	
Interest Deferred Credits	XXX	
Payable to Other Projects	XXX	
Total Deposit and Prepayment Liabilities		XXX
LONG TERM LIABILITIES		
Notes Payable	XXX	
Mortgage Payable	XXX	
Less Current Portion	(XXX)	
Total Long Term Liabilities		XXX
OTHER LIABILITIES		
Total Liabilities		XXX

Owner's Equity
(i.e. Capital)

Definition

Owner's Equity is a measure of the owner's financial interest in the assets of a project that remain after deducting its liabilities.

The ownership of a project can take several forms: single proprietorships, partnerships, and corporations are the most common. Projects that are not organized under state or federal laws that are owned by one individual are known as single proprietorships. Often, although not always, businesses that are comprised of two or more persons are organized under state law as partnerships. Corporations can be created as a "S" corporation or a "C" corporation. The major difference between an "S" and a "C" corporation is the way in which they are taxed.

A corporation that desires a "S" corporation status must file an application with the Internal Revenue Service (IRS). To be eligible for a "S" corporation status, a corporation must meet established criteria as outlined in the internal revenue code, such as the number of shareholders. The corporation does not pay taxes, instead the net income or loss is passed through to the individual shareholders who are responsible for any taxes due.

A "C" corporation is formed or incorporated under the laws of a state as a separate legal entity. The major characteristic of a "C" corporation is its status as a separate legal entity. This distinction makes the "C" corporation responsible for its own acts and its own debts and relieves the stockholders (owners) of any liability. The owners of a corporation are called stockholders because they obtain ownership through the purchase of stock which represents a unit share of the company's equity. Sometimes the ownership of stock will be in the form of a trust or estate.

A trust relationship exists whenever one person holds property for the benefit of another. For example, a minor may inherit stock in a corporation which will be held in a trust until the minor becomes of age. An estate is established upon the death of a person who owns property. Therefore, if a stockholder dies, an estate will be established and administered by the executor, or if there is no will, someone appointed by the court. Many HUD

projects are incorporated as limited liability partnership. Cooperatives are an example of a corporation.

The Owner's Equity section of a single proprietorship is presented as a single line item. The Owner's Equity section of a partnership shows each partner's capital accounts separately. In a corporation the amounts invested are recorded as contributed capital of paid in capital. Ownership of corporations can be obtained through the purchase of shares of stock. There are two basic classes of stock. These are common stock and preferred stock. The major distinction between preferred stock and common stock is that preferred stock holders have a priority as to payment of dividends and distribution of assets. The equity that represents the corporation's cumulative earnings, less net losses is called retained earnings and is discussed later in Chapter 6.

Where it comes from

Initially, owner's equity is established by means of a contribution of capital to the project, Typically this contribution is in the form of cash, but frequently some other asset, such as land, or the value of services provided is how owner's equity is established. In HUD projects, part of the value of the structures (buildings) may have been derived from services provided by a builder-developer. The asset is the structure, not the services themselves.

How it changes

Owner's equity can increase if the project realizes net income at the end of a year or if the owners make additional contributions. Owner's equity decreases if the project has a net loss or distributions are paid to the owner. Distributions to owners can only be made if surplus cash is available and the project is not in default. For a more detailed definition of surplus cash and the appropriateness of distributions to owners please see HUD Handbook 4370.2 Financial Operations and Accounting Procedures for Insured Multifamily Projects.

Why it is important

The amount of owner's equity is not as important to the Loan Management staff as is the change in owner's equity. Decreases in owner's equity may indicate that distributions have been paid to the owner. Increases in owner's equity created by owner advances may indicate that the project cannot meet its obligations solely through rental revenue or that an owner made an equity contribution at HUD's request.

Comment

The owner's equity account on the Balance Sheet is not the same as the owner's initial equity figure used to compute allowable distributions on limited dividend projects. The owner's equity for limited distribution projects is the initial owner's equity figure determined at the time of cost certification and should not be confused with the balance in the Owner's Equity section of the project's Balance Sheet.

Example

An example of how the owner's equity is listed on the Balance Sheet is shown in Exhibit 2-3. Note that this figure also shows how all three sections of a Balance Sheet might be arranged on one page. This format is generally referred to as the "report" form.

Exhibit 2-3.
Sample Statement of Financial Position (Balance Sheet)

ABC Partnership
Statement of Financial Position as of (date)

ASSETS

Current Assets	$39,000	
Deposits Held in Trust - Funded	2,000	
Prepaid Expenses	6,000	
Restricted Deposits and Funded Reserves	13,000	
Fixed Assets	755,000	
Total Assets		$815,000

LIABILITIES

Current Liabilities	40,000	
Deposit and Prepayment Liabilities	7,000	
Long Term Liabilities	777,000	
Other Liabilities	6,000	
Total Liabilities		830,000

OWNER'S EQUITY

Owner's Equity (Deficit)	(15,000)
Total Liabilities and Owner's Equity	$815,000

2-5 STATEMENT OF INCOME

(Synonym: Income Statement, Form HUD-92410)

Introduction

You have now become acquainted with one of the four primary financial statements - the Statement of Financial Position. The Statement of Financial Position dealt with assets, liabilities and owner's equity as of a point in time.

The Statement of Income is the second primary financial statement discussed. This statement provides a tool for measuring the financial results from operation of the project over a period of time.

What it is

The Statement of Income reflects the project's revenue and expenses for a specified time period.

What it does

The Statement of Income serves three purposes:

- o it details all revenues for a time period (usually one year, one quarter or one month),
- o it details all expenses for the same period,

- it calculates the net income or loss for the period by subtracting the expenses for that period from the revenues for that period.

Why it is important

It tells the Loan Management staff how well a project is functioning as a going concern. (A going concern is a project that has the financial strength to continue to operate in the future.)

How it is used

Some examples of how the Loan Management staff might use the Statement of Income are:

- analyzing a project's need for a rent increase,
- checking the efficiency of the project's operations,
- entering data into the MIPS (Multifamily Information Processing System).

MIPS is the computerized accounting system for storing and manipulating accounting data from HUD projects. MIPS is used for arithmetic computations and financial report generation. The data from Form HUD-92410, "Statement of Income," along with

the Balance Sheet information is entered into MIPS (See MIPS User Manual Application 5.3B, "Data Entry and Performance/ Risk Analysis"). This data is then used to generate reports and flags that help the Loan Management staff evaluate the financial health of the project. There are many reports generated by MIPS (Refer to User Manuals: "Rent Increase Processing," 5.2 a/b; "Financial Statement Date Tracking", Application 5.3a; and "Data Entry and Performance/Risk Analysis," Application 5.3b for more detailed explanation). These reports include:

- Risk Analysis (One Year.),
- Risk Analysis (Three-Year Report),
- Summary Report (One Year),
- Summary Report (Three-Year Report),
- Balance Sheet (One Year),
- Balance Sheet (Three-Year Report),
- Computation of Surplus Cash,
- Form HUD-92410 (Statement of Income), and
- Form HUD-92558 (Three-Year Statement of Income).

There are several ratios and analyses performed by MIPS. Frequently these mathematical computations result in less than desirable conclusions when compared to past or expected performance. These situations create flags and reports generated by MIPS indicating that special attention may be required. The Loan Management staff should take the necessary steps to verify that the data reviewed is up to date and accurate and then take immediate action to correct the adverse condition, or report the deficiency to the appropriate authority.

Components of the Statement of Income

The Statement of Income has three components:

- o revenues,
- o expenses, and
- o net income (or loss).

Revenue

What it is

Revenue is the flow of assets into the project from various sources. This is usually in the form of cash but can also take the form of a decrease in liabilities.

What it does

Revenue makes cash available to pay off the financial obligations of the project.

Types of revenue

There are three basic types of project revenues:

- o rental revenue,
- o service revenue, and
- o financial revenue.

Example

Exhibit 2-4 is an example of the Revenue section of a Statement of Income.

Exhibit 2-4.
Revenue Section of a Statement of Income

RENTAL REVENUE
- Tenant
- Apartments
- Rent Supplement Payments
- Tenant Assistance (Section 8; RAP)
- Flexible Subsidy Revenue
- Furniture and Equipment
- Stores and Commercial

Offices
Basement
Garage or Parking Spaces
Miscellaneous
Total Rent Revenue

FINANCIAL REVENUE
Interest Earned
Income from Investments
Interest Reduction Payments (Section 236)
Income from Replacement Reserves
Miscellaneous
Total Financial Revenue

SERVICE REVENUE
Elderly
Total Service Revenue

OTHER REVENUE
Laundry Services
Vending
Late Charges (NSF)
Total Other Revenue

Total Revenue

Expenses

What they are	Expenses are the outflows or using up of assets (e.g., cash) or increases in liabilities (e.g., payables) which occur as a result of the major or central operations of the project.
What they do	In order for a project to survive it must incur certain costs that are unavoidable. The payment of these costs require the use of assets. Expenses measure the dollar amounts associated with the outflow or using up of these assets.
Types of expenses	There are many types of expenses. These include:

- renting expenses,
- administrative expenses,
- operating expenses,
- utilities expenses,
- maintenance expenses,
- depreciation expenses,
- taxes and insurance,
- financial expenses,

- o service expenses, and
- o corporate or mortgagor entity expenses.

How they are used

The efficiency of a project's operations can be checked by comparing its expenses with those of similar projects. Because expenses are a historical record of the project's costs, they can be used to prepare a budget which outlines future operating costs. In addition, the project's expenses can be compared from year to year to determine the validity of any increases or decreases. This information can be reviewed via applications and reports generated by MIPS. These applications will assist in identifying misuse or diversions of project assets and income, enabling the Department to take prompt recovery action and, as necessary, impose administrative sanctions or seek civil or criminal penalties against Owners and Management Agents. For more information on potential violations, Loan Management staff should consult HUD Handbook 4370.1 Reviewing Annual and Monthly Financial Reports. A review of expenses should also include a spot check of the type of expenses reported to ensure that only necessary and allowable expenses are being incurred. Large expense items listed as "other" or "miscellaneous" as well as large increases in a

particular item should be reviewed to ensure that improper use or diversion of funds has not taken place.

Project funds are to be used for operation of the project and for payment of allowable distributions only. Since owners and agents control project funds, the potential for unauthorized distributions and diversions is great. It is important to identify and recover unauthorized distributions or diversions so that project funds can be properly used for meeting mortgage payments, maintenance needs, or other project expenses. For a more detailed discussion of how to check payments to owners and agents review, the Handbook on "Financial Analysis for Loan Servicers", Unit III: Course material in Checking Payments to Owners and Agents.

Example

Exhibit 2-5 is an example of the Expense section of a Statement of Income.

Exhibit 2-5.
Expense Section of a Statement of Income

ADMINISTRATIVE EXPENSES
- Office Salaries
- Office Expense
- Office Rent
- Management Fee
- Manager or Superintendent Salaries
- Legal Expenses (Project)
- Telephone and Telegraph
- Bad Debts
- Miscellaneous
  - Total Administrative Expenses

RENTING EXPENSES
- Advertising
- Commissions
- Concessions to Tenants
- Alterations
- Miscellaneous
  - Total Renting Expenses

OPERATING AND MAINTENANCE EXPENSES
- Elevator Payroll
- Elevator Power
- Fuel
- Engineer Payroll
- Janitor Payroll
- Janitor Supplies
- Bus Operator Payroll
- Gasoline, Oil and Grease
- Electricity
- Water
- Gas
- Exterminating Payroll
- Exterminating Supplies
- Exterminating Contract
- Garbage and Trash Removal
- Miscellaneous
- Protection Payroll
- Protection Fee, Cost or Contracts

- Grounds Payroll
- Grounds Supplies and Replacements
- Grounds Contract

Clearing Payroll
Repairs Payroll
Repairs Material
Repairs Contract
Repairs - Extraordinary and Nonrecurring
Elevator Maintenance
Air Conditioning Repair and Maintenance
Decorating Payroll
Decorating Supplies
Decorating Contract
Motor Vehicle Repairs
Maintenance Equipment Repairs
Miscellaneous
Total Operating and Maintenance Expenses

TAXES AND INSURANCE
Taxes
Insurance
Total Taxes and Insurance

FINANCIAL EXPENSES
Interest on Bonds Payable
Interest on Mortgage Payable
Interest on Notes Payable (Long Term)
Interest on Notes Payable (Short Term)
Insurance on Mortgage
Miscellaneous
Total Financial Expenses

SERVICE EXPENSES
Total Service Expenses

DEPRECIATION
Alterations
Buildings
Building Equipment - Fixed
Building Equipment - Portable
Furniture for Project Administrative Use
Furniture and Equipment Owned for Rental or Lease

Furnishings
Maintenance Equipment
Motor Vehicles
Miscellaneous
Total Depreciation

CORPORATE OR MORTGAGOR ENTITY EXPENSES
Officer Salaries
Legal Expenses (Entity)

Federal Income Tax
State Income Tax
Other Taxes (Entity)
Leased Furniture Expenses (Entity)
Other Expenses (Entity)
Total Corporate Expenses
Total Expenses

Net Income or Loss

Definition Net Income or (Loss) is the difference between the total revenue and the total expenses of a project in a particular accounting period, usually one year. Net income is realized when revenues exceed expenses, but a net loss is incurred if expenses exceed revenues.

Example

Project A		Project B	
Revenue	$1,000,000	Revenue	$1,000,000
Expenses	- 950,000	Expenses	- 1,250,000
Net Income =	$50,000	Net Loss =	($250,000)

What it does Net income or loss, as reported on the bottom line of the Statement of Income, provides information more suited for the project owner's income tax return, than for review by the Loan Management staff. However, Chapter 4 will show you how an adjusted version of net income can be very useful in analyzing the performance of a project.

Comment HUD has a special Statement of Income form it requires owners to use. It is called Form HUD-92410. Exhibit 2-6 is an example of this form.

Exhibit 2-6
STATEMENT OF INCOME, FORM HUD-92410

Statement of
Profit and Loss

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form HUD-92410 (7/91)
ref. Handbook 4370.2

Exhibit 2-6
STATEMENT OF INCOME, FORM HUD-92410

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form HUD-92410

2-6 STATEMENT OF CASH FLOWS

Introduction The Statement of Financial Position tells you what the project owns and owes as of a point in time. The Statement of Income tells you how much revenue flowed into the project and the amount of expenses that were incurred over a period of time. Another facet of the project's financial picture involves how the cash that flows into and out of the project was used or where it came from.

What it is The Statement of Cash Flows is a financial report that summarizes the cash receipts and cash payments for the same one year period covered by the Statement of Income.

Why it is important Properly prepared, the Statement of Cash Flows is a useful presentation of a project's sources and uses of cash. It helps the Loan Management staff check for compliance and performance problems. There are two methods of presenting the Statement of Cash Flows, however, HUD requires the use of only one of these methods, which is the "Direct" method. The Direct method is discussed in detail in Chapter 5.

How it is used The Statement of Cash Flows can be used to help assess:

- o the project's ability to generate positive (more cash in than cash out) net cash flows;
- o the project's ability to meet its obligations and pay distributions to owners;
- o its need for external financing or owner contributions;
- o the reasons for differences in net income and the

associated cash receipts and payments; and

- the effects of cash and noncash activities as they relate to the financial position of the project.

Components of the Statement of Cash Flows

The Statement of Cash Flows has three sections:

- Cash flows from operating activities,
- Cash flows from investing activities, and
- Cash flows from financing activities.

Example

Exhibit 2-7 is an example of a Statement of Cash Flows.

Exhibit 2-7.
Example Statement of Cash Flows

Statement of Cash Flows For the Year Ended (date)

Cash flows from operating activities:			
Rental receipts		$XXX	
Interest receipts		XXX	
Other receipts (detail)		XXX	
Administrative		XXX	
Management fees		XXX	
Utilities		XXX	
Salaries and wages		XXX	
Operating and maintenance		XXX	
Real estate taxes		XXX	
Mortgage insurance		XXX	
Payroll taxes	XXX		
Property insurance		XXX	
Miscellaneous taxes and insurance		XXX	
Interest on mortgage note		XXX	
Miscellaneous financial		XXX	
Tenant security and other deposits		XXX	
Forfeited security deposits		XXX	
Net cash provided (used) by operating activities			XXX
Cash flows from investing activities:			

Purchase of depreciable assets	XXX	
Decrease (increase) in:	XXX	
Reserve for replacement of depreciable assets	XXX	
Reserve for taxes and insurance	XXX	
Net cash provided (used) by investing activities		XXX
Cash flows from financing activities:		
Mortgage principal payments	XXX	
Cash distributions paid to partners	XXX	

Net cash provided (used) by financing activities	XXX
Net increase (decrease) in cash	XXX
Cash - beginning of period	XXX
Cash - end of period	XXX

Reconciliation of net income (loss to net cash provided by operating activities:

Net income (loss)	XXX
Adjustments to reconcile net income (loss) to net cash provided (used) by operating activities	XXX
Depreciation	XXX
Decrease (increase) in:	
Accounts receivable - rent subsidy	XXX
Accounts receivable - tenants	XXX
Prepaid property insurance	XXX
Prepaid mortgage insurance	XXX
Prepaid property taxes	XXX
Increase (decrease) in:	
Accounts payable - trade	XXX
Accounts payable - mgmt agent	XXX
Accrued interest payable	XXX
Tenant security deposit payable	XXX
Rents received in advance	XXX
Net cash provided (used) by operating activities	XXXX

Operating Activities Section

What it is — The Operating Activities section of a Statement of Cash Flows is a record of changes in the cash balances that are caused by the inflow and outflow of cash that result from the day-to-day operations of the project and all other transactions and events that were not investing or financing activities.

What it does — The Operating Activities section provides the Loan Management staff with information about how the project's operating income is generated and used.

How it is used — The Operating Activities section can be reviewed to determine if there are performance or compliance problems. The Loan Management staff can see how much cash came from rental revenue and how much had to be obtained from sources outside of the project.

Investing Activities Section

What it is — The Investing Activities section of a Statement of Cash Flows is a record of transactions that involve purchasing and selling of investments (other than cash equivalents), the making and collecting of loans, and the purchase and sale of plant assets and other productive assets.

Why it is important — The Investing Activities section provides a summary of the flow of cash resulting from investments.

How it is used — The Loan Management staff can examine the Investing Activities section to identify compliance with HUD regulations regarding asset management and diversion of funds. For example, the Loan Management staff could cheek to see if project funds were lent out to other projects or the owner; or if physical plant assets are properly safeguarded for use by the project and not collateralized for other purposes.

Financing Activities Section

What it is — The Financing Activities section of a Statement of Cash Flows records the transactions regarding the obtaining of resources from the owners and providing them with a return on their investment. Financing activities also include borrowing cash on a short term basis and the repayment of amounts borrowed, except for cash payments for credit purchases of merchandise which are operating activities.

What it does — The Financing Activities section provides the Loan Management staff with information pertaining to additional financing necessary from project owners and other external sources.

How it is used — The Financing Activities section is where the Loan Management staff looks to determine if there are excessive amounts of cash resources flowing into or out of the project. The Loan Management staff compares this with rental revenue and determines how much cash had to be obtained from other sources (e.g., loans, owner contributions, delays in paying bills, etc.).

2-7 STATEMENT OF RETAINED EARNINGS

What it is — The Statement of Retained Earnings is a financial report that details the changes that have occurred in the project's retained earnings during the year.

What it does — The Statement of Retained Earnings provides the Loan Management staff with information regarding the project's cumulative net income less net losses and dividends.

How it is used — The Statement of Retained Earnings is used to evaluate a project's ability to meet its obligations and still provide owners a return on their investment (dividends) from year to year.

Example — Exhibit 2-8 illustrates what a project's Statement of Retained Earnings might look like.

Exhibit 2-8

Statement of Retained Earnings Statement

Blair East, Incorporated
Retained Earnings Statement
For Year Ended December 31, 1991

Retained earnings, December 31, 1990	$ 9,600
Add 1991 net income	9,400
Total	19,000
Deduct dividends declared	5,000
Retained earnings, December 31, 1991	$14,000

2-8 HOW THE FOUR STATEMENTS WORK TOGETHER

Taken together, the Statement of Financial Position (Balance Sheet), Statement of Income, Statement of Cash Flows and Statement of Retained Earnings offer the reader insight into the financial position, progress and stability of the project.

Statement	What It Measures	How It Relates To The Balance Sheet.
Balance Sheet	Project's relative financial position at a given point in time Assets, Liabilities and Owner's Equity	Not Applicable
Statement of Income	Results of operations (Net Income or Net Loss)	Profit or Loss recorded here causes changes in the Owner's Equity on the Balance Sheet.
Statement of Cash Flows	Where cash came from and what it was used for during the accounting period	Explains changes in the Financial Position of the project relative to cash.
Statement of Retained	The effect of net income and dividends	Details the change in the

Earnings	on Retained Earnings	retained earnings reported on the prior year's Statement of Financial Position.

2-9
CASH BASIS
ACCOUNTING

Introduction	The four financial statements summarize information about the financial operations of the project. To understand the entries on each of these statements, the Loan Management staff needs to understand how accountants make decisions concerning revenue and expenses. This section will familiarize you with the two basic methods of accounting used to create financial statements:

- o cash basis accounting, and
  accrual basis accounting

Definition	The cash basis of accounting is the method of accounting where revenues are recognized when cash is received and expenses are recognized when cash is paid.

What it does	The cash basis method simplifies the accounting process because it records revenue only after cash is received and records expenses only after cash is paid out.
Where it is used	The cash basis method is only acceptable in businesses where the amount of prepaid, unearned and accrued items are not included in computation of net income.
Example	Your personal checkbook is an example of cash basis accounting. You record revenue when your paycheck is deposited, not when earned. You record an expense when the check is written, not when the expense is incurred. This method of accounting is often used by tax exempt organizations and by construction companies.
Advantage of cash basis accounting	Cash basis accounting is a very simple method. Revenue and expenses are recorded when the cash flows in and out of the project, respectively.
Disadvantages of cash	Cash basis accounting is not GAAP (generally accepted accounting principles). It does not adequately reflect

basis accounting	the true financial obligations of a project; for example, the electric company allows the project to use the electricity and bills it at a subsequent date. Therefore, under the cash basis of accounting the project net worth appears to be higher than it actually is, since the accrued liability associated with the electricity used is not reflected in the accounting records. Similarly, cash basis accounting makes no provision for revenue earned that has not been deposited.
Note	GAAP refers to a common body of accounting concepts, standards, and procedures that has been accepted by the accounting profession to guide the practice of accounting.

2-10
TAX BASIS
ACCOUNTING

Definition	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. This system of accounting is based on the rules and regulations for accounting for transactions under the Internal Revenue Code.

Where it is used	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). This basis of accounting also does not conform with the accounting measurements prescribed by GAAP.
What it does	The cash basis method refers to the timing and amount of expense and revenue recognition. Therefore, pretax GAAP net income for the year differs from taxable income because the project owner is permitted by law in some cases to use one method or procedure for tax purposes and a different method or procedure for keeping accounting records.
Example	The project owner depreciates an asset for tax purposes using the double-declining (DD) method and uses the straight-line (SL) method for keeping accounting records. The asset cost $100,000, has a four year estimated useful life and a salvage value of $8,000:

Year	Income	DD	SL	Taxable Income	GAAP Pretax

Income					Net
1	$80,000	$50,000	$23,000	$30,000	$57,000
2	80,000	25,000	23,000	55,000	57,000
3	80,000	12,500	23,000	67,500	57,000
4	80,000	4,500	23,000	75,500	57,000

Advantages of Tax-Basis Accounting

Tax-basis accounting allows the project owner to defer the payment of income taxes and reflects what the entity filed on its tax return.

Disadvantage of Tax-Basis Accounting

Tax-basis accounting requires the project owner to keep an additional set of accounting records because tax basis accounting does not conform with GAAP.

Note

When reporting on cash basis or tax basis financial statements, the standard auditor's report (unqualified opinion) should include paragraphs discussing the scope of the audit, generally accepted auditing standards and government auditing standards, the basis of accounting used, and the opinion rendered on the statements and supporting data. For more information on Cash Basis and Tax Basis Financial Statements please see HUD Handbook 4370.1, "Reviewing Annual and Monthly Financial Statements."

HUD does not accept financial statements prepared using Cash or Tax Basis.

2-11 ACCRUAL BASIS ACCOUNTING

Introduction

Most theorists and practitioners agree that the cash basis of accounting is clearly inadequate to monitor accurately the financial position of most organizations. The cash basis of accounting reflects only the inflow and outflow of cash. It ignores all contingent (pending) assets and liabilities, some of which are essential in determining the true financial condition of a project. The tax basis of accounting reflects tax laws which are generally not GAAP. This lack of information is not present in the accrual basis of accounting.

What it does

Accrual Basis Accounting reflects both the outstanding obligations and revenue of a project. Revenues are recorded when earned. Expenses are recorded when incurred.

Definitions | Incurred: An expense is incurred when the benefit is received by the enterprise. It is not necessary that the expense be paid for or even billed. The expense is owed, because products or services have been received or used.

Accrued: Applies to either revenue or expenses. Accrued revenue is revenue earned but not yet received, and accrued expenses are expenses incurred but not yet paid.

Advantages of Accrual Accounting

Accrual basis accounting allows you to anticipate the project's outflow of cash for expenses that have been incurred, but have not yet been paid for. It can then be determined how much money should be set aside for these future payments. This information enables the Loan Management staff to determine more accurately the financial strength or weakness of the project by evaluating these future payments and deposits of cash.

Disadvantages of Accrual Accounting

Accrual basis accounting does have disadvantages that the Loan Management staff should be aware of For instance, it is not always clear-cut as to when an expense is incurred or when income is earned. Accounting on an accrual basis does not have a clear-cut distinction as to when to record revenue and expenses as does the cash basis method of accounting. In addition, accrual basis accounting assumes that all revenue earned will actually be collected and that these receipts will be available to pay future bills. This assumption does not always hold true.

Example

The tenant has a legal obligation to pay rent to the project when due, but does not always do so. If the project doesn't collect all of this rent, it will not be in as good a position as accrual basis accounting might reflect.

Comment

The Loan Management staff should also note that the Balance Sheet has accounts that minimize these distortions (for instance, an allowance is made for uncollectible rent). The limitations of the accrual system of accounting are far outweighed by its advantages, and the objectives of financial reporting are more suited toward accrual basis accounting.

2-12
SUMMARY

Purpose

Chapter 2 was designed to introduce the four primary financial statements and familiarize the reader with the methods of cash and accrual accounting.

Review

The Balance Sheet identifies what the project owns and owes as of a point in time.

The Statement of Income summarizes the net effect of revenue and expenses of a project for a year.

The Statement of Cash Flows tells how cash that flows into and out of the project was used and where it came from.

The Statement of Retained Earnings details the changes in net income, less net losses and dividends from year to year.

The four primary financial statements work together to provide a picture of the financial health of a project. This enables the Asset Management (Loan Management) staff to check for compliance with HUD requirements.

The cash basis of accounting reflects only the inflow and outflow of cash and thus, it is inadequate for recording assets and liabilities that may have been earned or incurred but not yet received or disbursed.

The accrual basis of accounting shows the income earning history of the project. It records expenses when incurred and revenue when earned, and therefore, provides a truer picture of the long term financial health of the project.

Both systems have limitations; however, the accrual basis of accounting better fits the needs of both HUD and the owners and is in accordance with GAAP. The cash accounting method would permit asset managers (loan specialists) to evaluate most aspects of compliance, but would not permit a thorough analysis of the project's financial performance stability or needs, because it ignores transactions that may have an immediate impact on the project in the very near future.

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CHAPTER 2

ACCOUNTING KNOWLEDGE QUIZ

1. What is the Statement of Financial Position (Balance Sheet) and what does it portray?

   ____
   ____
   ____
   ____

2. Define each of the following terms:

   Assets: ____
   ____

   Liability:____
   ____

   Owner's Equity: ____
   ____

3. What is the Statement of Income and what does it portray?

   ____
   ____
   ____
   ____

4. Define each of the following terms:

   Revenue: ____
   ____

   Expenses: ____
   ____

5. What is the Statement of Cash Flows and what does it portray?

6. What is the Statement of Retained Earnings and what does it portray?

7. What is cash basis accounting?

8. Explain the advantages and disadvantages of cash basis accounting.

Advantages: ______________________________

Disadvantages: ______________________________

9. What is accrual basis accounting?

10. Explain the advantages and disadvantages of tax basis accounting.

Advantages: ______________________________

Disadvantages: ______________________________

11. What is accrual basis accounting?

____
____
____
____

12. Explain the advantages and disadvantages of accrual basis accounting.

Advantages: ____
____

Disadvantages: ____
____

13. If utility bills totaling $61,000 are paid during the first year of a project's operation, unpaid bills at the end of the year total $16,000, and unbilled usage is $8,000, what is the total utility expense for the year under the cash method of accounting?

____
____
____
____

14. On a pure accrual basis, if goods services have been received but a billing statement has not yet been received, does a liability exist?

____ Yes ____ No

____
____
____
____

15. Since accounting is purely historical, of what use can it be, particularly to HUD projects?

____
____
____
____

16. Give two examples of how the owner's equity account on the Balance Sheet is established or increased?

____
____
____

ANSWERS

1. The Statement of Financial Position (Balance Sheet) is a written financial summary which illustrates the financial position of a project which documents what the project owes and owns as of a specific point in time (p. 2-4).

2. Assets: Measurable properties, rights and economic resources of a project. They have monetary value and are of present or future benefit to the project (P. 2-4).

   Liability: Claims against the project by outside parties. Economic obligations which require payment in the future (p. 2-8).

   Owner's Equity: The measure of the owner's financial interest in the assets of a project that remain after deducting its liabilities (p. 2-10).

3. The Statement of Income is a listing of a project's revenue and expenses for a specified time period. It details all revenue and expenses and then subtracts the two totals to calculate the profit or loss for the period (p. 2-14).

4. Revenue: The flow of assets into a project from various sources. This is usually in the form of cash but can also take the form of a decrease to liabilities (p. 2-15).

   Expenses: The outflow of assets or increases in liabilities which occur as a result of the major or central operations of the project or using up of assets (p. 2-18).

5. The Statement of Cash Flows is a financial report that summarizes the cash receipts and cash payments for the same one year period covered by the Statement of Income. It details the projects sources and uses of cash and helps the Loan Management staff evaluate the financial health of the project (p. 2-26).

6. The Statement of Retained Earnings is a financial report that details the changes that have occurred in the projects retained earnings during the year. The Statement of Retained Earnings provides information regarding the project's cumulative net income less net losses and dividends (p. 2-31).

7. Cash basis accounting is an accounting method which records revenue and expenses only after cash has been received or disbursed (p.

2-33).

8. The main advantage of cash basis accounting is its simplicity. Its main disadvantage is that it only reflects cash transactions, and does not consider the other revenue or expenses which may have earned or incurred but not yet received or disbursed. It does not provide a clear picture of a project's future financial health (p. 2-34).

9. Tax basis accounting reflects transactions based upon the IRS code (p. 2-34).

10. Advantage: It reflects what the entity filed on its tax return and defers the payment of income taxes (p. 2-35).

    Disadvantage: It does not use generally accepted accounting principles (p. 2-35).

11. Accrual basis accounting is an accounting method which records both the outstanding revenue and expenses of a project. Revenues are recorded when earned and expenses are recorded when incurred (p. 2-36).

12. The main advantage of accrual basis accounting is it reflects assets other than cash, and liabilities other than paid bills. The main disadvantages are that it is more complex to use than cash basis accounting, and it presupposes that all parties involved will meet their financial obligations (pg. 2-36).

13. Only the $61,000 actually paid. This question indicates the weakness of the cash method of accounting because the clearer picture revealed under the accrual method shows an expense of $85,000 (pgs. 2-34 to 2-35).

14. Yes. Under the accrual basis of accounting the fact that the project has accepted delivery of goods or services is the sole determinant of the existence of a liability. The fact that a billing statement has not been received is irrelevant (p. 2-36 to 2-37).

15. It provides the Loan Management staff with the ability to evaluate the financial performance of the project, and can provide advance warning of financial problems (p. 2-1).

16. By additional cash or services, or by net income (e.g., if the project makes a profit, owner's equity is increased) (p. 2-10).

CHAPTER 3

STATEMENT OF FINANCIAL POSITION

(BALANCE SHEET) IN DETAIL

3-1 INTRODUCTION

The Statement of Financial Position, commonly referred to as the Balance Sheet, provides the Asset Management/Loan Management staff with the information needed to evaluate the financial health of a project. Consequently, the Asset Management staff must have an understanding of the contents of the Balance Sheet to evaluate project Performance.

This chapter discusses each of the three sections of the Balance Sheet:

- o assets,
- o liabilities, and
- o owner's Equity

Objectives

After reading this chapter, you should be able to:

- o define assets, liabilities, and owner's equity;
- o discuss the interrelationships of the various types of accounts; and
- o analyze the financial condition of a project using information shown on the Balance Sheet.

3-2 ASSETS

Definition

Current assets are defined as cash and other assets that are expected to be converted to cash or consumed within one year.

Examples

Current assets include:

- o cash,
- o collectible tenant receivables,
- o collectible short-term notes receivable,
- o marketable securities intended to be used as cash resources

for operations (short term investments),
- mortgagee escrow deposits, impound accounts and amounts due within one year,
- prepaid expenses, and
- inventories of merchandise or supplies.

Cash

What it is Cash is the most liquid asset a project owns. In accounting terms, it consists of:

- currency,
- checks, and
- checking account balances.

Definition An asset is liquid to the extent that it can be spent immediately or easily converted to cash which is the most liquid asset. A check is the next most liquid asset and is often considered cash. A building is the least liquid asset a project owns.

What it does Cash is used by the project to pay off its liabilities.

Why it is important Cash balances and transactions are of great importance to the Asset/Loan Management staff because at some point, the activity in almost every account involves the transfer of cash.

How it is used The Asset Management staff uses cash as one of the main components in the determination of the short-term financial solvency of a project.

Definition Short-term financial solvency is the project's ability to pay off its current liabilities as they become due.

What it relates to Cash relates to current obligations. It shows how many current obligations can be met with the available cash on hand.

Why it is presented first on the balance sheet The most liquid asset is listed first on the balance sheet. If the cash balance is reported on the balance sheet as zero or negative, this would indicate a troubled project or a project in the process of being sold.

What should and should not be counted as cash:

What Should Be Included	What Might Be Included*	What Should Not Be Included
Currency	*if "on hand" as of the Balance Sheet date	IOU's
Coins		Paid bills
Certified cashier's check	Traveler's checks	Post-dated checks
	Checks not yet deposited	Postage stamps
Checking accounts balance		Travel advances
Savings account balances		
Money orders		
Bank drafts		

Comment

The items listed as "What Should Not Be Included" should not technically be considered as part of cash. However, they are often included if their total is small when compared to the total cash balance.

The total amount of undeposited checks should be minimal since it is a weak internal control to keep checks in the office rather than depositing them in the bank. Some of the internal control requirements regarding cash receipts include:

- o all cash receipts (including those collected by management agents) must be deposited in the name of the project in a bank whose deposits are federally insured;
- o all collections, if possible, shall be promptly deposited on the day received;

- o bank statements shall be reconciled promptly to the formal accounting records by persons other than those recording or handling cash, or preparing and signing checks.

Note — For more information on internal controls regarding cash receipts and balances please see HUD Handbook 4370.2, Financial Operations and Accounting Procedures for Insured Multifamily Projects.

Accounts Receivable

Definition — Accounts receivable are amounts owed to the project that are due within the current operating cycle, usually one year.

Examples — The three major types of receivables found in HUD projects are included in the following table.

Type of Receivable	What It Includes
Tenant accounts receivable from current tenants.	The balance of rent due from current tenants, but unpaid as of the statement date.
Amounts for other services.	Future receipts from garage, furniture, meals, and damage repairs.
Tenant subsidy payments receivable from HUD.	The balance of subsidy payments due to project owner, but unpaid as of the statement date.

What it does — Accounts receivable measures the potential or future revenue of the project. When revenue is earned prior to its cash receipt, it is recognized as an account receivable because the project has a right to collect that revenue in cash.

Why it is important — The project's accounts receivable records amounts due the project for goods or services rendered and is a source of potential cash.

How it is used — Accounts receivable is one indication of how well the project is being managed. The accounts receivable balance can be studied to determine how much of the project's revenue is being deferred and whether or not it can realistically continue to extend accounts receivable.

It also measures management's effectiveness in collecting rent and other amounts owed to the project.

Note — Accounts receivable are often set up when the project lends money to owners or related projects. These types of loans are improper and accounts receivable can be used to identify such diversions or misuses of funds. For a more detailed discussion of diversion or misuse of funds, please consult Program Integrity Bulletin P-88-5, Misuse and Diversion of Funds, HUD Insured and HUD-Held Multifamily Projects.

Allowance for Doubtful Accounts

Introduction — In Chapter 2 it was mentioned that there is no guarantee a project will collect all of its accounts receivable. In fact, there is often a considerable portion of accounts receivable whose collectability is doubtful. Due to the uncollectible nature of a portion of the accounts receivable, an allowance for doubtful accounts is included in the Balance Sheet,

What it is — The allowance for doubtful accounts is an estimate of how much of the accounts receivable the project will be unable to collect. It is subtracted from accounts receivable on the Balance Sheet.

What it does — It can take several years for an account to be identified as uncollectible, only then can it be written off (charged to expense). For this reason the contra account, allowance for doubtful accounts, must be set up. The allowance for doubtful accounts is recorded as an expense on the Statement of Income and is deducted from the receivables balance on the balance sheet. Consequently, it has the effect of reducing accounts receivable to a more realistic figure. (See Handbook 4370.2 for a discussion on allowance for doubtful accounts.)

How it is used — The Asset Management/Loan Management staff can use allowance for doubtful accounts as a measure of the project's ability to collect tenant account receivables.

What it relates to — Allowance for doubtful accounts relates mainly to tenant accounts receivable. It reflects the estimated amount of rent that will not be collected from tenants.

Notes Receivable

What they are	Notes receivable are amounts due the project that have the form of a signed written agreement describing the terms of the amount due.
What they do	They provide a way of recording money owed to the project other than tenant accounts receivable. They usually represent the sale of a single item or are the result of negotiations regarding the payment of amounts previously due.
Why they are important	Notes receivable are a source of future cash, and a reflection of goods or services already provided,
How they are used	Notes receivable are considered when evaluating the solvency of a project. It is also an indication of possible diversions or misuse of funds such as an unauthorized loan of project cash to the owners (although these are most often found in accounts receivable),

Short Term Investments

What they are	Short term investments represent cash a project has invested and that is not needed to meet current operating expenses.
Examples	Short term investments include the following: o certificates of deposit, o savings account balances, and o purchase of U.S. Treasury Notes.
What they do	Short term investments provide an additional source of revenue (interest) for the project.
Why they are important	Short term investments are important for two reasons: o they provide an additional source of financial strength for the project, and

	o they are assets of the project that are not used to meet current obligations.
How it is used	The Asset Management staff will check to see if the investments are properly protected and have been guaranteed by the U.S. Government. They will also check to see that interest earned on investments is properly handled.

What they relate to: Short term investments are related to cash and current liabilities. These investments represent the second most liquid asset that could be converted to cash and used to pay off liabilities.

Deposits Held In Trust

What they are: Deposits held in trust consist of cash that is being held by the project that will be returned if certain conditions are met.

What they do: It is a way of separating out money, like tenant security deposits, from other current assets. They provide added assurance that certain actions or conditions will be met and are a added guarantee against losses.

Tenant Security Deposits

What they are: Tenant security deposits consist of cash collected from renters which is being held by the project. When a tenant vacates, security deposits may be used to:

- o pay delinquent rent, and
- o repair damages over and above normal wear and tear.

Why they are important: These deposits cover part of repair costs which would otherwise be offset against rental revenue. The need for a rent increase may be reduced if security deposits are used for appropriate repairs. The potential loss of the deposit gives tenants an additional incentive to take better care of their respective units.

How they are used: The Asset Management staff monitors this account to make sure that the owner is not improperly using the tenant's money to pay off the project's obligations.

What they relate to: The tenant security deposit asset account must always be equal to or exceed the balance of the tenant security deposit liability account. These funds must be maintained in a separate bank account. (Some state laws also may require deposits to be held in a separate bank account.)

Other Deposits

Example — Other deposits might include deposits held at the utility company. These are sometimes required by a utility company before service is offered.

How they are used — Other deposits are not used very often. If a large amount of other deposits exist, the Loan Management staff should investigate, or review the Notes to the Financial Statements to see if an explanation was provided.

Prepaid Expenses

Definition — Prepaid expenses represent payments made for products or services that have not been delivered or received. Their value is likely to be used up within one year.

What they do — Prepaid expenses:

- o provide some benefit during the current year, and
- o reduce cash outlay during the current year.

Examples — Prepaid expenses include the following items:

- o unexpired insurance,
- o prepaid taxes, and
- o supplies.

Comment — Prepaid expenses are generally not important to the Loan Management staff except as they reduce cash outlay during the current year. Accounting procedures require the proper recordation of expenses that have already been paid for before the product or services have been used. If only a portion of prepaid expenses has been used they should be prorated to the proper accounting period.

Restricted Deposits and Funded Reserves

Components — Restricted deposits include:

- o mortgagee escrow deposits,
- o reserve for replacement account, and
- o residual receipts account.

Why they are important — Restricted deposits represents money set aside to pay large future obligations like taxes, insurance and major repairs. Except for escrow deposits, these funds are generally released only upon HUD's approval.

Mortgagee Escrow

Deposits
(Synonym:
Impound
Accounts)

Definition	Mortgagee escrow deposits consist of cash and investments belonging to a mortgagor but held by a mortgagee. They ensure that the mortgagor will have enough cash on hand to pay such items as taxes and insurance when they become due.
Why they are important	Mortgagee escrow accounts are important to the Loan Management staff because enough money must be set aside for future payment of the following items: o taxes, o insurance, and o Mortgage Insurance Premiums (MIP).
How they work	Taxes, insurance, and MIP are generally paid once a year. They are usually large amounts which could not be paid out of one month's rental income. The mortgage requires the mortgagee to collect a portion of the taxes, insurance and MIP expense as part of the total monthly mortgage payment.
How they are used	The Asset Management staff can compare the balance of the deposits to prior actual expenses to determine if the reserve will be adequate to cover the upcoming expense.
Comments	The mortgagee usually performs an escrow analysis at least

annually to ensure that amounts collected are sufficient to cover any increased costs due to inflationary pressures and tax rate increases. Consequently, the monthly escrow deposit amounts to be collected often increase from year to year.

Reserve Fund for
Replacements

Definition	The Reserve Fund for Replacements is money set aside to help pay for some of the replacements to the major structural and mechanical components of the building and to replace major appliances.
Why it is Important	If the deposits are made as required, there will be some cash set aside for major repairs when rental revenue may

not be adequate to cover them. Withdrawals from the replacement account must be authorized in writing by HUD. Adequate funding of the Reserve Fund for Replacements account helps ensure the long term financial health and physical well being of the project.

Examples Examples of major structural and mechanical components often covered by the Reserve Fund for Replacements account include:

- roof,
- major appliances (refrigerators, ranges, etc.), and
- heating plant (furnace, boiler).

How they are used The Reserve Fund for Replacements account can be used to review one aspect of the project's long term financial strength. This is done by comparing the amounts set aside with the estimate of future replacement needs.

What it relates to Reserve for replacements should be examined along with any long term budgets that have been prepared.

Note 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. For more discussion on residual receipts see Handbook 4370.2.

Miscellaneous Current Assets

What they are Miscellaneous current assets are any current asset that does not fit into one of the previous categories of current assets.

Examples Examples of miscellaneous assets include inventories of merchandise or supplies.

How the servicer uses them This account is rarely used. If a relatively large number appears on this line, the Asset/Loan Management staff should ask for details. A good IPA (Independent Public Accountant) will include an explanation of large items that appear here in the Notes to the Financial Statement.

Fixed Assets

Definition — Fixed assets are those assets with an expected life greater than one accounting period, usually one year. Fixed assets are:

- o used for operations and are not held for resale,
- o subject to depreciation, amortization or depletion, and
- o made up of physical (tangible) substance.

Components — Fixed assets include:

- o buildings,
- o land,
- o improvements (landscaping),
- o equipment,
- o vehicles,
- o tools,
- o furniture, and
- o other owned tangible property.

Comments — Buildings, furniture, equipment and fixtures are recorded at historical cost. Their current market value or replacement cost has no bearing on the books of an ongoing concern. An allowance for depreciation is then deducted from that amount to arrive at the book value. Some of the monies required to replace and repair fixed assets are generated by monthly deposits to the reserve for replacements account, as required by the regulatory agreement.

What they do — Fixed assets measure the value of property belonging to the project. These assets are generally used in the production of services (and goods), rather than being held for resale.

Example — For example, a HUD project purchases a quantity of major appliances for its apartments. The appliances are not purchased with the idea of reselling them. They are used to maintain proper living conditions in the individual units.

Why they are important — The Asset Management staff should be concerned with major changes in fixed asset accounts rather than their amounts, as compared to current or other assets. The fixed assets are indispensable to the project. They provide the physical base from which the project can earn revenue by selling its services.

How they — If the value of a fixed asset changes drastically. The

are used	HUD servicer should investigate to determine whether or not the disposal or improvements to the asset were approved by HUD.
What they relate to	When new fixed assets are acquired, their cost is added to the appropriate account. Similarly, when a fixed asset is disposed of, its cost and the related depreciation should be removed from the account. A more detailed discussion of depreciation can be found in Chapter 4 of this Handbook.

3-3
LIABILITIES

Current Liabilities

What they are	Current liabilities are obligations that must be generally met within one year. These obligations must be met using existing resources properly classified as current assets or by the creation of another liability.
Why they are important	Proper statement of current liabilities is extremely important in the analysis of a project's financial position, particularly when computing surplus cash and residual receipts.
How they are used	The Loan Management staff compares the total current liabilities to the total current assets to see if there are enough current assets to cover all of the current liabilities. This is a way of analyzing the short term liquidity of the project.

What they relate to	Current liabilities interact with cash. Cash is the most liquid asset in the project and is most often used for satisfaction of current liabilities.
Components	Current liabilities include the following six items:

- o accounts payable,
- o accrued liabilities,
- o Notes payable (short term),
- o deferred income,
- o distributions or dividends payable, and
- o security deposit liability.

Accounts Payable

What they are	Accounts payable are obligations of the project that have been incurred and billed but not yet paid for. Accounts payable usually represents the actual invoices from

vendors.

Example — An example of an accounts payable is a utility bill that a project received at the end of one month but will not pay until the middle of the following month.

What they relate to — Accounts payable interact directly with cash. The accounts payable balance can be compared with the cash account balance to see if it is sufficient to cover accounts payable.

Accrued Liabilities

Definition — Accrued liabilities are a record of expenses that have been incurred but not yet billed or paid,

Examples — Accrued liabilities included the following:

- o payroll,
- o taxes,
- o part-period utilities, and
- o interest due.

How they are used — The amount of the accrued liability has an impact on the financial solvency of the project.

What they relate to — Accrued liabilities are an indication of the projects short-term obligations that will show up on the statement of income as an expense when paid.

Notes Payable (Short Term)

Definition — Notes payable (short term) is the account where the dollar value of the project's short term borrowing is recorded.

What they do — The existence of notes payable may imply that rental revenue has not been sufficient to meet obligations, and often times is an indication of financial difficulty.

Example — For example, a short term bank loan needed to meet the payroll.

What they relate to — Short term notes payable interacts with current assets like cash, which will be used to pay them.

How they are used — The Loan Management staff may compare notes payable to either current assets or cash remaining after normal operations to determine whether or not the project will be able to repay the loan when it is due.

Comment: If the notes are payable to related parties, such as the project's owners, this fact should be disclosed in the Notes to the Financial Statements and the details investigated to ensure this is not a violation of HUD requirements.

Mortgage Payable (Current Portion)

Definition: Mortgage payable (current portion) is that portion of the long-term liability that becomes payable within one year after the balance sheet date.

What they do: The existence of mortgage payable indicates a creditor has a secured prior claim against one or more of the project's assets which can be sold if the debt is not paid within the operating year.

Why is it important: The loss of significant assets due to nonpayment on a mortgage can result in the failure of the project.

What they relate to: Mortgage payable (current portion) interacts with current assets like cash, which are used to make the mortgage payments.

How they are used: The Loan Management staff may use it to determine if the project is financially sound to satisfy the current portion of the mortgage without risking the loss of collateral.

Deferred Income

Definition: Deferred income is created when cash has been received but not yet earned. A liability exists to provide the service or to otherwise earn the income.

Example: Prepaid rents are an example of deferred income, although their amount is rarely large.

What it does: The function of deferred income is to measure the dollar amount of services that the project will have to perform for money that has already been received.

Why it is important: Deferred income is important because it represents the possibility of using future income to pay current expenses.

How it is used	If the deferred income represents a large figure when compared to project income, the Loan Management staff should investigate the cause.
What it relates to	Deferred income interacts with future budgets.

Distributions or Dividends Payable

What they are	Distributions or dividends payable are an accumulation of unpaid dividends owed to the owner. If distributions are made they must be in accordance with the Regulatory Agreement.
Why they are important	They represent money the owner expected to get but didn't. Therefore, the owner may be reluctant to make additional cash contributions to the project.

How they are used	Existence of these items usually means that project rental revenue has not been sufficient to cover both operating costs and return the permitted profit to the owners. This means the rent collection efforts must increase, expenses must be reduced, or rents must be raised.
What they relate to	When the distributions or dividends payable is increased, the owner's equity line on the Balance Sheet is decreased, and vice versa.

Security Deposit Liability

What it does	Security deposit liability measures the financial obligation of the project to the tenants.
What it is	It is the project's obligation to repay funds held on deposit if certain conditions are met by the tenants.
Interactions	Security deposit liability interacts directly with the asset of tenant security deposits. If an owner is complying with HUD requirements regarding security deposits, the balance in the tenant security deposit account should equal or exceed the total security deposit liability, including any interest owed or potentially owed to tenants.

LONG TERM LIABILITIES

Notes Payable

What it is — Notes payable (long term) is the Balance Sheet account that records money lent to the project that is due in more than one year.

Why it is important — Notes payable represent potential noncompliance with HUD regulations because HUD has to approve any long term notes payable.

Interactions — Notes payable interacts with future income of the project (in the budget). It also affects the long term liquidity of the project.

Example — A bank loan to the project to purchase equipment such as lawnmowers, motor vehicles, etc. is an example of a notes payable.

Mortgage Payable

What it is — Mortgage payable is the Unpaid Principal Balance (UPB) of the mortgage principal less the current portion.

What it does — Mortgage payable is a record of the unpaid principal balance.

How they are used — The Loan Management staff may use it to see if a project's monthly mortgage payments are being made on schedule.

Other Liabilities

Why they are important — Other liabilities provides an all encompassing account for any other long term liabilities not fitting any other categories.

Example — A bond is an example of a long term liability that comes under this category.

How the servicer uses them — If the amount of other liabilities is large compared to the total liabilities, the Loan Management staff should investigate for possible project financial troubles.

Amounts Due To Owners

What it is	Amounts due to owners is the amount of money advanced by the owners that is not currently due.
What it does	Such amounts appear as a liability to emphasize the owner's right to collect them, even though this right is dependent on the future financial performance of the project.
Why it is important	Amounts due to owners is important to the Loan Management staff because this obligation usually cannot be paid to the owners without prior HUD approval.

3-4 OWNER'S EQUITY

What it is Owner's equity is the claims of the owner against the assets of the project. The balance in owner's equity plus all liabilities should always equal the total value of the project's assets.

The owner's equity consists of the following accounts:

- o capital account,
- o withdrawals account, and
- o retained earnings.

What it does Owner's equity summarizes the financial loss or gain of the project.

Interaction Owner's equity interacts with total liabilities and total assets.

Why it is important The dollar amount of owner's equity has very little economic meaning beyond its effect on the owner's tax return. The most important factor is the transactions that affect owners equity. The Loan Management staff should pay close attention to the contributions and distributions reported in calculating owner's equity.

Capital Account

What it is The Capital account is the account used to record the owners initial investment of the business plus any permanent additional increases or decreases in owner's equity. The capital account is often referred to as contributed capital. For corporations and cooperatives this account is represented by paid in capital which may include surplus or deficient amounts from operations.

What it does — The Capital account measures the individual owners initial investment plus any increase or decrease in the individual owners equity.

Interaction — The capital account interacts with the other equity accounts.

Why it is important — The capital account is one indication of the owners willingness to invest capital into the project.

Withdrawals Account

What it is — The withdrawals account is the account used to record transfers of assets from a project to its owners.

What it does — The withdrawals account measures the individual owners collection of assets from the business. These draws reduce the owners equity.

Interaction — The withdrawals account interacts with the other equity accounts.

Why it is important — The withdrawals account is important because it is an indication of the owners ability to receive a return on monies invested.

How it is used — The withdrawals account can be used to determine if amounts are being distributed to owners in accordance with HUD guidelines.

Retained Earnings Account

What it is — Retained earnings details the types of transactions that result in the increase and decrease in equity resulting from earnings.

What it does — Retained earnings measure the results of operating activities.

Interaction — Retained earnings accounts interact with the other owner equity accounts.

Why they are important — These accounts are important in determining how net income relates to how much money an owner is able to realize on amounts invested.

3.5

FINANCIAL
RATIOS

What they are — Financial ratios are mathematical computations that assist in the analysis of financial statements. Financial ratios include:

- o Liquidity Ratios,
- o Acid Test Ratios,

- o Profitability Ratios, and
- o Activity Ratios.

What they do — Financial ratios help the Loan Management staff asses the financial health and stability of the project.

How they are used — The Loan Management staff can use financial ratios to predict the amount and timing of future net cash flows and project viability.

How they interrelate — Financial ratios interrelate with the various financial statements. The relationship of financial ratios to the other statements will be discussed later.

Note — For a more detailed discussion of ratios, please see Handbook 4370.1.

Liquidity Ratios

Current Ratio

What it is — The Current Ratio is one of the liquidity ratios that is the relationship of a project's current assets to current liabilities.

What it does — It provides an analysis of the working capital (current assets less current liabilities) structure of a project.

What it means — A high Current Ratio indicates a large proportion of current assets to current liabilities. The higher the ratio, the better is a company's current position, and the better able to it is meet current obligations. As a general rule a 2:1 ratio is considered to be an adequate index for most industries.

How it is used — The Current Ratio is arrived at by dividing a projects current assets by its current liabilities. The resulting ratio can be used to evaluate a projects working capital position. Appropriate actions should be taken if ratios fall well outside of the HUD or industry standards.

The formula for calculating the Current Ratio is as follows:

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

Acid Test

(Quick Ratio)

What it is — 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 such as (cash, short-term investments and accounts receivable).

What it does — It provides an analysis of whether the project can meet current obligations without the use of non-cash current assets.

What it means — An Acid Test Ratio of less than one would indicate that if all the quick assets were converted to cash, this would not satisfy the current liabilities owed. Therefore, an Acid Test Ratio of at least 1 would be considered satisfactory to meet current obligations. As a general rule, a 1:1 ratio is considered to be an adequate index.

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

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

Mortgage Coverage Ratio

What it is — The Mortgage Coverage Ratio is defined as net available funds divided by the current mortgage payment, including escrows.

What it does — It provides an analysis of whether the net available funds are sufficient to meet the current cash obligations.

What it means — A Mortgage Coverage Ratio of less than one indicates that net available funds are not sufficient to meet current cash obligations. Therefore a ratio of at least one would be satisfactory.

How it is used — The Mortgage Coverage Ratio is arrived at by determining the net

available funds and dividing the sum by the monthly mortgage payment. The net available funds consists of available funds (unrestricted cash, HUD receivables, investments of unrestricted cash and other current assets) less cash obligations. Cash obligations consists of all current liabilities, except accrued liabilities related to (but not including) mortgage escrows. The mortgage coverage ratio is an indication of how easily a project can meet it's current mortgage payment without converting net available funds to cash or acquiring financing. The formula for calculating the mortgage coverage ratio is as follows:

$$\frac{\text{Net Available Funds}}{\text{Monthly Mortgage Payment*}} = \text{Mortgage Coverage Ratio}$$

*Per note and including escrows

Other Financial 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.

Profitability Ratios include:

- o Profit Margin on Rental Revenue, and
- o Return on Partners'/Owner's Capital.

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:

Net Profit Before Depreciation
________________________________ = Profit Margin
on Rental Revenue Rental
Revenue

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

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' Capital Ratio is calculated as follows:

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

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

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

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

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

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.

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%.

3.6 CHAPTER SUMMARY

A detailed understanding of the Balance Sheet can help the Loan Management staff determine both the long and short term solvency of the project. This conclusion is arrived at by studying the relationships between the various assets and liabilities of the project. In order to understand the relationships between a project's assets and liabilities, the Loan Management staff has to understand the following:

- o how the project records its earnings,
- o how it records and spends its monies to pay its debts, and
- o how it handles uncollectible accounts.

It is also helpful for the Loan Management staff to understand what the Balance Sheet reveals about the owner's relationship to the project, since it has a bearing on the willingness of the owner to contribute additional capital to the project. Financial ratios help evaluate the financial health and stability of a project. Many of the financial ratios discussed here and in later chapters can be generated via MIPS. For more detailed information regarding MIPS and financial ratios please review HUD User Manual Application 5.3b, Data Entry and Performance Risk Analysis.

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CHAPTER 3

ACCOUNTING KNOWLEDGE QUIZ

Questions

1. ____________________________ is the most liquid asset a project owns.

2. Short term financial solvency is the project's ability to pay off its ____________________ as they become due.

3. ____________________________ are amounts owed to the project.

4. Allowance for doubtful accounts can be used as a measure of a project's ability to collect ____________________________.

5. ____________________________ are cash a project has invested that is not needed to meet current operating expenses.

6. ____________________________ consists of cash collected from the renters by the project that are an assurance or guarantee that rental units will be properly maintained by tenants. If a tenant vacates the apartment these funds can be used to:

   a. ____________________________ and
   b. ____________________________.

7. Prepaid expense are likely to be used up within ____________________.

8. Mortgagee escrow accounts must have enough money for future payment of:

   a. ____________________________,
   b. ____________________________ and
   c. ____________________________.

9. The ____________________________ is money set aside for replacements to the major structural and mechanical components of the building.

10. Assets with an expected life of more than one accounting period are known as ____________________________.

11. Obligations that must be met within one year are __________________.

12. ____________________________ are obligations of the project that have been incurred and billed, but not yet paid.

13. Prepaid rent is an example of ____________________________.

14. ____________________________ is the account that records money lent to the project that is due in more than twelve months.

15. ____________________________ records the Unpaid Principal Balance (UPB) of the mortgage.

16. ____________________________ represents money advanced by the owners that is not currently due.

17. Place a check mark next to the items listed below that are defined by accountants as assets of a HUD project.

(a) ______ Prepaid expenses
(b) ______ Depreciation
(c) ______ Escrow deposits
(d) ______ Rent supplement contracts
(e) ______ Mortgage on the property
(f) ______ Checking account balance
(g) ______ Accounts receivable

18. When a tenant "skips" owing $300 in rent and $1,250 for legitimate damages, does a $1,550 receivable exist?

____ Yes ____ No

____
____
____
____

19. What are the arguments for including prepaid expenses and mortgagee escrow deposits as current assets?

a. ____
____

b. ____
____

20. If a mortgage balance is $10 million, but three payments (totaling $200,000 of interest and $ 100,000 of principal) are delinquent, what is the total mortgage payable amount to be shown on the Balance Sheet?

$ _______________

21. _____________________ is the claims of the owner against the assets of the project.

22. ______________________ represents the initial investment of the owners plus any permanent increases or decreases in owner's equity.

23. ______________________ are mathematical computations that assist in the analysis of financial statements.

Answers

1. Cash (p. 3-2)
2. Current liabilities (p. 3-2)
3. Receivables (p. 3-4)
4. Tenant receivables (p. 3-5)
5. Short term investments (p. 3-6)
6. Tenant security deposits (p. 3-7)
   a. Pay delinquent rent (p. 3-7)
   b. Repair damaged apartments (p. 3-7)
7. One year (p. 3-8)
8. a. Taxes (p. 3-9)
   b. Insurance (p. 3-9)
   c. Mortgage insurance premiums (MIP) (p. 3-9)
9. Reserve for replacement (p. 3-10)
10. Fixed Assets (p. 3-11)
11. Current liabilities (p. 3-12)
12. Accounts payable (p. 3-13)
13. Deferred income (p. 3-15)
14. Notes payable (3-16)
15. Mortgage payable (p. 3-17)
16. Amounts due to owners (p. 3-17)
17. a. Yes: despite the word expenses, they are assets, because they will result in future benefit to the entity. (p. 3-1)
   b. No: depreciation is an expense, and the allowance for depreciation on the balance sheet is an offset to an asset. (p. 3-11)
   c. Yes: they are the project's property and have future value. (p. 3-9)
   d. No: only the cash received by the project from the contract is an asset. (p. 3-16)
   e. No: the property is an asset and the mortgage is a liability; the mortgage is an asset of the mortgagee, however. (p. 3-17)
   f. Yes: part of cash. (p. 3-2)
   g. Yes: but the estimated uncollectible portion reduces the value of the asset. (P. 3-4)

18. Yes, but, unless it is likely to be collected an allowance for doubtful accounts should be set-up or eventually it should be written off. (p. 3-4)

19. a. They will be of benefit during the coming year.
    b. If they had not been there, cash would have been required in the coming year. (p. 3-8, 3-9)

20. $10 million. The delinquency does not change the Unpaid Principal Balance, it only describes its status. The $200,000 would be shown on the Balance Sheet as delinquent interest payable. (p. 3-17)

21. Owner Equity (p. 3-18)

22. Capital Account (pgs. 3-18)

23. Financial Ratios (p. 3-19)

CHAPTER 4

STATEMENT OF INCOME IN DETAIL

4-1 Introduction

All HUD projects deal with revenue and expenses. The Asset Management/ Loan Management staff examines the relationships between a project's revenue and expenses in order to determine if the project is being operated efficiently and in accordance with HUD regulations.

Overview

This chapter, will enable you to:

1. Discuss the types of revenue, their use and their importance to the project.
2. Discuss the types of expenses, their use and their importance to the project.
3. Define Net Income or Loss and its importance in the evaluation of the project.

4-2 Revenue

Definition

Revenue is the inflow of cash or other assets in exchange for services provided.

Components

The three types of revenue that will be discussed are:

- rental revenue,
- service revenue, and
- financial revenue.

Rental Revenue

What it is

Rental revenue is the result of a contractual agreement between the owner of a HUD project and a tenant for the occupancy of a unit of housing.

Components of Rental Revenue

COMPONENTS OF RENTAL REVENUE

GROSS POTENTIAL RENTAL REVENUE

OCCUPIED APARTMENTS	RENT-FREE APARTMENTS	UNOCCUPIED APARTMENTS	SKIPS

Definitions

Gross Potential Rental Revenue refers to the maximum amount of rental revenue (i.e., 100% paying occupancy) a project could earn.

Occupied Apartments are those presently earning revenue.

Rent-Free Apartments are those apartments assigned to project employees at no charge. It is not appropriate to show the value of these units as vacancies. However, since they represent part of the project's potential revenue, they are included here. To account for the fact that they do not add to the project's revenue, rent-free apartments show an "artificial" revenue with an offsetting expense under an appropriate caption like "manager salary".

Unoccupied Apartments refer to units which are not earning income because no one is living in them.

Skips refer to units where a tenant vacates without notice prior to the end of a lease. Revenue has been earned but will probably not be collected.

Why it is important

Rental revenue is evaluated for two reasons:

- o to see if the project is going to have enough income to meet its expenses, and
- o to see if the rental revenue is in compliance with the HUD approved amount.

Service Revenue

What it is

Service revenue is revenue the project earns for providing services (other than rental units).

Examples

Examples of services that provide revenue include:

- o laundry and vending,
- o NSF and late charges,
- o damage and cleaning fees,
- o forfeited tenant security deposits, and

Comment
If the amount of service revenue is large, IPAs are required to provide a breakdown of the amount in the Notes to the Financial Statements. Loan Management staff should review the Notes to the Financial Statements to see if the explanation of large amounts is reasonable and

appropriate.

Financial Revenue

What it is — Financial revenue is usually the result of interest earned.

Components — Financial revenue is derived from one or more of the following:

- o project operations,
- o reserve funds,
- o security deposits,
- o residual receipts, and
- o Interest Reduction Payments (IRP) for Section 236 projects.

How they are used

- o The Loan Management staff should encourage the owner to invest cash that is set aside or that is not being used to meet current operating expenses.

- o If the Notes to the Financial Statements show that reserves or security deposits are invested, the Loan Management staff will expect to see financial revenue on the Statement of Income.

4-3
Expenses

Definition — Expenses are the outflow of assets or increases in liabilities that

occur as the result of providing the products or services that generate revenue during the period.

Types of Expenses — The following are basic types of expenses found on HUD projects:

- o administrative expenses,
- o utilities expenses,
- o operating and maintenance expenses,
- o taxes and insurance,
- o financial expenses,
- o elderly and congregate service expenses,
- o corporate or owner entity expenses, and
- o depreciation.

Interaction — All expenses interact with the operating budget. All expense items are compared to the budget. Variances are identified and explained.

Expenses also interact with cash and liabilities, especially accounts payable and accrued liabilities. For example, the project is billed for a service and decides not to pay it immediately. Under the accrual method of accounting, an account payable is created or increased.

Why they are important — The operating budget and rent schedule assumes that expenses will be reasonable and necessary. If expenses are not controlled, the revenues generated may be insufficient to cover expenses.

How they are used — Increases in expenses which are beyond the control of the project managers usually justify a rent increase. The Loan Management staff will often compare these expenses to those of similar projects to determine if rent levels are reasonable and appropriate.

Administrative Expenses

What they are — Administrative expenses are monies expended to manage the project.

Why they are important — Administrative expenses are important in that they can be used to tell if the project is being managed in compliance with the management agreement. It is also an area in which abuse is common.

How they are used — Administrative expenses are used by the Loan Management staff to check for common abuses like:

- o fees accrued in excess of that permitted in the management agreement, and
- o unreasonable legal and audit costs.

Example — If the project has a stable and high occupancy rate and a waiting list for apartments, it should not be spending a large amount on advertising. If there is a poor occupancy rate and no evidence of sufficient advertising, the Loan Management staff should inquire as to why. If the advertising costs are excessive, the Loan Management staff should check to see if the type of advertising is appropriate.

Components — The components of administrative expenses include the following items:

- advertising,
- office salaries,
- office expenses,
- office rent,
- management fee,
- manager or superintendent salaries,
- legal expenses (project),
- auditing expenses (project),
- telephone and telegraph,
- bad debts, and
- miscellaneous.

Operating and Maintenance Expenses

What they are

Operating and Maintenance (O&M) expenses are the costs of running and maintaining the project.

Why they are important

Operating and maintenance expenses are the expenses most difficult to control. Even if the manager shops wisely and operates the project efficiently, inflation and other factors often drive operating expenses up. Increases in these costs are the most common reason for rent increases.

Components

The components of operating and maintenance expenses include the following items:

- elevator payroll,
- elevator power,
- fuel,
- engineer payroll,
- janitor payroll,
- janitor supplies,
- bus operator payroll,
- gasoline, oil and grease,
- electricity,
- water,
- gas,
- exterminating payroll,
- exterminating supplies,
- exterminating contract,
- garbage and trash removal,
- miscellaneous,
- protection payroll,
- protection fee, cost of contracts,
- grounds payroll,
- grounds supplies and replacements,

- grounds contract,
- cleaning payroll,
- repairs payroll,
- repairs material,
- repairs contract,

- repairs - extraordinary and nonrecurring,
- elevator maintenance,
- air conditioning repair and maintenance,
- decorating payroll,
- decorating supplies,
- motor vehicle repairs,
- maintenance equipment repairs, and
- miscellaneous.

How they are used The project's operating and maintenance expenses are often compared to similar projects to see if they are reasonable. Large increases in operating and maintenance expenses are sometimes an indication of the need for a rent increase.

If operating and maintenance expenses are significantly higher than those of similar projects, the Loan Management staff should investigate to see if the owner is shopping and comparing prices to ensure that materials, supplies and services are the most advantageous to the project and are not in excess of amounts normally paid for such items. Management should also maintain an active list of vendors and contractors which offer competitive pricing. Loan Management staff can also suggest improvements which will enhance the efficiency of operations.

Why they are important Operating and maintenance expenses are important because they can be used to evaluate the efficiency of both the maintenance and management operations. By taking advantage of discounts and shopping for the best buy, the manager can exert more control over these expenses than can be exerted over other expenses.

Depreciation

What it is Depreciation is the process of expending a portion of an asset's cost as it is used during each year of the asset's estimated useful life. This is necessary to charge the correct portion of the asset's value "used up" during the year. Generally accepted accounting principles require that depreciation be computed by a systematic and rational method over the estimated useful life of an asset. However, in 1981 and 1986 the tax laws established cost recovery provisions that have no relationship to the estimated useful life of an asset. The tax legislation was designed to stimulate investment and development by profit-motivated investors.

Why it is important

Depreciation is important because it is an non-cash expense item (that required cash up front) but gives the owner a tax deduction. The fact that the owner can lose a part of this tax write-off if HUD forecloses is a motivating factor that helps convince the owner to correct any noted deficiencies.

Components

Assets which are depreciated include the following items:

- alterations,
- buildings,
- building equipment - fixed,
- building equipment - portable,
- furniture for project administration use,
- furniture and equipment - project owned for rental or lease,
- furnishings,
- maintenance equipment,
- motor vehicles, and
- miscellaneous.

Types of depreciation

Exhibits 4-1 and 4-2 describe types of depreciation commonly used in HUD projects. Traditional methods of depreciation include straight-line, which allocates the cost equally over the life of the asset, and accelerated depreciation which allocates more of the cost during the early years of an assets life. Accelerated depreciation methods include the declining balance method and the sum-of-the-years-digits method. Under the declining balance depreciation method, an asset can be depreciated up to twice the straight-line rate (200%) without considering salvage value. To determine the double-declining rate, first determine the straight-line rate by dividing 100% by the estimated life of the asset. Then multiply the straight-line rate by the desired acceleration (125%, 150%, 200%). Calculate the annual depreciation by multiplying the declining-balance rate by the end-of-year book value. Under the sum-of-the-years-digits method, the years in an asset's life are added (e.g., 1+2+3+4+5 = 15). The sum becomes the denominator of a series of fractions used in calculating the annual depreciation. The numerators are the years in the assets life (e.g., 5/15, 4/15, 3/15).

Unlike the declining balance method, depreciation is calculated each year on the cost of the asset less the salvage value.

Recent tax laws enacted by the IRS allow for two new methods of

depreciation that vary from the traditional methods, but have similar characteristics of accelerated depreciation. For assets purchased after 1980 but before 1987 the tax law allows for a method of depreciation called Accelerated Cost Recovery System (ACRS). For assets purchased after December 31, 1986 ACRS was revised to allow for a method of depreciation known as the Modified Accelerated Cost Recovery System (MACRS). The ARCS method allows rapid recovery using a fixed recovery schedule over a prescribed statutory period. Therefore, the property's salvage value and the estimated useful life are not required. For example, 5-year property (e.g., office furniture, equipment, heavy-duty trucks) is depreciated at 15% the first year, regardless of when it was placed in service during the year. The second year at 22% and the remaining three years at 21% percent. The MACRS method, like ACRS, does not consider useful life or salvage value, however, consideration is given as to when the combined bases of property was placed in service. Property in the 3-year to 10-year classes are depreciated using a 200% declining-balance method, switching to straight-line; 15 and 20-year classes are depreciated using a 150% declining-balance method, switching to straight-line method; and residential (271/2 years) and nonresidential (311/2 years) property is depreciated using the straight-line method. Awareness of the type of depreciation can assist Loan Management staff in negotiating workouts with owners of troubled projects.

Comment

Owners prefer accelerated depreciation because it defers the payment of income taxes from the early years of the project. Taxes are deferred because larger amounts of depreciation are charged, therefore reducing net taxable income. This provides more operating funds for the project which may be suffering insufficient rental income due to the project not being fully rented. However, the taxes are only deferred, they are not avoided. If the owner sells the project or HUD forecloses, the project owner may need to repay some of the income tax savings to satisfy the larger income taxes that may become due in the asset's later years.

Note that HUD will accept only GAAP treatment of computing depreciation.

Amortization

What it is — Amortization is the expending of a share of the cost of an asset, usually an intangible asset. An intangible asset is one that has no physical existence but has value due to the rights resulting from its ownership and possession. The most common intangible assets of a multifamily project is the costs associated with organizing a cooperative or corporation.

Why it is important — Amortization is an expense on the Statement of Income that does not use cash, (cash is required to purchase or acquire the rights to the asset) but provides for an income tax deduction.

Components — The types of assets that are amortized include:

- o organizational costs of a corporation or cooperative,
- o leasehold improvements,
- o patents,
- o copyrights,
- o trademark, and
- o trade names.

Note: "Amortization" in this context should not be confused with the "amortization" of the mortgage principal, which does use cash to retire. or repay, the mortgage indebtedness.

Exhibit 4-1. Types of Depreciation Per Generally Accepted Accounting Principles

METHOD OF DEPRECIATION - The procedure followed for calculating depreciation expense.

STRAIGHT LINE ACCELERATED - More

Cost allocated equally over the asset's life.

of the cost is allocated to the earlier years of an asset's depreciable life.

200% DECLINING BALANCE	150% DECLINING BALANCE	125% DECLINING BALANCE	SUM OF YEARS DIGITS

Exhibit 4-2. Types of Depreciation Per Income Tax Basis

METHOD OF DEPRECIATION - The procedure followed for calculating depreciation expense for tax purposes.

Accelerated Cost Recovery System (ACRS) - Used for assets purchased after 1980 and before 1987.	Modified Accelerated Cost Recovery System (MACRS) Used for assets purchased after December 31, 1986.	5 YEAR 167K Used for rehabilitation housing. A special life despite their much longer actual useful life.
Personal Property 3-year class to 7-year class	Personal Property 3-year class to 20-year class	
Real Property 15-year class to 19-year class	Real Property 271/2-year class for residential rental property and 311/2-year class for all other real estate	

Taxes and Insurance

What they are

Taxes (payroll, county, etc.) and insurance are important for two reasons:

- if taxes (payroll, county etc.) are not paid, the IRS and local government might be able to place a lien or foreclose on the project;
- if the insurance is not paid, the building would not be properly protected against loss due to fire or natural disaster; and
- payment is required by the Regulatory Agreement and mortgage note.

How they are used — The Asset Management/Loan Management staff often reviews the insurance expense to ensure that the property is adequately protected. If the tax expense is unusually low or high, the Asset Management staff will determine if the taxes are paid in full or if penalties and interest are included. Advice can be given to the project owner on how to lower these costs, if excessive. For example, the Asset Management staff can recommend the filing of a property tax appeal.

Components — The following three items are components of taxes and insurance:

- property taxes,
- payroll and other taxes, and
- property and personal liability insurance.

Financial Expenses

What they are — Financial expenses are costs associated with the acquisition and use of assets from sources outside of the project.

Examples — Examples of financial expenses include the following items:

- the interest portion of each mortgage payment,
- financing charges or interest on notes payable,
- financing charges on purchases, and
- interest paid on bonds sold by the project.

Why they are important — Financial expenses record the payment of the mortgage. This account may also reveal payments of other debts that may or may not have been HUD approved.

Components — The components of financial expenses include the following items:

- interest on bonds payable,
- interest on mortgage payable,
- interest on notes payable (long term),
- interest on notes payable (short term),
- insurance on mortgage (MIP), and
- miscellaneous.

How they are used — The Loan Management staff can check for compliance with HUD requirements by comparing the expense category against the approved debts of the project to see if there are payments for unapproved debts.

Service Expenses

What they are — Service expenses are the costs associated with tenant services other than housing.

Examples — Examples of service expenses include items such as:

- maid service,
- T.V. antenna rental, and
- laundry services.

Why they are important — Service expenses are important because they must be self-supporting and be independent of other project funds.

How they are used — The Loan Management staff can compare service expenses to service revenue to see if the services are self-supporting and not drawing on other project funds.

Corporate Expenses

What they are — Corporate expenses are the costs of maintaining the legal status of the corporation. These types of expenses are not found in partnerships, except for required filing fees.

Components — The components of corporate (other than Subchapter S corporations) expenses sometimes include the following items:

- officer salaries,
- legal expenses (entity),
- federal income tax,
- state income tax,
- other taxes (entity),
- other expenses (entity).

Why they are important — Some corporate expenses, such as taxes, are relatively unimportant unless the sum is large; others, such as legal expenses and officer salaries, could represent possible diversions of project funds for unauthorized expenditures. The Asset Management staff should review the Notes to the Financial Statements to determine if the owner is having personal legal expenses paid out of project income which is a violation of HUD requirements or if some of the corporate expenses that are listed might be unallowable distributions.

4-4 NET INCOME OR LOSS

What it is — Net income or loss is simply the difference between a project's total revenues and its total expenses.

Why it is important — Net income or loss is a major component used for evaluating the financial health and stability of a project. The financial success of a HUD project is not measured solely on the basis of its net income or net loss, which is only one factor used to determine a project's financial health and stability.

Other factors that should be considered with net income or loss include a projects:

- o ability to maintain high levels of, occupancy and collections;
- o ability to maintain reasonable rent levels when compared with similar projects;
- o ability to meet all obligations as they become due;
- o financial and organizational ability to maintain the project in good physical condition;

- o availability of funds for necessary replacements, major repairs, and unforeseen circumstances;
- o ability to maintain reasonable levels of expenses, compared to similar projects; and
- o availability of cash for distribution to owners.

Comment — Most HUD projects show a loss at the bottom of the Statement of Income. This is mainly due to depreciation, which is a large expense, that does not require the use of cash. To obtain a clearer picture of the project's cash basis income or loss, the Loan Management staff should add all "non-cash" expenses (like depreciation) back into the bottom line of the Statement of Income. This provides a more meaningful "net income or loss" figure which can be used to evaluate the efficiency of the operations. (See Chapter 5 of this Handbook for a complete discussion of cash flows.)

Non cash expenses other than depreciation include:

- o accounts receivable,
- o prepaid items,
- o accounts payable,
- o accrued expenses,
- o tenant Security Deposit Payable,
- o deferred income, and
- o accrued year-end revenue.

The Loan Management staff can evaluate the impact of these other non-cash expenses on net income or loss by comparing the current year end balances in these accounts with the beginning balances.

Example

Net Income	($240,000)
Accrued Revenue	(20,000)
Depreciation	220,000
Accrued Expenses	20,000
Gross Profit (Loss) before Depreciation	($20,000)

Comments

Financial ratios which assist in the evaluation of the Statement of Income are discussed in Chapter 3 of this Handbook.

4-5
Chapter Summary

The relationship between revenue, expense and net income or loss can be summed up in the following equation:

REVENUE - EXPENSES = NET INCOME OR LOSS

The Loan Management staff can get a clear picture of a project's efficiency and stability by studying The Statement of Income. This information can be used to identify a project's strengths and weaknesses and can be used to evaluate adherence to HUD standards of operation.

CHAPTER 4

ACCOUNTING KNOWLEDGE QUIZ

QUESTIONS

1. The inflow of cash and other assets resulting from rental and other services relating to HUD projects is called ______________________.

2. The three types of revenues are:

   a. __________________________
   b. __________________________
   c. __________________________

3. Outflows of assets are called ______________________.

4. Management fees are an example of ______________________ expense.

5. Repairs payroll is a part of ______________________ expense.

6. MACRS, ACRS, straightline, accelerated and 5-year 167K are types of ______________________.

7. Finance charges and purchases are components of____________ expenses.

8. The project's owner should not have personal legal expenses paid out of ______________________.

9. Is the value of apartments used as employees' rent-free residences and as project offices properly considered a vacancy loss? If not, how is this rental loss accounted for?

   ____
   ____
   ____
   ____

10. What is the effect and purpose of depreciation?

    Effect: ____
    ____

Purpose: ____
____

11. Can a project show continuous net losses and still survive without additional capital contributions?

____ Yes ____ No

____
____
____
____

ANSWERS

1. Net Revenue (i.e. income) (p. 4-1)

2. a. rental
   b. service revenue
   c. financial revenue (p. 4-1)

3. Expenses (p. 4-4)

4. Administrative (p. 4-5, 4-6)

5. Maintenance (p. 4-7)

6. Depreciation (p. 4-8, 4-9)

7. Financial (p. 4-11)

8. Project income (p. 4-13)

9. This use is not a vacancy loss. It can properly be shown as revenue with an offsetting expense, or as reduced rent potential.

10. A. The effect is to allocate more of the cost of the asset to the early years of its depreciable life, or match the expense with revenue generated over the life of the assets. (p. 4-8, 4-9)

    B. The purpose can be to match depreciation expense with corresponding revenue, but is used most often to reduce the owner's taxable income. (p 4-8, 4-9)

11. No. While net losses may be due primarily to depreciation expenses or other non-cash expenses that do not require the current use of cash, the project must eventually break even at a minimum to be an ongoing concern. (p. 4-8, 4-9)

CHAPTER 5

STATEMENT OF CASH FLOWS IN DETAIL

5-1 INTRODUCTION

Cash is the lifeblood of any ongoing concern. Cash is the fuel that keeps the business afloat. As was stated in Chapter 2, the Balance Sheet and the Statement of Income are prepared using the accrual method of accounting, where revenues are recorded when earned and expenses are recorded when incurred. The Statement of Cash Flows departs from the accrual treatment and gives a simple picture of the cash flowing into the project (actual receipts) and the cash flowing out of the project (actual disbursements). An example of a Statement of Cash Flows can be found in Chapter 2, Exhibit 2-7. The Statement of Cash Flows documents transactions that the project made during the reporting period that may not be shown clearly on the Statement of Income or the other primary financial statements. A HUD project experiences changes in cash flows throughout the accounting period. Examples of various activities that create cash flows include:

- cash received for rents,
- cash received by the project for services rendered,
- cash disbursed to meet the project's obligations,
- cash disbursed to purchase plant assets,
- cash received from the sale of plant assets, and
- cash disbursed to pay dividends.

The cash position of a project is an important factor in evaluating its financial health and stability. The cash position of a project changes constantly. The Statement of Cash Flows categorizes these changes as follows:

- cash flows from operating activities,
- cash flows from investing activities, and
- cash flows from financing activities.

There are two methods of presenting the Statement of Cash Flows. The preferred method is the direct method, which details the flow of cash in the Operating Activities section, The less popular method is the indirect method which uses the net cash provided by

operating activities approach. The direct method is recommended by the AICPA (Statement of Accounting Standards (SAS) No. 95) and is required for HUD projects. This chapter will discuss the Statement of Cash Flows using the direct method.

Objective At the end of this chapter, the reader should be able to:

1. Define the various types of cash flow activities and discuss their use in monitoring the project.

2. Understand the various transactions that affect cash flows and discuss their use in monitoring the project.

3. Compare net cash from operating activities with net income and understand their relationship.

5-2 OPERATING ACTIVITIES SECTION

What it is The Operating Activities section of a HUD project usually has the greatest impact on cash flows.

Why it is important The Operating Activities section details the flow of cash resulting from the day to day operations of the project.

What it relates to The cash flows from Operating Activities section relates to the Statement of Income.

Cash Received From Operations

What it is Cash received from operations consists of rental revenue and other miscellaneous revenue received.

Components There are two main components of cash receipts:

- o cash received from operating the project, and
- o cash disbursed to meet obligations resulting from operating the project.

What it does Cash received from operations measures the amount of revenue that is received from tenants and other sources.

Why it is important Cash received from operations gives the Asset Management/Loan Management staff an idea of a project's ability to pay out disbursements and its status as an ongoing concern.

How it is used — The Asset Management staff can compare these figures to the potential amount of money that could have been received (from the Statement of Income) to measure the effectiveness of collections.

Cash Disbursements For Project Operations

What they are — Cash disbursements to meet project obligations consist of disbursements made in conjunction with rental operations.

Why they are important — These disbursements are important because they can indicate compliance with HUD requirements regarding allowable costs and price levels. They can also show if the project is able to meet the obligations that are generated in conjunction with rental revenue. If not, a rent increase may be necessary.

Examples — Examples of cash disbursements to meet project operations include:

- o cash payments for merchandise or supplies,
- o cash payments to project employees for salaries and wages, and
- o other cash payments that are neither financing or investing activities.

How they are used — The Asset Management staff compares these costs with the amounts disbursed on similar projects to see if they are in line.

5-3 FINANCING ACTIVITIES SECTION

What it is — The Financing Activities section details the flows of cash resulting from a project's financing activities.

Examples — The following are examples of items that might appear in the Financing Activities Section:

- o mortgage principal and interest payments,
- o capital contributions by owners,
- o cash received from the issue of stocks or bonds,

- cash paid to retire bonds,
- cash paid for dividends declared,
- cash disbursed to repay amounts borrowed,
- cash payments for MIP, taxes and insurance, and
- cash payments for repayment of debt (i.e., mortgage payable).

How it is used

The Asset Management staff reviews the Financing Activities Section and determines if the transactions are in accordance with HUD requirements. The Asset Management staff will also check to see if the amounts are in line with similar projects.

5-4 INVESTING ACTIVITIES SECTION

What it is

The Investing Activities section details the flows of cash from a project's investing activities.

Examples

The following are examples of items that might appear in the Investing Activities section:

- cash paid for the purchase of plant assets,
- cash received from the sale of plant assets,
- cash receipts from monies borrowed,
- cash disbursed for monies lent,
- cash received from return on monies invested,

- cash disbursed to acquire investments,
- cash received from repayments on monies lent, and
- cash disbursed for repayments on monies borrowed.

How they are used

The Asset Management staff reviews the amounts in this section and determines if the expenditures are HUD approved. The Asset Management staff will also check to see if the transactions are in line with the requirements of the regulatory agreement.

5-5 RECONCILING NET INCOME TO NET CASH FLOW FROM OPERATIONS

What it is

The AICPA Statement of Accounting Standards (SAS) No. 95 requires a reconciliation of net income to net cash provided (or used) by operating activities. This reconciliation is a way of analyzing net income as it relates to operations and excluding any amounts included in net income that did not provide cash inflows or outflows from operating activities.

Why it is important — The reconciliation of net income to net cash provided by operations is important because it reconciles the net income (HUD 92410) to the net cash flow from operating activities.

Types of Adjustments — There are three types of adjustments necessary to reconcile net income to net cash provided by operations:

- o changes in noncash current assets and current liabilities,
- o changes in items that relate to operating activities but do not create cash inflows or outflows, and
- o gains or losses resulting from transactions that do not relate to operating activities.

Changes in Noncash Current Assets and Current Liabilities

What they are — Changes in noncash current assets and current liabilities have an impact on net income but do not affect cash flows from operating

activities. These changes include decreases and increases in:

- o accounts receivable,
- o prepaid items (i.e., MIP, Insurance, Taxes),
- o accounts payable,
- o accrued expenses,
- o tenant security deposits payable, and
- o deferred income (rent received in advance).

Why they are important — The changes listed above are important to the Asset Management/Loan Management staff because they are an indication of items that affect net income but are not the result of activities involving the day to day operations of the project.

Example — An example of how the net income can be more clearly analyzed by eliminating the items listed above is increases in accounts receivable. The increase in the adjustment for accounts receivable balance in HUD projects is usually due to rental revenue that will be collected at a later point in time. While this revenue has an impact on net income, it is not reflected on the Statement of Cash Flows. Therefore the increase in accounts receivable must be deducted from net income to reflect its absence from the net cash flows from Operating Activities section. On the other hand, a decrease to accounts payable is reflected in the Statement of Cash Flows but is not the result of a transaction which occurred in the current period. Therefore this amount must be added back to net income to account for its inclusion in the Operating Activities section of the Statement of Cash Flows.

How they are used

Changes in noncash current assets and current liabilities can be analyzed to provide a clearer picture of how net cash flows from operating activities has affected the net income of a project. If there is an insufficient net cash flow from operating activities, the Asset Management staff should review the changes in noncash current assets and current liabilities to see if the deficit is the result of increases or decreases in noncash current assets and current liabilities. For "ample, an increase in accrued year-end revenues would increase net income, however, there is no corresponding increase to net cash flow. Conversely, accrued expenses decrease net income, but have no impact on net cash flow.

Changes in Operating Items that do not Create Cash Flows

What they are

Changes in operating items that do not create cash flows are generally expenses that are directly related to operations but do not require the use of cash.

Example

Depreciation is an example of an expense item that affects operating activities but does not require the use of cash.

Why they are important

Adjustments to net income for changes in operating items that do not require cash are important because they provide a clearer picture of net income as it relates to cash flows from operations.

How they are used

The Asset Management staff can review adjustments made to net income for changes in operating items that do not require the use of cash to determine the amount of income that is generated or offset by noncash items during the current period.

5-6
Gains or Losses from
Non Operating
Activities

What they are	The gains or losses from non-operating activities are transactions that affect net income but are not the result of operations.
Example	Interest earned on investments is an example of a non-operating activity that affects net income.
Why they are important	The adjustments for gains or losses from activities other than operating are important in that they have an effect on net income that is achieved from a source other than operations.
How they are used	The gains and losses from activities other than operations can be reviewed to evaluate the financial efficiency of activities outside the day to day operations of the project. If major losses are identified here the Asset Management staff should investigate the events surrounding these transactions.

5-7 CHAPTER SUMMARY	Chapter 5 presents a description of the inflow and outflow of cash from the HUD project. The information provided here will enable the Asset Management/Loan Management staff to understand the cash position of the project and evaluate its financial health and stability. In addition, the Asset Management staff should be able to reconcile net income to net cash provided (or used) by operations and understand how they interrelate. Certain cash receipts and payments may have characteristics that fall into more than one category. The preparer of the Statement of Cash Flows should record the activity in the section that pertains most to its function with regard to the overall goals of the project.

CHAPTER 5

QUESTIONS

1. List the various Sections of the Statement of Cash Flows.

____
____
____
____

2. The Operating Activities section of the Statement of Cash Flows relates to the ____.

3. What does cash provided from operations consist of?

____
____
____
____

4. What is the Asset Management/Loan Management staff's primary objective when reviewing the Statement of Cash Flows from Operating Activities section?

____
____
____
____

5. What is the Asset Management staffs primary objective when reviewing the Financing Activities and Investing Activities sections of the Statement of Cash Flows?

____
____
____
____

6. Place a check mark next to the activities that are shown on the Statement of Cash Flows.

_____ (a) Withdrawals by owners
_____ (b) Additional capital contributions
_____ (c) Fixed asset purchases
_____ (d) Payments of mortgage principal

_____ (e) Proceeds from borrowing

7. The cash position of a project is an important factor in determining its ___________________________.

8. A way of analyzing net income as it relates to net cash flow from operations is known as ____________________________ net income to net cash flows from operations.

9. The three types of adjustments necessary when reconciling net income to net cash flow from operations are:

   a. _______________________________
   b. _______________________________
   c. _______________________________

10. Four examples of noncash current assets and liabilities are:

   a. _______________________________
   b. _______________________________
   c. _______________________________
   d. _______________________________

11. _______________________ is an example of an expense item that effects operating activities but does not require the use of cash.

12. _______________________ on investments is an example of non-operating activities that affect net income.

ANSWERS

1. a. Operating Activities section (p.5-1)
   b. Investing Activities section (p.5-1)
   c. Financing Activities section (p.5-1)

2. Statement of Income (p. 5-2)

3. Cash provided from operations consists of rental revenue and other revenue recemiscellaneous ived. (p. 5-2)

4. The Asset Management staff compares these figures (actual amount of received) to money the potential amount of money that could have been Statement of received (from the Income) to measure the effectiveness of collections. (p. 5-3)

5. The Asset Management staff reviews transactions in these statements if the expenand determines ditures are in accordance with HUD requirements. (p. 5-4)

6. All of them are shown on the Statement of Cash Flows. (p. 5-4, 5-5, and 5-6)

7. Financial health and stability as an ongoing concern. (p. 5-1)

8. Reconciling. (p. 5-5)

9. a. Changes in noncash current assets and liabilities. (p. 5-5)
   b. Changes in items that relate to operating activities. (p. 5-5)
   c. Gains or losses from transactions that do not relate to operating activities (p. 5-5)

10. a. Accounts receivable (p. 5-6)
    b. Prepaid expenses (p. 5-6)
    c. Accounts payable (p. 5-6)
    d. Deferred income (p. 5-6)

11. Depreciation or consumption of prepaid expenses. (p. 5-6)

12. Interest, gains or losses on sales of plant assets. (p. 5-7)

CHAPTER 6

STATEMENT OF RETAINED EARNINGS IN DETAIL, OTHER REPORTS, AND NOTES TO THE FINANCIAL STATEMENTS

6-1 INTRODUCTION

Corporations declare dividends to pay owners for their share of project income and provide them with a return on their investment. Many HUD projects are corporations. Cooperative housing projects are incorporated projects. A project cannot pay cash dividends unless retained earnings are available and there is enough cash on hand to cover the payment. If enough cash is not available a corporation can elect not to pay dividends, or it may pay dividends by distributing additional shares of stock. The Statement of Retained Earnings provides information regarding incorporated projects' ability to pay dividends and the impact of those payments on retained earnings. Projects that are not incorporated (i.e., partnerships and individually owned) do not submit a Statement of Retained Earnings, however similar information about ownership is contained in the Owners Equity section of the Balance Sheet, or is included in a separate schedule as discussed in Chapter 3.

Why it is important

Profit motivated, including limited dividend, projects that are incorporated are owned by the stockholders of record (Many corporate nonprofit mortgagors are non-stock companies.). Unless the mortgagor is a non-profit entity. these investors receive a return on their investment based on the number of shares of stock held when dividends are declared. On HUD projects, distributions can only be made if the surplus cash computation results in an amount sufficient to cover payments to owners and continue to meet other cash obligations throughout the year. For more information regarding surplus cash please see HUD Handbook 4370.1, Reviewing Annual and Monthly Financial Statements. The Asset Management/Loan Management staff can determine the financial efficiency of a project by evaluating the timing and amount of dividends declared. The Statement of Retained Earnings provides the information required to perform this task. An example of a Statement of Retained Earnings is found in Chapter 2, Exhibit 2-2.

6-2
THE STATEMENT
OF RETAINED
EARNINGS

Prior Period
Retained Earnings

What they are	The prior period's retained earnings is the amount of net income less net losses and dividends that remain from the prior year.
Why they are important	The prior period's retained earnings is important when performing comparative analyses from one year to the next and when determining the financial efficiency of the project.
How they are used	The Asset Management/Loan Management staff can compare the prior period's retained earnings with the ending period retained earnings to determine how well the project has performed in the current year. The Asset Management staff should also review these balances for prior period adjustments.

Net Income (Loss)

What it is	Net income (loss) is the amount the project earned in the current year.
Why it is important	Net income (loss) is important because it is a measure of the projects financial efficiency.
What it relates to	Net income (loss) relates to the Statement of Income.
How it is used	Net income (loss) can be reviewed to determine the profitability of the project.

Cash Dividends
Declared

What they are	Cash dividends are payments to owners for their equity share (common stock) invested in the company.

How they	Dividends can be reviewed by Loan Management staff to

are used	determine if the amounts are appropriate and in accordance with HUD requirements.

Retained Earnings
Year End

What they are	The retained earnings year end is the closing balance of a projects net income less net losses and dividends that remain at year end.
Why they are important	The Loan Management staff can compare this with the prior years retained earnings to evaluate a projects financial efficiency during the current period.
How they are used	The retained earnings year end balance is used to evaluate the ability of the project to continue as an ongoing concern based on its earnings per share of common stock. Adverse conditions such as insufficient balances in retained earnings should be researched. In most states it is improper for a company with a deficit balance in retained earnings to declare dividends.
	The amount 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.
	The tax consequences for amounts that may subsequently transferred back to HUD from the residual receipts accounts of certain Section 8 projects may deserve special treatment.

6-3
OTHER
STATEMENTS
(Schedules)

What they are	Other financial statements and reports also are required with the submission of the four primary financial statements. We will only touch upon these briefly however, a more detailed discussion of these items can be found in HUD Handbook 4370.2 Financial Operations and Accounting Procedures for Insured Multifamily Projects. The following is a list of other reports including a

brief description of each:

A. A Statement of Shareholders' Equity or Partners' Capital. 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). This is most often found in projects that are not incorporated.

B. Supporting data, in the form of explanatory comments or appropriate schedules. 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 (MIPs), 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.

   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 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 in the form required 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 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 Income. If any unauthorized distribution of project income is revealed during the audit a separate schedule must be prepared detailing the amounts involved, date of such distribution and any other relevant information.

13. Comments on Statement of Financial 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. The format for the Computation of Surplus Cash, Distributions and Residual Receipts at the Balance Sheet Date can be seen in Appendix 2 of HUD Handbook 4370.2.

15. 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.

16. Listing of Identify 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 a vendor, a project, or a lender when (1) the project; or (2) any officer, partner, 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 or directly or indirectly owns 10 percent or more of the project, is also (1) an officer, partner, 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.

6-4 NOTES TO THE FINANCIAL STATEMENTS

Notes to the Financial Statements include 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 statements by the mortgagor's accountant. In addition, the notes should indicate the type of Section 8 project, if applicable, and basis for computation of distributions.

How they are used

Notes to the Financial Statement are to be reviewed by the Asset Management/Loan Management staff to determine if they offer insight into items that were not fully disclosed in the financial statements. The Asset Management staff should do research of and make inquiries about items that are not clearly understood after reading the Notes to the Financial Statements. Examples of items that might be contained in the Notes to the Financial Statements include comments on:

- going concern basis difficulties,
- significant accounting policies,
- outstanding accounts receivable,
- commitments and contingencies, including lawsuits,
- manager's salary, and
- increases in management fees.

6-5 CHAPTER SUMMARY

The Statement of Retained Earnings is a valuable tool in evaluating the financial efficiency of a project. The mortgagor's ability to declare dividends and the amount of these dividends is critical to incorporated project owners (stockholders). The Asset Management staff can review the Statement of Retained Earnings to perform comparative analysis of retained earnings from one year to the next. There are many other reports that can add additional information about HUD projects. In addition, the Asset Management staff can gain insight about unusual conditions or transactions by reviewing the Notes to the Financial Statements.

CHAPTER 6

ACCOUNTING KNOWLEDGE QUIZ

QUESTIONS

1. A company's net income less net losses and dividends is ________________________________.

2. Amounts paid by a corporation to its owners are known as ____________________________.

3. Owners of a corporation are known as __________________________.

4. Dividends can be compared with _______________________ to determine if the amount seems reasonable.

5. Asset Management/Loan Management staff can gain insight about unusual conditions or transactions that were not fully disclosed in the financial statements by reviewing the _______________________.

ANSWERS

1. Retained Earnings. (p. 6-3)

2. Dividends. (p. 6-1)

3. Stockholders of Record. (p. 6-1)

4. Net income. (p. 6-2)

5. Notes to the Financial Statements (p. 6-8)

CHAPTER 7

AUDITING CONCEPTS

7-1 INTRODUCTION

Even though the annual financial statements may be physically prepared by an auditor, the statements come from the project's records and are considered the representation of the owner. The project owners are expected to maintain books and records in accordance with Generally Accepted Accounting Principles (GAAP) and the auditor must thoroughly examine these records using Generally Accepted Auditing Standards (GAAS) and Government Auditing Standards (GAS). The purpose of an audit is to have the auditor render an independent professional opinion on the reliability of the financial statements as an accurate reflection of the project's financial condition and performance.

7-2 AUDITOR/OWNER RESPONSIBILITIES

The following table describes the responsibilities of the auditor and the owner in relation to the audit process. The ongoing nature of the audit process requires auditors to evaluate and comment on the adequacy of the accounting records and procedures and the system of internal controls. The auditors can make recommendations regarding internal controls, accounting procedures and systems but cannot administer any system, maintain the books or perform recordkeeping functions.

OWNER RESPONSIBILITIES	AUDITOR RESPONSIBILITIES
1) Adopting sound accounting policies.	1) To examine the records provided by management.
2) Maintaining the required system of accounts.	2) To express opinions on the fairness of financial information presented.
3) Safeguarding assets.	
4) Devising a system of internal controls	3) To express opinions on the effectiveness of the

to help assure the production of proper financial statements. | internal control structure and compliance with applicable laws and regulations.

5) Complying with all laws, regulations, and project agreement.

Who is a qualified and independent auditor

For the purposes of HUD multifamily audits, a qualified independent auditor is an Independent Public Accountant (IPA) licensed by a regulatory authority of a state on or before December 31, 1970 or is a Certified Public Accountant (CPA). CPA's are licensed by the individual states following completion of specified educational and experience requirements which includes the attainment of a passing score on a nationally standardized, three day written examination. The licenses of the independent public accountant subject to the state chapter of the American Institute of Certified Public Accountants (AICPA) or state licensing boards which can suspend or revoke licenses for reasons such as failure to adhere to professional standards. Many states also have continuing education requirements for renewal of public practice licenses.

Note

Qualifications and standards such as the ones mentioned above can assist in preventing or removing an incompetent or unethical auditor from public practice, but they do not guarantee quality work on the part of the auditor. Nevertheless, they do provide potential penalties for poor performance. Reports of failure to adhere to professional standards can damage a firm's reputation,

and, in extreme or repeated cases, can result in cancellation of license.

Independence of the auditor

For the purposes of HUD multifamily audits, an independent auditor must have no business relationship with the owner except for the performance of the audit, systems work and tax preparation. Systems work includes the design and implementation of a system but not its continuing day-to-day operation. As such, monthly "write-up work" (such as the posting of ledgers and journals) goes beyond systems work and impairs the independence of the auditor. The independence standard does not prohibit audit related work, such as interim reviews or consulting on personnel or accounting matters.

Independence Standard — The AICPA discussion of the independence standard states that the auditor in accordance with GAAS "must be without bias with respect to the client under audit." Although it is difficult to be totally independent of anyone who pays you for services performed, the ability to remain independent "in attitude" is considered a professional requirement and responsibility. Its successful accomplishment is dependent upon the professional integrity of the auditor.

Engagement Letter — The engagement letter is, in effect, the contract between the auditor and the project. It describes:

- o the scope of the work to be done, and
- o the fee and billing arrangements to be followed.

HUD-required components — For HUD audits, the engagement letter must include:

- o a statement that the audit will include compliance with the HUD IG Handbook 2000.4, "Consolidated Audit Guide for Audits of HUD Programs", and

- o a statement that HUD specifically has the right to examine the working papers supporting the audit.

How audit fees are determined — Fee arrangements are between the project and the auditor, HUD is only a third-party beneficiary to the contract. HUD can exercise indirect control over fees through its review of rent increases and, in some cases, budgets. Although audit fees are

often stated (or bid) at a specific dollar amount, they are initially computed by the audit firm at hourly rates times estimated total hours required to complete the job. Often times the audit fee will include charges for preparation of the necessary income tax forms. The preparation charge for project income tax reporting requirements are acceptable costs however, personal income tax preparation for project owner's is not an allowable project expense.

Why fees vary — Owners should obtain competitive fee estimates from and evaluate the qualifications and experience of accounting firms that might be used. The following are some conditions or factors that may affect the fee charged by the accounting firm:

- The size of the accounting firm. As a general rule, fees charged by large national firms are greater than those charged by smaller local firms.

- Project fiscal year. Audit fees often depend on the level of work to be performed. Most accounting firms have their peak business from December through April.

- Quality of the project's records and systems. This is the most common reason for the variance of audit fees from one project to another. High audit fees often indicate that management's systems and records are poorly maintained. For example, the auditor may be required, in the course of the audit, to post or reconstruct transactions or to make adjustments to the closing balances of the project accounts. The worse the condition of the records and systems of the project, the more an accounting firm will likely charge for the audit.

- Audit fees should not be confused with bookkeeping or accounting fees. Accounting firms which provide bookkeeping and accounting services have to be independent of the firm that performs the actual audit. Bookkeeping and accounting fees vary and project owners should attempt to get quality services at the lowest price possible. In

addition, the auditor may prepare the income tax returns required by IRS. These fees may also vary, therefore the conditions and factors listed above should be considered.

What an auditor does

Before rendering an opinion on the reliability of the financial statements, the auditor must perform certain tasks and make certain tests. These include, but are not limited to, the following:

- review and evaluation of internal control systems,
- tests of transactions,
- tests of account balances, and
- review of compliance with laws and regulations.

Certification

Owner/Management Agent. The financial statements must contain a certification, signed by the owner, and the management agent if applicable, stating that the owner and management agent, if applicable, 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 the financial statements. The management agent is required to certify the financial statements so that the Department can identify any affiliations, interest 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 partners (including at least two general partners if there are two or more general partners) must certify.

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.

7-3 ACCOUNTING PRINCIPLES AND STANDARDS

The purpose of auditing financial statements is to determine whether they are fairly presented in accordance with generally accepted accounting principles (GAAP). The auditor must conduct an audit in accordance with generally accepted auditing standards (GAAS) and Government auditing standards (GAS).

GAAP

GAAP can be defined as rules and practices necessary at a particular time that represent accepted accounting principles and practices. Accounting principles encompass unwritten rules and written rules. The written rules are commonly referred to as promulgated GAAP.

GAAS — 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, and (3) standards of reporting.

GAS — 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.

General Standards — The most important factor in any profession is the people who make up that profession. Desirable traits are difficult to describe in any individual, much less a profession. Therefore, general standards have been created that are open to a broad and considerable degree of interpretation.

The three general standards require that an individual:

o have adequate technical training and proficiency as an auditor,

o maintain an independence in mental attitude, and

exercise due professional care in performing the audit and preparing the report.

Fieldwork Standards — Before an opinion on the financial statements can be formulated, an auditor must be convinced about the fairness of the statements. The standards of field work provide the auditor with a basis for judging the quality of the financial statements. The three standards of fieldwork require:

o the work to be adequately planned and assistants properly supervised,

o proper study and evaluation of the existing internal control as a basis for reliance thereon, and

o sufficient competent evidential matter is to be obtained to afford a reasonable basis for an opinion regarding the financial statements under examination.

Reporting Standards

A critical part of the auditor's role is communicating the results of the engagement to a variety of financial statement users. The communication of information and opinions is always a formidable task. The four standards are:

- o The report shall state whether the financial statements are presented in accordance with GAAP.

- o The report shall identify those circumstances in which principles have not been consistently observed in the current period in relation to the preceding period.

- o Information disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

- o The report shall contain either an expression of

opinion regarding the financial statements taken as a whole, or an assertion to the effect that an opinion cannot be expressed.

Government Standards

The General Accounting Office (GAO) establishes standards for audits of government organizations, programs, activities, and functions, and of government funds received by contractors, nonprofit organizations, and other nongovernment organizations. These standards incorporate the AICPA standards of reporting for financial audits and prescribe supplemental standards of reporting needed to satisfy the unique needs of government financial audits.

7-4 REVIEW AND EVALUATION OF INTERNAL CONTROL SYSTEMS

What is required

Generally Accepted Auditing Standards require a review of internal controls and an opinion of the reliability of the system used by the project. This review includes considerations of type and quality of personnel, separation of duties and review processes. HUD requirements, however, go further, specifying particular items which must be reported if not satisfactory.

Tests of Transactions

What is done — In most projects, it is neither practical nor necessary to test all transactions which occurred during the year. Testing a sample of the transactions is sufficient. The auditor normally uses "statistical sampling procedures" adopted by the AICPA and the U.S. General Accounting Office (GAO). Based on the results of these tests, the auditor determines the reliability of the transactions.

Example — A complete test of a "disbursement" transaction would actually include examination of the cancelled check, the related documentation (invoice, purchase order, approval, etc.) and posting entries to the project journals and ledgers.

Tests of Accounts Balances

What it does — In this part of the audit process, the auditor performs whatever tests considered necessary to determine or verify the balance of a specific account.

Example — The test of the cash balance would include direct communication with the bank(s) involved, the review of the year-end section of cash receipts and disbursements journals, the ledger balance, examination of bank statements and cancelled checks, both before and after the Balance Sheet date. Evidence generated outside of the audit entity is a necessary component of tests of account balances.

7-5 MATERIALITY

What it is — Materiality deals with the importance of an item on the books of the project. Materiality is a basic concept in accounting and guides the accountant to disregard trivial matters and disclose all important matters. There is no obligation on the part of auditors to make corrections and disclosures which they view as not significant to a review of the statements by a knowledgeable reader. However the auditor is expected to include Notes to the Financial Statements which explain in greater detail any items that are material in nature but that may not have been fully disclosed in the financial statements themselves.

How it is used — Materiality is used to determine whether or not a questionable item on the financial statements is important enough to require detailed disclosure and the necessity of the inclusion of Notes to the Financial Statements. The Asset Management/Loan Management staff's review of financial statements should include review of any Notes to the Financial Statements to determine if a more in depth investigation should be conducted of the transaction or group of transactions detailed in said notes. Materiality is the basis for the type of auditor's qualified opinion.

Typical problems — Many auditors, especially those with only one or two HUD clients, are often unaware of the special concerns of HUD projects. To date, the quality of audit work in the compliance and internal control areas still appears quite varied. Therefore, the absence of findings cannot always be relied upon by HUD as an indication that no problems exist. In particular the following

problems can exist:

- Some auditors lack competence or diligence in performing compliance tests that are not thought of as part of a normal audit.
- Items originally found as discrepancies are sometimes eliminated from the report after a conference in which the auditor is persuaded by the client that the item is insignificant and not worth reporting.
- Items on the questionnaire may be marked "N/A" for questionable reasons, avoiding a "No" response which would require a negative finding and disclosure in the audit report.

7-6 REPORTS — Six basic reports are required:

1. Auditor's Report on Financial Statements Audit. An independent public accountant shall examine the books and records of the owner in accordance with GAS, GAAS and GAAP and shall furnish an opinion on the annual financial statements. The independent accountant may be requested by HUD to justify any material departure from the "unqualified opinion" language.

2. Auditor's Report on 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 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 standards.

3. Auditor's Report on Compliance. In accordance with GAAS and GAS, an independent public accountant should prepare a written report on their tests of compliance with applicable laws and regulations. This

report, which may be included in either the report of the financial audit or a separate report, should include all material instances of noncompliance and all instances or indications of improper acts which could result in criminal prosecution. 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 independent accountant shall justify any material departure from the standard language.

The report on compliance shall also include compliance with requirements applicable to nonmajor HUD program transactions.

4. Management Letter, or Schedule of Findings and Questioned Costs. When the auditor identifies a finding the following information should be provided to the mortgagor 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/agent should be doing),
- o effect (what happened as a result of the problem), and
- o cause (why the problem exists).

5. Auditor's Comments on Audit Resolution Matters.

This report is recommended by GAAS; it 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.

6. Auditee's Response, or Corrective Action Plan. This report, recommended by GAAS, must be prepared by the mortgagor. The report should provide a statement of agreement or disagreement with the findings and recommendations. 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.

For examples of the reports discussed in this paragraph see Handbook 4370.1, Reviewing Annual and Monthly Financial Reports.

What audit work papers are

Audit working papers document the work performed by the auditor in the verification of financial data presented in the financial statements. The auditor retains ownership and possession of them at all times, however, they are subject to examination by HUD. In general, working papers are quite technical and are not intended to be easily understood by nonauditors. Accordingly, they should only be requested when persons qualified in auditing are available to review them.

CHAPTER 7

ACCOUNTING KNOWLEDGE QUIZ

QUESTIONS

1. True or False. The auditor is responsible for devising a system of internal controls to help assure the production of proper financial statements. ____________________

2. For the purposes of HUD multifamily audits, the auditor must be ____________________________ and ___________________________.

3. The _________________________ is, in effect, the contract between the auditor and the project.

4. Audit fees charged by an accounting firm may be affected by the following:

   (1) ___________________________
   (2) ___________________________
   (3) ___________________________

5. ___________________________ deals with the importance of an item on the books of the project.

6. True or False. The absence of findings in the audit report can be relied upon by HUD as an indication that no problems exist in the project. ________________________

7. ________________________ document the work performed by the auditor, and the verification of financial data presented in the financial statements.

8. __________________________ provide explanations of transactions or events that may not have been fully disclosed in the financial statement.

9. The three additional audit reports recommended by GAAS are:

   a. ___________________________
   b. ___________________________
   c. ___________________________

ANSWERS

1. False. It is the mortgagor's responsibility. The auditor reviews and evaluates internal control systems established by the mortgagor. (p. 7-2)

2. Qualified and independent. (p. 7-2, 7-3)

3. Engagement Letter. (p. 7-3)

4. (1) Size of the accounting firm (p. 7-4)
   (2) Project fiscal year (p. 7-4)
   (3) Quality of the project's systems and records (p. 7-4)

5. Materiality. (p. 7-9)

6. False. (p. 7-9)

7. Audit working papers. (p. 7-12)

8. Notes to the Financial Statements (p. 7-9)

9. a. Management Letter, or Schedule of Findings and Questioned Costs
   b. Auditor Comments on Audit Resolution Matters
   c. Auditee's Response, or Corrective Action Plan

TABLE OF CONTENTS

Paragraph Page

CHAPTER 4. STATEMENT OF INCOME IN DETAIL

CHAPTER 5. STATEMENT OF CASH FLOWS IN DETAIL

Paragraph Page

CHAPTER 6. STATEMENT OF RETAINED EARNINGS IN DETAIL, OTHER REPORTS, AND NOTES TO THE FINANCIAL STATEMENTS

CHAPTER 7. AUDITING CONCEPTS

EXHIBITS

EXHIBIT Page

APPENDICES

FOREWORD

Under the provisions of the regulatory agreement, project owners are required to submit certain financial accounting reports to the Department for review. The financial statements are a critical tool through which Loan Management staff can evaluate the performance of a project. In addition, the timely review of financial statements can identify actions needed to avoid defaults and minimize insurance claims against the Department.

This Handbook provides the information needed to understand concepts and terms necessary to accomplish the Loan Management staffs review of audited financial statements and monthly accounting reports. This Handbook should be used in conjunction with:

o	IG 2000.4	Consolidated Audit Guide for Audits of HUD Programs
o	HUD 4080.1	Compliance Handbook for Housing
o	HUD 4350.1	Insured Project Servicing
o	HUD 4350.3	Occupancy Requirements of Subsidized Multifamily Housing
o	HUD 4355.1	Flexible Subsidy
o	HUD 4370.1	Reviewing Annual and Monthly Financial Reports
o	HUD 4370.2	Financial Operations and Accounting Procedures for Insured Multifamily Projects
o	HUD 4370.3	Uniform System of Accounts for Cooperatives Using Computer and Manual Systems
o	HUD 4381.5	Management Documents, Agents & Fees
o	HUD 4470.1	Mortgage Credit Analysis for Project Mortgage Insurance, Section 207
o		HUD User Manuals on Multifamily Information Processing System (MIPS) Loan Management Module

HOUSING

Special Attention of: Regional Administrators, Regional Housing Commissioners, Director of Regional Housing, Field Office Managers, Directors of Housing Development Division, Directors of Housing Management Division, Loan Management Branch Chiefs and Assisted Housing Management Branch Chiefs.

Transmittal for Handbook No.: 4370.4

Issued: 6/24/92

1. This transmits Revised Handbook 4370.4 REV-1, Basic Accounting Desk Reference for HUD Loan Servicers.

2. Explanation of Materials Transmitted. This Handbook is a complete revision of the Basic Accounting Desk Reference for HUD Loan Servicers, 4370.4, dated January 1981. It can be used as a reference to provide loan management staff with the accounting knowledge necessary to perform their duties regarding the review and analysis of financial statements submitted on Secretary held or HUD Insured Multifamily Projects. The Handbook helps the loan management staff use accounting information more effectively and offers a better understanding of accounting concepts. This Handbook should be reviewed by Loan Management staff responsible for reviewing financial reports.

3. Significant Changes.

   - Include revised accounting/auditing nomenclature in accordance with American Institute of Certified Public Accountants, Government Auditing Standards and appropriate standards.

   - Include cross-references to current HUD Handbooks and automated system (Multifamily Information Processing System MIPS) for functions related to loan management.

   - Encompass ratios (liquidity, profitability and activity) that measure a project's financial stability, collection procedures and management effectiveness.

   - Revise the forms used in reviewing and analyzing multifamily projects.

   - Revise the Table of Contents to include a list of exhibits and acronyms.

   - Include discussion of Modification Agreements as an option which can be pursued by project owners.

   - Incorporate revised accounting knowledge quizzes throughout the Handbook.

   - Expand on the details of Statement of Cash Flows instead of the

Statement of Changes in Financial Position and Statement of Receipts and Disbursements.

- o Discuss in detail the Statement of Retained Earnings.

- o Expand discussion of owner's equity to include a description of accounts which comprise owner's equity.

- o Introduce MIPS and flags and reports and discusses how it relates to Form HUD-92410.

- o Delete all reference to the Statement of Changes in Financial Position.

- o Incorporate discussion of comparing impound balances to prior expense.

- o Incorporate expanded discussion of Generally Accepted Audit Standards (GAAS), Generally Accepted Accounting Principles (GAAP), and Government Auditing Standards (GAS), and includes new requirements for audit reports.

- o Expand discussion of "Notes to the Financial Statements" and their purpose.

- o Modernize discussion of depreciation to bring up to date with current IRS methods and expands discussion of depreciation to include GAAP versus Income Tax Methods.

- o Explain the necessity of the Computation of Surplus Cash and Residual Receipts.

3. Effective Date: Upon Receipt.

4. Cross References: This Handbook contains a Foreword which cross references all applicable handbooks and guidance relating to reviewing multifamily financial statements and supplemental data.

5. Filing Instructions:

Remove:	Insert:
Basic Accounting Desk Reference for HUD Loan Servicers dated 1/81	Basic Accounting Desk Reference for HUD Loan Service dated 6/92

Arthur J. Hill, Assistant Secretary
for Housing-Federal Housing Commissioner

Handbook 4370.4 REV-1

U.S. Department of Housing and Urban Development
Washington, D.C. 20410

Departmental Staff
and Program
Participants

June 1992 Basic Accounting
Desk Reference for
HUD Loan Servicers

FINANCIAL STATEMENTS PACKAGE

SAMPLE FINANCIAL STATEMENTS

FHA PROJECT NO.: 123-45678-ABC
PROJECT NAME: WEST OAKDALE APARTMENTS
AS OF DECEMBER 31, 1991

The following set of financial statements illustrates what might be found on an actual HUD project. Use them to familiarize yourself with financial statements.

INDEX TO THE FINANCIAL STATEMENTS
FHA PROJECT NO. : 123-45678-ABC
PROJECT NAME: WEST OAKDALE APARTMENTS
AS OF DECEMBER 31, 1991

EXHIBIT D - Statement of Cash Flows for the Year Ended December 31, 1991

SCHEDULE D-1 - Computation of Surplus Cash and Residual Receipts as of December 31, 1991

AUDITOR'S REPORT ON THE FINANCIAL STATEMENTS

XYZ & Company, CPA
123 Main Street
Anytown, USA

J. Doe
West Oakdale Apartments
528 North America Dr.
Anytown, USA

We have audited the accompanying balance sheet of West Oakdale Apartment, HUD Project No. 123-45678, as of December 31, 1991, 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 West Oakdale Apartment at December 31, 1991, 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 are presented for the purposes of additional analysis and are not a required part of the basic financial statements of the West Oakdale Apartment. 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.

XYZ and Company
Certified Public Accountants

February 12, 1992

AUDITOR'S REPORT ON THE INTERNAL CONTROL STRUCTURE

XYZ & Company, CPA
123 Main Street
Anytown, USA

J. Doe
West Oakdale Apartments
528 North America Dr.
Anytown, USA

We have audited the financial statements of West Oakdale Apartments as of and for the year ended December 31, 1991, and have issued our report thereon dated February 12, 1992. We have also audited West Oakdale Apartments compliance with requirements applicable to major HUD-assisted programs and have issued our report thereon dated February 12, 1992.

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 December 31, 1991, we considered the West Oakdale Apartments internal control structure in order to determine our auditing procedures for the purpose of expressing our opinions on the West Oakdale Apartments 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 also have 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 Audits of HUD Programs, IG Handbook 2000.4. 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: accounting managerial, and systems.

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.

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 West Oakdale Apartments in a separate communication dated January 31, 1992.

This report is intended 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.

XYZ and Company
Certified Public Accountants

February 12, 1992

AUDITOR'S REPORT ON COMPLIANCE

XYZ & Company, CPA
123 Main Street
Anytown, USA

J. Doe
West Oakdale Apartments
528 North America Dr.
Anytown, USA

We have audited the financial statements of West Oakdale Apartments as of and for the year ended December 31, 1991 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 December 31, 1991. The management of the West Oakdale Apartments 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 West Oakdale Apartments 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 West Oakdale Apartments complied, in all material respects, with the requirements described above that are applicable to its major HUD-assisted programs for the year ended December 31, 1991.

February 12, 1992

AUDITOR'S COMMENTS ON AUDIT RESOLUTION MATTERS

Per HUD letter of November 10, 1991 all prior audit findings have been successfully resolved.

February 12, 1992 XYZ and Company, CPA

AUDITEE'S RESPONSE, OR CORRECTIVE ACTION PLAN

Name and Number of Project: West Oakdale Apartments - 123-45678
Auditor/Audit Firm: XYZ and Company
Audit Period: December 1, 1991 - December 31, 1991

Section I - Internal Control Structure Review

A. Comments on Findings and Recommendations

West Oakdale Apartments concurs with the findings of the auditor.

B. Actions Taken or Planned

None Required

C. Status of Corrective Action or Prior Findings

Per letter of November 10, 1991 from HUD West Oakdale Apartments has corrected all prior audit findings.

Section II - Compliance Review

A. Comments on Findings and Recommendations

(See Section I.A. above.)

B. Actions Taken or Planned

None Required

West Oakdale Apartments
FHA Project
123-45678

CERTIFICATE OF OWNER/MANAGEMENT AGENT

I hereby certify that I have examined the accompanying financial statements and supplemental data of West Oakdale Apartments and, to the best of my knowledge and belief, the same is complete and accurate.

J. P. Doe February 12, 1992

CERTIFICATE OF MANAGEMENT AGENT

We hereby certify that we have examined the accompanying financial statements and supplement data of West Oakdale Apartments and to the best of our knowledge and belief the same is complete and accurate. The financial statements were prepared by A - B Management Co.

A - B Management
J. Jones February 10, 1992

Exhibit A STATEMENT OF FINANCIAL POSITION (BALANCE SHEET)
FHA PROJECT NO.: 123-45678
PROJECT NAME: WEST OAKDALE APARTMENT'S
AS OF DECEMBER 31, 1991

ASSETS

CURRENT ASSETS				
1120	Funds in Banks and On Hand (Schedule A-1)		$13,859	
	Accounts Receivable:			
1130	Tenants (Note 2)	$270		
1140	Federal Housing Assistance Section 8	45		
	Other (Note 2)	749	1,064	
1240	Prepaid Expenses - property insurance		2,465	
	Funds held in impound by Department of Housing and Urban Development for:			
1310	Taxes (Note 3)	$5,713		
1320	Reserve for replacements (including painting reserve) (Note 4)	12,882	18,595	
	TOTAL CURRENT ASSETS			$35,983
FIXED ASSETS (Schedule A-2) (Note 1)				731,259
	TOTAL ASSETS			$767,242

LIABILITIES AND OWNER'S EQUITY

CURRENT LIABILITIES				
2110	Accounts Payable (Schedule A-3)		5,551	
2130	Accrued Interest Payable (net of interest and MIP subsidy of $3,143)	1,287		
2140	Sponsor's Dividend Payable (Schedule D-2)	2,035		
2191	Security Deposits	4,671		
2320	Mortgage Payable - current portion (Note 5)		5,902	
	TOTAL CURRENT LIABILITIES			$19,446
2140	SPONSORS DIVIDEND PAYABLE - DEFERRED (Schedule D-2)			8,364
2320	MORTGAGE PAYABLE (Note 5)			753,520
	TOTAL LIABILITIES			$781,330

3130 OWNER'S EQUITY (DEFICIT) (Exhibit C)	(14,088)
TOTAL LIABILITIES AND OWNER'S EQUITY	$767,242

Schedule A-1

SCHEDULE OF FUNDS IN BANKS AND ON HAND
FHA PROJECT NO.: 123-45678
PROJECT NAME: WEST OAKDALE APARTMENT'S
AS OF DECEMBER 31, 1991

Cash in Office (petty cash fund)		$50
Bank of U.S.A.		1,318
Region Savings and Loan Associations - unrestricted		7,754
Thrifty Savings and Loan Associations:		
Tenant's security deposit account:		
Restricted - (contra)	$4,671	
Unrestricted	66	4,737
TOTAL FUNDS IN BANKS AND ON HAND		$13,859

Schedule A-2

SCHEDULE OF CHANGES IN FIXED ASSETS ACCOUNT
FHA PROJECT NO.: 123-45678
PROJECT NAME: WEST OAKDALE, APARTMENTS
FOR THE YEAR ENDED DECEMBER 31, 1991

ASSETS

FIXED ASSETS	Balance 12/31/90	Additions	Deductions	Balance 12/31/91
1410 Land	$155,000			$155,000
1420 Building	762,529			762,529
1430 Building Equipment -portable	613	$744		1,357
1460 Furnishings	10,670	4,692		15,362
1470 Maintenance Equipment	1,072			1,072

TOTAL	$929,844	$5,436		$935,320

DEPRECIATION RESERVE

FIXED ASSETS	Balance 12/31/90	Additions	Deductions	Balance 12/31/91
1410 Land				
1420 Building	$167,079	$30,501		$197,580
1430 Building Equipment -portable	61	197		258
1460 Furnishings	1,949	3,223		5,172
1470 Maintenance Equipment	957	94		1,051
TOTAL	$170,046	$34,015		$204,061

FIXED ASSETS	Net Book Value 12/31/91
1410 Land	$155,000
1420 Building	564,949
1430 Building Equipment-portable	1,099
1460 Furnishings	10,190
1470 Maintenance Equipment	21
TOTALS	$731,259

Schedule A-3

SCHEDULE OF ACCOUNTS PAYABLE
FHA PROJECT NO.: 123-45678
PROJECT NAME: WEST OAKDALE APARTMENTS
AS OF DECEMBER 31, 1991

Andrew Buller and Associates (hazard insurance premium, August 17, 1991-1992)	$2,372
A-B Management Company	424
A-B Management Company - clients' trust	136
Local Electric Company	1,226
State Gas Company	458
City of Anytown	426
Ajax Hardware, Inc.	294
Acme Disposal Company	84
Others	131

TOTAL ACCOUNTS PAYABLE TO BE PAID FROM PROJECT FUNDS	$5,551
Current	$5,460
30-60 days	91
	$5,551

Statement of Income

GRAPHICS MATERIAL IN ORIGINAL DOCUMENT OMITTED

form HUD-92410 (7/91)
ref. Handbook 4370.2

Page 1 of 2

Exhibit B

Statement of Income (Continued)

GRAPHICS MATERIAL IN ORIGINAL DOCUMENT OMITTED

form HUD-92410

Page 2 of 2

Exhibit C

STATEMENT OF CHANGES IN OWNER'S EQUITY (DEFICIT)
FHA PROJECT NO. 123-45678
PROJECT NAME: WEST OAKDALE APARTMENTS

FOR THE YEAR ENDED DECEMBER 31, 1991

OWNER'S EQUITY, DECEMBER 31, 1991	$8,982
NET (LOSS) FOR YEAR (Exhibit B)	(16,792)
SPONSOR'S DIVIDEND	(6,278)
OWNER'S EQUITY (DEFICIT) DECEMBER 31, 1991	($14,088)

Exhibit D

Statement of Cash Flows for the Year Ended December 31, 1991

West Oakdale Apartments

Cash flows from operating activities:			
Rental receipts		$96,809	
Interest receipts		879	
Other receipts (Laundry)		936	
Administrative		(350)	
Management fees		(17,182)	
Utilities		(1,152)	
Salaries and wages		(10,000)	
Operating and maintenance		(20,000)	
Real estate taxes		(8,581)	
Mortgage insurance		(3,810)	
Payroll taxes	(1,000)		
Property insurance		(2,720)	
Miscellaneous taxes and insurance		(395)	
Interest on mortgage note		(15,630)	
Miscellaneous financial		(262)	
Tenant security and other deposits		35	
Forfieted security deposits		512	
Net cash provided (used) by operating activities			$18,089
Cash flows from investing activities:			
Purchase of depreciable assets		($5,436)	
Decrease (increase) in:			
Reserve for replacement of			

depreciable assets net	(2,783)	
Reserve for taxes and insurance	1,894	
Decrease in other deposits	(115)	
Net cash provided (used) by investing activities		(6,440)

Cash flows from financing activities:		
Mortgage principal payments	(5,504)	
Cash distributions paid to partners	(4,623)	
Decrease in Accounts Payable	(225)	
Net cash provided (used) by financing activities		(10,352)
Net increase (decrease) in cash		1,297
Cash - beginning of period		12,562
Cash - end of period		$13,859

Reconciliation of net income (loss to net cash provided by operating activities:

Net income (loss)	(16,792)*	
Adjustments to reconcile net income (loss) to net cash provided (used) by operating activities		
Depreciation	34,015 *	
Interest earned on Bonds	879 *	
Decrease (increase) in:		
Accounts receivable - rent subsidy	1,750	
Accounts receivable - tenants	(1,152)**	
Prepaid property insurance	(200)**	
Prepaid mortgage insurance	(800)**	
Prepaid property taxes	(758)**	
Increase (decrease) in:		
Accounts payable - trade	(225)**	
Accounts payable - management agent	300	
Accrued interest payable	1,372	
Tenant security deposit payable	300	
Rents received in advance	(600)**	

Net cash provided (used) by
operating activities $18,089
==========

* These amounts are taken from the Statement of Income.

** These amounts are arrived at by comparing current year-end balances with prior year-end balances.

GRAPHICS MATERIAL IN ORIGINAL DOCUMENT OMITTED

HUD-93486 (12-80)

NOTES TO THE FINANCIAL STATEMENTS
FHA PROJECT NO.: 123-45678
PROJECT NAME: WEST OAKDALE APARTMENTS
AS OF DECEMBER 31, 1991

NOTE 1 - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Project, owned by John J.P. Doe, an individual, consists of real property located in San Francisco, California and an apartment complex of 46 units operated thereon under Section 236 of the National Housing Act. Such projects are regulated by HUD as to rent charges and operating methods. The regulatory agreement limits annual distributions of net operating receipts to "surplus cash" available at the end of each year.

The maximum distributable amount for the year ended December 31, 1991 was $6,278 and "surplus cash" amounted to $2,035. Undistributed amounts are cumulative and may be distributed in subsequent years if future operations provide "surplus cash" in excess of current requirements. The cumulative amount distributable at December 31, 1991 was $10,399, limited to "surplus cash."

The following significant accounting policies have been followed in the preparation of the financial statements:

Land and building are stated at recognized "actual cost" per U.S. Department of Housing and Urban Development Form No. 2580 (adjusted for subsequent legal fee of $5,989). Capitalized costs include interest during construction. Depreciation is provided using the straight-line method over the estimated useful lives of the assets.

No income tax provision has been included in the financial statements since income or loss is required to be reported by the owner on his income tax return.

NOTES TO THE FINANCIAL STATEMENTS
FHA PROJECT NO.: 123-45678
PROJECT NAME: WEST OAKDALE APARTMENTS
AS OF DECEMBER 31, 1991

NOTE 2 - ACCOUNTS RECEIVABLE

	Number of Tenants	Amount Due
Tenants:		
December	3	$110

October	1	95
September	1	65
TOTAL		$270

Others:

XYZ Agency, Inc.	$634
Other	115
	$749

NOTE 3 - MORTGAGE ESCROW DEPOSITS

Estimated amount required for future payment of:

City and County taxes	$1,434
Amount on deposit in excess of estimated payments	4,279
TOTAL CONFIRMED BY MORTGAGEE	$5,713

NOTES TO THE FINANCIAL STATEMENTS
FHA PROJECT NO.: 123-45678
PROJECT NAME: WEST OAKDALE APARTMENTS
AS OF DECEMBER 31, 1991

NOTE 4 - RESERVE FOR REPLACEMENTS (INCLUDING PAINTING RESERVE)

In accordance with the provisions of the regulatory agreement, restricted cash is held by Department of Housing and Urban Development to be used for replacement of property and exterior painting with the approval of HUD as follows:

Reserve for Replacements:			
Balance, December 31, 1990		$5,152	
Monthly Deposits:			
$215.69 x 12	$2,588		
Extra	340	2,928	$8,080
Withdrawals:			
February 8, 1991:			
Carpets - capitalized	1,428		

Door - expenses	33	1,461		
May 6,1991:				
Drapes - capitalized	318			
Disposal - expensed	21	339	(1,800)	$6,280
Painting Reserve:				
Balance, December 31, 1990	4,946			
Monthly Deposits ($138 x 11)	1,518	6,464		
Transferred to HUD		(6,464)		
Monthly Deposits ($138 x 1)			138	6,602
BALANCE, DECEMBER 31,1991, CONFIRMED BY MORTGAGEE				$12,882

NOTES TO THE FINANCIAL STATEMENTS
FHA PROJECT NO.: 123-45678
PROJECT NAME: WEST OAKDALE APARTMENTS
AS OF DECEMBER 31, 1991

NOTE 4 - RESERVE FOR REPLACEMENTS (INCLUDING PAINTING RESERVE) (CONTINUED)

The following information pertains to Reserve for Replacement reimbursement requests that were authorized:

Amount of Request	Purpose of Request	Account Charged	Fiscal Year Affected
$354 (1)	Refrigerator	1430	December 31, 1991
823 (2)	Carpets and Drapes	1460	December 31, 1991

(1) Form HUD 9250 - approved October 17, 1991 (applied to January, 1992 payment)
(2) Form HUD 9250 - approved December 13, 1991 (applied to February, 1992 payment)

NOTE 5 - MORTGAGE PAYABLE - DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

The Project has obtained a mortgage loan insured by FHA under the interest reduction provisions of Section 236 of the National Housing Act. The Section 236 program is a federally assisted program designed to provide housing for families with low and moderate incomes. The annual payments of principal and interest for 1992 total $58,874, less interest and MIP subsidy of $37,714, for net annual payments of $21,160. The annual MIP premium for 1992 will be $3,781. The January, 1992 mortgage payment consists of the following:

NOTES TO THE FINANCIAL STATEMENTS
FHA PROJECT NO.: 123-45678
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NOTE 5 - MORTGAGE PAYABLE - DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT (CONTINUED)

Principal	$476.22
Interest at 7%	4,429.96
Property taxes	772.11
Mortgage insurance premium	315.31
Replacement reserve payment	430.31 *
Painting reserve payment	166.67
Interest and MIP subsidy	(3,143.06)
Reserve for replacement withdrawal	(353.60)
NET PAYMENT	$3,093.92

* This represents the current monthly payment of $323.00 plus December, 1991 shortage of $107.31.

NOTE 6 - RENT INCREASE

Approval was received for a rent increase to $103,800 per year effective September 1, 1991 from $96,360.

NOTE 7 - MANAGER'S SALARY

The amount includes $1,648 (seven months at $180 and November and December, 1991 at $194) for manager's apartment. The current manager, J. Jones, (as of January 26, 1992) occupies Apartment #5 at a current monthly rental of $194.

NOTES TO THE FINANCIAL STATEMENTS
FHA PROJECT NO.: 123-45678

PROJECT NAME: WEST OAKDALE APARTMENTS
AS OF DECEMBER 31, 1991

NOTE 8 - MANAGEMENT FEES

Includes $596 special fee adjustment for December 31, 1990 ($7,179 x 8.3%).

NOTE 9 - FINANCIAL EXPENSES

Interest on mortgage payable	$53,341	
Insurance on mortgage	3,810	
Less: Interest and MIP subsidy	(37,741)	$19,410
Interest - County of San Francisco		262
TOTAL FINANCIAL EXPENSES		$19,672

NOTE 10 - COMMITMENTS AND CONTINGENCIES

The Project has entered into a management contract with A-B Management Company to manage the apartment complex. A-B Management Company receives 7 1/2% of gross receipts as a management fee. The contract expires on February 29, 1992. Managing agent on January 23, 1992 sent to FNMA and HUD approval to extend agreement for one year to February 28, 1993; it has been signed by the managing agent and the sponsor.

NOTE 11 - COMPENSATION OF OWNER

None

NOTE 12 - RENT SUPPLEMENT CONTRACT

A Section 8 Housing Assistance Payments Program contracted with the U.S. Department of Housing and Urban Development has been entered into, effective October 1, 1988 and ending September 30, 1992. It provides for an annual maximum commitment of $68,796 per annum. Collections on this contract were as follows:

	Contract	Collections
October 1, 1988 - September 30, 1989	$68,796	$14,021
October 1, 1989 - September 30, 1990	68,796	28,471

October 1, 1990 - September 30, 1991	68,796	40,026
October 1, 1991 - September 30, 1992	68,796	11,144*
	$275,184	$93,662

*To December 31, 1991.

NOTE 13 - RELATED ENTITY

The Project uses services provided by Service Maintenance Corporation, a company wholly owned by Able Smith, who is a partner in A-B Management Company, the managing agent of the Project.

The total amount of services rendered by Service Maintenance Corporation during 1991 was $17,507. Some of the services provided are gardening, general repairs and maintenance, plumbing repairs, drain service, painting, masonry, heavy electrical, plastering, purchase of carpets and drapes, and consultation on repairs and maintenance.

NOTES TO THE FINANCIAL STATEMENTS
FHA PROJECT NO.: 123-45678
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AS OF DECEMBER 31, 1991

NOTE 14 - DEPRECIATION

The following details the depreciation expense for the period ending December 31, 1991.

Buildings	$30,501
Building Equipment-portable	197
Furnishings	39223
Maintenance Equipment	94
	$34,015

AUDIT COMPLIANCE AND INTERNAL CONTROL QUESTIONNAIRE

NOTE A - ITEM 3d (FIDELITY BOND)

The managing agent manages sixty properties (forty-five HUD projects) with potential collections for two months aggregating $1,973,242. He carried a fidelity bond of $200,000, or 10.14%. Your office has indicated that this provision should be figured on the aggregate. We have therefore listed this as a condition not in compliance.

REPLY

The managing agent has been in contact with John Smith, Office of Multifamily Housing Management, HUD Central, Washington, D.C. as to the aggregate requirement of two times potential collections of the largest project managed; this would amount to $197,930, and therefore the current $200,000 would be adequate. Mr. Smith has stated that a resolution to this matter will be forthcoming and that the field will be notified.

NOTE B - ITEMS 6a, 6b, 6c and 6d (TENANT ELIGIBILITY)

Our sampling of tenants' files disclosed that a portion did not contain original FHA Form 3131, current recertification forms, or evidence of independent verification of family income.

REPLY

The managing agent's staff is currently working to bring all tenant files into a condition of compliance with these requirements.

GLOSSARY

ACCOUNTING:

The activity of providing quantitative information, primarily financial in nature, that is intended to be useful in making economic decisions; the process of measuring recording, summarizing and reporting the assets, liabilities and owner's equity of an enterprise and the changes in them.

ACCOUNTING PERIOD:

A length of time established as a period for which accounting activity will be recorded, summarized, and reported. Accounting periods provide the divisions required for comparative financial analysis. Normally, they are established monthly and quarterly for interim statements and annually for completed audited statements and disclosures.

ACCOUNTS PAYABLE:

All amounts owed for goods, properties or services which were purchased on credit and have been received. See definition of accrued liabilities, below.

ACCOUNTS RECEIVABLE:

All amounts owed to an entity for facilities or services that were provided during the current or prior accounting period(s). (Rent that is due or overdue, including government Rent Supplement amounts, is a common example of an account receivable).

ACCRUAL BASIS OF ACCOUNTING:

The method of accounting in which income is recognized when earned (regardless of when cash has been received) and expenses are recognized when incurred (regardless of when cash has been paid).

ACCRUALS:

Entries made at the end of an accounting period which are due entirely to the use of the accrual basis of accounting; i.e., to record expenses incurred but not paid.

ACCRUED EXPENSES:

An expense which has been incurred during an accounting period but which has not been paid and recorded in the accounting records because payment is not due. These expenses are essentially for financial statement preparation only.

ACCRUED LIABILITIES:

Amounts computed by an entity as owed to outsiders for goods or services received but not invoiced. Examples include utilities and wages where the service period does not coincide with the financial statement period of the project.

ACCRUED REVENUE:

A revenue that has been earned during an accounting period but has not been received and recorded in the accounting records because payment is not due. These expenses are essentially for financial statement preparation only.

AMORTIZATION:

(1) The portion of a mortgage payment which represents a payment of principal. (2) The spreading of the cost of certain assets over more than one accounting period.

ASSETS:

Economic resources used by the business entity and expected to benefit future operations.

AUDITING:

The examination of financial statements and their underlying data to determine whether the statements are fairly presented in accordance with generally accepted accounting principles. Auditing is done by CPAs or others licensed by the state or authorized by the government to do such work.

BALANCE SHEET:

The basic financial statement which presents the assets, liabilities and owner's equity of an entity. The total of the assets must equal (balance) the total of the liabilities and owner's equity.

BOOKKEEPING:

The process of recording transactions in an entity's books of accounts.

CAPITAL:

The dollar balance of the amount of ownership interest of the owners of an entity. Also referred to as Owner's Equity.

CAPITALIZE:

To set up an expenditure as an asset or to increase the recorded value of an asset so that the expenditure can be charged off as depreciation expense during future accounting periods. It is the opposite of "expending" an expenditure.

CASH:

Currency, checks and other negotiable instruments acceptable for direct deposit by a bank.

CASH BASIS OF ACCOUNTING:

The method of accounting in which revenue and expenses are recorded and reported in the accounting period in which cash is actually received or disbursed, regardless of when the related goods or services were received or provided. The cash basis of accounting does not follow generally accepted accounting principles.

CERTIFIED PUBLIC ACCOUNTANT (CPA):

A person who is licensed by the state to offer professional auditing and accounting services to the public; license is granted upon successful completion of an examination and completion of qualified professional experience.

CHART OF ACCOUNTS:

A list, by number and title, of all of a development's accounts, grouped according to type of account. The Chart of Accounts prescribed by HUD for insured multifamily projects is at Chapter 4 of HUD Handbook 4370.2 and Chapter 6 of HUD Handbook 4370.3.

CONSISTENCY:

A convention in accounting that once an accounting method (such as depreciation) has been adopted it should not be changed without full disclosure and an explanation of the impact of the change on published financial statements.

CONTRA ACCOUNT:

An account established to record offsetting liabilities or reductions in value to another account(s). Examples of contra accounts include Accumulated Depreciation of Buildings and Equipment, Allowances for Doubtful Accounts Receivables and the liabilities applicable to security deposit accounts. The manner in which contra accounts are to be reported on financial statements varies, but usually are shown separately as subtractions from the account(s) to which they are contra.

CURRENT ASSETS:

Cash and other assets that are reasonably expected to be realized in cash or used up during the normal operating period of a business, typically one year.

CURRENT LIABILITIES:

Obligations due to be paid or settled within the normal operating period of a business, typically one year.

DEFAULT:
There are two types of defaults: (1) fiscal and (2) covenant.

(1) A monetary default exists when the owner fails to make any payment due under the mortgage.

(2) A covenant default exists when the owner fails to perform any other covenant under the provisions of the mortgage or of the regulatory agreement, which is incorporated into the mortgage. A lender becomes eligible for insurance benefits on the basis of a covenant default only after the lender has accelerated the debt and the owner has failed to pay the full amount due, thus converting the covenant default to a monetary default.

DEFERRED INCOME:
Goods or services owed by an entity to an outsider for which cash has been received in advance.

DEPRECIATION:
The process of distributing the cost of fixed assets over a period of years, in a systematic and rational manner.

DIRECT METHOD (for Statement of Cash Flows):
Refer to Financial Accounting Standards Board (FASB) Statement No. 95.

DISBURSEMENT:
Any outlay of funds, either in cash or by check.

DIVIDEND:
A distribution of cash or other assets made by a corporation to its stockholders.

EXPENDITURE:
An outflow of assets or increases in liabilities in connection with the acquisition of assets or expenses; includes both expenses and purchases of fixed assets.

EXPENSE:
The outflow of assets or increases in liabilities that takes place in connection with the products or services provided during an accounting period.

EXPENSED:

The process of having charged an expenditure against operations, such expenditure having been considered to benefit a current accounting period (as opposed to a future accounting period). It is the opposite of "capitalizing" an expenditure.

FINANCIAL POSITION:
The assets, liabilities and owner's equity of an entity and the relationship among them as displayed by the Statement of Financial Position (Balance Sheet), the Statement of Retained Earnings and the Statement of Cash Flows.

FISCAL YEAR:
The twelve month period which an entity chooses as the period for reporting the annual report of its financial operations; normally runs to the end of a month. Often used in contrast to the Calendar Year ending December 31st.

FIXED ASSETS:
Assets such as buildings, land and equipment that are necessary to the operations of the business and have a useful life of more than one year.

FUND:
(1) An amount restricted for a specified purpose, such as for replacement of fixed assets (Reserve Fund for Replacements).

(2) A separate set of accounts for a subdivision of a governmental or other nonprofit entity.

FUNDS:
(1) Plural of fund.
(2) Cash and cash equivalents.
(3) Current assets or net current assets.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP):
General understandings governing accounting measurements derived from long-standing experience and conventions in the profession.

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General understandings governing auditing measurements and standards of presentation derived from long-standing experience and conventions in the profession.

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General understandings used by the government that govern auditing measurements and standards of presentation derived from long-standing experience and conventions in the profession. These audit standards set forth in the "Government Auditing Standards (Standards for Audits of Governmental Organizations, Program Activities and Functions)" issued by the Comptroller General of the United States.

GOING CONCERN:

The accounting assumption that an entity will have an indefinite future life.

IDENTITY-OF-INTEREST:

This term applies to parties having business relationships with the project owner or any officer, director, or partner of the mortgagor entity. Such a relationship should be construed to exist when the owner and the vendor are not the same person but (1) the project owner; or (2) any officer, partner, or director of the project owner or (3) any person who directly or indirectly controls 10 percent or more of the project owner's voting rights or directly or indirectly owns 10 percent or more of the project owner; is also (1) an officer, director, partner, or owner of the vendor; or (2) a person who directly or indirectly controls 10 percent or more of the vendor. For purposes of this definition the term "person" includes any individual, partnership, corporation, or other business entity. Any ownership, control or interest held or possessed by a person's spouse, parent, child, grandchild, brother or sister is attributed to that person.

IMMATERIAL:

Judged by an accountant or auditor as insignificant to an informed reader of financial statements; said of minor items which are erroneous, omitted, or inconsistent.

IMPOUND ACCOUNT:

Amounts held by a mortgagee (or mortgagee's agent) which belong to the mortgagor but are collected to ensure future payment of items such as property taxes and insurance.

INCOME (PROJECT):

Excess of revenues over expenses

INCOME (TENANT):

The gross annual income of the tenant from all sources before taxes and withholdings, after giving effect to exclusions allowed by the Housing Commissioner.

INCOME STATEMENT:
See Statement of Income

INTERNAL REVENUE CODE:
The codification of the numerous revenue acts passed by Congress.

INVOICE:
A document (commonly called a "bill") that states the price and an itemized description of goods and/or services bought and requesting payment. Not to be confused with vendors' "statements, it which summarize transactions periodically.

LIABILITY:
The economic obligation to convey assets (usually cash) or to render services in the future; claims against an entity by outside parties resulting from past or current transactions and requiring future settlement.

LIQUID ASSETS:
Cash and other short-term assets that are expected to be converted to cash within a short period of time. First items presented on asset side of Balance Sheet

LONG-TERM INVESTMENTS:
Certificates of deposit, stocks, bonds, notes receivable, etc., that are intended to be held for more than one year.

LONG-TERM LIABILITIES:
Obligations that come due a year or more hence, such as mortgages.

MATERIALITY:
The concept of whether an amount or event would, if known, influence the judgment of an informed reader of a financial statement; a test of the significance of an item.

MORTGAGE:
A loan made for the purpose of purchasing, building or rehabilitating real property, and secured by that property.

MORTGAGE NOTE:

Sets forth the amount the owner owes the lender and the manner in which the debt is to be satisfied. The note establishes the payment terms, conditions under which prepayments may be made, and the lender's rights in the event of default.

MORTGAGE INSURANCE PREMIUM (MIP):

A payment made to HUD for insurance to protect the lender against any failure by the mortgagor to make payments on the mortgage loan. Paid by the mortgagor through the lender, it amounts to one-half of one percent (0. 5%) annually of the unpaid balance of the mortgage loan. In Section 236 projects, an "interest reduction payment" (IRP) also pays the MIP.

MORTGAGEE (INVESTING/HOLDING):

The institution which holds a particular mortgage. The mortgagee may be a bank, savings and loan association, FNMA, GNMA, insurance company, etc. The mortgagee often engages another institution for the loan servicing function (example: FNMA services GNMA loans).

MORTGAGEE'S CERTIFICATE:

The lender executes the Mortgagee's Certificate at the loan closing. In executing the Certificate, the lender identifies all fees and escrow deposits collected in conjunction with the mortgagee transaction and agrees to collect, hold and administer the reserve for replacements and any required mortgage escrows in accordance with HUD's requirements.

MORTGAGOR:

An individual, corporation, or partnership that borrows money from the lending institution (the mortgagee) in exchange for a mortgage on the property.

NET INCOME:

Revenues of a period minus the expenses of that period. If expenses exceed revenues it is called Net Loss.

OWNER'S EQUITY:

The dollar balance of the amount of ownership interest of the owners of an entity.

PREPAID EXPENSES:

Assets consisting of remaining portions of amounts which have been paid for in advance for short term future expenses. Example: unexpired insurance.

PROJECT:

The mortgaged property and all its other assets used in or owned by the business conducted on a mortgaged property, which is providing housing and other such activities.

PRORATE:
To divide or apportion an amount according to the number of days or months during the period. Can relate to the amount of rent owed by a resident for occupying a unit for only a part of a month.

PURCHASE ORDER:
A form used by a purchaser to record the details of an order for goods, services, equipment, etc. It authorizes delivery and billing.

RESERVE:
(1) An accounting term for a formal segregation (appropriation) of owner's equity or for a valuation deduction from an asset account. (2) A fund of cash or cash equivalents retained for a specific purpose such as painting, replacements, or general contingencies.

RETAINED EARNINGS:
Stockholders' equity in a corporation resulting from earnings in excess of losses and dividends declared.

REVENUE:
The inflow of assets to an entity as a result of the rendering of services or delivering of goods.

STATEMENT OF CASH FLOW:
The statement that shows the sources and uses of cash over a specific reporting period in conjunction with the Statement of Income and Balance Sheet.

STATEMENT OF INCOME:
A statement that shows the revenues and expenses of an enterprise over a specific time period, and the resultant net income or net loss, e.g. HUD 92410.

STATEMENT OF RETAINED EARNINGS:
A statement which reports changes in a corporation's retained earnings during an accounting period.

STOCKHOLDER:
A person or enterprise owning a share or shares of stock in a corporation.

TAX BASIS OF ACCOUNTING:

The method of accounting which reflects transactions based upon the Internal Revenue Code, but does not follow generally accepted accounting principles.

TRANSACTION:
Any event that changes assets, liabilities or owner's equity.

UNPAID PRINCIPAL BALANCE (UPB):
The original amount of the mortgage loan less any decreases in the amount due to monthly amortization or prepayment of mortgage.

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DIVIDEND:
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EXPENDITURE:
An outflow of assets or increases in liabilities in connection with the acquisition of assets or expenses; includes both expenses and purchases of fixed assets.

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The outflow of assets or increases in liabilities that takes place in connection with the products or services provided during an accounting period.

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GOING CONCERN:

The accounting assumption that an entity will have an indefinite future life.

IDENTITY-OF-INTEREST:

This term applies to parties having business relationships with the project owner or any officer, director, or partner of the mortgagor entity. Such a relationship should be construed to exist when the owner and the vendor are not the same person but (1) the project owner; or (2) any officer, partner, or director of the project owner or (3) any person who directly or indirectly controls 10 percent or more of the project owner's voting rights or directly or indirectly owns 10 percent or more of the project owner; is also (1) an officer, director, partner, or owner of the vendor; or (2) a person who directly or indirectly controls 10 percent or more of the vendor. For purposes of this definition the term "person" includes any individual, partnership, corporation, or other business entity. Any ownership, control or interest held or possessed by a person's spouse, parent, child, grandchild, brother or sister is attributed to that person.

IMMATERIAL:

Judged by an accountant or auditor as insignificant to an informed reader of financial statements; said of minor items which are erroneous, omitted, or inconsistent.

IMPOUND ACCOUNT:

Amounts held by a mortgagee (or mortgagee's agent) which belong to the mortgagor but are collected to ensure future payment of items such as property taxes and insurance.

INCOME (PROJECT):

Excess of revenues over expenses

INCOME (TENANT):

The gross annual income of the tenant from all sources before taxes and withholdings, after giving effect to exclusions allowed by the Housing Commissioner.

INCOME STATEMENT:
See Statement of Income

INTERNAL REVENUE CODE:
The codification of the numerous revenue acts passed by Congress.

INVOICE:
A document (commonly called a "bill") that states the price and an itemized description of goods and/or services bought and requesting payment. Not to be confused with vendors' "statements, it which summarize transactions periodically.

LIABILITY:
The economic obligation to convey assets (usually cash) or to render services in the future; claims against an entity by outside parties resulting from past or current transactions and requiring future settlement.

LIQUID ASSETS:
Cash and other short-term assets that are expected to be converted to cash within a short period of time. First items presented on asset side of Balance Sheet

LONG-TERM INVESTMENTS:
Certificates of deposit, stocks, bonds, notes receivable, etc., that are intended to be held for more than one year.

LONG-TERM LIABILITIES:
Obligations that come due a year or more hence, such as mortgages.

MATERIALITY:
The concept of whether an amount or event would, if known, influence the judgment of an informed reader of a financial statement; a test of the significance of an item.

MORTGAGE:
A loan made for the purpose of purchasing, building or rehabilitating real property, and secured by that property.

MORTGAGE NOTE:

Sets forth the amount the owner owes the lender and the manner in which the debt is to be satisfied. The note establishes the payment terms, conditions under which prepayments may be made, and the lender's rights in the event of default.

MORTGAGE INSURANCE PREMIUM (MIP):

A payment made to HUD for insurance to protect the lender against any failure by the mortgagor to make payments on the mortgage loan. Paid by the mortgagor through the lender, it amounts to one-half of one percent (0. 5%) annually of the unpaid balance of the mortgage loan. In Section 236 projects, an "interest reduction payment" (IRP) also pays the MIP.

MORTGAGEE (INVESTING/HOLDING):

The institution which holds a particular mortgage. The mortgagee may be a bank, savings and loan association, FNMA, GNMA, insurance company, etc. The mortgagee often engages another institution for the loan servicing function (example: FNMA services GNMA loans).

MORTGAGEE'S CERTIFICATE:

The lender executes the Mortgagee's Certificate at the loan closing. In executing the Certificate, the lender identifies all fees and escrow deposits collected in conjunction with the mortgagee transaction and agrees to collect, hold and administer the reserve for replacements and any required mortgage escrows in accordance with HUD's requirements.

MORTGAGOR:

An individual, corporation, or partnership that borrows money from the lending institution (the mortgagee) in exchange for a mortgage on the property.

NET INCOME:

Revenues of a period minus the expenses of that period. If expenses exceed revenues it is called Net Loss.

OWNER'S EQUITY:

The dollar balance of the amount of ownership interest of the owners of an entity.

PREPAID EXPENSES:

Assets consisting of remaining portions of amounts which have been paid for in advance for short term future expenses. Example: unexpired insurance.

PROJECT:

The mortgaged property and all its other assets used in or owned by the business conducted on a mortgaged property, which is providing housing and other such activities.

PRORATE:
To divide or apportion an amount according to the number of days or months during the period. Can relate to the amount of rent owed by a resident for occupying a unit for only a part of a month.

PURCHASE ORDER:
A form used by a purchaser to record the details of an order for goods, services, equipment, etc. It authorizes delivery and billing.

RESERVE:
(1) An accounting term for a formal segregation (appropriation) of owner's equity or for a valuation deduction from an asset account. (2) A fund of cash or cash equivalents retained for a specific purpose such as painting, replacements, or general contingencies.

RETAINED EARNINGS:
Stockholders' equity in a corporation resulting from earnings in excess of losses and dividends declared.

REVENUE:
The inflow of assets to an entity as a result of the rendering of services or delivering of goods.

STATEMENT OF CASH FLOW:
The statement that shows the sources and uses of cash over a specific reporting period in conjunction with the Statement of Income and Balance Sheet.

STATEMENT OF INCOME:
A statement that shows the revenues and expenses of an enterprise over a specific time period, and the resultant net income or net loss, e.g. HUD 92410.

STATEMENT OF RETAINED EARNINGS:
A statement which reports changes in a corporation's retained earnings during an accounting period.

STOCKHOLDER:
A person or enterprise owning a share or shares of stock in a corporation.

TAX BASIS OF ACCOUNTING:

The method of accounting which reflects transactions based upon the Internal Revenue Code, but does not follow generally accepted accounting principles.

TRANSACTION:
Any event that changes assets, liabilities or owner's equity.

UNPAID PRINCIPAL BALANCE (UPB):
The original amount of the mortgage loan less any decreases in the amount due to monthly amortization or prepayment of mortgage.

ACRONYMS

CPA:	Certified Public Accountant
GAAP:	Generally Accepted Accounting Principals
GAAS:	Generally Accepted Auditing Standards
GAS:	Government Auditing Standards
GAO:	General Accounting Office
IG:	Inspector General
IPA:	Independent Public Accountant (generally, same as CPA)
IRP:	Interest Reduction Payment
MIP:	Mortgage Insurance Premium
MIPS:	Multifamily Information Processing System
RAP:	Rental Assistance Payment
UPB:	Unpaid Principal Balance

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