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:

- designing the procedures and systems needed to keep the project running smoothly,
- recruiting, hiring and training project personnel,
- monitoring project operations,
- informing project owners of project operations, and
- 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:

- 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

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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)