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:

- o Statement of Financial Position (Balance Sheet),
- o Statement of Income,
- o Statement of Cash Flows, and
- o 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:

- o check to see if the project is in compliance with HUD requirements,
- o evaluate the financial efficiency of the operations,
- o assess the financial needs of the project, and
- o 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:

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

- o Taxes.
- o 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:

- o current liabilities,
- o deposit and prepayment liabilities, and
- o 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:

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

- service expenses, and
- 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

GRAPHICS MATERIAL IN ORIGINAL DOCUMENT OMITTED

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

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

GRAPHICS MATERIAL IN ORIGINAL DOCUMENT OMITTED

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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?

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____
____
____

2. Define each of the following terms:

Assets: _______________________________________
____

Liability: ____________________________________
____

Owner's Equity: _______________________________
____

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

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____
____
____

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

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____
____
____

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

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____
____
____

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).