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
Checking accounts balance	Checks not yet deposited	Postage stamps
Savings account balances		Travel advances
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:

- certificates of deposit,
- savings account balances, and
- 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:

- they provide an additional source of financial strength for the project, and

- 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:

- pay delinquent rent, and
- 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:

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

Examples — Prepaid expenses include the following items:

- unexpired insurance,
- prepaid taxes, and
- 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:

- mortgagee escrow deposits,
- reserve for replacement account, and
- 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:

- accounts payable,
- accrued liabilities,
- Notes payable (short term),
- deferred income,
- distributions or dividends payable, and
- 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:

- payroll,
- taxes,
- part-period utilities, and
- 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:

- capital account,
- withdrawals account, and
- 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.

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:

- how the project records its earnings,
- how it records and spends its monies to pay its debts, and
- 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 ____________________________.

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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)