CHAPTER 4: FINANCIAL MANAGEMENT

4.1 INTRODUCTION

Successful projects require sound financial management procedures to track funds, prepare realistic budgets, manage project funds effectively, and report financial progress. This chapter covers the borrower's financial management responsibilities, and provides guidance to Loan Servicers on monitoring a borrower's financial management performance.

The chapter is divided into five sections:

Section 1: Project Accounting System describes program requirements and Agency monitoring responsibilities for the project accounting system.

Section 2: Project Accounts discusses the contribution, use, and monitoring of project accounts.

Section 3: Reserves outlines the requirements for and monitoring of reserve accounts.

Section 4: Project Budgets explains project proposed budget requirements and the budget approval process.

Section 5: Reporting and Financial Examination describes project actual reporting and financial examinations and Agency review of these reports.

SECTION 1: PROJECT ACCOUNTING SYSTEM

4.2 OVERVIEW OF ACCOUNTING SYSTEM REQUIREMENTS *[7 CFR 3560.302]*

Borrowers must establish accounting systems that support safe and sound project financial management. The accounting system must allow borrowers to maintain records in a manner suitable for an audit; track the use of funds, report accurate operational results to the Agency, and otherwise comply with the terms of their loan agreement. The following requirements apply to the borrower's accounting system:

- **Agency approval.** The accounting system must be approved by the Agency as part of the management plan (as discussed in Chapter 3). The borrower must notify the Agency of any changes in the method or system of accounting through a revision to the project management plan.

- **Method of accounting.** The borrower is required to use the accrual method of accounting throughout the year for bookkeeping and budget preparations. Annual reporting must be convertible to the standards identified in §3560.308. When the accrual method of accounting is used, the accrual-to-cash adjustment must equal the difference between Beginning Cash Balance and Ending Cash Balance to ensure these balances match their respective Balance Sheet figures. The sole purpose of this adjustment is to reconcile a company's internal ledger, kept on an accrual basis, to the IRS forms which are required to be on a cash basis.

- **Recordkeeping.** Borrowers must retain all financial records and supporting material for at least 3 years after the issuance of annual financial reports and financial statements or until the next Agency monitoring visit whichever is longer. These records must be maintained in a manner that can be audited by the Agency or a third party. Records may need to be retained longer for IRS retention rules or Tax Credit Guidelines. Borrower accounts and records will be made available in a location with reasonable access for review at the request of the Agency.

  If an account is a problem case or an investigation or audit is in process, do not destroy material until problem is resolved or the investigation audit is closed.

- **Account requirements.** The following general requirements apply to the borrower's accounts:

  ◊ Accounts must be held in domestic institutions;

  ◊ Accounts must be insured by an agency of the Federal Government, backed by collateral approved by the bank, or held in securities meeting the requirements of 7 CFR part 3560, subpart G;

  ◊ Funds maintained in an institution may not exceed the limit established for Federal deposit insurance. If funds exceed the amount covered by Federal deposit insurance, borrowers must obtain a collateral pledge from the institution to cover all funds, or must move funds to an institution that will insure funds; and

  ◊ Borrowers must maintain at least one demand deposit or checking account so that funds are always readily available to pay necessary operating expenses.

- **Use of funds.** Funds other than those in the security deposit/membership fee or patron capital accounts serve as security for the Agency grant or loan and must be held in trust by the borrower until used.

  ◊ In no case may project funds be pledged as collateral for non-project debts;

  ◊ Funds must be used only for authorized purposes as described in 7 CFR part 3560, subpart G and in the project loan agreement or resolution; and

  ◊ Priority Order of planned and actual project expenditures are discussed in 7 CFR, part 3560, subpart G.

Separate accountability. The accounting system must establish separate accountability for different projects. Funds for housing projects managed by the same management company must not be co-mingled.

The borrower may combine funds from different projects owned by the same borrower with the same tax identification number or Social Security Number in the same bank account, as long as the accounting system segregates and tracks each project's funds separately. A statement issued by a Certified Public Accountant (CPA) stating that the accounting system is structured to meet the principle of separate accountability will be provided. If funds for different projects are combined, the management plan must document how revenue and expenses that are not clearly associated with a particular project are prorated across projects. For example, the plan must document how costs for a computer system that serves several projects are allocated across the projects. The accounting system must track these prorated costs.

4.3 OVERVIEW OF ACCOUNTS

The borrowers must establish and maintain the accounts required by their loan agreement or resolution. At a minimum, these include the following accounts:

- General operating account;
- Tax and insurance account (amounts escrowed may be part of the general operating account but tracked separately);
- Reserve account;
- Tenant security deposit account
- Membership fee account (if applicable); and
- For cooperative projects, a patron capital account.

Each account serves a different purpose, as described in Section 2.

SECTION 2: PROJECT ACCOUNTS

4.4 GENERAL OPERATING ACCOUNT

The borrower must establish a general operating account to handle all revenues and expenses associated with project operations. Authorized expenses payable from this account include expenses that are directly attributable to project operations and are necessary to carry out successful project operations. For a list of eligible expenses, see Attachment 4-C

A. Initial Operating Capital and Other Advances *[7 CFR 3560.304]*.

The period between initial occupancy and full rent-up in a project can be risky because rental income may not be sufficient to cover all operating costs, make payments on the Agency loan, and make required contributions to the reserve fund. To assist projects through this phase, the Agency requires the establishment of a fund for Initial Operating Capital.

This Initial Operating Capital is to be used for initial operating expenses, such as advertising, insurance, fidelity coverage, and initial lease-up expenses. The funds may also be used to meet project obligations, such as debt payments and reserve deposits, until cash flow is sufficient to fund these accounts. In addition to these regular operating expenses, there are some special expenses associated with this period, such as purchasing furniture or equipment for public spaces or advertising and marketing. Borrowers are to provide the Agency with a list of proposed uses for Initial Operating Capital during loan origination.

Other Advances include any advances made by the borrower, borrower entity, or designee to cover ordinary project operating expenses.

- **Funding of Initial Operating Capital**

  All borrowers must provide Initial Operating Capital equal to at least 2 percent of the total development costs to support initial operation of the project. Borrowers must put this amount down at the loan closing or construction start, whichever comes first. The Agency may loan the required 2 percent to not-for-profit borrowers. (For details on this process, see Chapter 5 of HB-1-3560.)

- **Accounting for Initial Operating Capital**

  When the project accounts are established, Initial Operating Capital is blended with other revenue and used for operating expenses.

  The borrower may leave an amount of money equal to the initial capitalization of the fund in the operating account. This money should not be treated as surplus funds in the operating account nor should it be transferred to reserves. Its presence in the operating account should not be used as justification for the Loan Servicer to deny a rent increase.

- **Duration of Initial Occupancy**

  The initial occupancy phase lasts until the project has attained a stable occupancy rate and the operating budget can reliably be supported by rental income. Projects vary as to when they achieve this stability; the Agency anticipates it occurs sometime between the end of the second and seventh year of occupancy. When project stability is reached before the end of the seventh year, a for-profit borrower whose cash contribution created the Initial Operating Capital may request that the contribution be repaid.

- **Repayment**

  ◊ **Agency Policy**

  The borrower may, with the consent of the Agency, withdraw its original contribution to the Initial Operating Capital in multiple annual installments or a single installment after the second year of the housing project operations and prior to the seventh full year of project operation, provided the borrower can satisfy Agency criteria for approving repayment. Repayment can only be made once the project has been operating for 2 years, and the project's operations and finances have stabilized. Repayment must be made during the initial operating phase. Repayment may be in one to five annual installments, until the borrower's contribution to Initial Operating Capital has been fully repaid and prior to the close of year seven.

The borrower must be able to demonstrate that the project is financially stable, that repayment will not require a rent increase, and that the project is in compliance with Agency requirements. The financial condition of the project may preclude full repayment of Initial Operating Capital.

◊ **Borrower Submissions**

The borrower may submit a request for repayment of Initial Operating Capital when the annual financial report is submitted. The borrower's request is submitted in writing and addressed to the Servicing Office.

The submission should specify the amount of the repayment the borrower is requesting in the current year and, if applicable, the borrower's plan for withdrawing the balance of the repayment in ensuing years. The submission includes documentation demonstrating how the project meets Agency criteria for repayment:

- **Occupancy.** The occupancy rate for the project over the most recent 12 months has averaged at least 90 percent.
- **Contributions to reserves.** Contributions to reserves are on schedule, less any authorized withdrawals.
- **Sufficient income.** The project's financial position is stable. All accounts payables are less than 30 days old. When the amount of the repayment is subtracted from the general operating account, the ending cash balance still includes an amount equal to 20 percent of projected annual operating costs and required escrows for taxes and insurance.
- **Impact on rents:**
  - Repayment is acceptable if no rent increases are projected in the year the repayment is made.
  - A rent increase will not affect repayment if rents are increasing to cover increases in costs, such as wages, taxes, or insurance.
  - Repayment is denied if it creates a shortfall in operating income that must be made up by a rent increase.
- **Physical maintenance.** There are no outstanding deficiencies in management's physical maintenance of the housing project**.**
- **Compliance.** There are no outstanding compliance violations, and the project is not under a workout agreement.

◊ **Agency Processing**

Agency staff will examine the submission for eligibility, completeness, and compliance with the criteria the Agency has established that a project must meet in order for a repayment to be made. If staff finds that the project can support the repayment, the repayment amount will be calculated.

a. Amount of Repayment

The borrower may receive a lump sum amount equal to the original contribution of Initial Operating Capital, or smaller amounts in installments if the operating budget cannot support repayment in a single lump sum amount (see Example below).

Example

	Case One	Case Two	Case Three
Year-end cash balance	$57,000	$40,000	$27,000
20% O&M requirement plus taxes & insur.	27,000	27,000	27,000
Surplus	**30,000**	**13,000**	**0**
Initial Operating Capital	30,000	30,000	30,000
Repayment Amount	**30,000**	**13,000**	**0**
Initial Operating Capital unpaid balance	0	17,000	30,000

- The borrower in Case One can be repaid in a single installment.
- The borrower in Case Two will require 3 installments assuming little change in the project's financial condition.
- The borrower in Case Three could not receive any repayment this year.

b. The Decision Process

- The Servicing Office has 60 calendar days to review the annual financial statement, including any request for repayment of Initial Operating Capital.

- The Servicing Office may decide to:

  - Permit repayment in the amount requested by the borrower;

  - Permit repayments, but in an amount less than that requested by the borrower; or

  - Deny repayment because the project does not meet the criteria for repayment.

- The decision of the Servicing Office is provided to the borrower in a letter. In addition to the amount of any authorized repayment or the reasons for denying repayment, the letter states the amount of any remaining unpaid balance of the original contribution to Initial Operating Capital. If repayment is denied appeal rights will be sent.

- The Servicing Office updates Multi-Family Information System (MFIS) Tracked accounts and Servicing efforts to show the amount of the authorized repayment and the unpaid balance of Initial Operating Capital.

- **Other Borrower Advances**

  Prior written approval by the Loan Servicer is required for any advances made by the borrower, borrower entity, or designee to cover ordinary project operating expenses. Such advances may be authorized when justified by unusual short-term conditions. When conditions are not short term in nature, a servicing plan may be developed and advances may be approved if justified by the following:

  - A review of the documented circumstances and the project operating budget before any funds are advanced. The financial position of the project must not be jeopardized.
  - Funds are not immediately available from any of the following sources:
    - Reserve funds;
    - Initial operating capital; or
    - An imminent rent increase.

  The borrower may charge or be paid interest on the loan using project income; however, interest must be reasonable. The proposed loan may be denied if Agency financing can be provided to resolve the problem in a more cost-effective manner.

  No lien in connection with the loan will be filed against the property securing the Agency's loan or against project income. The advance may be shown as an unsecured project liability on financial statements prepared for year-end reports until such time as it is authorized to be repaid.

- Repayment of Advanced Loan Funds

  The repayment of the advance may be permitted by the Loan Servicer, provided the terms and conditions were mutually agreed to by the borrower and the Agency at the time of the advance, and the financial position of the project will not be jeopardized. Repayment should only be permitted on the advance when the Agency debt is current and the reserve requirements are being maintained in accordance with Section 3 of this chapter.

B. Return on Investment /Return to Owner [7 CFR 3560.305]

The borrower's return on investment (ROI) is the annual amount of profit an owner operating on a limited or full-profit basis may receive from a project, as established in the loan agreement. If a lesser amount was budgeted for the return on investment paid with be the lesser amount. The amount is calculated as a percentage of the owner's investment in the project.

The borrower may take the earned ROI before withdrawing the original contribution to Initial Operating Capital. A full or partial ROI may be taken in a given year. If only a partial is taken, the remainder may be taken the following year. The borrower may receive a ROI in accordance with the terms of its loan agreement, and if the following conditions exist:

1. The borrower may take the ROI after the project's fiscal year ends if there is a positive net cash flow (see line 30 on *Form RD 3560-7, Multiple Family Housing Project Budget/Utility Allowance*), and the balance of the reserve account is equal to or greater than required deposits minus authorized withdrawals.

   When determining positive net cash flow, the Agency will consider such items as accounts payable and reserve withdrawals to cover operating expenses. For example, the borrower may not circumvent the order for funding accounts by using reserve funds or creating an accounts payable for budgeted operating expenses to make it appear as though the budget has a positive cash flow at year end. If the annual financial reports indicate that the borrower should not have taken an ROI, the Agency will require the borrower to return the unauthorized ROI to the project.

2. If the project's operations show a negative cash flow (see Form RD 3560-7, line 30) as in the Example, Case 1 below, the Agency may authorize the borrower to take the ROI only after the Agency has reviewed the project's annual financial report and determines:

   - There is surplus cash in either the general operating account or the reserve account and;

   - The housing project has sufficient funds to address identified capital or operational needs. Needs of the property may be identified by inspections and/or capital needs proposed.

   The Agency considers surplus cash to be the portion of the ending cash balance on *Form RD 3560-7* that after all payables, exceeds 20 percent of projected annual operating and maintenance expenses, the taxes and insurance escrow, and initial operating capital, if applicable. To determine surplus cash, refer to Attachment 4-D, *PROPOSED BUDGET AND YEAR END ANALYSIS PROCESS.*

3. An earned, but unpaid ROI for the previous year may only be requested if, at the end of a project's current fiscal year, surplus project funds are more than sufficient to pay ROI for the year just ended. The borrower may request that the additional surplus project funds be used to pay any portion of the prior year's ROI that could not be paid previously. See Example below, Case 1.

4. The borrower will indicate the year the ROI being withdrawn represents on Form RD 3560-7, Part I, line 23 under "Comments".

5. The borrower may request the ROI from the reserve account if the conditions set out in the loan agreement are met and the account balance is greater than the required deposits minus authorized withdrawals. After the disbursement the

reserve account actual balance must be equal to or greater than the required balance. The disbursement does not reduce the required balance.

Example

Consider a project that has been operational for 8 years, has a $1,000 ROI specified in the loan agreement, and needs $10,000 cash to cover 20% of annual operating and maintenance expenses, and taxes and insurance escrow.

Case 1: If the project had a negative cash flow after payment of operating and maintenance expenses, reserves, and debt service expenses during the fiscal year (FY) 2017 but had $20,000 available in the general operating account, the Agency would approve an ROI from funds available at the end of FY 2017. In this example, "FY 2017 RTO" would be noted in the comments section of *Form 3560-7*." This return would be taken immediately after the end of the fiscal year, preferably January 2018.

After the $1,000 RTO was paid, if all or a portion of the previous year RTO is unpaid – it may be paid from the remaining surplus cash. Any remaining previous years unpaid RTO will then be written off.

Case 2: If the project had a negative cash flow during FY 2017 but had only $5,000 available in the general operating account, the Agency would not approve an ROI from funds available at the end of FY 2017. This FY 2017 RTO could be requested the following year if there is surplus cash to cover it, the 2018 RTO is paid first and it does not cause a rent increase. These returns would be taken immediately after the end of the fiscal year, preferably January 2019.

Case 3: Consider the same project as described above. During FY 2017, the borrower believed that there would not be adequate cash to pay taxes at year end, so the borrower requested $2,000 from the reserve account for operating purposes; however, the project ended the year with $3,000 positive cash flow. In this case, the borrower can take the $1,000 without Agency permission, as they used a reserve withdrawal request to cover operating expenses. However, if the net cash amount was less than $2,000, the borrower can only take ROI from surplus cash.

	Case One	Case Two	Case Three
Form RD 3560-7 Part I Line 30	$ (2,000)	$ (2,000)	$ 3,000
Form RD 3560-7 Part I Line 33	$ 20,000	$ 5,000	
Tax & Ins escrow	$ (5,000)	$ (5,000)	
Accounts Payable	$ (2,500)	$ (2,500)	
Cash Available	$ 12,500	$ 0	
Cash Required (20% proposed O&M - Tax & Insurance)	$(10,000)	$(10,000)	
Surplus Cash	$ 2,500	$ 0	

C. Surplus Funds [7 CFR 3560.306]

If the general operating account has surplus funds at the end of the housing project's fiscal year, the Agency will require the borrower to use the surplus funds to address capital needs, make a deposit into the housing project's reserve account, reduce the debt service on the borrower's loan, or reduce rents in the following year.

4.5 TAX AND INSURANCE ACCOUNT

The borrower must deposit money on a monthly basis to pay required taxes and insurance. Generally, these funds can be kept in the general operating account as long as they are tracked separately from other general operating funds to ensure that funds are available to pay taxes and insurance. In some cases, however, the Agency may require a separate account for taxes and insurance to ensure the availability of these funds. See Chapter 3 for a discussion of insurance requirements and taxes. Also, see Attachment 4-D for evaluation of escrow amounts.

4.6 RESERVE ACCOUNT

The reserve account is used primarily to pay for large planned expenses for maintenance and improvements of capital items. It is funded through contributions from project operating funds. The reserves are not to be used as an alternative operating budget. The project's reserves must be held in a supervised account that requires the Agency's countersignature on all withdrawals. The administration of project reserves is covered in detail in Section 3 of this chapter.

4.7 SECURITY DEPOSIT OR MEMBERSHIP FEE ACCOUNT

The security deposit or membership fee account holds funds provided by residents as security deposits and membership fees. See Chapter 7 for a full discussion of security deposits and membership fees.

- **Uses of funds.** Funds deposited in the security deposit/membership fee account must be used for purposes outlined in the management plan:

  ◊ The borrower may only use security deposits to cover costs of fixing damage to units beyond ordinary wear and tear by the tenant who provided the deposit. The funds must be returned to the tenant if not used in accordance with the State Law. If the borrower cannot locate the tenant to return the deposit, these funds must be deposited in the general operating account or handled in accordance with applicable state laws. In cooperatives, the return of membership fees depends upon the legal instruments governing the project.

  ◊ Funds retained by the borrower as a result of a lease or occupancy violation must be transferred to the general operating account and treated as project income.

- **Interest.** The interest on security deposit/membership fee accounts is handled in accordance with state law. If no state law governs the use of interest, it must be deposited in the general operating account, at least once annually, and used for general operating expenses. In no case may interest accrue to the benefit of the borrower or management agent.

4.8 PATRON CAPITAL ACCOUNT

In cooperative projects, borrowers must establish a patron capital account to hold surplus operating funds in trust for cooperative shareholders.

- Any funds in excess of 3 months of average operating expenses remaining in the general operating account at the end of the fiscal year must be deposited in the patron capital account. This account must be interest bearing, and must be administered according to state laws governing patronage capital.

- Each shareholder of the cooperative association must be assigned an equal portion of the funds in this account. These funds are held in trust for the shareholders of the association until they terminate their membership in the cooperative. Shareholders may receive their portion of the funds only if they have paid all association charges and costs due the cooperative association.

SECTION 3: RESERVE ACCOUNT *[7 CFR 3560.306]*

4.9 PURPOSE OF RESERVES

The Agency has a financial interest in a project over the life of its loan. During this period, which can be as long as 50 years, major replacements and capital expenditures will have to be made to the building, such as replacing the roof, rewiring, replacing windows, doing major exterior work, or adding new kitchen and bathroom fixtures. The reserve account is primarily used to meet the major capital expense needs of a project. If these expenditures are not made, the property loses value, becomes less attractive to tenants, and begins to deteriorate. The Agency's financial interest in the project is then at risk.

Adequate replacement reserves are a critical component of a successful project. The reserves are not to be used as an alternative operating budget. Rents should reflect and cover the reasonable and customary costs of annual operating expenses of the property in the market.

4.10 RESERVE ACCOUNT REQUIREMENTS

The reserve account is a required account subject to the requirements set out in this paragraph. The borrower will initiate monthly deposits in this project account, starting in the same month the first loan payment is due the Agency. As projects age, the required reserve account level may be adjusted to meet anticipated life-cycle needs, such as equipment and facility replacement costs, by amending the loan agreement/resolution. Refer to Attachment 4-B for guidance on the amendment.

Requirements for the reserve account include the following:

- All Rural Rental Housing, Rural Cooperative Housing, and Farm Labor Housing borrowers are required to establish and maintain a reserve account. This requirement excludes On-Farm Labor Housing borrowers with fewer than12 units.

- Reserve accounts must be deposited in interest-bearing accounts or securities with rates greater than or equal to savings or checking accounts.

- Reserve funds are required to be placed in a supervised account. The provisions of 7 CFR part 1902, subpart A, apply.

- Any amount in the reserve account that exceeds the total sum specified in the loan agreement or resolution may be transferred to the general operating account for authorized purposes only when it is agreed, between the borrower and the Agency, to be in excess of the requirement and there is a specific need for the excess funds. However, the Loan Servicer may direct the excess sum to be retained in the reserve account or applied as an extra payment on the loan.

- Section 515 properties leveraged with 538 Guarantee Rural Rental Housing (GRRH) program funding are not subject to countersignature requirements. Direct Section 515 loan borrowers, exempted from the counter-signature requirements, must comply with the Section 538 GRRH program regulatory requirements. In all cases, the Section 538 lender must get prior written approval from the Agency before reserve account funds involving a direct MFH loan project can be disbursed to the borrower.

4.11 RESERVE INSTALLMENTS

Required reserve installments will be transferred to the reserve account at least at the rate stipulated by the borrower's loan agreement or resolution, starting with the date the first loan payment is due to the Agency. Transfers of funds to the reserve account will continue until the account reaches the total amount specified in the loan agreement or resolution. Transfers will be resumed the period following withdrawals that decrease the reserve account balance below its fully funded level until it is restored to the specified total minimum sum.

The Agency may approve a change in the reserve account funding level based on the findings of an approved capital needs assessment The approval to increase reserve account funding levels will take into consideration the housing project's approved budget and ability to support increased reserve account deposits without causing basic rents to exceed conventional rents for comparable units in the area. If the borrower requests an increase in the project's reserve account, the borrower must have a capital needs assessment prepared and submitted to the Agency to reflect the project's anticipated needs for replacement of capital equipment and systems. The cost for preparation of a capital needs assessment will be approved by the Agency as an eligible project expense, provided that the cost of the assessment is reasonable and meets Agency requirements.

The Agency may approve a borrower's request to increase the fully funded level of the reserve account to ensure sufficient funds are available to address the capital requirements of a Transition Plan. Loan funds may also be used for this purpose.

The following definitions are displayed on the MFIS Tracked Accounts page, and are used to further explain the reserve account:

- **Required Balance.** The amount that the reserve account is required to contain as of the date displayed. This amount is calculated by adding deposits as required by the loan agreement/resolution and subtracting authorized withdrawals.

- **Fully Funded.** The amount set in the borrower's loan agreement/resolution for funds to be set aside during the life of the project.

- **Annual Deposit.** The amount of funds that must be deposited annually to the reserve account according to the borrower's loan agreement/resolution.

- **Account Balance.** The account balance as of the date displayed. This would correspond to the reserve section actual balance on financial reports.

- **Account Status.** This shows whether the reserve account is current or delinquent according to the required balance less the account balance.

4.12 RESERVE ACCOUNT PRINCIPLES

Reserve account funds are governed by the following principles:

A. Investment Vehicles and Institutions

◊ Reserve account funds not immediately needed to pay for expenses or authorized purposes may be held as set out in this paragraph. Reserve account funds may be held in the form of: A checking, savings, negotiable order of withdrawal, or similar account at a federally-insured domestic institution, such as a bank, savings and loan, or credit union.

◊ Readily marketable obligations of the U.S. Treasury Department (e.g., U.S. Treasury bonds, U.S. Savings bonds, zero coupon bonds, etc.) at a federally-insured domestic institution or at an insured domestic institution authorized to sell securities.

◊ An account established at an insured domestic institution authorized to sell securities, provided that the accounts meet the remaining conditions set out in this paragraph and are not used in a speculative manner. The account may be a tax exempt account or a taxable account, and the institution may or may not charge brokerage fees.

B. Limitations on Investments in Securities

Any securities must be:

- Backed by the U.S. Government or an Agency of the U.S. Government;
- Triple A-rated Government National Mortgage Association (GNMA)-collateralized tax-exempt bonds; or
- Triple A-rated pre-refunded bonds.

Pre-refunded bonds are bonds that originally may have been issued as general obligation or revenue bonds but are now secured, until the call date or maturity, by an escrow fund consisting entirely of direct Government obligations that are sufficient for paying the bondholders.

C. Reporting Actual Costs of Securities

To ensure that required amounts have been paid into the reserve account, the actual costs of securities (which in many cases may not be the face value) must be shown on the project books. In addition, details of these transactions should be disclosed in footnotes to financial information provided to the Agency.

1. Security Sales

When the Agency approves withdrawals from the reserve account and the funds are invested in securities, borrowers must, to the extent that securities are available, assure that securities are sold in an amount that results in proceeds sufficient to cover the disbursement.

2. Forecasting Security Sales

Since the sale or redemption of any securities may result in cash proceeds of less than the amount invested, borrowers should take steps to minimize the risk of loss from converting securities to cash. Needed reserve account withdrawals should be planned in advance to permit Agency approval of anticipated needs such that security sales can be arranged to be sold in favorable market conditions. When sales of securities take place, the proceeds will normally be held in a reserve fund at a domestic bank, savings and loan, credit union, or similar institution insured by an Agency of the Federal Government until such time as withdrawals are actually needed for the purposes authorized. Should unusual circumstances require the sale of securities in unfavorable market conditions, the borrower will not be required to reimburse the project for any losses incurred.

3. Knowledge Required of Securities Investors

Those investing in securities must be knowledgeable of common industry practices prior to investing in securities. Knowledge of the various fees that may be associated with the purchase and sale of securities and the maintenance of security accounts must be considered when making security investments. Examples of these fees are front-end loads or fees, back-end loads or fees, and maintenance fees. These fees may be paid using general operating account or reserve account funds. However, the Agency must give its prior consent before reserve account funds may be used.

4. Financial Advisor Limitations

Project proceeds may not be permitted to be used to pay for the services of a financial advisor to assist in the selection of securities for investment, since the securities permitted are relatively limited and must meet the requirements set out in this chapter. However, normal brokerage fees may be paid to secure and sell securities. It is recognized that financial advice may also be provided as part of the normal brokerage fee.

4.13 USE OF THE RESERVE ACCOUNT

A. Planned Use of Reserve Funds

The borrower will request approval for use of the reserve funds using *Form RD 3560-12, Request for Authorization to Withdraw Reserve Funds,* before they are needed if items were not included on the approved capital budget. The borrower will request withdrawal from the reserve fund using Form RD 3560-12.

Annual budgets are to include realistic routine income and expense levels to avoid the need to use reserve funds for routine expenses (operating shortfalls) not caused by emergencies or very unusual servicing situations. The Agency expects borrowers to anticipate and plan for major capital expenditures at least annually.

The borrower is required to submit an annual capital expenditure budget as part of the annual budget submission. The budget should include plans to catch up with any maintenance expenses deferred from previous years, correct any deficiencies identified during Agency site visits, and/or make necessary modifications to remove physical barriers as identified in a Transition Plan. A cost analysis provides data on projected useful life of materials, common replacement and repair schedules. Independent resources of information such as insurance actuary tables, FANNIE MAE Physical Needs Assessment Guidance to the Property Evaluator or Agency documentation should be consulted for common costs and repair/replacements schedules.

When a reserve account and contributions to the reserve account have been sized in accordance with a fully acceptable capital needs assessment, the reserve account funds are to be used to fund capital items as described in the plan. Since under a capital needs assessment, funding of the reserve is designed to match the timing and amount of needs, following the plan should limit the amount of funds required from operating sources to pay for capital needs.

B. Authorized Uses/Eligible Expenditures

Items usually considered as eligible for draws from the reserve account include capital items such as, but not limited to, the following:

- Making improvements to the housing project without creating new living units, or to retrofit units to make them accessible to the physically handicapped. This is not meant to limit the use of reserve account funds to meet handicapped accessibility needs required to make reasonable accommodations for persons with a disability who apply for housing.

- Using reserve funds to address the capital requirements identified by the borrower's Transition Plan and other servicing tools. Loan funds may also be used for this purpose.
- Making permanent improvements to the housing project, such as installing an energy-conserving heat pump.
- For other purposes desired by the borrower, which in the judgment of the Agency will promote the loan purposes; strengthen the security of the loan; or facilitate, improve, or maintain the project and the payment of the loan without jeopardizing the loan or impairing the adequacy of the security.
- Facilitating payment of fees associated with the buying or selling of securities or maintaining a securities account.
- Meet loan obligations of the project in the event the amount available for debt service is not sufficient for the payments.
- Meet an emergency shortfall in operating expenses when the emergency is beyond the control of the borrower and threatens life, or the safety or the physical security of the project. Examples include an extreme weather disaster or reductions in rental income caused by changes in the rental market that affect other housing projects in the market as well. In cases of weather disasters, the project insurance coverage will be reviewed to determine if funding from insurance will be available for repairs. Suitable justification as to why the general operating account is insufficient is required.
- With Agency approval, borrowers operating on a for-profit or a limited-profit basis may make an annual withdrawal from the reserve account equal to no more than 25 percent of the interest earned on the reserve account during the prior year. The borrower uses *Form RD 3560-12 to* request the withdrawal, and must provide documentation of the prior year interest earned. For example, in the report submitted for the period January 1, 2009 through December 31, 2009, the owner is entitled to 25% of the interest earned during calendar year 2009. The borrower is not entitled to interest earnings from prior years.
- Other items considered eligible for draws from the reserve account include capital items listed in Attachment 4-A.

C. Unanticipated Uses of Reserves

The Agency recognizes that not all capital expenditures can be predicted a year in advance. Sometimes a major piece of equipment will break down unexpectedly or a severe storm will create damage. Borrowers must seek Agency approval for the unforeseen use of reserves. In emergency situations when the borrower can demonstrate an imminent and serious threat to the health, safety, or physical security of the project, the borrower may request the Agency to post-approve the use of reserves. The Agency will only approve emergency withdrawals if the reserves are used for eligible expenses. If post-approval is requested, the bidding requirements, as described below, still apply. If the bid is obtained post-approval and is less than the expense, the difference will be reimbursed to the account by the borrower.

D. Withdrawal Approval Process

The borrower must submit a written request, on *Form RD 3560-12*, Request for Authorization to Withdraw Reserve Funds, to the Agency to withdraw reserve funds, even if the Agency has reviewed and approved the capital expenditures in its review of the annual capital budget.

The Loan Servicer will take prompt action on a request for reserve withdrawal, normally within 5 working days of receipt of the request, and provide written authorization to the borrower, on *Form RD 3560-12,* for any authorized withdrawal of funds before the borrower actually withdraws any funds.

Upon receipt of authorization to use reserve funds, the borrower submits a request for payment, supported by an invoice that describes the specific service and a banking transaction document (i.e. check, withdrawal slip) for countersignature. It is acceptable for the approved withdrawal to be run through the general operating account.

Borrowers must maintain records documenting all expenses that were paid by withdrawals from the reserve account.

1. Bid Requirements

Expenditures of $5,000 or less do not require bids, even if it is an identity-of-interest (IOI) entity.

The expenditure of reserve funds for a project (all work included in one contract) estimated to cost *more than* $5,000 will require a minimum of two bids. When there is an IOI between the borrower or property manager and a bidder, the entity with the IOI must submit a minimum of three bids. The entity with the IOI must submit its bid directly to the Servicing Office prior to requesting bids from other firms. Once the bids are received the borrower will submit the request using Form RD 3560-12 to the servicing office with all bids attached. An explanation of why the borrower was unable to obtain two non-IOI bids must be provided when appropriate.

2. Projects Involving Moderate Levels of Construction

If construction does not involve substantial changes to structures or replacement of major systems, e.g. electrical, plumbing, heating, or cooling, and the cost is less than $100,000, the housing project is considered to involve moderate levels of construction. Examples include exterior repainting, roof repair, parking lot repaving, and repairs to plumbing or electrical systems.

When the borrower requests access to reserves for a moderate construction activity, the Agency first reviews the project documents for acceptance, and then reviews a payment request.

In addition to the items for bids specified above, the borrower must provide the following:

- Project planning documents that describe the work to be performed;
- Copies of written bids; and
- A copy of the contract/proposal.

After the project has been completed, the borrower submits a request for payment, supported by an invoice.

3. Project Involving Large Levels of Construction

A project with large levels of construction involves substantial changes to the structure, replacement of major systems, and/or expenditures in excess of $100,000. Such activities are subject to the design requirements of RD Instructions 1924-A and 1924-C. In addition to the items for bids specified above, the borrower must provide:

- Project planning documents, including specifications and drawings as necessary to fully describe the work;
- Copies of written bids;
- A rationale for awarding the contract; and
- A copy of the construction contract.

The required planning documents may be prepared by any individual or firm meeting the qualification requirements of the local building jurisdiction.

After the planning documents and construction contract have been accepted by the Agency, the borrower may request an initial draw to pay for materials or make a down payment to the contractor. The request for an initial draw should be accompanied by an invoice and a check made out to the contractor or vendor, to be cosigned by the Agency. The Agency may approve such a request provided the amount of the initial draw does not exceed a reasonable percentage of the value of the construction contract. Refer to RD instruction 1924-A.

The Agency will inspect the project before approving the work and again at construction completion before approving the final payment.

- The purpose of the initial inspection is to establish that the proposed work is needed, and is an appropriate response to existing conditions.
- The purpose of the final inspection is to establish that the work was performed as described in the Agency-accepted documents.

The Agency may conduct additional inspections as necessary.

The borrower should be required to hire an independent third-party inspector to verify that the work complies with all applicable requirements. To verify that all major systems are adequate, State-licensed inspectors must certify that the dwelling has been inspected and meets Agency standards. When a State does not have licensed inspectors, a qualified, independent, third-party inspector may provide these certifications.

SECTION 4: PROJECT BUDGETS

4.14 BUDGET REQUIREMENTS *[7 CFR 3560.205 and 3560.303]*

A. General Information

Project budgets are planning documents that provide a picture of a project's financial operations for the coming year. They reflect:

- Expected revenues and expenses;
- Plans for maintenance, capital improvements, and reserve account activity;
- Return on the owner's investment, or a Non-profit Asset Management Fee;
- Establish rents; and
- Reasonable and customary costs to cover turnover costs and maintenance which should be in line with comparable properties in the market.

For projects with 8 units or more, all borrowers will be required to submit project budgets through the Management Agent Interactive Network (MINC). The Agency may make an exception to this requirement if the borrower submits documentation that the costs associated with electronic submission of project budgets would pose a financial hardship to the project.

Borrowers must submit annual project budgets to the Agency for approval. Budgets must meet the following requirements:

- Budgets must be reasonable and realistic. Revenues and expenses must be consistent with past project budgets and comparable projects. Any differences must be due to legitimate operating needs of the project.

- Project expenses will include only expenses necessary to maintain successful projects. An example of an unnecessary expense is owner or manager entertainment expenses. Project expenses cannot be used for unearned personal benefit or gain, or for reimbursement of false or inaccurate expenses.
- The priority order of project expenditures must be:
    - Senior Position lien holder, if any;
    - Operating and maintenance expenses, including taxes and insurance;
    - Debt service to the Agency;
    - Reserve account deposits;
    - Other authorized expenses; and
    - Return on the owner's investment or Non-Profit Asset Management Fee.

B. Sections of the Project Budget (*Form RD 3560-7*)

The *Form RD 3560-7* is used to plan and report the financial activity of a multiple family housing project as required by Agency regulations. Refer to the Forms Manual Insert (FMI) for this form and for a detailed explanation of each line item on the budget. The form is divided in 6 parts as described below:

1. Cash Flow Statement

For budgeting purposes, the cash flow statement projects whether the property will generate enough revenues for all cash needs for the budget period. The proposed budget ending balance must be a positive cash balance and not cause an unwarranted rent increase. It should not exceed the total of: (1) approximately 20 percent of Total O&M Expenses (Part I, line 16); (2) the amount held for taxes and insurance; (3) any initial operating capital during the first 7 years or until it is withdrawn, whichever comes first. Accrual method accounting will be considered with the annual financial reports and is discussed in Section 5 of this chapter.

- The borrower must not include expenses for purposes unrelated to the housing project or for fines, penalties, and legal fees in the event the borrower has been found guilty of violating laws such as civil rights, evictions, and building codes.
- The borrower is responsible for submitting project budgets that address the project's physical accessibility needs. The Loan Servicer may approve the cost of providing accessible rental housing as an authorized use of project funds.
- The borrower must not include organizational expenses among project expenses. These items are covered by the management fee. (For a list of the bundle of services covered in the management fee, see Chapter 3, Attachment 3-D, and 7 CFR 3560.102.)
- A vacancy and contingency allowance is calculated from the previous 3 years' historical vacancy rate of the property, and should not exceed the caps as

identified below. If the historical vacancy rate is greater than established caps, the vacancy and contingency allowance is capped at the following levels:

- ◊ For projects with 15 or fewer units, the vacancy and contingency allowance is capped at 15 percent.
- ◊ For projects with more than 15 units, the vacancy and contingency allowance is capped at 10 percent.
- ◊ When historical vacancy rates exceed the caps, a budget may be approved with the historical rates only after a feasible workout plan has been submitted and approved.

- A Non-Profit Asset Management Fee may be requested by non-profits and cooperatives. Non-profit owners are entitled up to $7,500 per project for certain organizational expenses, such as Errors and Omissions insurance and actual expenses prorated by the number of Rural Development units. Expense reimbursement may not be duplicated on multiple properties. Evidence of expenses is necessary to support the budgeted amount. Examples of acceptable documentation for this expense would be:
  - ◊ A copy of the Errors and Omissions Insurance policy that reflects who is covered and the cost;
  - ◊ Documentation of hours, number of meetings, and the hourly wage rate used for Board of Director's review.
  - ◊ The oversight functions include:
    - ▪ Board of Director's review and approval of proposed budgets, including proposed repairs, outlays, and accruals;
    - ▪ Review of capital expenditures;
    - ▪ Approval of annual financial reports and considerations of any management comments noted; and
    - ▪ Long-term asset management reviews.
- Any investor asset management fee, investor service fee, or similar fee may be paid solely from the annual Return to Owner and may not be paid from project operating funds. This is not the same as the Non-Profit Asset Management Fee.

2. *Operating and Maintenance Expense Schedule*

Operating and Maintenance Expenses entered in this section are broken down as indicated on the appropriate lines according to the following categories:

- Operating and Maintenance include items such as maintenance payroll, painting, snow removal, and grounds. Borrowers should include expected unit turnover expenses, based on the properties historic turnover rate, in the operating budget. Turnover expenses, such as the replacement of a refrigerator, scheduled unit carpet cleaning, curtain or flooring cleaning or replacement, painting, etc. should be treated as a normal operating occurrence and do not represent a reserve account need. If the unit sustains damages beyond reasonable wear and tear, then an exception may be warranted, as the costs may be abnormal. This is not the typical situation. If an item is budgeted in the annual operating budget as an operating expense, the item must be paid for out of the operating budget, unless it is a circumstance beyond the borrower's control.

- Utilities include only utilities paid by the project. Utilities paid by the tenant are not included on this form.
- Administrative expenses are project expenses only and do not include expenses that a management firm incurs. The management fee and the services performed for the fee are defined in the 7CFR 3560.102 (i)(1) , Management Certification and or Management Agreement. The Management Plan establishes the systems and procedures that will be employed on site to ensure that project operations comply with Agency requirements.
- Taxes and Insurance expenses include all project insurance and real estate taxes or any special assessments or other taxes allowed.

3. Account Budgeting/Status

This section of the budget reflects the projected reserve account. The balances of the other accounts are not completed for budgeting purposes, only when actuals are received.

The Loan Servicer must review the reserve account levels and contributions to ensure that they are consistent with the loan agreement. The review focuses on four items:

◊ **Beginning balance.** The Loan Servicer should review the beginning balance of the reserve account to ensure accuracy.

◊ **Transfers to reserves.** The Loan Servicer should examine the budget to ensure that the appropriate dollar amount, as specified in the loan agreement/loan resolution, is budgeted for deposit in the reserve account.

◊ **Transfers from reserves.** Any transfers from the reserve account that are included in the budget should be described in the budget narrative and justified by the capital plan.

◊ **Ending balance.** The ending reserve account balance is calculated by taking the beginning balance, adding the transfers to the reserve account, and subtracting the transfers from the reserve account.

If the Loan Servicer finds that the reserve account level is not where it is supposed to be, that the budget does not show correct contributions to reserves, or that transfers from reserves are not adequately documented, then the borrower must submit corrected budget documents.

4. Rent Schedule and Utility Allowance

The rent schedule documents the rent and utility allowance structure, and establishes the Rental Income entered in Form RD 3560-7, Part I, Line 1.

◊ The Basic Rent is the level required to cover all uses of cash and the repayment of the Rural Development loan at the interest credit reduced payment.

◊ The Note Rate rent is the level required to cover all uses of cash and the repayment of the Rural Development loan at the unsubsidized or promissory note rate.

When tenants pay some or all of their utility costs themselves, borrowers must establish a utility allowance to determine the amount tenants pay toward rent. The utility allowance is deducted from the total shelter cost calculated for the tenant, and the difference is paid by the tenant as rent. If the tenant is entitled to a utility reimbursement, management companies may issue a joint check payable to the tenant and utility company, if they choose.

5. Annual Capital Budget

The capital budget form, Form RD 3560-7, Part V provides information on plans for capital improvements. It lists all the capital items in the project, and provides space for the borrower to indicate their condition and any needed improvements. The Annual Capital Budget allows capital items to either be expensed from operations or capitalized from the reserve.

The borrower identifies major maintenance and replacement needs during the annual budget cycle and develops a schedule for making withdrawals from the reserve account to pay for their cost. These plans are incorporated by the borrower into the annual capital expenditure budget, and may also be reflected in the operating budget if the work is to be paid for out of operating income. Attachment 4-A offers guidance for budgeting capital items. The objective is to help ensure the borrower properly manages reserve account resources and establishes budgets to address the project's capital needs.

If the Loan Servicer finds the operating and capital budgets inadequate to keep the project in compliance with Agency standards for physical conditions *[7 CFR 3560.103]*, the Loan Servicer must request the borrower to modify the annual capital plan. The Loan Servicer may also request modifications if it is found that the borrower has proposed expenditures to be paid from reserves that should be charged to the operating account.

6. Narrative, Signatures, Dates and Comments

This section of the form will be used to complete the borrower's Budget Narrative, Signatures, Dates and Comments.

- ***Budget Narrative:***

  The budget narrative provides a description of the budget and highlights important elements to aid Loan Servicers in their review of the budget. The budget narrative must be completed or the budget will be considered incomplete.

  ◊ **Items to Be Covered in a Budget Narrative:**

  The following information should be included in the budget narrative.

  - A brief description of the project and its status. The description should address key indicators of project status.
  - A statement of project compliance. Indicate any outstanding monitoring findings and the progress in addressing the problems.
  - An explanation of projected capital expenditures and reserve withdrawals for the upcoming year and capital needs for the next three years.
  - A description of the project's overall financial status and important factors contributing to the changes. If the analysis reveals that the subtotal for any operating expense category (maintenance and operating costs, utilities, administration, or taxes and insurance) exceeds the tolerance threshold, the borrower will provide adequate documentation that the expenses for this category are reasonable and necessary. For example:
    - Costs are comparable to the costs for similar properties in the conventional market. In this example, the borrower might show that insurance costs for the same coverage at a conventional project are comparable to the costs for the project shown in the budget.
    - The factors contributing to the cost increases are beyond the borrower's control and the borrower is actively implementing cost-containment measures. For example, the project is subject to utility rate or tax increases.
    - The cost increase is needed to cover actions to address identified physical deficiencies that are not due to negligence by the borrower or the management agent. Physical deficiencies that are due to negligence by the borrower or the management agent are not acceptable reasons for a rent increase.

- ***Signatures:***

  The budget form requires signatures of the borrower. If the budget has been submitted electronically, a signed copy is not required to be submitted to the Agency. Agency approval may be by letter submitted electronically or by signing and returning form RD 3560-7.

- ***Comments:***

  Borrowers are encouraged to submit additional information detailing sources and uses of cash required. Detailed breakouts should relate to specific line subtotal al or total entry as listed on the form. Comments are encouraged to better explain the contents of the submitted budget. Use the comment area if additional disclosures or analyses are necessary. Rural Development Servicing Officials should document additional relevant information, or record issues or concerns noted during review.

C. Borrower Submission Requirements

The borrower should ensure that the project budget meets all the following:

- ***Complete Budget***

  The Budget is considered complete when the borrower has submitted the information listed in Exhibit 4-1.

- ***Changes in Rents***

  It may be necessary for the borrower to request Agency approval to effect a rent change as operating costs and/or revenues in a project fluctuate. Exhibit 4-3 shows the timeline for borrower submission and Agency review of rent change requests.

  All borrowers, including those using HUD project-based Section 8 contract assistance, must obtain prior Agency approval for a rent increase. Changes in rental rates will apply to all units in a project. Rent change requests for multi-family housing projects with no HUD subsidy are typically submitted and reviewed at the same time the borrower submits an annual budget for approval. Rent changes in HUD project- based Section 8 projects resulting from rent increases by HUD must also be reviewed and are not to be automatically approved. As with any Section 515 project, only the amount of rent necessary to cover project expenses must be approved.

- ***Annual Utility Allowance Reviews***

  The borrower should review utility allowances on an annual basis to determine whether any changes have to be made. The borrower should indicate no changes to utility rates in the budget narrative.

  ◊ **Setting Utility Allowances**

  The utility allowance is based on expected costs for utilities. Once established, the borrower must review the utility allowance annually. This is done in conjunction with the annual budget process. The borrower must submit documentation along with *Form RD 3560-7* to the Field Office using the following procedures:

1. A 12-month average will be used for the calculation.
2. Borrowers must establish utility allowances for each size and type of rental unit in the housing project based on utility costs.
3. Borrowers will request a change to the existing utility allowance if the proposed change is 10% or more.
4. A summary of the calculations must be submitted to the Servicing Official along with the *Form RD 3560-7*.
5. The borrower must obtain the following documentation describing the utility allowances and keep in the project files:
    - **Rate Changes**: Documentation of the rate changes may include billing information or documentation from utility companies;
    - **Usage**: Documentation of a 12-month sampling of tenant utility usage from the utility company. If tenant utility information is unavailable from the utility company or only provided at cost, utility billings received by tenants are acceptable**.**
    - **No Changes:** Documentation of no change in utility rates has occurred during the period being reviewed. A public release from the utility provider indicating no change in rates has occurred during the period reviewed is acceptable. The borrower should indicate no changes to utility rates in the budget narrative.

- ***Tenant Notification and Comments***

At the same time the borrower submits the initial notice to the Agency that it intends to submit a rent or utility allowance change request, the borrower will send or deliver notices to each tenant in the project notifying them of the rent change request that will be submitted to the Agency with their annual budget. *Handbook Letter 203(3560)* provides an example of such a notice. The borrower must also post this notice in a common area frequented by the tenants, such as the laundry room or near the mailboxes.

The notice must inform the tenants that they have 20 calendar days to provide their comments to the Agency. If during this time the Agency receives any tenant comments, these must be immediately forwarded to the borrower with the identity of the tenant protected. This can be done by either paraphrasing the comments for the borrower or by removing any identifying information from the correspondence received from the tenant before forwarding it on to the borrower. The Agency will respond to the tenant that their comments will be considered in the review of the budget.

Upon conclusion of the 20-day comment period, the Agency must notify the borrower of approval or denial within 10 days.

Exhibit 4-1 Information Required for a complete Budget Submission reflects information the borrower is required to submit on the annual budget for the project.

Exhibit 4-1
Information Required for Budget Submission to be Complete

1. *Form RD 3560-7* must be used to reflect the project's financial needs for the year and thereby rental charge requirements. A new operating budget for the fiscal year must show:

- Proposed budget at proposed new rents
- Annual Capital budget
- Narrative explaining why the rent and utility allowance change is necessary and addressing project financial stability and concerns;

2. *Actual utility costs.* Required documentation for utility costs as described earlier in this Chapter.

3. *HB Letter 203(3560)* Notice to Tenants (Members) Of Proposed Rent (Occupancy Change) And Utility Allowance Change (if applicable).

4. *Other information*. Any other information the borrower believes is necessary to justify the proposed rent and/or utility allowance change request.

- ***Documentation***

The borrower must fully document any rent and utility allowance change request. Requests for a rental charge change must be based on a realistic projected budget for the interim year or the ensuing full year. The borrower must provide to the Agency the information identified in Exhibit 4-1 with the rent or utility allowance change request.

The narrative attached to the budget form must clearly explain the necessity for the change request, and the Loan Servicer must analyze the supporting documentation to the budget and *Form RD 3560-7*, to see if it supports the request. For example, if the rent increase is due to increased taxes, then the Loan Servicer should look for copies of tax increase notices in the budget documentation. If the rent increase is due to an increase in general operating expenses, the Loan Servicer must review those expenses for reasonableness.

- ***Late Budget Submissions***

The schedule provided for budget reviews relies on timely submission of budget documents by the borrower. If the borrower is tardy in submitting required documents, the Agency cannot ensure that all deadlines will be met. Therefore, if a borrower submits the budget late, Agency deadlines no longer apply, and the borrower is not eligible for "automatic approval" of the budget (as discussed in Paragraph 4.14 D of this chapter). If no budget is approved by the end of the project's fiscal year, the borrower must operate under the previously approved budget (referred to as a Carry-Over budget) until the Agency reviews and approves the new budget.

- ***Carry-Over Budgets***

If a budget for the new fiscal year is not entered in MFIS before the first day of the fiscal year, a Carry-Over budget is automatically built from the prior year budget on the first day of the project's fiscal year by MFIS. This is necessary as the borrower has not presented an acceptable budget in time to be effective on the first day of the project's fiscal year and is, therefore, operating under the current existing budget, which would then become the Carry-Over budget.

When an acceptable budget is received, after the beginning of the fiscal year, a Mid-Year Budget will need to be completed.

- ***Mid-Year Budgets***

A Mid-Year Budget is a budget that has an effective date other than the first day of the project's fiscal year. This type of budget should be used if there is a change in rents or utilities on the project after the current budget has been approved. It should include operating income and expenses that would be expected for the next 12 months after the effective date of the budget. MFIS will prorate the budget correctly for analysis. The Mid-Year Budget will need to be added to MFIS with the new effective date. This process would also be used for transfers to establish the first budget.

A Mid-Year Budget may also be needed if the regular annual budget was not submitted and approved prior to the first day of the project's fiscal year and a Carry-Over budget went into effect.

Exhibit 4-2 Timeline Example for Carry-Over and Mid-Year Budgets provides an example of the timelines for Carry-Over and Mid-Year budgets and updates in MFIS.

Exhibit 4-2

Timeline Example for Carry-Over and Mid-Year Budgets

1. No budget was received by 1-1-XXXX	MFIS creates a Carry-Over budget using a 1-1-XXXX approved date.
2. Budget received 2-10-XX with rent change effective 6-1-XXXX	Create new budget in MFIS (Mid-Year budget) with effective date of 6-1-XXXX

Exhibit 4-3 Schedule for Budget Submission and Review provides the timeframes for project budget submission and its review by Loan Servicers.

Exhibit 4-3

Schedule for Budget Submission and Review

Budgets Without Rent Change	
60 calendar days prior to end of the project's fiscal year *November 1**	Borrower submits budget documents to Agency. Agency has 30 calendar days total to review the complete budget
30 calendar days prior to end of fiscal year *December 1*	Agency approves or denies the budget.** • If the budget was unacceptable, the borrower may submit additional information to address deficiencies within 10 calendar days. • Agency makes final approval or denial of budget within 20 calendar days of receipt of this additional information.
End of fiscal year *December 31*	Final approval or denial of the budget. If budget is denied, the current year's budget remains in effect.
Budgets With Rent Change	
90 calendar days prior to end of fiscal year *October 1**	Borrower notifies tenants of requested rent change *(Handbook Letter 203(3560)* and submits budget documents to Agency. • Tenants have 20 calendar day comment period to provide comments to the Agency. • Within 30 calendar days of receipt, the Agency must deny the budget or contact the Borrower to request additional information or clarification.
60 calendar days prior to end of fiscal year *November 1*	Agency provides notice to the borrower of budget approval or denial.** • If the budget was unacceptable, the borrower may submit additional information to address deficiencies within 10 calendar days. • Agency has 20 calendar days to review the additional information.
30 calendar days prior to end of fiscal year *December 1*	Agency gives final approval or denial of the budget. • If the budget is approved, tenants must have at least 30 calendar days' notice (*Handbook Letter 204(3560*) or notification required by local law before the rent increase takes effect. If the notices given to tenants at the outset stated the correct amount of the effective increase, then notice has been given. • If the rent increase is denied, the borrower may submit a revised budget at previously approved rents with expenditures acceptable to the Agency. In the absence of such a revised budget, the current year's budget remains in effect.
Beginning of project's fiscal year *January 1*	New budget and rent increase take effect.

* The dates provided are for a sample project with a fiscal year that begins January 1. For projects with different fiscal years, adjust accordingly.

** If the borrower submitted the budget on time, and has not been notified by the Agency of any deficiencies by this time, the budget is considered approved unless it is not eligible for automatic approval.

D. Agency Review Requirements

Loan Servicers must take the steps shown in Exhibit 4-4, Steps in the Budget Review and Approval Process, when reviewing and approving budgets.

Exhibit 4-4

Steps in the Budget Review and Approval Process

- Follow procedure for receipt of budgets;
- Prioritize budgets for review;
- Review outstanding monitoring findings;
- Review the budget for reasonableness;
- Review the rent change, if requested; and
- Approve or deny the budget.

Budgets for projects that receive HUD project based Section 8 assistance need to be reviewed with the same rigor as other projects. However, there are certain procedures that differ. These procedures are discussed later in the chapter.

1. Receiving the Budget

Standard procedures for budget receipt will help Loan Servicers track the progress of budgets through the approval process and meet approval deadlines. Further, intake procedures should help prioritize the review of budgets so that those with the highest priority (e.g., those with rent changes) receive the attention they need in a timely manner.

The following steps are taken upon receipt of budget submissions:

- When hard copies of the budget are submitted, the documents should be date stamped, entered into MFIS (complete transmitted date and input the financial details), and forwarded to the appropriate Servicing Official for review.
- When budgets are transmitted through MINC, the Loan Servicer will find the budget under Industry Interface in MFIS. If the budget transmission is accepted, the system will complete the transmitted date for this item. The following items are needed for the budget to be accepted by the MFIS system:
  - ◊ Effective day must be 1st of the month.
  - ◊ Effective day must be within fiscal year range.
  - ◊ The budget cannot be in approved status.
  - ◊ The type of units identified in the rent schedule submitted must match the units identified in MFIS and must support all project units.

◊ Budget line items identified as 'Other' must contain a supporting detailed comment.

- If the budget is complete, the budget review should continue as described in the following sections, and the received date will be completed in MFIS. Refer to Exhibit 4-1 for complete budget requirements. If the budget is incomplete, the Loan Servicer must take the steps described below.

- Incomplete Budgets

  If any items are missing or are of such poor quality that there is insufficient information to begin an assessment of the budget, the budget is considered incomplete.

  If the budget submission is incomplete, the Loan Servicer must contact the borrower, stating that the budget is incomplete, and discuss the deficiencies.

  ◊ If the borrower submits the information within 10 days, the budget is considered to be on time, and the review can still be completed prior to the end of the fiscal year. The budget is eligible for automatic approval, as described later in this chapter.

  ◊ If the borrower does not submit the requested information within a 10-day time period from the Agency's contact, the Agency cannot guarantee approval of the budget before the beginning of the new fiscal year. In these cases, the borrower must continue operations under the previous year's budget until a budget is approved. The borrower is not eligible for automatic approval as described in Paragraph 4.14 D, and the budget will be returned unapproved.

  ◊ A notice should be sent to the borrower when it is determined the budget is past the deadlines set by the Agency.

- **Agency Review Time**

  The total Agency review time for a budget from submission to initial approval or denial is 30 calendar days for budgets with or without rent increases.

  If the initial budget is denied, this schedule allows for a second review of the budget and approval (if appropriate) before the start of the fiscal year. However, the Agency must take final action on all budgets within <u>60 calendar days</u> of receipt of the borrower's budget.

2. Prioritizing Budgets for Review

After budgets have been received and determined to be complete, the Loan Servicer should prioritize budgets for review. Prioritizing the budgets helps to ensure that the budgets that require the most thorough review receive the attention they need. Budgets with the highest priority for review include budgets for projects with:

- Requests for rent increases above $25/month;
- Vacancy rates above the allowable threshold; and
- Past monitoring findings.

While Loan Servicers should place the highest priority on reviewing these budgets, they should plan their time to allow for sufficient review of all budgets.

3. *Reviewing Outstanding Monitoring Findings*

Having determined that the budget submission is complete, the Loan Servicer must check the project for outstanding monitoring findings, and assess whether the borrower's budget reflects adequate efforts to address these findings.

- If the outstanding monitoring issues have been adequately addressed in the budget, the Loan Servicer should proceed with the review for reasonableness.
- If project compliance issues have not been addressed, the budget documents should be returned to the borrower for revision.

4. *Review the Budget for Reasonableness*

If all outstanding compliance issues have been addressed, the Loan Servicer must review the budget for reasonableness. The Loan Servicer must use the steps outlined in Attachment 4-D to make a determination of reasonableness. These review items are automated in the MFIS budget analysis process.

- Review Form RD 3560-7 to verify that all appropriate line items are completed. Perform a quick assessment to ensure that they appear to be completed properly.
- The budget analysis must be completed prior to entering an "Approved" date in the Supervisory Activity of MFIS. The analysis will reflect areas of observations and review items.
  - ◊ Observations are the results of a test performed that may be of importance to the loan servicer.
  - ◊ Review items are the results of a test performed that require comments as documentation of the review.

  Just because an item is brought out as an observation or review does not necessarily mean the budget cannot be approved.

  Attachment 4-D shows the items included in the analysis and how they are calculated.

◊ Ratio analyses are reflected in the Budget Analysis in MFIS. Ratios are an effective tool for financial analysis. They prescribe various measures of actual operating performance. The ratios should be reviewed for a comparative analysis. The Loan Servicer should become familiar with these percentages as a comparative analysis, and consider utilizing the Hyperion MFH Budget Line Item Comparative Cost data report for their Region in their analysis. The ratios run in the MFIS Analysis Review are described in Attachment 4-D.

◊ Norms are also reviewed on the Budget Analysis. The Norms are based on Regional Groupings of "like" properties. This gives the Servicer an analysis of how the property is performing compared to other "like" properties. The norm definitions are described in Attachment 4-D.

- Determine whether the ending cash balance exceeds the permissible limit. If it does, the surplus must be contributed to reserves to address capital needs, be deposited in the project's reserve account, or applied to the loan balance to reduce the debt service on the borrower's loan. Based on the surplus, the Agency may require a rent decrease.

- Verify that the capital budget is complete. Capital improvements including implementing a borrower's transition plan, and Capital Needs Assessment (CNA) should be included as part of the capital budget portion of Form RD 3560-7 when applicable. Compliance-related costs include reasonable fees and costs for preparing self-evaluations and transition plans.

- Annual Capital Expenditure Budget

  The Loan Servicer uses the budget cycle to assess the borrower's annual capital expenditure budget compared with available information about the types of capital improvements needed to maintain the project's physical condition. Independent sources of information such as insurance actuary tables, FANNIE MAE Physical Needs Assessment Guidance to the Property Evaluator or Agency documentation should be consulted for common costs and repair/replacements schedules.

Independent resources of information such as insurance actuary tables, FANNIE MAE Physical Needs Assessment Guidance to the Property Evaluator or Agency documentation should be consulted for common costs and repair/replacements schedules.

The Loan Servicer reviews the operating and annual capital budgets, and compares them with previous budgets, site visit reports, physical inspections, capital needs assessments, and audit reports. When doing so, the Loan Servicer should consider the following questions:

- ◊ Are expenditures sufficient to maintain the project according to the Agency's performance standards and the requirements of the project management plan?

- ◊ Were any essential items of maintenance deferred during the past year, which should be financed from the upcoming operating or capital budget?

- ◊ Are there any uncorrected defects noted in site visit reports that should be financed from the upcoming operating or capital budget?

- ◊ Has a Capital Needs Assessment (CNA) of the property been prepared? Does the budget match the prepared CNA?

- ◊ Is the amount budgeted for maintenance and replacement reserve expenditures sufficient to address immediate capital needs?

- ◊ If capital needs information is available from a prepared CNA, are replacement reserve contributions and funding levels sufficient to address anticipated capital needs over the next 5 years? Does the CNA need to be updated?

5. Review the of Rent Change Requests

When the borrower submits a budget with a rent or utility allowance change request, the Agency must respond to the borrower within 30 calendar days of submission. If the Agency does not contact the borrower, the borrower may assume that any rent change request of $25 per month or less has been automatically approved.

Even if the Loan Servicer has determined that the budget is reasonable based on the tests outlined in Attachment 4-D, the rent increase must still be reviewed to confirm that the rent/utility allowance change will not adversely affect the marketability of the units and create a vacancy problem. If a review of the rent increase shows that the rent increase will adversely affect the marketability of units, the full rent increase cannot be approved. The borrower should seek a reduced rent increase and, if appropriate, request a servicing action that will enable the project to achieve a positive cash flow at lower rents. The Agency will not consider rent increases based solely on guaranteeing that the borrower will receive an ROI at the end of the project's fiscal year.

a. Circumstances in which the Agency Will Not Approve a Rent Increase

The Loan Servicer must not approve a rent increase under the following circumstances:

- The borrower is able but unwilling to comply with program requirements. Such a borrower has ignored repeated requests from the Loan Servicer to take servicing actions by a specified deadline.

- If the borrower is in default of the Agency loan agreement and does not have an Agency-approved workout plan, or is not in compliance with an Agency-approved workout plan.

- There are sufficient project funds under the existing rents to meet project operating expenses, and the borrower is not able to justify the higher rents. Such a condition is established when the project budget shows that income meets expenses at current rent levels.

- The project is operated on a for-profit basis, and the rent change would result in rents higher than what tenants can afford. This condition is established by comparing rents with 30 percent of tenant-adjusted incomes. If it is shown that tenants would be paying in excess of 30 percent of their adjusted incomes with new rents and the increase is not necessary to meet projected costs, then the increase must not be approved.

Addressing Rent Increases

Loan Servicers must make every effort to review budgets with significant rent increases within the time limits. Postponing approval is not an acceptable way to address rent increases.

b. Denial of Rent Change Requests

If the Loan Servicer denies the change request, the borrower must be notified of the denial and be provided with appeal rights. (See Chapter 1)

c. ***Effective Dates of Change***

The effective dates of any approved changes will coincide with the start of the project's fiscal year or the start of the season for labor-housing projects. For a rent/utility change request on which comments were solicited and the amounts were increased from the original notice, the borrower must deliver a notice to tenants, using Handbook Letter 204 (3560), announcing the rent or utility allowance increase to be effective 30 calendar days (or in accordance with local regulations) from the date of the notification. If the rent/utility increase will be the same as what was stated in the initial notice to the tenants, HB Letter 204 (3560) will not be required. The initial notice then serves the purpose of "the notice".

If the rent/utility change figure from the original notice is revised downward, the borrower must notify the tenants of their new rents prior to the first day of the month in which the new rent amounts are due. However, the borrower does not have to give a 30-day notice of the new rents in this case.

For notices to tenants, see Appendix 4.

d. ***Rent Change Requests Under Special Circumstances (Mid-Year Budgets)***

The Loan Servicer may accept borrower requests for rent or utility allowance changes at times other than with the annual budget submission. Under special circumstances if a change is necessary to preserve the financial integrity of a project and the financial distress is due to circumstances beyond a borrower's control, a change request may be considered. Such circumstances might be in the event of a natural disaster or when workout procedures are necessary.

When a Plan II housing project is experiencing severe vacancies due to market conditions, the Agency may allow the borrower to charge a Special Note Rent (SNR) that is less than Note Rent but higher than Basic Rent, to attract or retain tenants whose income level would require them to pay the SNR. The requirements for receiving an SNR are established in Chapter 10 of HB-3-3560.

Both of these situations would require a Mid-Year Budget be submitted to the Agency for approval.

e. Approving Utility Allowances

Agency Staff must review the utility allowance documents submitted with the budget to make sure that the numbers being used are reasonable and comparable to other projects in the same market area. In addition, the Loan Servicer should check project budgets of any other Agency-funded projects in the area to see if utility allowances are similar.

f. Rent Changes for Units Receiving HUD Project-Based Section 8 Assistance [7 CFR 3560.207, and HUD's Section 8 Renewal Policy Guide Book, Chapter 14]

The Agency has the responsibility to review and approve project budgets on an annual basis based on need to meet cash flow and expense requirements. Therefore, the Loan Servicer will not take into account HUD's automatic annual adjustment for Section 8 contract rents. The Loan Servicer must approve only the rents needed to provide sufficient income to meet approved project expenses.

The agreement in the Memorandum of Understanding (MOU) between HUD and Rural Development indicates that the RD-approved budget will be submitted to HUD by the Project Owner, and will serve as the basis for the budget-based rent in the contract renewal process. The rents at initial renewal will be determined by the HUD staff, who will compare the RD-approved, budget-based rent as submitted by the Project Owner to the current rents adjusted by an Operating Cost Adjustment Factor (OCAF), and will set the contract rent at the lesser of the two amounts. HUD staff will then notify both ~~the~~ RD and the owner of the new contract rents. Rent adjustment at subsequent renewals will be determined by OCAF unless the owner requests and HUD approves a budget-based increase that has been approved by RD.

Since HUD- and Agency-approved rental rates frequently differ, it may be necessary to have a 3-column budget in properties with HUD project-based Section 8 contracts. Exhibit 4-5 Reviewing Budgets with HUD Subsidies depicts how many columns are required in the budget, depending upon the project type.

Exhibit 4-5

Reviewing Budgets with HUD Subsidies

Project Type	Rents Needed In Budget
• **Section 8/515 without interest credit**.	• Note Rate Rent (HUD contract rent); difference is excess funds and deposited into reserves.
• **Section 8/515 with interest credit**.	• Basic Rent, Note Rate Rent, and HUD contract rent.

When reviewing the budget, if the Loan Servicer concludes that the HUD-authorized rent is more than what is needed to meet project expenses, a lesser amount than the HUD rent must be approved. When this occurs, in accordance with Exhibit 4-6 Impact of Interest Credit Agreement on Ability to Cancel Interest Credit, Collect Overage, and Deposit Excess Funds in the Reserve Account, the borrower must deposit the difference between the Agency-approved Note Rate Rent and the higher HUD-authorized rate into the reserve account. The manager or borrower must use Form RD 3560-29, Notice of Payment Due Report, to document the required deposit in the reserve account. The Loan Servicer will monitor this deposit when reviewing the year-end actuals.

If excess HUD rents accumulate in the reserve account beyond the sum shown in the borrower's loan agreement or resolution, the Loan Servicer may reduce or cancel the interest credit on the project. The Agency may reinstate interest credit whenever HUD rent becomes lower than the Agency Note Rate Rent, determined by the Interest Credit Agreement. Refer to Exhibit 4-5.

Before depositing excess funds in the reserve account, the borrower may have to collect overage. Whether overage is collected and a project is subject to cancellation of interest credit depends upon the issuance date and execution date of the project's interest credit agreement.

Certain early versions of the Interest Credit Agreement do not have a legal basis to support the Agency's policy to cancel interest credit or collect overage to offset interest credit. Each HUD project-based Section 8/515 project needs to be categorized according to the issuance date and execution date of the project's Interest Credit Agreement on Form FHA 444-7, Interest Credit Agreement or its successor Forms FmHA 444-7, FmHA 1944-7, and RD 3560-9.

Exhibit 4-6 Impact of Interest Credit Agreement on Ability to Cancel Interest Credit, Collect Overage, and Deposit Excess Funds in the Reserve Account provides a description of the rules that apply to each interest agreement form.

6. *Approval or Denial of Budgets*

Once the budget analysis is complete, Loan Servicers must notify the borrower whether the budget has been approved or denied.

Exhibit 4-6

Impact of Interest Credit Agreement on Ability to Cancel Interest Credit,

Collect Overage, and Deposit Excess Funds in the Reserve Account

Form	Executed Before October 27, 1980	Executed On Or After October 27, 1980
FHA 444-7, dated 11/17/69 and 7/27/72	No basis to cancel or reduce interest credit, collect overage, or deposit excess funds in the reserve account unless the borrower agrees.	Legal basis exists to cancel or reduce interest credit, collect overage, and deposit excess funds in the reserve account and/or apply it on the loan.
FmHA 444-7, dated 10/13/77	• If first, second, fourth or fifth block of paragraph 2 checked, no legal basis to cancel or reduce interest credit, collect overage, or deposit excess funds into reserves. • If the third block of paragraph 2 is checked, no legal basis to cancel or reduce interest credit, unless borrower agrees. However, there is legal basis to collect overage and deposit excess funds to reserves and/or apply it on the loan.	Legal basis exists to cancel or reduce interest credit, collect overage, and deposit excess funds in the reserve account and/or apply it on the loan.
FmHA 1944-7, dated 11/29/82		Legal basis exists to cancel or reduce interest credit, collect overage, and deposit excess funds in the reserve account.
FmHA 1944-7, dated 4/85		Legal basis exists to cancel or reduce interest credit, collect overage, and deposit excess funds in the reserve account.

a. Budget Approval

If a budget is received with reasonable operating expenses and a rent increase request to cover turnover costs and maintenance costs in line with comparable properties, the Agency should not artificially hold down rents and make it an unworkable situation. In some cases, rents may need to be increased. When market conditions do not allow for sufficient rents to fund both operating and capital needs, the workout authorities of 7 CFR

3560, Paragraph 3560.453 should be reviewed for their applicability in the situation.

If the Loan Servicer has determined that the budget represents reasonable costs and adequately addresses all outstanding compliance issues in the budget, the reserve account is current, and the rent change (if requested) is acceptable, the budget may be approved. To approve the budget, Loan Servicers must acknowledge approval (*Form RD 3560-7*). This acknowledgement may be by letter if the budget was submitted electronically, or by signing, and returning a copy of the form to the borrower with a cover letter. The Loan Servicer must also enter the approval date in MFIS. If the approved rent/utility change is increased from the originally posted change, the borrower must deliver a notice to tenants announcing the rent or utility allowance increase to be effective 30 calendar days (or in accordance with local regulations), from the date of the notification using Handbook Letter 204 (3560).

b. Automatic Budget Approval

Budgets that are not reviewed within the 30-day period are automatically approved unless:

◊ The budget proposes a monthly rent increase above $25/month per unit; or

◊ The budget is submitted late or misses other deadlines set by the Agency.

If a budget is not eligible for automatic approval and no decision is made prior to the beginning of the project’s new fiscal year, the borrower must continue operations under the previous year’s budget. A denied date must be completed in MFIS at this time. In these cases, the Agency must continue to work with the borrower to address the requested increase. When agreement is reached, a new budget may take effect.

A notice will need to be sent to the borrower when it is determined the budget submission is past the deadline set by the Agency. If no response is received within timeframes established in the notice, servicing actions will begin using Servicing Letter #1 (HB-3, HB Letter 301 (3560)).

c. Procedure for Automatic Approval.

In the case of automatic approval, the Loan Servicer must still acknowledge approval (Form RD 3560-7). This acknowledgement may be by letter if the budget was submitted electronically, or by signing and returning a copy of the form to the borrower with the letter.

d. Budget Denial

If the Loan Servicer denies the proposed budget because it is found to be unacceptable for reasons related to outstanding monitoring findings, cost reasonableness, reserves, or a rent increase, the borrower has an opportunity to address the deficiencies.

◊ The Loan Servicer must return the proposed budget to the borrower with a letter listing deficiencies.

◊ The Loan Servicer must enter the appropriate 'Denied' tracking step in MFIS.

◊ The borrower has 10 calendar days to submit new information to the Agency. The borrower may adjust the size of the rent increase requested or provide new documentation to justify budget items.

◊ The Loan Servicer must review the new submissions within 20 calendar days of receipt, and either approve or deny the budget.

◊ If the budget is approved based on the new submissions, the Loan Servicer must acknowledge approval. Approval may be by letter submitted electronically or by signing and returning a copy of the form to the borrower. MFIS will be updated by removing the "Denied" step and populating the "Approved" step.

◊ If the budget is denied based on the new submission, the Loan Servicer must send the borrower a letter stating the deficiencies, and informing the borrower that the previous year's budget remains in effect. The borrower must be given the option to submit a new budget using the previous year's rent levels but adjusted for projected capital expenditures and other known changes for the coming year. The borrower may appeal the budget denial in accordance with Agency appeal procedures.

SECTION 5: REPORTING AND FINANCIAL EXAMINATION

4.15 MONTHLY AND QUARTERLY REPORTS *[7 CFR 3560.307]*

A. Overview of Reports

Financial reporting provides the Agency and the borrower a means to monitor the project's financial progress.

- **Quarterly reports.**

  Quarterly reports, based on a Borrower's Fiscal Year are required in the following situations:

- At completion of new construction or substantial rehabilitation;
- When the project is subject to a workout agreement; and
- In the case of reamortization and transfer of an existing project loan.

- **Monthly reports.**

  Loan Servicers may require borrowers to prepare and submit reports on a monthly basis when additional tracking and supervision are needed. For example, when a project is subject to a workout agreement; when there has been a violation of program rules or reporting requirements; or, when the project shows signs of financial distress.

  Loan Servicers may discontinue the monthly reporting requirement for projects that have demonstrated consistent compliance with program requirements over a sufficient time period. Generally 12 months of consistent compliance is considered sufficient to discontinue the reporting requirements.

B. Review of Monthly and Quarterly Reports

The borrower must submit the required reports following the close of the reporting period (quarter or month, as appropriate), and submit them to the Agency by the 20th of the month following the reporting period via the MINC system. Upon receipt, the Loan Servicer must review the analysis report as indicated in Attachment 4-D, and review the following:

◊ Look for red flags such as dramatic changes in income, expenses, the general operating account, or the reserve account.

◊ Check balances in accounts as referenced in Paragraph 4.3 Overview of Accounts in this chapter, to make sure they are consistent with the management plan, loan agreement/resolution, and the budget.

◊ Check project expenditures against the budget. Make sure the project is being operated in accordance with the approved budget.

◊ Check progress against workout agreements. Make sure the borrower is taking any actions indicated in a workout agreement and is abiding by the established schedule for these actions.

4.16 PREPARATION OF ANNUAL FINANCIAL REPORTS [7 CFR 3560.308 and 7 CFR 3560.578]

A. General Requirements for All Borrowers: Annual Financial Reports

To ensure that the project is in sound financial condition and is complying with the program financial management requirements, the Agency requires annual financial reports to be submitted by each borrower.

All borrowers who have a Section 515 Rural Rental Housing loan or a Section 514 Off-Farm Labor Housing loan must comply with the financial reporting requirements of this section. Projects with fiscal years ending 12-31-19 and after are to follow the reporting requirements outlined here in Section 4.16.

Combined Federal Financial Assistances is defined as a combination of any or all of the following sources:

- Outstanding principal balance at the beginning of the fiscal year of a U. S. Department of Agriculture (USDA) Mortgage, a mortgage insured by the Federal Housing Administration (FHA) or HUD- held mortgages or loans (including flexible subsidy loans);
- Any USDA Rental Assistance or Project based Section 8 assistance received during the fiscal year;
- Interest reduction payments received during the year (interest subsidy);
- Federal grant funds received during the year and/or;
- Outstanding principal balance at the beginning of the fiscal year of an existing USDA Section 538 Guaranteed Rural Rental Housing loan.

Exhibit 4-7 Year End Financial Reporting Requirements outlines the financial reporting requirements for specific types of properties.

Exhibit 4-7
Year End Financial Reporting Requirements
For-Profit or Limited Profit

Total Borrower Federal Financial Assistance*	Forms RD 3560-7 and 3560-10	Borrower Certification Of Performance Standards	Uniform Administrative Requirements Audit required in accordance with RD Audit Guide*
RD Borrower with **less than $500,000** in Federal financial assistance	Yes	Yes	No
RD borrower with **$500,000 or greater** in **F**ederal financial assistance	Yes	Yes	Yes**

State and local Governments, Indian tribes and Non-Profit Organizations

Total Borrower Federal Financial Assistance*	Forms RD 3560-7 and 3560-10	Borrower Certification of Performance Standards	Single Audit in accordance with 2 CFR part 200 subpart F
RD Borrower with **less than $750,000** in Federal financial assistance	Yes	Yes	No
RD Borrower with **$750,000 or greater** in Federal financial assistance	Yes	Yes	Yes***

*__See RD Audit Determination Worksheet and Major Program Determination – Attachment 4-G__. Compilation of Prescribed Forms may be necessary, if an audited financial statement is not required by another federal agency or other business agreement,

**Must be completed by a CPA

__***__In accordance with the Council of Financial Assistance Reform (CoFAR) uniform guidance. This Single Audit is in accordance with 2 CFR part 200 subpart F, Appendix XI Compliance Supplement; and submitted to the Agency as part of the financial reporting requirements.

For projects with 8 units or more, borrowers will be required to submit Forms RD 3560-7 and 3560-10 electronically through MINC. The Agency may make an exception to these requirements if the borrower submits documentation that the costs associated with electronic submission would pose a financial hardship to the project. Borrowers with fewer than 8 units may submit hard copies to the Agency within 90 calendar days of the project's fiscal year end.

B. Budget Actuals and Balance Sheet

Year-end reporting requirements include the use of ~~2 forms,~~ Forms RD 3560-7, Multiple Family Housing Project Budget/Utility Allowanc**e** Budget Actuals and Form RD 3560-10, MFH Borrower Balance Sheet.

- Form RD 3560-7 is used for end-of-year reporting using actual income and expenses.
- Form RD 3560-10 is a summary of the balances of the accounts, a listing of the liabilities, long term debts, and an indicator of the net worth of the project.

If the borrower has accurately reported actual income and expenses, specific figures on the two forms should be the same.

- Ending balances of the accounts listed on Form RD 3560-7, Part III should match the balances listed on Form RD 3560-10, lines 1-4.
- Ending cash balance on Form RD 3560-7, line 33 should match the balances listed on Form RD 3560-10, lines 1, 2, 5, and 6. These checks are a part of the analysis run in MFIS.
- Since the borrower is using the accrual method of accounting, the accrual-to-cash adjustment, Form RD 3560-7, line 32 must equal the difference between lines 31 and 33. This ensures Form RD 3560-7, lines 31 and 33 match their respective figures on Form RD 3560-10. The sole purpose of this adjustment is to reconcile a company's internal ledger kept on an accrual basis to the IRS forms which are required to be on a cash basis.

Borrower signatures are required on these forms. If they are submitted electronically through MINC, signed copies are not required to be submitted to the Agency.

Borrower Certification of Performance Standards

All financial reports must include a Borrower Certification of Performance Standards. Attachment 4-F is used by the owner to certify to these standards. The Borrower or borrower representative must sign and date this self-certification.

The Borrower must self-certify:

◊ Required accounts are properly maintained and tracked separately;

◊ Payments from operating accounts are disclosed and accurately represented;

◊ Reserve amount is current and maintained in a supervised bank account in accordance with the provisions of 7 CFR part 1902, subpart A, i.e., contributions are on schedule, the balance accounts for contributions less authorized withdrawals; and there are no encumbrances;

◊ The replacement reserve account was used for authorized purposes in accordance with 7CFR 3560.306 (g)

◊ Tenant security deposit accounts are fully funded and are maintained in separate accounts;

- ◊ Payment of owner return (ROI) was consistent with the terms of the applicable loan agreement or loan resolution;
- ◊ Borrower/grantee has maintained proper insurance in accordance with the requirements of 7 CFR 3560.105; and
- ◊ All financial records are adequate and suitable for examination.
- ◊ There have been no changes in project ownership other than those approved by the Agency and Identified in the certification. All current owners are to be identified in the Status Report of Ownership table on Attachment 4-F. All Non-Profit organizations certify that the board is active and maintains oversight of the property.

- ◊ Real estate taxes are paid in accordance with state and/or local requirements and are current.

C. **Owner's Compilation of Prescribed Forms**

For-profit or limited profit borrowers that receive less than $500,000 in combined Federal financial assistance, for which there are no audit requirements per other agencies or agreements, will submit an annual owner certified compilation of prescribed forms containing Form RD 3560-7 and Form 3560-10 utilizing the accrual method of accounting in accordance with Statements on Standards for Accounting and Review Services (SSARS) promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants (AICPA), to include a full set of notes to the financial statements. Borrowers may use a CPA to prepare this compilation report of the prescribed forms.

E. Financial and Compliance audit utilizing HUD Office of Inspector General's (OIG) Consolidated Audit Guide standard. with RD Audit Guide

For-profit or limited profit Borrowers that receive $500,000 or more in combined federal financial assistance must submit an independent auditors' report to include financial statements and notes to the financial statements, supplemental information containing Agency approved forms for project budgets and borrower balance sheets, a report on internal control over financial reporting and on compliance and other matters based on an audit of financial statements in accordance with Generally Accepted Government Auditing Standards; a report on compliance for each major program and internal control over compliance (if applicable).

Borrower's s will utilize HUD's Office of Inspector General's (OIG) Consolidated Audit Guide located at https://portal.hud.gov/hudportal/documents/huddoc?id=20004OIGH.pdf in developing the audit. The audit will not utilize HUD's Chart of Accounts, nor will the report require the CPA to review tenant files, as this compliance test is being conducted by MFH field staff during regularly scheduled supervisory visits and annual improper payment auditing.

An audit will consist of the following items (financial statements issued in two year comparative format, as applicable~~)~~:

- Independent Auditor's Report
- Financial Statements
  - Balance Sheets
  - Statements of Operations
  - Statements of Changes in Partner's Equity (Deficit)
  - Statements of Cash Flows
- Notes to the Financial Statements
- Supplemental Information
  - Management Fee Calculation
  - Insurance Disclosure
  - Return to Owner
  - Changes in Rental Property
- Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards
- Independent Auditor's Report on compliance for each major RD program and Internal control over Compliance
- Audit Findings on Compliance
- Multiple Family Housing Borrower Balance Sheet and supporting documentation – Form RD 3560-10
- Multiple Family Housing Project Budget and supporting documentation - Form RD 3560-7

F. Standards for State and local governments, Indian tribes, and Non-Profit Organizations

1. State and local governments, Indian tribes, and Non-Profit Organizations that receive less than $750,000 in combined Federal financial assistance and there are no audit requirements per other agencies or agreements will submit an annual owner certified compilation of prescribed forms containing Form 3560-7 and Form 3560-10 utilizing the accrual method of accounting in accordance with Statements on Standards for Account and Review Services to include a full set of note to the financial statement. A CPA may be used to prepare this compilation of the prescribed forms.

2. State and local governments, Indian tribes, and Non-Profit Organizations that receive $750,000 or more in combined federal financial assistance must submit audits in accordance with 2 CFR 200, Part F , and the Office of Management and Budget's (OMB) Uniform Administrative Requirements, Cost Principles and Audit Requirements for Federal Awards. Copies of the audit will be forwarded

by the borrower to the Servicing Official and the appropriate Federal cognizant agency for audit. Within USDA, the USDA, OIG fulfills “cognizant agency” for audit responsibilities, (see “cognizant agency” defined 7 CFR 3052.105).

The auditor may refer to the American Institute of Certified Public Accountants (AICPA) for additional guidance in meeting audit requirements.

Organizations subject to 2 CFR 200, Part F, must submit the single audit along with the borrower’s certified performance standards (Attachment 4-F), Forms RD 3560-7, and 3560-10.

Other Financial Reports

- **Additional opinions.**

  The Agency may require additional opinions of financial condition and compliance, such as audits, to ensure the security of the asset; to determine whether the project is being operated at a reasonable cost; or to detect fraud, waste, or abuse.

- **Annual financial statements.**

  Any project audits independently obtained by the borrower must be submitted to the Agency.

G. Annual Financial Reporting Due Dates and Agency Review of Annual Financial Reports

1. Annual Financial Reporting Due Date

Annual financial reports including *Form RD 3560-7* with 12 months of actual income and expenses, *Form RD 3560-10*, compilations of prescribed forms, certification of performance standards and audits, as appropriate, msut be submitted to the Agency no later than 90 days following the close of the project fiscal year. 2 CFR §200.512 allows the audit to be submitted within the earlier of 30 days after receipt of the auditor’s report, or 9 months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit.

If the annual financial reports cannot be submitted by the due date, the borrower must present a request for extension supported by evidence that delay is at the request of the auditor, and the request has a reasonable explanation of why an extension of the due date is needed. The Servicing Official may authorize up to a 30-day extension of the due date.

If an explanation is not forthcoming from the Borrower, or the explanation received is without good reason, or the Servicing Official otherwise suspects fiscal difficulty, the Servicing Official may request the borrower to submit to the

Servicing Office for review, the project bank statements for the general operating, reserve, and investment accounts covering the most recent 60 day period.

If the borrower fails to submit the requested bank statements by the date stipulated by the Servicing Official, the Servicing Official will immediately refer the matter to the OIG.

The Servicing Official may authorize the initial verification of review to cover a period up to 18 months for a new project whose first operating year was less than 6 months or when an existing owner changes their fiscal year.

2. **Agency Review of Annual Financial Reports**

Loan Servicers must review financial reports within 60 days of receipt, in accordance with guidelines provided in Attachment 4-D to ensure that they meet Agency requirements. Loan Servicers will complete the checklist provided as Attachment 4-K. In particular, Loan Servicers must:

◊ Confirm that the engagement (audit report) was conducted as described in the requirements above;

◊ Confirm that the performance standards were certified as described above;

◊ Confirm that non-profit and public bodies have submitted any OMB required annual financial statements;

◊ Note any findings identified in the engagement and determine corrective actions. These would be located in the findings of the audit findings page;

◊ Utilize the MFIS analysis tool to perform the preliminary assessment of the financial statements. Refer to Attachment 4-D for the Analysis process;

◊ Confirm the information on *Forms RD 3560-7 and 3560-10,* submitted to the Agency electronically through MINC, is the same as the forms submitted with the financial reports from the auditor.

◊ If the Loan Servicer has determined that the annual financial reports are suitable, the reports may be accepted. To approve the financial reports, Loan Servicers must acknowledge acceptance (*Form RD 3560-7*). This acknowledgement may be by letter if the report was submitted electronically, or by signing and returning a copy of the form to the borrower with a letter. The Loan Servicer must also enter the final reviewed date in MFIS.

◊ If the Loan Servicer has determined that the annual financial reports are not acceptable, a notice will be sent to the borrower explaining the issues, and requesting a response within 30 days. If no response is received from this notice, servicing actions will begin using Servicing Letter #1 (HB-3, HB Letter 301(3560).

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ATTACHMENT 4-A
CAPITAL EXPENDITURES

TYPICAL RESERVE ACCOUNT USE

Items traditionally contemplated as eligible for draws from the reserve account include capital items such as (but not limited to):

1. Unless shown in the operating budget, replacement of range hood, refrigerators, ranges, washer, dryers and other major appliances in the dwelling units.
2. Flooring and Carpeting.
3. Extensive replacement of kitchen and bathroom sinks and countertops, bathroom tubs, toilets, and doors (exterior and interior).
4. Extensive unit clean up and repairs due to tenant death, misuse of unit, damage or vermin eradication.
5. Kitchen cabinet or bathroom vanity replacement.
6. Unless shown in the operating budget, window coverings – blinds, draperies.
7. Replacement or major overhaul of central air conditioning and heating systems, including cooling towers, water chilling units, furnaces, stokers, boilers, and fuel storage tanks.
8. Major plumbing and sanitary system repairs.
9. Permanent improvements to the housing project, such as installing an energy-conserving heat pump.
10. Overhaul of elevator systems.
11. Systematic replacement of building or unit components.
12. Major roof repairs, including major replacements of gutters, downspouts, and related eaves or soffits.
13. Repainting of the entire building exterior.
14. Extensive replacement of siding.
15. Window system replacement.
16. Extensive window screen replacement.
17. Major landscape and grounds items, such as fencing, recreation areas, property signs, lawnmowers and snow blowers.
18. Major repaving/resurfacing/seal coating (sidewalks, parking lots, and driveways).
19. Extensive replacement of exterior (lawn) sprinkler systems.
20. Capital requirements identified in transition plan.
21. Automation equipment located on site.
22. Shortfalls in operating expenses beyond the control of the borrower and threatens life, safety, or the physical security of the project. Example: weather disaster.

23. Twenty-five percent of the interest earned on a reserve account during the prior year. [7CFR 3560.306 (h)(3)].
24. Return on Investment according to 7 CFR 3560.305 (a)(2)(i) which states: "Surplus cash exists in either the general operating account as defined in 3560.306(d)(1) or the reserve account, if the balance is greater than the required deposits minus authorized withdrawals…"
25. Improvements to accommodate reasonable accommodation/modification requests.

The reserve account should not be used to pay for unit turnover or routine maintenance costs; turnover and routine maintenance expenses should appear in the operating budget.

ATTACHMENT 4-B
AMENDMENT TO LOAN AGREEMENT/RESOLUTION
RESERVE ACCOUNT REQUIREMENTS

1. **PARTIES AND TERMS DEFINED.** This amendment hereby modifies reserve account requirements contained in Form ____________ dated __________________ signed by __________________________, herein called "Borrower" with the United States of America acting through Rural Development, United States Department of Agriculture, herein called the "Government." This amendment is necessary due to increased life-cycle needs, including equipment and facility replacement costs, and is supported by a Capital Needs Assessment, dated ____________.

2. **MODIFIED RESERVE ACCOUNT REQUIREMENTS.** Transfers at the rate not less than **$_______** (monthly) shall be made to the Reserve Account beginning _________ until the amount in the Reserve Account reaches the sum of **$________** or according to the scheduled listed at the bottom of this form, or such higher amount later agreed to with the Government and shall be resumed at any time necessary, because of disbursements from the Reserve Account to restore it to said sum. Withdrawal and use of funds deposited to this account will be in accordance with 7 CFR part 3560. With prior consent of the Government, funds in the Reserve Account may be used by the Borrower as provided for in the original document referred to in paragraph 1.
3. All other provisions of the prior executed document referred to in paragraph 1 above shall remain in effect.

Optional Schedule (if applicable)

Monthly Transfer	Beginning Date
$_______________	________________
$_______________	________________
$_______________	________________
$_______________	________________
$_______________	________________

______________________________ ______________________________
(Borrower) **(RD Representative)**

______________________________ ______________________________
(Borrower) **(Date)**

____
(Date)

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ATTACHMENT 4-C
ELIGIBLE PROJECT EXPENSES

There are generally accepted project expenses outlined in the MFH Regulation 7 CFR 3560.102 (management fee-related) and 3560.303 (project related) allowable expenses that should be charged to the operating account. *Text in boxed Italics* following the Regulation citation provides clarification on allowable expenses.

(b) Allowable and unallowable project expenses. Expenses charged to project operations, whether for management agent services or other expenses, *must be reasonable, typical, necessary and show a clear benefit to the residents of the property*. Services and expenses charged to the property must show value added and be for authorized purposes.

(1) Allowable expenses. Allowable expenses include those expenses that are directly attributable to housing project operations and are necessary to carry out successful operations.

(i) Housing project expenses must not duplicate expenses included in the management fee as defined in §3560.102(i).

> *"Sales tax" on management fees is not an allowable expense unless an exception has been granted by the Administrator for the State.*

(ii) Actual costs for direct personnel costs of permanent and part-time staff assigned directly to the project site. This includes managers, maintenance staff, and temporary help including their:

> - *Payroll and fringe benefits expenses included in the proposed budget must agree with the number of employees, positions, salaries, fringe benefits, health plans, etc. in the management plan and the property must be able to cash flow with the included expense(s).*
> - *Site personnel who oversee multiple properties must pro-rate the expense of benefits between properties. Wages will be charged per billing method to the property.*
> - *Large increases in site payroll or site maintenance should be supported by management plan changes. RD does not have to approve a budget that includes positions that are not shown in the management plan.*
> - *To be a project expense tasks must be project specific in nature.*
> - *Payment of supervisory positions are paid from the management fee bundle of services and not from project operations. See §3560.102(i)(1)(i).*

(A) Gross salary;

(B) Employer FICA contribution;

(C) Federal unemployment tax;

(D) State unemployment tax;

(E) Workers compensation insurance;

(F) Health insurance premiums;

> *-The management plan should identify site personnel. If there is a question about health insurance coverage for site employees, Servicing Officials should review the health insurance policy for confirmation of coverage and appropriate charges to the project.*
> *-Management's central office staff's health insurance is not a project expense.*

(G) Cost of fidelity or comparable insurance;

(H) Leasing, performance incentive or annual bonuses;

> *-This expense is for project-specific site personnel and should be included as part of the site compensation.*

(I) Direct costs of travel to off-site locations by on-site staff for property business or training; and/or

> *-On-site staff travel to and from the management company office to the property is an allowable expense. However, such travel should be reasonable. For example, maintenance staff should not routinely be sent out from the main office to do one thing each day when it would be more efficient to combine trips, or can be completed by the on-site maintenance person.*
> *-Other management company staff travel to and from the property is a management fee expense (see §3560.102 (i)(1)(xiii)(I))*
> *-Purchase of "company vehicles" for such travel is not an allowable project expense.*

(J) Retirement benefits.

(iii) Legal fees directly related to the operation and management of the property including tenant lease enforcement actions, property tax appeals and suits, and the preparation of all legal documents.

> *-Property legal fees are for the borrower or the project, and not for third-parties, such as investors or syndicators.*
> *-Fees must be paid by Borrowers from non-project funds for fines, penalties and legal fees when the borrowers are found guilty of civil rights or other violations.*

(iv) All outside account and auditing fees, if required by the Agency, directly related to the preparation of the annual audit, partnership tax returns and 401-K's, as well as other outside reports and year-end reports to the Agency, or other governmental agency.

-The account, auditing, partnership, and year end reports must be directly related to the property. It does not include individual tax filing expenses for any member of the ownership entity. Properties may have financial reporting requirements beyond that required by the Agency. If these are directly related to the property, and not the partnership or ownership, they are allowable project expenses. *-There are no regulatory caps on the audit expense, however if costs exceed the average for similar properties, confirm the audit is not of the partnership etc., which is a borrower expense.* *-Utilize Agency reports to assist in the comparison process of similar properties.*

(v) All repair and maintenance costs for the project including:

-Repair and maintenance expenses appear on the RD Form 3560-07 in Part II, lines 1-11. Capital expenses, which are discussed in §3560.103(c), should not appear in the operating repair and maintenance costs; capital budget expenses appear in Part V. *-There should be no manipulation of the budget or expenses to avoid taxes.* *-The reserve account should not be used to pay for typical unit turnover or routine maintenance costs; these should appear in the operating budget. Excessive repairs due to death in the unit, drug production clean up or extreme vandalism is not typical unit turnover.* *-Servicing Officials should question unusually low maintenance and repairs costs, especially in an aging property.*

(A) Maintenance staffing costs and related expenses.
(B) Maintenance supplies.

Servicing Officials should carefully review this item. Small tool purchases, such as hammers, putty knives, and sprayers, which could be used repetitively, should not be repeatedly purchased by the property.

(C) Contract repairs to the projects (e.g., heating and air conditioning, painting, roofing).

(D) Make ready expenses including painting and repairs, flooring replacement and appliance replacement as well as drapery or mini- blind replacement. (Turnover maintenance).

(E) Preventive maintenance expenses including occupied unit repairs and maintenance as well as common area systems repairs and maintenance.

(F) Snow removal.

(G) Elevator repairs and maintenance contracts.

(H) Section 504 and other Fair Housing compliance modifications and maintenance.

-Annual reviews updating of transition plans by management should be completed with budgets and actual financial reviews. An explanation for the lack of work and not following the transition plan schedule should be provided.
-It is not a reasonable expense to complete a transition plan every three years, especially if none of the items have been corrected or completed since the initial plan. Management should review the existing plan annually with a year-end update.
-There is no requirement that a transition plan be done by a third party.
-Future changes may occur to the property as a result of maintenance work, at which point, if it is not clear the proper work is completed, a further self-evaluation and transition plan may be needed.
-If there is a change in the applicable standard or circumstances at the property the Transition plan should be updated. The Servicing Official should determine if the borrower's financial situation is such that completion of the transition plan can be accomplished.
-The cost of providing Limited English Proficiency (LEP) services is an allowable expense.

(I) Landscaping maintenance, replacements, and seasonal plantings.

(J) Pest control services.

-This includes the expense of bed bug control. If the property is experiencing unusual pest activity or an unusually high expense, Servicing Officials should request a breakdown of costs.

(K) Other related maintenance expenses.

-"Other maintenance expenses" is a broad category that should be carefully reviewed by Servicing Officials to ensure that charges are appropriate and reasonable. Expenses that belong in other categories should be moved by the Borrower to ensure that the Agency is collecting the correct data on specific property costs.

-If the expense appears on Part II, line 10, it must be identified.

(vi) All operational costs related to the project including:

-"Other Administrative" in general: Servicing Officials should closely review this line item for potential abuse. "Other Administrative" should include only directly property-related administrative costs; for example, the Section 538 Guarantee Fee is an allowable expense. A break out of the expenses should be provided with the narrative.

-Bad debts should not appear in the operational costs:

- The proposed budget, bad debts will appear as a contingency item (Part I)
-The actual expenses, bad debts would be reflected in less income than expected, with legal cost and maintenance expenses on appropriate line item.

-Other fees and charges should appear in the appropriate line item (i.e., bank charges, HFA compliance fees, credit checks, etc.) Such expenses must be accompanied by a narrative with detailed explanation.

-For-profit borrowers are entitled to 25 percent of the interest earnings on the Reserve account in the prior year, which should be a Reserve withdrawal request; this amount should not be taken from the operating account. See §3560.306(h)(3).

(A) The costs of obtaining and receiving credit reports, police reports, and other checks related to tenant selection criteria for prospective residents.

The cost of these items may be charged as an application fee as long as it does not exceed the actual cost of obtaining the necessary items related to the tenant selection criteria.

(B) The cost of duplicating forms for those properties not owning a copier. This will include the costs of producing or purchasing forms and mailing or delivering those forms to the project site.

Photocopying or printing expense related to actual production of project brochures, marketing pieces, forms, reports, notices, and newsletters which all directly relate to the property in question are allowable project expenses no matter what location or point of origin the work is performed. This includes outsourcing the work to a professional printer.

(C) All bank charges related to the property including purchases of supplies (e.g., checks, deposit slips, returned check fees, service fees).

Bank charges should be typical and not extraordinary; bank-charged late fees should be closely reviewed for reasonableness and not due to mismanagement. Electronic check readers and lockbox fees are an allowable project expense.

(D) Costs of site-based telephone including initial installation, basic services, directory listings, and long-distance charges.

Cell phones issued to on-site personnel for project-related work is allowable. Cell phones issued to management personnel who oversee multiple properties must pro-rate the expense between properties. An allowance to a site personal for use of a personal cell phone is acceptable.

(E) All advertising costs related specifically to the operations of that project. This can include advertising for applicants or employees in newspapers, newsletters, radio, cable TV, and telephone books.

This includes social media.

(F) Postage and delivery costs from the site including expenses to the Agency or other governmental agencies, tenants, verifying third parties, central management offices, etc.

Postage expenses associated with the site to mail out rental applications, third-party (asset income and adjustments to income) verifications, application processing correspondence (acceptance or denial letters), mailing project invoice payments, required correspondence, report submittals to various regulatory authorities to the managed property are allowable project expenses no matter what location or point of origin the mail is generated.
This expense does not include normal or routine management company personnel responsibilities covered under §3560.102(i)(1)(xiii)(C).

(G) Partnership or corporate business expenses including state taxes and other mandated state or local fees as well as other relevant expenses required for operation of the property by a third- party governmental unit. Costs of continuation financing statements and site license and permit costs.

(H) Expenses related to site utilities including actual costs and surcharges as well as deposits and expense of utility bonds in lieu of bonds.

(I) Site office furniture and equipment including site based computer and copiers. Service agreements and warranties for copiers, telephone systems and computers are also included (if approved by the Agency).

Items must be part of a proposed approved budget to be an eligible expense.

(J) Real estate taxes (personal tangible property and real property taxes) and expenses related to controlling or reducing taxes.

Late Fees due to mismanagement must be paid by Borrowers from non-project funds.

(K) All costs of insurance including property liability and casualty as well as fidelity or crime and dishonesty coverage for on-site employees and the owners.

(L) Costs of collecting rents on-site including bookkeeping supplies and recordkeeping items.

Note that these costs are for supplies such as for notices;
Costs of processing transactions, maintaining books and records are covered as part of the management fee. See 3560.102(i)(1)(iii).

(M) Costs of preparing and maintaining tenant files and processing tenant certifications including all office supplies, copies and other associated expenses.

-Office supplies, copies and other associated expenses needed to prepare and maintain tenant files must be site-specific.

-The project management staff is responsible for preparing, reviewing, submission and maintaining tenant files and that cost is generally part of the salary expense to be paid by the management fee. 3560.102(i)(1)(xi).

Costs associated with off-site tenant file storage, physical or digital, are allowable project expenses.

-Processing tenant certifications includes the transmission/submission of tenant certifications is covered by the management fee §3560.102(i)(1)(xi), is not an allowable project expense and there should not be an additional fee.

(N) Public relations expense relative to maintaining positive relationships between the local community and the tenants with the management staff and the borrowers. Chamber of Commerce dues, contributions to local charity events, and sponsorship of tenant activities, are examples.

(O) Tax Credit Compliance Monitoring Fees imposed by HFAs.

-This expense pays the charge from the tax credit allocator. *-Reporting to general and limited partners for LIHTC, compliance purposes is included in the management fee and is not an allowable project expense; see §3560.102(i)(1)(xxvii). These fees can be paid from either management fee or return to owner.*

(P) All insurance deductibles as well as adjuster expenses.

(Q) Professional service contracts (audits and compilations, tax returns, energy audits, utility allowances, architectural, construction, rehabilitation and inspection contracts, etc.)

-If costs appear unreasonable Servicing Officials should review any professional services contracts. *-The Agency has no monthly unit inspection requirement.* *-Inappropriate practices are covered under §3560.102(i)(4)(viii).* *-The cost of installation of project-wide cable, satellite TV, or wi-fi/Internet, is an allowable project expense, provided that each apartment unit receives a separate billing for the service, and it is not included in the rent charge or utility allowance. The property will not pay for access by each unit, including vacant units. Management could negotiate a service fee for the property and collect the monthly fee from each tenant. The budget would reflect other income source from the tenants and a cable expense in O & M.*

(R) On-site training pre-approved by the Agency provided by outside training vendors.

-Training for on-site staff should be appropriate to managing affordable housing with subsidies from RD, HUD, or LIHTC. Suspected abuses should require documentation of the course or certifications received. *-Site staff who oversee multiple properties must pro-rate the expense between properties.* *-Borrowers who attend trainings do so at their own expense and it is not an allowable project expense. Management company meetings to discuss management policies are a management fee expense (see §3560.102(i)(1)(xiv), (xv), (xxiv) and (xxv).* *-Expenses during training should be reasonable and not involve costs for items previously identified by the OIG audit, especially gifts, bonuses (other than that identified in the management plan as part of the site manager's salary), or alcohol. Training expenses may include reasonable hotel charges, meals, and snacks; such expenses should not be excessive.*

(S) Site manager salary for additional hours associated with congregate housing.

(vii) With prior Agency approval, cooperatives and nonprofit organizations may use housing project funds to pay asset management expenses directly attributable to ownership responsibilities. Such expenses may include:

These are organizational reimbursements for nonprofit owners. This expense is not the traditional industry definition of "asset management", but rather an effort to partially offset the cost of doing business for a nonprofit as an RD property owner. The reimbursement is pro-rated among owned RD-financed properties so no duplication of expense will be incurred.

(A) Errors and omissions insurance policy for the Board of Directors.

(B) Board of Directors' review and approval of proposed Agency's annual operating budgets, including proposed repair and replacement outlays and accruals.

(C) Board of Directors' review and approval of capital expenditures, financial statements, and consideration of any management comments noted.

(D) Long-term asset management reviews.

(2) Unallowable expenses. Housing project funds may not be used for any of the following:

(i) Equity skimming as defined in 42 U.S.C. 543 (a).

(ii) Purposes unrelated to the housing project.

(iii) Reimbursement of inaccurate or false claims.

(iv) Settlement agreements, court ordered decrees, legal fees, or other costs that result from the filing of civil rights complaints or legal action alleging the borrower, or a representative of the borrower, has committed a civil rights violation.

Borrowers must pay from non-project funds for fines, penalties and legal fees when the borrowers are found guilty of civil rights or other violations.

(v) Fines, penalties, and legal fees where the borrower or a borrower's representative has been found guilty of violating laws, including, but not limited to, civil rights, and building codes.

(vi) Association dues to be paid by the project should be related to training for site managers or management agents. To the extent that association dues can document training for site managers or management agents related to project activities by actual cost or pro-ration, a reasonable expense may be billed to the project.

(vii) Pay for bonuses or monetary performance awards to site managers or management agents that are not clearly provided for by the site manager salary contract.

(viii) Billing for parties that are large or unreasonable, such as renting expensive party halls or hotel rooms and payment for alcoholic beverages or gifts to management agent staff.

(ix) Billing for practices that are inefficient such as routine use of collect calls from a site manager to a management agent office.

(c) Priorities. The priority order of planned and actual budget expenditures will be:

1. Senior position lienholder, if any;
2. Operating and maintenance expenses, including taxes and insurance;
3. Agency debt payments;
4. Reserve account requirements;
5. Other authorized expenditures; and
6. Return on owner investment.

The expense of the return on owner investment (ROI) must be included in the proposed budget in order for the Borrower to be eligible to collect the payment. §3560.305(a) includes the conditions on the return payment. §3560.305(b) discusses when an unpaid ROI may be taken: *"An earned, but unpaid ROI for the previous year only may be requested by the borrower and authorized by the Agency under the provisions of §3560.305(a)(1) provided the current year's ROI has been paid first and a rent increase is not required to generate funds to pay the unpaid ROI."*

ATTACHMENT 4-D
PROPOSED BUDGET AND YEAR END ANALYSIS PROCESS
Including Return to Owner/Surplus Cash Worksheet

The summary of the budget analysis process is reviewed in the Multi-Family Information System (MFIS). The Agency must review this analysis for reasonableness for the budget and year end reports. If items are noted as a deficiency or concern, the Loan Servicer will determine whether the budget narrative or case file provides an adequate explanation, whether the borrower must submit a corrected budget, or if appropriate servicing actions should be considered prior to approval. The document is split into the following nine sections:

1. **Project Information**
   This area contains the Project Name, Borrower Name, State Code, Servicing Office Code, County Code, Borrower ID, Project Number, Classification, Budget Effective Date, Last Analysis Date, Project Unit counts, and Last Rent Change (year-end actual only). Vacancy data is displayed for each type of budget. Proposed budget shows the average vacancy over the last 3 years; the last 6 months; and the last month's average vacancy. Monthly, quarterly and year-end actual budgets show the vacancy covered by that period. The Loan Servicer needs to determine if the vacancy allowance is reasonable.

2. **Surplus Cash**
   This section displays the calculated amount of surplus cash per the information entered on the budget. If there is surplus cash it may need to address capital needs, make a deposit in the housing project's reserve account, reduce the debt on the borrower's loan, or reduce rents in the following year.

   The calculation used is displayed on the analysis document. (This is not displayed for Monthly/Quarterly reports)

   * **Tax & Insurance Escrow should be evaluated based on the following:**

   - **Total Annual Tax Expense / 12 months = Monthly Expense**
   - **Monthly Tax Expense x # Months remaining in fiscal year figured from last due date month = Tax Escrow Required**
   - **Insurance expense / 12 Months x # Months remaining in fiscal year figured from renewal date = Insurance Escrow Required**

   The calculation for a Proposed Budget is indicated on the following page:

RETURN TO OWNER/SURPLUS CASH WORKSHEET

CASH AVAILABLE	***EXAMPLE***
Actual Ending Cash Balance (Form RD 3560-7 Actuals Part I Line #33) (Includes Balance Sheet #1, 2, 5 & 6)	$34,000
Subtract Tax & Insurance Escrow Amount *(Escrow Analysis based on Proposed Budget)	$ 8,500
Subtract 2% Remaining Initial Operating (Balance in MFIS 2% Tracked Account)	$-0-
Subtract Accounts Payable (Balance Sheet Line #22)	<u>$ 4,000</u>
Cash Available	**$21,500**

CASH REQUIRED

Proposed O & M Expense (Form RD 3560-7 Proposed Part I Line #16)	$95,000
Subtract Annual Tax & Insurance Expense (Proposed Part 2, Line 34, 37, 38 and 39)	<u>$10,000</u>
Subtotal	$85,000
Multiply Subtotal by 20%	<u>20%</u>
Cash Required	**$17,000**

SURPLUS CASH

Cash Available	$21,500
Subtract Cash Required	<u>$17,000</u>
Surplus Cash	**$ 4,500**

3. **Rent Schedule Change (proposed budget only)**

   This section indicates if the budget includes or does not include a rent change. If a new rent schedule is entered for the budget, the rent structure will be checked to see if the correct rents are entered dependent on the Subsidy Code of the Project and also that all revenue producing project units are covered. If these checks fail, the message “Invalid Rent Schedule Structure” will be displayed.

   The amount of the rent increase will be shown as dollar value representing the average of all bedroom sizes for the project. It will be either the basic, note or HUD rent depending on the project subsidy code. Rent increases of greater than $25 will be red flagged. Increases in the other two rent types will be noted at the bottom of the section.

   The Loan Servicer will review the request to determine if the proposed change is acceptable and will notify borrowers. .

4. **Reserve Account Status**

   This section lists information about the Reserve Account as it is within MFIS. Displayed information includes:

   If a Work Out Plan is In Place, Fully Funded Amount, Annual Deposit Amount, Capital Needs Amount, Capital Needs Amount As of Date, Account Balance Amount, Account Balance Amount As of Date, Required Balance Amount, Required Balance Amount As of Date, GAP Account Amount, GAP Account Amount As of Date and Amount Behind Schedule or Amount Ahead of Schedule.

   The Loan Servicer will review amounts to determine if these amounts are adequate.

5. **Reserve Account Authorizations**

   The section lists the entered authorizations that still have funds available for use or were created within the last year. This will be compared to what was actually reported.

6. **Project Servicing Efforts**

   The section lists all non-complete Servicing Efforts along with all completed efforts posted within the last fiscal year. A review will be made to determine if all appropriate servicing efforts are being utilized.

7. **Review Findings**

   List all open non physical findings or any created within the last fiscal year regardless of status. A review will be made to determine if these are correctly displayed and populated.

8. **Physical Findings**

This area lists all open physical findings or any created within the last fiscal year regardless of status. A list of capital budget items with a budgeted value is also displayed to compare the project response to these findings.

9. **Budget Analysis Results**

This area contains one or more general observations or situations that raise question on the viability of the budget. Observations are just the results of a test performed that may be of importance to the servicing official. All 'Review' items must have their check box clicked to indicate they have been reviewed before the budget is considered analyzed and therefore can be approved.

If the item is corrected it will not be displayed the next time the analysis is executed. If the item is reviewed, a comment must be entered as to why the situation is OK. The budget may not be approved if any review item remains present and not marked as reviewed in this section. Once an item is marked as reviewed (or comment entered), it will maintain those changes in future analysis runs.

A detailed list of the tests that are executed on the indicated lines of the budgets is available in the MFIS Message Board under Frequently Asked Questions. The results of the tests will display in the analysis report.

The following tests are common across multiple line items:

1. **TYPO CHECK –** all input values of Proposed, Monthly/Quarterly or Year-End Actual budget line items – system will flag if:
   - If the input value is equal or greater than 100 times the last year's value (if last year's value is not zero).
   - If the input value is equal or greater than $1,000,000.

2. **MONTHLY/QUARTERLY CHECK –** some Monthly/Quarterly budget line items
   - All Part I input lines period and YTD are compared to the associated proposed for expected period value
   - All Part II subtotals period and YTD are compared to the associated proposed for expected period value

3. **GENERAL RULE** - for some Year-End Actual line items
   - If the proposed budget had a non-zero value, the actual should have a non-zero value.

4. **10 PERCENT RULE –** for some Proposed and Year-End Actual line items
- Proposed items- if proposed budget value differs from last years value by more than 10% (even if last years value was zero) MFIS will comment about a narrative explanation.
- Actual items - if actual budget differs from proposed by 10% or more it is flagged for review.
- The system checks operating expenses and income sources to see if subtotals are more than 10 percent different from last years. If this is the case, determine if the budget narrative provides an adequate explanation for the unusual item.

5. **$12 RULE –** for direct comparison of numbers on some Proposed and Year-End Actual line items such as correct debt payment, correct reserve payment, owner's return on investment:
- If values differ by more than +- $12.00 then flag as a REVIEW item
- If values differ by less or equal to +- $12.00 then flag as an OBSERVATION item
- If any of these are unacceptable, the borrower will need to submit a new budget.

6. **COMMENT RULE –** for some Proposed and Year-End Actual line items
- OTHER type line items with a value require a comment
- LIST type line item with a value require a comment

7. **INHERITANCE RULE –** for some Proposed line items
- If last years actual had a value and this years proposed does not have a value

8. **RATIO ANALYSIS** - are reflected in the Budget Analysis. Ratios are an effective tool for financial analysis. They prescribe various measures of actual operating performance. The ratios should be reviewed for a comparative analysis. The Loan Servicer should become familiar with these percentages as a comparative analysis, and should consider utilizing the Hyperion MFH Budget Line Item Comparative Cost data report for their Region in their analysis. The ratios run in the MFIS Analysis Review are as follows:
  - Maintenance and Operating Expense / Total Operating & Maintenance
  - Utilities / Total Operating & Maintenance
  - Administrative / Rental Income
  - Total Operating & Maintenance / Rental Income
  - Per Unit Per Month Operating & Maintenance Expense
  - 3 year Resident Turnover Rate

9. **NORMS** - are also reviewed on the Budget Analysis. The Norms are based on Regional Groupings of "like" properties. This gives the Servicer an analysis of how the property is comparing to other "like" properties. The norm definitions are as follows:

- Utility Allowance: If Rent schedule has one yes, else no.
- Profit type: Code = 1 or 2 yes, else no
- Tax Status: Line 34 > 0 yes, else no
- Interest Credit: Plan code = 07, 08, 21, 24 yes, else no
- Age (years): <6, <11, <20, <30, all others
- Size (units): <5, <12, <24, <40, <80, all others
- Elderly: Rental code = EL, CG yes, else no

The States are grouped into regions as follows:

1. CT, MA, ME, NH, RI, VT
2. NJ, NY
3. DE, MD, PA, VA, WV
4. AL, FL, GA, KY, MS, NC, SC, TN
5. IL, IN, MI MN, OH, WI
6. AK, AR, LA, NM, OK, TX
7. IA, KS, MO, NE
8. CO, MT, ND, SD, UT, WY
9. AZ, CA, HI, NV
10. ID, OR, WA
11. PR, VI, WP, GUAM

10. Look at the cash flow and ending cash balance.
    a. Cash flow: Is the cash flow positive? A negative cash flow is permissible as long as it does not appear to represent a trend that cannot be corrected.
    b. Cash balance:
        i. If cash flow is negative, what is the ending cash? Does it cover the negative cash flow?
        ii. Does the ending cash balance exceed the permissible limit? If so, the surplus must address capital needs, be deposited in the housing project's reserve account, reduce the debt service on the borrower's loan, or reduce rents in the following year.
        iii. Using the accrual method of accounting, the accrual to cash adjustment must equal the difference of Beginning Cash Balance and Ending Cash Balance to insure these balances match their respective Balance Sheet figures. The sole purpose of this adjustment is to reconcile a company's internal ledger kept on an accrual basis to the IRS forms which are required to be on a cash basis.

If the analysis of cash flow and cash balance reveals a problem, appropriate servicing actions should be considered prior to budget approval.

Attachment 4- E

AUDIT PROGRAM

PLEASE NOTE

PROJECTS WITH FISCAL YEARS ENDING 12-31-2019 AND THEREAFTER ARE TO FOLLOW THE REPORTING REQUIREMENTS OUTLINED IN SECTION 4.16 OF HB – 2-3560.

Attachment 4-E, Audit Program has been modified by the financial reporting requirements. Attachment 4-E should only be used to report construction cost engagements.

USDA

UNITED STATES DEPARTMENT OF AGRICULTURE
OFFICE OF INSPECTOR GENERAL
Washington D.C. 20250

AUDIT PROGRAM	Rural Development Rural Housing Service Multi-Family Housing Division Rural Rental Housing Program

This audit program provides instruction and guidance for independent public accountants in conducting agreed-upon procedures engagements of recipients of Rural Development loans, except for those audits required to be performed in accordance with Office of Management and Budget Circular A-133. The audit program is effective for the period ending December 31, 2005, and thereafter.

This audit program may not be changed, altered, revised, or modified without the concurrence of the Office of Inspector General.

APPROVED BY: Robert W. Young
ROBERT W. YOUNG
Assistant Inspector General
for Audit

9/29/04
Date

TABLE OF CONTENTS

I. GENERAL

A. PURPOSE

B. BACKGROUND

C. PERTINENT REGULATIONS AND INSTRUCTIONS

D. STANDARDS FOR CONDUCTING THE AGREED-UPON PROCEDURES ENGAGEMENTS

E. OBJECTIVES

II. CONSTRUCTION COST ENGAGEMENTS

III. ANNUAL AGREED-UPON PROCEDURES FOR THE ANNUAL ATTESTATION ENGAGEMENT

EXHIBIT A – ILLUSTRATIVE AUDITOR'S AGREED-UPON PROCEDURES REPORT (FORM RD 1924-13 OR FORM RD 3560-7)

I. GENERAL

A. PURPOSE

This guide is designed to assist independent public accountants ("practitioners") in conducting agreed-upon procedures engagements of Rural Rental Housing (RRH) properties financed by Rural Development. The RRH Program has a history of abuse involving the construction and ongoing operation of properties. This guide includes procedures to assist the practitioner in determining borrower and management company compliance with certain statutory, regulatory, and contractual requirements of the RRH Program. Thus, practitioners need to be familiar with laws, regulations, and procedures related to the RRH Program.

B. BACKGROUND

Rural Development uses cost certifications to verify that borrowers spent loan funds for eligible and actual costs when constructing apartment complexes as part of the RRH Program. Rural Development requires borrowers to annually report the financial operations of RRH properties on *Form RD 3560-7, Multiple Family Housing Project Budget*.

RRH borrowers typically use identity-of-interest companies in both the construction of apartment complexes and in managing the day-to-day operations of RRH properties. RRH borrowers that have an identity-of-interest with the borrower (general contractor) are required by Rural Development to report the actual costs of construction on *Form RD 1924-13, Estimate and Certificate of Actual Cost.* In addition, *Form RD 1924-13* must be submitted whenever there is an identity-of-interest relationship between a borrower and a subcontractor, material supplier, or equipment lessor.

The USDA Office of Inspector General has performed audits and investigations that identified significant fraud and abuse in the RRH Program. Some of the fraud and abuse related to construction includes: Ineligible, unsupported, and duplicate costs; misrepresentation by borrowers of their roles as general contractors; shifting costs (e.g., overhead expenses) that exceeded budgeted amounts to different cost categories on *Form RD 1924-13*; and using identity-of-interest companies which are merely "shell" companies to either inflate legitimate charges or bill properties for costs that were never incurred.

Similar abuse using identity-of-interest companies has been identified in the ongoing management of RRH properties. Borrowers and management companies also charge ineligible, unsupported, and duplicate expenses (generally for management related costs) to properties. Also, management companies frequently do not maintain suitable records when of properties, and overcharge for these services. Rural Development regulations refer to any scheme that improperly withdraws funds from RRH project accounts as "equity skimming."

USDA Office of Inspector General audits have also identified instances of conflicts of interest and a lack of independence on the part of certified and licensed public accountants when performing audits of RRH properties. Thus, practitioners should strictly adhere to the standards and principles of the American Institute of Certified Public Accountants' Code of Conduct and Bylaws and applicable State Boards of Accountancy.

C. PERTINENT REGULATIONS AND INSTRUCTIONS

Construction Cost:

The instructions for *Form RD 1924-13* provide guidance on eligible construction costs, as well as the required format for the presentation of costs. Rural Development has also established regulations that restrict the amount of builder's profit for each project, the use of identity-of-interest companies, and the business relationships of practitioners performing engagements of RRH construction costs. The following regulations and Rural Development instructions should be used as guidance:

(v) Rural Development Instruction 1924-A, and
(vi) Rural Development Instruction 1944-E.

Management of Ongoing Operations:

Rural Development regulation RD 3560 provides details on allowable and unallowable operating costs, and places restrictions on the use of identity-of-interest companies and other activities related to managing RRH properties. The instructions for *Form RD 3560-7* also provides direction on eligible costs.

D. STANDARDS FOR CONDUCTING THE AGREED-UPON PROCEDURES ENGAGEMENTS

Practitioners are to perform attestation engagements using agreed-upon procedures of construction costs and ongoing operations in accordance with attestation standards established by the American Institute of Certified Public Accountant's (AICPA) and the standards applicable to attestation engagements contained in Government Auditing Standards issued by the Comptroller General of the United States." The practitioner's report on agreed-upon procedures should be in the form of procedures and findings. (See exhibit A for an illustrative example.)

If practitioners become suspicious of fraud or illegal acts during the course of performing the agreed-upon procedures engagement, they are to promptly report these matters (regardless of materiality) to:

U.S. Department of Agriculture
Rural Development
Rural Housing Service
Director, Multi-Family Housing Processing Division
14th and Independence Avenue SW
Washington, D.C. 20250
(202) 720-3773

The report and workpapers prepared in the course of these engagements are subject to a quality control review by the USDA Office of Inspector General.

E. OBJECTIVES

The objective of the construction cost engagement is to verify the propriety of costs reported on *Form RD 1924-13*. The practitioner should be alert for kickbacks on the purchase of services and materials, billings in excess of agreed-upon prices, billings for nonexistent materials or services, “sweetheart contracts,” and the diversion of materials to other construction sites.

The objective of the ongoing operations engagement is to verify the propriety of operating and maintenance expenses reported to Rural Development on *Form RD 3560-7*, Part II, and reserve account activity reported on *Form RD 3560-7*, Part III. The practitioner should be especially alert for equity skimming schemes involving maintenance costs, and unauthorized withdrawals from reserve and tenant security deposit accounts.

Of primary concern is compliance with general contractor and management company requirements and the role of identity-of-interest companies in the construction and management of RRH properties.

II. CONSTRUCTION COST ENGAGEMENTS

A. AGREED-UPON PROCEDURES FOR THE CONSTRUCTION COST ATTESTATION ENGAGEMENT

The procedures in this section are designed to identify ineligible expenses and fictitious charges to Form RD 1924-13. RD Regulations 1924-A and the instructions for preparing *Form RD 1924-13* provide guidance on eligible construction costs.

Borrowers and contractors involved in the construction of Rural Development financed RRH properties are required to maintain recordkeeping systems which establish accounts that categorize costs in conformity with sections 1924.13 (e) (1) (v) (A) and 1924.13 (e) (2)
(i) (H) of Rural Development Instruction 1924-A. *Form RD 1924-13* includes a certification that the cost of labor, materials, and other necessary services incurred during construction are accurate and fairly presented.

Borrowers are required to comply with laws, regulations, and Rural Development procedures related to the construction of RRH properties. USDA Office of Inspector General audits have identified borrowers that received builder's profit for being the general contractor when, in fact, general contractor responsibilities were being performed by other contractors. The audits also disclosed that some identity-of-interest companies were merely "shell" companies with no employees, inventory, or other business activities. Other identity-of-interest companies have charged rental fees for equipment use for the entire construction period when the equipment was actually used for short or intermittent periods during construction.

These actions have resulted in significant amounts of overcharges to RRH properties. Sections 1924.13 (e) (1) (v) (H) and 1924.13 (e) (2) (viii) of Rural Development Instruction 1924-A prohibit borrowers from receiving builder's profit for acting as the general contractor if more than 50 percent of the property is subcontracted to one subcontractor or 75 percent to three or fewer subcontractors. Sections 1924.13 (e) (1) (I) and 1924.13 (2)
(viii) of Rural Development Instruction 1924-A require that before a borrower can claim expenses paid to an identity-of-interest company, it must also provide services and/or materials to the general public and not just to RRH properties.

Agreed-Upon Procedures

1. Compare the total amount paid through the construction checking account (by adding the total amount from monthly statements) to the total amount of costs reported on *Form RD 1924-13*. Report any differences.

2. Examine selected checks, invoices, job cost ledgers, receiving documentation, etc., that support costs presented on *Form RD 1924-13* to ensure they were actually incurred to construct the project. (Note: Verify that checks have been cancelled and ensure that indirect costs are not included with the cost of labor and materials on *Form RD 1924-13*.)

3. Inspect selected checks held as retainage from subcontractors for evidence that they were actually paid by the bank. Confirmation with subcontractors may be necessary if cancelled checks are not available or not cancelled by the bank. (Note: Office of Inspector General audits have disclosed instances where checks were made to subcontractors, but never cashed.)

4. Compare the address on selected delivery documents and invoices (using the sample from audit step II.A.2.) to the project's address to ascertain whether materials and services were provided to the project under review. (Note: Office of Inspector General audits have disclosed instances where delivery was not made to the RRH project site.)

5. Examine selected cancelled checks related to accounts included in the "to be paid" column of *Form RD 1924-13* to determine the propriety of the costs reported. (Note: Office of Inspector General audits have disclosed instances where these costs were invoiced by identity-of-interest companies, but were never actually paid by the borrower.)

6. Confirm payments with selected subcontractors and material suppliers and investigate any discrepancies. (Note: Be alert for any discounts, rebates, or refunds that were provided to the contractor but not included on *Form RD 1924-13*.)

7. Inspect selected bid documentation to verify that the lowest bid submitted was accepted. If the lowest bid was not accepted, evaluate the justification for the higher bid. If documentation does not exist, report this and the reason why as a finding. (Note: Be alert for "sweetheart contracts" and contracts to disclosed or undisclosed identity-of-interest companies.)

8. Compare selected subcontractor billings (invoices) to contract amounts. If billings were in excess of contractual terms, ascertain the reason for the higher expense.

9. Obtain the number of subcontractors used during construction and calculate the percentages of subcontractors to ensure compliance with Rural Development requirements.[1]

10. Examine selected accounting records for undisclosed identity-of-interest companies. The practitioner should focus on transactions involving the use of one or two contractors/subcontractors, or if one contractor/subcontractor provided a significant percentage of materials or services.

11. Determine if identity-of-interest companies meet Rural Development requirements[2] of providing services to the general public.

    a. Question the general contractor/borrower about the business activities of any identity-of-interest company used and request evidence that the company provides services or materials to the general public.

    b. Review identity-of-interest records (e.g., sales records, invoices, receiving documents, etc.).

    c. Confirm by independent verification that identity-of-interest companies exist and provide services to the general public. (Note: This evidence could include listings in a telephone directory, advertisement to the public, etc. Also, be alert for "shell" companies that exist solely for processing invoices and adding markups to the original supplier's invoices. Markups made by identity-of-interest companies that do not provide services/supplies to entities other than the RRH property are not allowable.)

12. Compare equipment rental and supervision charges by identity-of-interest companies to independent rental companies to determine reasonableness[3] of charges. Report any significant variances.

[1] Sections 1924.13 (e) (1) (v) (h) and 1924.13 (2) (2) (viii).

[2] Sections 1924.13 (e) (1) (I) and 1924.13 (2) (viii).
[3] A charge would be considered reasonable if it is approximately the same amount of cost that a non identity-of-interest company would charge.

a. Question the borrower about the use of equipment during construction and how rental rates were established and time of use determined.

b. Contact an independent rental company to determine commercial rental rates and compare them to the identity-of-interest charges.

c. Examine borrower documentation (e.g., commercial rate lists, time sheets, construction schedules, etc.) to support the rates that were used and time that was charged for equipment rental fees. (Note: Office of Inspector General audits have disclosed that borrowers are charging rental fees when equipment is not in use.)

d. Question the borrower about supervision charges.

e. Verify that the borrower has documentation (e.g., timesheets or timecards, travel reports, payroll records, etc.) to support supervision charges.

III. ANNUAL AGREED-UPON PROCEDURES ENGAGEMENTS

A. AGREED-UPON PROCEDURES FOR THE ANNUAL ATTESTATION ENGAGEMENT

The Office of Inspector General has identified significant fraud and abuse of operating and maintenance expenses in the RRH Program. The procedures in this section are designed to assist practitioners in identifying ineligible charges and misused funds reported on *Form RD 3560-7*, Part II, Operating and Maintenance Expense Schedule and Part III Account Budgeting/Status. RD Regulation 3560 provides requirements for owners and management companies participating in the RRH Program, particularly those involving identity-of- interest companies. The procedures in this section are designed to identify noncompliance with these requirements.

The most common occurrence involves identity-of-interest companies that are merely “shell” companies with no employees, inventory, or other business activities. In these instances, owners and management companies use identity-of-interest companies to inflate costs from legitimate vendors or bill the properties directly for work that was never performed. While Rural Development requires the disclosure of identity-of-interest companies, many owners and management companies fail to comply with this requirement.

Agreed-Upon Procedures

1. Compare the total amount paid from the operating and maintenance bank account (by adding the total amount from monthly statements) to the total amount of costs reported on the general ledger and *Form RD 3560-7*. Part II.

2. Examine selected receipts, invoices, cancelled checks, etc., that support operating and maintenance expenses presented on *Form RD 3560-7*, Part II, to ensure they were actually incurred during the ongoing operations of the project. The practitioner should focus on line items 1-10, and 19-32. (Note: Do not accept photocopies of receipts or invoices and be alert for invoices that appear to be altered, have duplicate invoice numbers, or that are not pre-printed.)

3. Compare selected operating and maintenance records pertaining to expenses on *Form RD 3560-7*, Part II, to Rural Development regulations for eligibility and reasonableness. Practitioners should use professional judgment in determining the reasonableness of charges.

4. Confirm payments with selected vendors for maintenance and operating expense items (or any questionable charges) from *Form RD 3560-7*, Part II. (Note: Discounts, rebates, or refunds should be credited to the property’s account.)

5. Confirm with the financial institution year-end reserve account balances on *Form RD 3560-7*, Part III, and that there are no encumbrances of reserve account funds.

5. Calculate the number of reserve account withdrawals from bank statements. This number is to be included in the engagement report. (Note: Original bank statements should be used for this analysis and be alert for transfers and automatic withdrawals from the reserve account.)

6. Examine the caretaker agreement for compliance with Rural Development requirements[4]. (Note: Office of Inspector General audits have disclosed instances where caretaker duties included services paid for in the management fee.)

7. Examine documents to confirm that owners/management companies solicited bids from independent companies for services/materials that were provided by identity-of-interest companies.

8. Determine who owns selected contractor companies from the applicable State agency (for example Secretary of State records) and compare to RRH project owner and management company ownership names to uncover undisclosed identity-of-interest companies.

9. Compare the address on selected work orders, delivery documents, invoices, remittance notices, etc., to the RRH project address to ensure that services/supplies were provided to the appropriate property.

10. Confirm by independent verification that identity-of-interest companies exist and provide services to the general public. (Note: The evidence could include listing in a telephone directory, advertisement to the public, etc. Also, be alert for "shell" companies that exist solely for processing invoices and adding markups to the original supplier's invoices. Markups made by identity-of-interest companies that do not provide services/supplies to entities other than RRH property are not allowable.)

[4] RD Regulation 3560.102(b)(1)(ii)

Illustrative Auditor's Agreed-Upon Procedures Report

(*Form RD 1924-13* or *Form RD 3560-7*)

To the Owners and Management Company of *(name of RRH project, city and State)* and the project's financial accounts:

We have performed the procedures enumerated below, which were agreed to by Rural Development and the owner of *(name of RRH project, city and State)* and the project's financial accounts, solely to assist those parties in evaluating the accompanying (*Form RD 3560-7, Multiple Family Housing Project Budget* or *Form RD 1924-13, Estimate and Certificate of Actual Cost*) prepared in accordance with the criteria specified in Rural Development Regulations 1924 and 3560 for the year ended December 31, *(applicable year)*. The owner is responsible for *(name of the RRH project)* financial accounts. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and the standards applicable to attestation engagements contained in Government Auditing Standards issued by the Comptroller General of the United States. The sufficiency of these procedures is solely the responsibility of Rural Development. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

The agreed-upon procedures performed during this engagement were included in the audit program designed for the Rural Rental Housing Program dated September 29, 2004. The findings for each of the agreed-upon procedures are as follows.

(Agreed –Upon Procedure No.) (Finding) (Agreed –Upon Procedure No.) (Finding) (Agreed –Upon Procedure No.) (Finding) (etc)

We were not engaged to and did not conduct an audit, the objective of which would be the expression of an opinion on the financial statements of *(name of RRH project, city and State).* Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the owner and management company of *(name of RRH project, city and State)*, and Rural Development, and is not intended to be and should not be used by anyone other than these specified parties.

(Signature)

(DATE)

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ATTACHMENT 4-F
Performance Standards
Borrower Self-Certification Letter

Date

USDA Rural Development Office
Address
Address

In accordance with the criteria specified in Section 5; Paragraph 4.16 C. of the USDA Rural Development Handbook (HB-2-3560) for the year ended ***DATE, YEAR***, the borrower must self-certify that ***PROJECT NAME*** is in compliance with the nine performance standards. The following is a summary of our compliance with the performance standards.

1. The required accounts are *(are not)* properly maintained and tracked separately. The accounts we maintain are marked below:

   __ Operating Account(s) __ Security Deposit Account
   __ Tax & Insurance Account __ Reserve Account
   __ Other Accounts: ____

2. The payments from operating account(s) are *(are not)* disclosed and accurately represented.

3. The reserve account(s):

   a. is on *(not on)* schedule with the Agency required minimum funding requirements;
   b. is *(is not)* maintained in a supervised bank account that requires the Agency's countersignature on all withdrawals;
   c. is on *(not on)* schedule with contributions to the reserve account for the current year with the Agency required minimum funding;
   d. has no *(has)* encumbrances on the reserve funds; and
   e. replacement reserve accounts were *(were not)* used only for authorized purposes in accordance with 7 CFR 3560.306(g).

4. The tenant security deposits accounts are *(are not)* fully funded and are (*are not)* maintained in separate accounts.

5. The payment of owner return was:

   __ paid in the amount of $_____ for 20XX fiscal year and was *(was not)* in accordance with the Agency's requirements; OR
   __ not paid during the reporting year; OR
   __ not allowable due to our nonprofit status; OR
   __ not allowable due to our nonprofit status. However, an asset management fee in the amount of $_____ was paid for 20XX fiscal year.

6. The borrower has *(has not)* maintained proper insurance in accordance with the requirements in 7 CFR 3560.105. Coverage maintained for ***PROJECT NAME*** is as follows:

   __ Liability Insurance   __ Flood Insurance
   __ Property Insurance   __ Earthquake Insurance
   __ Fidelity Bond   __ Other: ____________________

7. All financial records are *(are not)* adequate and suitable for examination.

8. There have been no changes in the ownership of ***PROJECT NAME***, other than those approved by the Agency and identified in the certification. All current owners are identified in the Status of Ownership table in this Certification. This includes all General Partners, Limited Partners, President, Vice President, Secretary, Treasurer, Member and other Partners as applicable.

   For non-profit borrowers: The Board of Directors is *(is not)* active and maintains oversight responsibilities for the project.

9. The real estate taxes (property taxes) are paid in accordance with state and/or local requirements. As of ***YEAR END DATE,*** there are no delinquent real estate taxes (property taxes).

I certify that the above is true, accurate and is properly supported by documentation kept in our files.

[Signature of Borrower] _________________________

PRINTED SIGNATURE _________________________

DATE ___________________________

BORROWER ENTITY NAME ___________________________

NOTE TO BORROWER: *If the project is not in compliance with any of the above Performance Standards, you must state that you are not in compliance with the standard and provide the Agency with a statement about the non-compliance and the methods taken to correct the non-compliance.*

STATUS REPORT OF OWNERSHIP

FISCAL YEAR ________

____

BORROWER NAME

TITLE	**NAME**	**ADDRESS PHONE NUMBER**	**TAXPAYER ID NUMBER**

_______The above information is current and there have been no changes in the ownership since the inception of the loan agreement/resolution(s), except as approved by the Agency. *(7 CFR 3560.405 (c) (2))*

_______There has been/will be a change in the ownership as reflected above. For any change in the ownership, information is attached as required by *7 CFR 3560.405 (c) (3)* and *HB-3-3560, Chapter 5 or 7* as applicable.

______________ ______________________________

Date Owner

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ATTACHMENT 4-G

RD PROGRAMS AUDIT DETERMINATION WORKSHEET

Step 1: Gather all the information below to determine whether a Financial and Compliance audit is required by RD.

RD Borrower ID: __________________
RD projects associated with ID ______________________ _____________________
(List all – may need additional pages

Federal Financial Assistance	**Assistance Current Year**	**Received**
RD 515 Loan balances at beginning of FY	_________	_________
Interest Subsidy	_________	_________
RD Rental Assistance &/or Section 8	_________	_________
RD GRRH 538 Loan balance	_______________	_________
Other: ____________________	_______________	_________

Total Federal Financial Assistance received from the borrower: $___________

Step 2: Is the RD project owned by a not-for-profit entity?

Yes, follow the rules under Exhibit 4-7 of this HB 2 3560 Ch 4 and the single audit requirements under 2 CFR part 200

No, go to Step 3.

Step 3: Did the project receive over $500,000, in the aggregate, in Federal Financial Assistance?

Yes, a RD Financial and Compliance Audit is necessary. Go to Step 4.

No, go to Step 5.

Step 4: Are any of the individual programs identified in Step 2 greater than $500,000?

Yes, these program(s) are the property's major program(s). A major program report is required. Refer to Attachment H

No, there are no major programs. A major program report is not required in the audited financial statements.

Step 5: Does another regulatory agency, legal entity, and/or other business agreement require an audit in accordance with Generally Accepted Auditing Standards or Government Auditing Standards?

Yes, submit a copy of that audit to RD. This audit must contain the required reporting information illustrated in Chapter 4.

No, Go to Step 6.

Step 6: Prepare and submit an accountants' compilation of prescribed forms as outlined illustrated in Chapter 4.

ATTACHMENT 4-H

ANNUAL RD COMPLIANCE AUDIT TO BE CONDUCTED IN CONNECTION WITH THE ANNUAL FINACIAL STATEMENT AUDIT

Background - This section contains the U.S. Department of Agriculture, Rural Development's (RD) requirements for conducting the compliance portion of the annual financial audits of profit-motivated entities participating in RD's housing programs.

Compliance Procedures – See Attachment 4-I, Compliance Requirements and Audit Areas of Chapter 4: Financial Management.

Major Program Determination / Defined – **Attachment 4-H** of Chapter 4: Financial Management has been developed to assist auditors on how to determine a major program. Major program is defined as an individual assistance program for which expenditures equal or exceeded $500,000 during the applicable year or a project that had an outstanding RD-insured RD-guaranteed loan balance equal to or exceeding $500,000 as of the end of the period under audit.

Special Note on RD Rental Assistance, Major Program Determination and Reporting.
For RD projects that have determined that RD Rental Assistance is a major program, no additional testing or reporting (such as testing of a tenant file, review of the recertification forms, etc.) is necessary given that all RD rental assistance is reviewed and approved directly by RD.

Nonmajor Program Testing – Under this attachment, there are no requirements to test nonmajor programs.

Group project based testing - RD prohibits the use of Group Project Based Testing as allowed and defined by the HUD audit guide.

Instances of Noncompliance – All material instances of noncompliance should be reported as finding in the Schedule of Findings and Questioned Costs. However, nonmaterial noncompliance must be reported to management in writing and must be referenced in the auditor's report by name and the actual or planned date of issuance. A copy of this letter may be requested by RD at its discretion.

Test of Controls Over Compliance – The auditor is required to test controls over compliance.

Attribute Sampling - Applies to all testing performed for the compliance component of an audit performed under this section.

When planning to test a particular sample of transactions, the auditor should consider the specific audit objective to be achieved and determine whether the audit procedure or combination of procedures to be applied will achieve that objective. The size of a sample necessary to provide sufficient evidential matter depends on both the objectives and the efficiency of the sample. All material instances of noncompliance, including those identified through sampling, must be reported as findings in the audit report.

Determining Test Objective, Defining the Population, and Defining an Exception

Before testing begins, the auditor must understand and document what attributes and assertions are being tested. The auditor needs to identify and document the appropriate population and should also perform procedures (for example, reconciliations or inquiry) to ensure that the population from which the sample is selected is complete.

Each compliance requirement selected for testing should be considered a separate population, and samples should be selected accordingly. The sample selected could possibly be used to test multiple attributes within each compliance requirement. Additionally, auditors must assess the control environment at entities with multiple locations. If controls at the different locations are significantly different, each location must be considered a separate population.

The auditor must document the "sampling unit," which is the individual item subject to sampling in the population. When selecting the sample of individual items, auditors must ensure that the sample is representative of the universe for the compliance requirement being tested.

The auditor should also clearly define what would be considered an exception. A single exception would indicate noncompliance, subject to further determination of materiality necessary to determine the required method of reporting.

Determining the Sample Size

To determine attribute testing sample sizes, the auditor needs to determine the value for three inputs: desired confidence level, tolerable exception rate, and expected exception rate. The compliance sample size table below is based on the following assumptions:

- **Desired confidence -** Auditors should obtain the appropriate level of assurance by using a confidence level of 90 or 95 percent.
- **Tolerable exception rate -** A 5-10 percent exception rate is acceptable.
- **Expected exception rate -** No exceptions should be expected.
- **Materiality -** Using attribute testing, monetary materiality, or tolerable misstatement is not a necessary input for determining sample size.

Sample Size Table

Using the above considerations and standard attribute sampling methodology, a low to normal level of assurance can be obtained by applying a 90 percent confidence level when there is an expectation of an error rate between 0 and 5 percent. The minimum recommended sample size using these parameters at a 5 and 10 percent tolerable exception rate is 50 and 25, respectively. Similarly, using a 95 percent confidence level, an expected error rate between 0 and 5 percent, and a 5 or 10 percent tolerable exception rate, the sample size is 65 and 35, respectively. These sample sizes are shown in the table below.

Compliance sample size table

Importance or significance of the attribute being	Confidence level	Tolerable rate	Minimum sample size for populations
Low to normal	90%	5%	50
Low to normal	90%	10%	25
High	95%	5%	65
High	95%	10%	35

This table is illustrative and does not replace professional judgment. As noted in the table, these are minimum sample sizes, and there may be many situations in which the auditor should also consider qualitative factors when determining sample size. Factors indicative of higher risk include but are not limited to:

- Whether this is the initial audit of the entity performed by the auditor.
- The entity's size and level of decentralization. The existence of a large number of prior, significant deficiencies, material weaknesses, or other audit findings.
- Poor internal controls.
- Extremely high volume of activity relating to a particular compliance requirement.
- High employee turnover in a particular area or department.

If the initial sample does not include a particular attribute being tested, typically there would be a need to have additional items included in the sample to address only that specific attribute.

Each compliance test performed should be evaluated separately for purposes of determining sample size. Professional judgment should be used to determine what tests are considered low versus high risk. When making the risk determination, it is important to understand the nature of the population.

Populations of 250 Items or Fewer

When performing compliance testing of populations of 250 items or fewer, auditors generally should examine at least 10 percent of the items in the population. This is a minimum sample size, and qualitative factors may exist that would require a larger sample size.

Testing and Evaluating Results

The sample sizes in the table above are based on an expectation of no exceptions. If the testing performed discovers no exceptions, the auditor has achieved a high degree of confidence that the attribute or assertion is being performed at an acceptable level.

If there are observed exceptions, the auditor should investigate the nature and cause of the exceptions to determine whether the exceptions are immaterial or represent material compliance findings or significant deficiencies or material weaknesses in internal control. It is not necessary to expand testing when exceptions are found.

In cases in which an exception is found, the auditor must determine whether the individual exception is material enough to report as a compliance violation. The auditor should also consider whether the lack of an effective internal control constitutes a significant deficiency or a material weakness and document the basis for an unqualified opinion if a finding is determined to be a significant deficiency or material weakness.

Audit Documentation

Documentation of sampling procedures must include the test objective, the definition of an exception, a description of the population tested and the sampling unit, the confidence level, the significance of the attribute, the sample size, and the results of testing.

Technical Assistance

Technical guidance on audit sampling is available in the AICPA's Audit Guide for Government Auditing Standards. Auditors may substitute an approach from the AICPA's audit guide for the approach described above, provided that the resulting sample size is equal to or greater than the above minimum sample sizes.

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ATTACHMENT 4-I

COMPLIANCE REQUIREMENTS AND AUDIT AREAS

Compliance Requirements and Audit Areas The following sections within this Attachment contain suggested audit procedures that RD believes should be performed. If an auditor determines that the stated procedures to be inappropriate and/or other audit procedures should be performed, the deviation from the stated procedures must be justified and documented in the auditor's working papers. The term "Owners" is utilized throughout this Attachment to refer to Borrowers, Projects, Entities, etc.

A. *Mortgage Status*

1. **Compliance Requirement** Owners shall promptly make all payments due under the note and mortgage.

2. ***Suggested Audit Procedures***

   a. Obtain a copy of the mortgage note, mortgage (or deed of trust), and associated loan amortization schedule to determine the terms and conditions of those agreements.

   b. Obtain an understanding of the Owner's procedures for assuring prompt payment of the mortgage.

   c. If the project is operating under a mortgage modification agreement, workout agreement, forbearance agreement, use agreement, or other agreement, determine whether the Owner is complying with the terms and conditions of the agreement.

B. *Replacement Reserve*

1. **Compliance Requirement** Owners, as required, shall establish a reserve for replacement account and make deposits in accordance with RD requirements, usually the loan agreement or other similar business agreement. Disbursements from the reserve for replacement fund may be made only after written consent is received from RD.

2. ***Suggested Audit Procedures***

   a. Obtain an understanding of the Owner's deposit and maintenance requirements included in the loan agreement, business agreement and any amendments or other written agreements with RD and determine whether there were any changes to the funding requirement by obtaining and reviewing Multi-Family Information System (MFIS) Project Reserve CheckBook Authorization (FIN 2100).

b. Obtain an understanding of the Owner's procedures for depositing, maintaining, requesting, and disbursing reserve for replacement funds.

c. Confirm the yearend balance of the replacement reserve. In addition to the confirmation of the balance, confirm with the financial institution that no encumbrances are being held on the reserve account.

d. Determine whether all disbursements from the reserve for replacement account were properly authorized by RD.

e. Determine whether the reserve fund has been established in a federally insured depository.

f. RD requires funds to be invested, determine whether funds were invested and interest was only withdrawn with RD approval.

g. Using the FIN 2100 Report, the confirmation of the account balance and the approved withdrawals determine whether all required deposits to the reserve for replacement were made in compliance with RD requirements and agreements and the project is on schedule with its funding requirements.

h. Review the related repairs covered by funds from the reserve for replacement account. Trace the reserve withdrawal amount to cancelled invoices and cancelled checks or check images to determine whether funds were used for the purpose authorized by RD.

C. *Return on Investment (ROI) or Return to Owner (RTO)s*

1. **Compliance Requirement** Owners may not make, receive, and/or retain any distribution of assets or any income of any kind unless the project has positive net cash flow per "Multiple Family Housing Project Budget", Form RD 3560-7, line 30. This process is further defined in Chapter 4.

2. ***Suggested Audit Procedures***

a. Obtain a copy of the project's loan agreement, business agreements and any amendments or associated documents to determine the owner's rights for receiving distributions.

b. Obtain an understanding of the Owner/management agent's procedures for determining the cash available for making distributions.

c. Scan minutes of board or partnership meetings for discussions authorizing distributions.

d. Question the Owner or management agent about the existence of any notices of default or other items of noncompliance under any of the terms of the loan or business agreement.

e. Determine whether the Form RD 3560-7 was prepared in accordance with the loan or business agreement and other RD guidance.

f. Determine whether distributions taken during the audit period exceeded the amounts calculated and/or authorized for that period based on the loan or business agreements, including any amendments.

g. Scan cash disbursements for evidence of any payments made to the Owner or related parties. Scan journal entries for unexplained decreases in accounts payable, notes payable, and the related unpaid interest to the Owner or related parties. Determine whether the owner paid partnership management fees, asset management fees, incentive management fees, and write-offs of related party receivables from funds other than allowable distribution amounts.

h. Scan the bank statements for any deposit, from the Owner and/or related parties, which would evidence that incorrect distributions or payments were made and that those funds were redeposited into the project's accounts during the year under audit.

i. Review inspection reports and Owner responses to verify compliance with all outstanding notices for proper maintenance of the project. Delays in making repairs could erroneously result in excess operating cash being reported to be on hand at the end of the reporting period, making funds available for distribution to the Owners.

j. With Agency approval, Owners operating on a for-profit or a limited profit basis may make an annual withdrawal from the reserve account, equal to no more than 25 percent of the interest earned on a reserve account during the prior year. The borrower uses Form RD 3560-12, requesting the withdrawal and must provide documentation of the prior year interest earned.

D. Equity Skimming

1. **Compliance Requirement** Equity skimming is the willful misuse of any part of the rent, assets, proceeds, income, or other funds derived from the project covered by the mortgage for any purpose other than to meet actual or necessary expenses of the project. Equity skimming deprives the project of needed funds for repairs, maintenance, and improvements, which contributes to the financial and physical deterioration of the project and the standard of living conditions for the families who depend on the federal government to provide housing. Also, a community where the project is located suffers since the project may become the breeding ground for crime, violence, and drugs.

2. **Suggested Audit Procedures** The various compliance areas in this Attachment have included audit steps that are designed to disclose equity skimming.

E. *Cash Receipts*

1. **Compliance Requirement** All cash receipts, including those collected by a management agent, must be deposited into an account in the name of the project at an institution in which deposits are federally insured.

2. ***Suggested Audit Procedures***

   a. Obtain an understanding of the Owner/management agent's procedures for handling cash receipts.

   b. Determine whether the account is exclusively in the name of the project.

   c. Verify that cash receipts are maintained in an FDIC account.

   d. Obtain the monthly project worksheets and determine the net tenant rent and rental assistance are reasonable compared to amounts recorded in the general ledger.

   e. Owners may be motivated to both understate and overstate revenue. The following audit steps are designed to disclose such occurrences:

      (1) Consider the fraud risk factors and the potential for material misstatement of the financial statements related to revenue recognition including vacancy loss and bad debt expense. Perform testing to address any material fraud risk factors identified. The auditor should tailor audit steps/procedures based on the individual risk factors identified and the results of other audit evidence gathered.

      (2) Determine whether vacancy loss is greater than 15 percent of total rental revenue or if the change in vacancy loss between the current year and prior year is greater than 5 percent. If so, the following steps should be performed:

         i. Determine whether rent potential and vacancy loss were properly calculated.

         ii. For all revenue accounts, scan the detailed general ledger. Review the supporting documentation for all material manual entries and unusual entries.

         iii. Determine the reason for the increase or cause of the high vacancy rate via discussion with management. The auditor may also want to select a sample of vacant units and perform tests to substantiate the high vacancy rate. Possible tests on the sample include but are not limited to the following:

(i). Reviewing the move-out notice from the tenant.

(ii). Reviewing the documentation from the move-out inspection.

(iii). Determining whether the security deposit was refunded to the tenant.

(iv). Reviewing the itemized list of damages and charges provided to the tenant, which was used to reduce the amount of security deposit due back to the tenant.

(v). Inspecting the vacant unit if the unit is still unoccupied.

(vi). Questioning site personnel, including the resident manager and the building manager, to determine the period when the unit was vacant.

(vii). Reviewing work orders to determine the period when the unit was vacant.

(3) Determine whether bad debt expense is greater than 10 percent of total rental revenue or whether the change in bad debt expense is greater than 5 percent between the current year and the prior year. If so, the following steps should be performed:

i. Obtain an understanding of the owner/management agent's procedures for collecting delinquent debt and policy for writing off debt.

ii. Determine whether delinquent accounts are sufficiently pursued according to procedures.

iii. Select a sample of accounts written off to bad debts expense and review supporting documentation to determine whether debt was written off in accordance with policy and generally accepted accounting principles.

iv. Determine the reason for any activity on the tenant record after the debt was written off.

F. ***Cash Disbursements.***

1. **Compliance Requirement.** All disbursements from the regular operating account must be supported by approved invoices, bills, or other supporting documentation. Project funds should only be used to pay for mortgage payments, required deposits to the reserve for replacement fund, reasonable expenses necessary for the operation and maintenance of the project, distributions, as permitted, and repayment of owner advances or as authorized by RD.

2. ***Suggested Audit Procedures.***

   a. Obtain an understanding of the Owner/management agent's procedures for withdrawing funds from the regular operating account and determine whether they are properly supported and used in accordance with the loan agreement.

   b. Select a sample of disbursements from the cash disbursement ledger or similar record related to Form 3560-7, Part II, line items 1-10 and 19-32 and perform the following steps:

      (1) Determine whether the disbursements are supported by approved invoices, bills, or other supporting documentation; the supporting documents are in the name of the project; and the costs are reasonable and necessary for the operation of the project. If the supporting documentation is not in the name of the project, determine whether only the portion applicable to the project was paid from project funds.

      (2) Determine whether the disbursements were made on behalf of other projects or entities since project funds cannot be loaned or used for nonproject purposes. Report instances even if amounts have been repaid prior to the issuance of the audit report unless clearly inconsequential and was discovered in the normal course of internal control processes.

      (3) Determine whether the disbursements were properly charged to the correct account.

G. ***Tenant Security Deposits.***

1. **Compliance Requirement.** Funds collected as a security deposit shall be kept in the name of the project, separate and apart from all other funds of the project in a trust account. The amount of this account shall at all times equal or exceed the aggregate of all outstanding obligations under that account. In addition, state and local governments may have specific regulations governing the handling of tenant security deposits.

2. ***Suggested Audit Procedures.***

a. Obtain an understanding of the Owner's procedures, including state and local laws, and regulatory agreement and RD requirements for establishment and maintenance of the security deposit account and making approved disbursements from that account.

b. Determine whether the account has been established in a federally insured depository in the name of the project, which is segregated from project operating funds, and the owner's records support the amount on deposit.

c. Determine whether interest is earned on the security deposit account and the disposition of that interest. If state and local law requires the owner to pay the tenant for interest earned, determine that the tenant interest is credited to tenants and paid upon termination of tenancy.

H. ***Management Functions.***

1. **Compliance Requirement.** The Owner is responsible for complying with all requirements of the regulatory and loan agreements. *The Owner may perform all management functions or contract with a management agent to provide project management, but the responsibility cannot be delegated to the management agent. The owner or management agent must be approved by RD and must certify that it will follow RD's rules and regulations.

2. ***Suggested Audit Procedures.***

a. Obtain a copy of the most recent RD-approved management agent's certification (Form RD 3560-13). Perform the following steps:

(1). Determine whether RD has approved the Owner or current management agent.

(2). Obtain the identity-of-interest (IOI) disclosure certificate (Form RD 3560-31) from the owner or RD and that the IOI's have been reported in the notes to the financial statements.

(3). Using the Form 3560-31, examine a sample of invoices from IOI companies and determine that the actual services and fees charged to the project were approved and properly supported.

(4). Determine whether the management agent fees paid exceeded the amount listed on the management agent certification. This amount should also agree with the amount in the management agreement.

b. Determine whether the Owner or the management agent has obtained a fidelity bond in accordance with 7 CFR 3560.105.

c. Determine whether hazard insurance has been obtained in the amount required by the project's mortgage.

d. Determine whether the Owner or management agent has responded to all RD management review reports, physical inspection reports, and inquiries regarding annual financial statements or monthly accounting reports within 30 days.

I. *Unauthorized Change of Ownership/Acquisition of Liabilities.*

1. **Compliance Requirements.** Owners shall not, without the prior written consent of RD, convey, assign, transfer, dispose of, or encumber any of the mortgaged property or permit the conveyance, transfer, or encumbrance of such property.

2. *Suggested Audit Procedures.*

   a. Question management about the existence of any agreements to sell, assign, dispose of, or encumber any of the mortgaged property or assets of or beneficial interest[1] in the property. Review any agreements. Determine whether RD has approved transactions or is in the process of approving transactions and report any instances of noncompliance.

   b. Confirm all material liabilities listed on the client's balance sheet. Review for indications of change of ownership or additional encumbrances that may have been made without RD approval.

   c. Report any other instances of unauthorized conveyance, assignment, transfer, disposal, or encumbrance of any of the mortgaged property or assets of or beneficial interest* in the property identified during the course of the audit.

J. *Unauthorized Loans of Project Funds.*

1. **Compliance Requirements.** Owners shall not, without the prior written consent of RD, assign, transfer, dispose of, or encumber any personal property of the project, including rents, or pay out any funds except for reasonable operating expenses and necessary repairs.

2. ***Suggested Audit Procedures.***

a. Question management about the existence of any agreements to assign, transfer, dispose of, or encumber any of the personal property of the project, including rents, and read any agreements.

b. Review the results of the audit procedures applied to specific accounts or other general procedures to identify the existence of any unauthorized transactions.

c. *Test accounts receivable to determine whether receivables are the result of routine operations and whether project funds have been loaned to the management agent, other projects, employees, or the owner.*

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* Beneficial interest is generally the right to profits from an estate or property without owning the estate or property.

ATTACHMENT 4-J
EXAMPLE INDEPENDENT ACCOUNTANTS' COMPILATION REPORT ON RD PRESCRIBED FORMS

Note – Subject to change based on the most recent professional literature and guidance.

It is the accountant's responsibility to use the most up to date language.

INDEPENDENT ACCOUNTANT'S COMPILATION REPORT

To the Partners of ABC Limited Partnership

City, State

I (We) have compiled the balance sheets of XYZ Partnership as of December 31, 20XX and 20XX and the related statements of income for the years then ended included in the accompanying prescribed forms. (2) I (We) have not have not audited or reviewed the financial statements included in the accompanying prescribed forms and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with forms prescribed by the U.S. Department of Agriculture, Rural Development.

Management is responsible for the preparation and fair presentation of the financial statements included in the forms prescribed by the U.S. Department of Agriculture, Rural Development, and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

My (Our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

The financial statements included in the accompanying prescribed forms are presented in accordance with the requirements of the U.S. Department of Agriculture, Rural Development, and are not intended to be a presentation in accordance with accounting principles generally accepted in the United States of America.

The accompanying supporting documentation on page(s) XX through XX of the prescribed forms is (are) presented for purposes of additional analysis and is (are) not a required part of the basic financial statements. The supplementary information has been compiled from information that is the representation of management. I (We) have not audited or reviewed the supplementary information and, accordingly, do not express an opinion or provide any assurance on such supplementary information. (3) (4)

This report is intended solely for the information and use of the management of ABC Limited Partnership and the U.S. Department of Agriculture, Rural Development and is not intended to be and should not be used by anyone other than these specified parties.

Date of report

(1) Statement on Standards for Accounting and Review Services (SSARS) 19 requires the report to be titled.
(2) Rural Development instructions indicates the report should cover both the 3560-10 and the 3560-7
(3) Although not explicitly stated in SSARS 19, the examples contained therein use a separate paragraph for reporting on supplementary information.
(4) If there is supplementary information that is not compiled by the accountant it should be described here. For example, "I (We) have not compiled, reviewed or audited the supplementary information included on page(s) XX through XX and do not express an opinion or provide any form of assurance on it."

See Accompanying Independent Accountants' Report

ATTACHMENT 4-K

EXAMPLE REPORTS

1. **Independent Auditor's Report**

2. **Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards**

3. **Independent Auditor's Report on Compliance For Each Major RD Program and Internal Control Over Compliance required by the Audit Guide for Audits of RD Programs**

Note – Subject to change based on most recent professional literature and guidance. It is the auditor's responsibility to use the most up to date language.

INDEPENDENT AUDITORS' REPORT

To the Partners of
ABC Limited Partnership
DBA ABC Apartments
City, State

USDA Rural Development
Servicing Office
City, State

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Limited Partnership, which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income and expense, changes in partner's capital, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Limited Partnership, as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Other Information

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The accompanying supplementary information shown on pages XX to YY is presented for purposes of additional analysis and is not a required part of the financial statements.

The accompanying supplementary information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the accompanying supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards,* we have also issued our report dated DATE, YEAR, on our consideration of ABC Limited Partnership's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering ABC Limited Partnership's internal control over financial reporting and compliance.

Firm's Signature
City, State
DATE, YEAR

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

To the Partners of
ABC Limited Partnership
DBA ABC Apartments
City, State

USDA Rural Development
Servicing Office
City, State

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of ABC Limited Partnership, which comprise the balance sheet as of December 31, 20X2, and the related statements of operations, changes in partners' equity and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated DATE, YEAR.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered ABC Limited Partnership's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of ABC Limited Partnership's internal control. Accordingly, we do not express an opinion on the effectiveness of ABC Limited Partnership's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether ABC Limited Partnership's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of ABC Limited Partnershp's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering ABC Limited Partnership's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Firm's signature
City, State
DATE, YEAR

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE FOR EACH MAJOR RD PROGRAM AND ON INTERNAL CONTROL OVER COMPLIANCE REQUIRED BY THE CONSOLIDATED AUDIT GUIDE FOR AUDITS OF RD PROGRAMS

To the Partners of
ABC Limited Partnership
DBA ABC Apartments
City, State

USDA Rural Development
Servicing Office
City, State

Report on Compliance for Each Major RD Program

We have audited ABC Limited Partnership's compliance with the compliance requirements described in the *Audit Guide for Audits of RD Programs* (the Guide) that could have a direct and material effect on ABC Limited Partnership's major U.S. Department of Rural Development (RD) program for the year ended December 31, 20X2. The Partnership's major RD program is as follows:

List the major program.

Management's Responsibility

Management is responsible for compliance with the requirements of laws, regulations, contracts, and grants applicable to its RD program.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for each of ABC Limited Partnership's major RD programs based on our audit of the compliance requirements referred to above. We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and the Guide. Those standards and the Guide require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the compliance requirements referred to above that could have a direct and material effect on a major RD program occurred. An audit includes examining, on a test basis, evidence about ABC Limited Partnership's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

We believe that our audit provides a reasonable basis for our opinion on compliance for each major RD programs. However, our audit does not provide a legal determination of ABC Limited Partnership's compliance.

Opinion on Each Major RD Program

In our opinion, ABC Limited Partnership complied, in all material respects, with the compliance requirements referred to above that could have a direct and material effect on each of its major RD program for the year ended December 31, 20X2.

Other Matters (needs to be included if immaterial instances of non-compliance were noted)

We noted certain matters that we are required to report to management of ABC Limited Partnership in a separate written communication. These matters are described in our management letter dated DATE, YEAR.

Report on Internal Control Over Compliance

Management of ABC Limited Partnership is responsible for establishing and maintaining effective internal control over compliance with the compliance requirements referred to above. In planning and performing our audit of compliance, we considered ABC Limited Partnership's internal control over compliance with the requirements that could have a direct and material effect on its major RD program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for its major RD program and to test and report on internal control over compliance in accordance with the Guide, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of ABC Limited Partnership's internal control over compliance.

A *deficiency in internal control over compliance* exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a compliance requirement of an RD program on a timely basis. A *material weakness in internal control over compliance* is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a compliance requirement of a RD program will not be prevented, or detected and corrected, on a timely basis. A *significant deficiency in internal control over compliance* is a deficiency, or a combination of deficiencies, in internal control over compliance with a compliance requirement of a RD program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of the Guide. Accordingly, this report is not suitable for any other purpose.

Firm's signature
City, State
DATE,YEAR

ATTACHMENBT 4-L

Agency Review of Annual Financial Reports

Borrower/Property Name: _________________________ Number of Units: ________ RA Units ________
Year Ending: ______________ Date Received: __________________ (complete package)

Borrower Submissions

☐ **Form 3560-7** MFH Project Budget *Actual Expenditures* (Submitted through MINC, unless <8 units)
☐ **Form 3560-10** MFH Borrower Balance Sheet (Submitted through MINC, unless < 8 units))
☐ **Borrower Certification of Performance Standards** (Attachment 4-F)
☐ **Engagement Letter (over $500,000 federal financial assistance) NOT required for State and Local Governments, Indian tribes and Nonprofit Organizations SUBJECT TO 2 CFR 200, Part F**
☐ **Independent Accountants' Compilation Report (over $500,000 federal financial assistance) NOT required for State and Local Governments, Indian tribes and Nonprofit Organization SUBJECT TO 2 CFR 200 Part F**
☐ **Audited Financial Statements** (In accordance with GAGAS and yellow book standards) **(over $500,000 federal financial assistance) OR:**
☐ **Audited Financial Statements** (In accordance with 2 CFR 200 Part F) **State and Local Governments, Indian tribes and Nonprofit Organizations (Entity with over $750,000 federal financial assistance)**

Reports to Print

☐ Year End Actual Analysis
☐ Year End Actual Management Fee Analysis
☐ Year End Actual Rental Income Analysis
☐ Year End Actual Escrow calculation
☐ FIN2100 - Project Reserve Account Checkbook and Project Outstanding Authorizations
☐ PRJS4200 – Occupancy Trend

Agency Review

☐ Confirm that the engagement was prepared by CPA as described in the requirements
☐ Confirm that the performance standards were certified as described
☐ Confirm that nonprofit and public bodies have submitted any OMB required annual financial statements
☐ Note any findings identified in the compilation report and determine corrective actions. These would be located in the findings of the audit findings page
☐ Utilize the MFIS analysis tool to perform the preliminary assessment of the financial statements.
☐ Confirm the information submitted to the Agency electronically through MINC on Forms RD 3560-7 and 3560-10 is the same as the forms submitted with the financial reports from the auditor

Follow-up needed by __________on items in e-mail/letter to borrower dated __________.
(e-mail/letter attached)

COMMENTS:____
____
____

BORROWER CERTIFICATION OF PERFORMANCE STANDARDS

The Borrower must have certified the following per Attachment 4-F:

- ☐ Required accounts are properly maintained and tracked separately.
- ☐ Payments from operating accounts are disclosed and accurately represented.
- ☐ Reserve amount is current (i.e. contributions are on schedule and the balance accounts for contributions less authorized withdrawals), and there are no encumbrances.
- ☐ Tenant security deposit accounts are fully funded and are maintained in separate accounts.
- ☐ Payment of owner return was consistent with the terms of the applicable loan agreement or loan resolution.
- ☐ Borrower/grantee has maintained proper insurance in accordance with the requirements of 7 CFR 3560.105.
- ☐ All financial records are adequate and suitable for examination
- ☐ There have been no changes in project ownership other than those approved by the Agency and identified in this certification. Non-Profit organizations certify that the board is active and maintains oversight of the property. All current owners are identified in the Status of Ownership table in this attachment. This includes General Partners, Limited Partners, President, Vice President, Secretary, Treasurer, Member and other Partners as applicable.
- ☐ The real estate taxes are paid in accordance with state and/or local requirements and that there are currently no delinquent taxes.

AGENCY REVIEW OF ANNUAL FINANCIAL REPORTS

A. Analysis of actual income and expenses.

Using the actual budget submitted, review actual income and expenses in MFIS and note any unexpected variance. RUN Analysis Report – review and explain variances in comments.

B. Account maintenance, tracking, and disclosure.

☐ Review in MFIS the account balances from the report and confirm that the financial report states that:

- Required accounts (operating, reserve, tax & insurance, and tenant security deposits) are maintained and tracked separately; ○ Yes ○ No ____
- Payments from operating accounts are disclosed and accurately represented.
  ○ Yes ○ No ____

C. **Reserve account status.**

From the financial report, review the amounts listed for the reserve balance, deposits, and withdrawals, and confirm that the financial report states that the reserve account is current and that there are no encumbrances on the reserve account funds.
Review Reserve Tracked account to be sure actual withdrawals on reports match authorized withdrawals in Tracked Account.

If Reserve Account is Delinquent have you requested a Work Out Agreement? ○ Yes ○ No ____________

The following items are flags and require further analysis: Was Reserve used for operating? ○ Yes ○ No _____
Is there less than $1000 balance in the reserve account? ○ Yes ○ No _______________

D. **Tenant security deposit account status.**

Review in MFIS the tenant security account balance from the financial report and confirm that the report shows that the tenant security deposit balance meets liabilities and funds are maintained in a separate account and in accordance with state law.

E. **Payment of return to owner OR Non-Profit Asset Management Fee.**

- ❑ Confirm that the financial report states that the payment of the owner's return was consistent with the terms of the loan agreement or resolution.

  The payment of owner return was:

  - ❑ paid in the amount of $____________ for _____ fiscal year and **<u>was</u>** in accordance with the Agency's requirements
    - o Amount allowed from $______ Net Cash $ ____Excess Cash $___Reserve Account
  - ❑ paid in the amount of $____________ for _____ fiscal year and **<u>was not</u>** in accordance with the Agency's requirements
    - o Requested to refund ____________
  - ❑ not paid during the reporting year

  The payment of Non-Profit Asset Management Fee was:

  - ❑ paid in the amount of $____________
  - ❑ not more than $7500 per project for certain organizational expenses, such as errors and omissions and actual expenses prorated by the number of Rural Development projects.
  - ❑ documented by evidence of allowable expenses.

F. **Insurance status.**

☐ Confirm that the financial report states that all relevant insurance requirements were met.

G. **Taxes and other assessments.**

☐ Confirm that the financial report states that taxes and other assessments are current.

- List any taxes or assessments that are not current. ____

H. **Issues of financial compliance and conditions.**

☐ Confirm in the financial report that any funds used for unauthorized purposes have been repaid.

- ○ Not Applicable
- ○ Yes…Amount Repaid $__________________ / What for: ________________________________

I. Payment of management fees.

Using the actuals in the financial report, confirm that the management fee was paid in accordance with the management certification and that the management agent is not charging the project for agent expenses. Review Management Analysis in MFIS.

☐ The management agent is not charging the project for agent expenses

J. Miscellaneous Review

Is all Rental Assistance being utilized? ○ Yes ○ No _______________

☐ This borrower has $500,000 or less of federal financial assistance -- Audit is not required

PROJECT FINANCIAL AUDIT
Over $500,000 federal financial assistance

An audit should consist of the following items at a minimum:

- ❑ Independent Auditor's Report
- ❑ Financial Statements
  - ○ Balance Sheets
  - ○ Statements of Operations
  - ○ Statements of Changes in Partner's Equity (Deficit)
  - ○ Statements of Cash Flows
- ❑ Notes to the Financial Statements
- ❑ Supplemental Information
  - Management Fee Calculation
  - Insurance Disclosure
  - Return to Owner
  - Changes in Rental Property
  - Multiple Family Housing Borrower Balance Sheet – form RD 3560-10
  - Multiple Family Housing Project Budget – Form RD 3560-7
  - Supporting Documentation to Form 3560-10 and 3560-7
- ❑ Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards
- ❑ Independent Auditor's Report on compliance for Each Major RD Program and Internal control Over Compliance required by the Audit guide for Audits of RD Programs
- ❑ Schedule of Findings and Questioned Costs (current year and prior year)
- ❑ Corrective Action Plan (if applicable)

COMMENTS:
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Agency Review of Annual Financial Reports

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Review Completed By   Date