

CHAPTER 7: SERVICING PERMANENT LOANS

7.1 INTRODUCTION

This chapter is designed to serve as a best practices guidebook for servicing GRRHP loans which have reached the permanent financing phase. While it establishes minimum servicing standards, the Agency expects lenders to service the loans according to the same standards of excellence as other loans in the lender's portfolio.

Key Topics in this Chapter

- Section 1: Servicing Objectives
- Section 2: General Servicing Requirements
- Section 3: Asset Management
- Section 4: Special Servicing

SECTION 1: SERVICING OBJECTIVES

7.2 OBJECTIVES

In establishing servicing standards for GRRHP loans, the Agency has four major objectives:

- Protecting the Value of the Financial Asset;
- Ensuring the Program Compliance;
- Protecting the Tenants' Rights; and
- Protecting the Government's Interest.

7.3 PROTECTING THE VALUE OF THE FINANCIAL ASSET

The financial asset includes both the loan and the property that serves as collateral. Protecting the value of the asset ensures that the property will remain available as affordable housing for the term of the loan and protects the financial interests of the lender and the Agency. The lender and the borrower are responsible for protecting the value of the asset through regular monitoring, inspections of the property, regular maintenance, and management of reserve and escrow accounts.

7.4 ENSURING THE PROGRAM COMPLIANCE

The lender must be knowledgeable of the program requirements and be capable of enforcing the program requirements. As an approved lender in the program, the lender agrees to comply with the statute, regulations and guidance issuances for the program. Furthermore, the lender must monitor the borrower's activities to ensure compliance with the statute, regulations, and guidance issuances for the program. A key component of the program compliance is timely submission of reports due to the Agency.

7.5 PROTECTING THE TENANTS' RIGHTS

The lender must ensure that the borrower complies with the GRRHP occupancy requirements, rent restrictions, and tenant protections throughout the term of the guarantee and mortgage. As long as a tenant is in compliance with the lease, he/she has the right to remain in a rental unit even if his/her income increases above the 115% of median income threshold. To maintain affordability, the lender must monitor the project rents to ensure they do not exceed the GRRHP's limits, and monitor the median income levels for the property area as these median income levels change periodically.

7.6 PROTECTING THE GOVERNMENT'S INTEREST

Approved lenders [7 CFR part 3565, subpart C] must operate under the Agency approved plan for originating and servicing GRRHP loans. The Agency expects that the lender will service the loans according to the same standards it services all other multifamily loans it originates, services or holds in its portfolio. The requirements for the origination and servicing plan can be found in Chapter 2.

The GRRHP's servicing standards are designed to preserve the asset and protect the interests of the Government. Servicing requirements include, but are not limited to:

- Minimum requirements for annual reviews of the physical and financial conditions of the property.
- Reporting requirements designed to keep the Agency informed of the loan performance and property condition.
- Minimum standards for special servicing for loans that are delinquent or in default.

SECTION 2: GENERAL SERVICING REQUIREMENTS

7.7 FUNDS MANAGEMENT



A. Collecting and Processing Borrower Payments

The lender will collect and apply borrower payments on the loan in accordance with Generally Accepted Accounting Principles. At a minimum, such standards should meet the requirements established by Fannie Mae, Freddie Mac, or Ginnie Mae for similar properties.

B. Escrow and Reserve Account Management

The lender is responsible for proper maintenance of the borrower's escrow accounts. Escrow accounts should be established for both hazard and property insurance and, if applicable, flood insurance. Escrows should also be established to reserve the monthly share of annual property tax and property insurance payments. In addition, each property must have a replacement reserve account established to receive monthly deposits for projected replacement of appliances, furnishings, equipment, and major repairs.

C. Interest Credit, if Applicable

For each guarantee option, options one, two and three, interest credit will be paid annually, if applicable, starting on January 1 of the year after the Agency concurs in writing that the project has met the regulatory requirements for a guarantee of its permanent financing phase.

The interest credit calculation and the request for interest credit, if applicable, will be part of the annual report provided to the State Office. The State Office will review the calculation for accuracy and then forward the document to the Finance Office for processing. In its first year, interest credit, if applicable, will be calculated from the date of the Agency's written concurrence that the project has met the regulatory requirements for a guarantee of its permanent financing phase to the end of the year.

D. Approval of Reserve Releases

1. *Agency Recommended Approval Requirements*

Lenders must establish their own reserve management protocols in the lender servicing plan. The procedures should include, at a minimum, the following:

- **Lender approval** of releases of funds from required reserve accounts.
- **Documentation of completed work.** Most requests should be processed on a post-approval basis (once the work is completed or expenses paid and the required documentation submitted). While the Agency does not have specific requirements for verification of expenses, the lender should ensure that reserve funds are used for eligible purposes. Documentation should include original receipts and a borrower certification that the work described has been completed.

2. *Approval of Structural Repairs*

The Agency recommends pre-approval by the lender for repairs involving structural work. A review and approval of the plans and specifications for such work may also be warranted.

3. *Obtaining Bids in the Use of the Reserve Account*

Lenders should require borrowers to obtain bids on major repairs, construction projects, or purchases. A recommended standard is three written bids for any single purchase or project that exceeds \$10,000. Borrowers should be required to justify any bid accepted that is higher than the lowest bid.

4. *Minimum Replacement Reserve Levels*

For new construction, a replacement reserve balance of \$1,000 per unit is the minimum level for the reserve account by the time the project reaches the end of its third year of occupancy. The replacement reserve balance of \$1,000/unit must be maintained through whichever occurs first: year seven or the performance of a CNA that supports maintaining, decreasing, or increasing the yearly contributions. The CNA must be performed by year seven and updated every five years thereafter. The replacement reserve balances should be reviewed annually and modifications made if the reserve balances are not sufficient to address long term replacement needs.

For projects that are being rehabilitated, required deposits to the replacement reserve account for the first seven years of occupancy will be determined by the lender through a CNA. The lender must update the CNA every five years and update the per unit annual contribution accordingly.

Any drop below required levels for new construction or rehabilitated projects should be reported to the Agency as part of the annual report on the property.

5. *Eligible Uses of Reserve Funds*

Reserve funds should be used for the repair and replacement of depreciable physical property. The lender has the discretion to approve or disapprove the use of reserve funds, even if an item is permitted by Agency guidance, if the lender feels it is in the best financial interest of the property. A list of eligible uses is suggested in Exhibit 7-1. Items permitted by Fannie Mae, Freddie Mac, and Ginnie Mae as eligible reserve release items will also be considered eligible by the Agency.

Exhibit 7-1

Examples of Eligible Uses of Replacement Reserve Account Funds

- Replacement of refrigerators, ranges, and other major appliances in the dwelling units.
- Replacement of kitchen and bathroom sinks and counter tops, bathroom tubs, toilets, and doors (exterior and interior).
- Major roof repairs, including replacement of sheathing, gutters, downspouts, and eaves or soffits.
- Major plumbing and sanitary system repairs.
- Replacement or major overhaul of central air conditioning and heating systems, including cooling towers, water chilling units, furnaces, stokers, boilers, and fuel storage tanks.
- Overhaul of elevator systems.
- Repaving/resurfacing/seal coating of sidewalks, parking lots, and driveways.
- Repainting of the entire building exterior or interior common areas.
- Replacement of siding.
- Replacement of fire alarms.
- Playground equipment.
- Replacement of exterior (lawn) sprinkler systems.

Replacement items should be at least comparable in quality to items approved at the time of the original construction of the property and in accordance with the initial plans and specifications. When replacing obsolete or broken appliances, the purchase of new energy efficient models is encouraged.

On an annual basis, the lender must submit to the Agency a summary of the reserve withdrawal requests made and related work inspection reports for the prior year.

While enhancements to the property such as a personal computer or software may be considered for funding, items generally considered routine maintenance items should be ineligible for funding from the replacement reserve account. The Agency may require a lender to justify any release of reserve funds for these purposes. The use of reserve funds is normally considered a categorical exclusion under the Agency's environmental review process, unless the funds will be used in ways that alter the purpose, operation, location, or design of the project. Particular care should be taken that reserve funds are not used to alter the historic integrity of places listed or eligible for listing on the National Register of Historic Places until an environmental review is completed in accordance with RD Instruction 1940-G. Lenders must check with the Agency regarding the possible need for an environmental review prior to approval of the use of reserve funds.

E. Approval of Surplus Cash Distribution to the Borrower

Surplus cash is defined as year-end cash available after the project has met all operating expense and debt service payments, including the required funding of reserves.

While a surplus cash distribution to the owner is not restricted as to the amount, Agency regulations require that the lender ensure that the property be in "good financial and physical condition (no deferred maintenance) and in compliance with the regulatory agreement" prior to any distribution of surplus cash.

1. Borrower Request for Distribution of Surplus Cash

Once the project is fully operational, at the end of the project's 1st fiscal year after the completion of any construction, the borrower may request the release of surplus cash. As a prior condition for such release, the borrower must submit an annual audited financial statement of the property to the lender (see Paragraph 7.12 A.1. for information on audit requirements). The audit must not have any unresolved findings. Once the lender reviews the statement and certifies that the borrower is in compliance with program requirements, the lender may permit the owner to have access to all or a portion of any surplus cash.

2. *Lender Denial of Surplus Cash*

If the borrower has any current or previous unresolved audit findings or any violation of program requirements, the lender may deny access to surplus cash. Exhibit 7-2 gives examples of reasons for denial of surplus cash.

<p>Exhibit 7-2</p> <p>Examples of Reasons for Denial of a Year-End Surplus Cash Distribution</p> <ul style="list-style-type: none"> • Fair Housing violations • Violations of State or local law • Underfunded reserve accounts • Failure to submit a budget or other reporting requirements to the lender in a timely manner • Failure to properly maintain the property • Failure to comply with the mortgage documents or regulatory agreement

3. *Borrower Withdrawal of Surplus Cash Without Lender Approval*

Primary responsibility for control of surplus cash distribution remains with the lender. If a borrower withdraws surplus cash without lender approval, the lender must require the borrower to replace the funds into the proper operating account. If appropriate, the lender may permit repayments in installments as part of a corrective action plan. If the borrower fails to comply, the lender must enforce the technical default clause under the regulatory agreement and accelerate the loan.

This action must be reported to the Agency in the same manner as a monetary default on the mortgage.

7.8 ADDRESSING DEFAULTS AND DELINQUENCIES

Lender actions to remedy delinquencies and defaults must be addressed in the lender servicing plan. Since delinquencies and defaults trigger special servicing actions, it is important to identify when they occur and when the lender must initiate special action. Unless otherwise approved in the servicing plan, the following definitions will apply to delinquencies and defaults.

A. Delinquencies

A project will be considered to be delinquent when the borrower has failed to make the full amount of a required payment on the due date plus any grace period or fails to comply with non-monetary requirements. Once the loan becomes delinquent, the lender must submit monthly reports to the Agency in accordance with Paragraph 7.12 B.3.

B. Defaults

1. Monetary Default

A project that is in monetary default is defined as one that is delinquent for more than 60 days. Payments are due in the date specified in the Promissory Note.

2. Nonmonetary Default

Nonmonetary defaults include, but are not limited to, failing to maintain the Agency required debt service coverage ratio, failing to maintain project reserves, failing to adequately maintain the physical condition of the property, failing to comply with environmental mitigation measures, failing to meet fair housing requirements, and failing to properly report to the Agency

C. Declaring a Default

A lender may declare a default if the delinquency remains outstanding after 30 days from the due date of the payment or written notice of a non-monetary delinquency or default.



D. Initiating Special Servicing

Special servicing should be initiated in accordance with Section 4 of this chapter as soon as a default occurs. A workout plan must be submitted to the Agency no later than 60 calendar days after the date the lender notifies the borrower that they are in default. The holder must be notified at this time as well.



Example of Initiating Special Servicing – Failure to Pay Mortgage

1st of the month – The mortgage payment is due.

15th of the month – The mortgage payment has not been received. A delinquency notice is sent to the borrower warning them of a default under the mortgage documents if a full payment is not received by the end of the month.

End of the month – The mortgage payment has not been received. The loan is now in default. The lender informs the borrower of the default and demands payment. The borrower may request a workout plan. If the lender agrees to the workout plan, the borrower submits the plan to the lender.

End of the second month – The lender determines if the plan is acceptable (see Section 4 of this chapter). If so, then the plan is submitted to the Agency. It must be submitted to the State Office by the end of the second month (60 days from the date of notification).

7.9 TRANSFER OF OWNERSHIP

A. Changes in the Ownership Entity

Transfer of ownership is normally considered a categorical exclusion under the Agency’s environmental review process, unless the transfer will result in an alteration to the purpose, operation, location, or design of the project as originally approved.

Any changes in ownership, in whole or in part, must be approved by the lender and the Agency before such change takes effect. These include any change in the general partners or in limited partners with a partnership interest greater than 10 percent or a change that requires modification of the title. Prior to approving a change in the ownership entity, the lender must assure that the proposed new partner or entity is not currently on the General Services Administration (GSA) debarment list and that they are able to obtain a *Form RD 1944-37* clearance on the entity. The lender may access the GSA debarment list online at <https://www.sam.gov/portal/SAM/#1>.

If the proposed transfer meets the conditions aforementioned, then the lender must also determine that the transfer will not adversely affect the value and/or operation of the property before it is approved. If the transfer is not approved, the lender must document the reason for a denial and notify the applicant in writing.

B. Transfers of Title/Transfers of Physical Assets

Written Agency approval is required for transfers that involve the entire ownership entity. The lender must conduct a review of property conditions prior to recommending the transfer for Agency approval. All transfers of the entire ownership entity must include a plan to bring the property into full compliance with program requirements and loan documents, including any physical repairs or deficiencies in reserve amounts. The holder must be notified by the lender as well.

<p>Approval of Ownership Changes</p> <ul style="list-style-type: none"> • The lender and the Agency must approve all changes in general or limited partners, or a change that requires a modification to the title. • The Agency must approve all transfers of the entire ownership entity.
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7.10 TRANSFER OF LOANS OR MORTGAGE SERVICING

The transfer of servicing is prohibited unless the Agency determines that circumstances warrant such an action and the proposed lender to whom the loan will be transferred, is approved by the Agency. The Agency must approve the transfer of servicing before it is initiated. If the holder of the loan note guarantee is a different entity than the lender, the lender must notify the holder of the loan note guarantee of the servicing transfer.

SECTION 3: ASSET MANAGEMENT

7.11 OVERVIEW

Asset management involves regular monitoring of the operation and maintenance of a loan and collateral to ensure that the value of the asset is maintained or enhanced over the life of the loan. Asset management includes financial and physical management of the property and compliance with program and other Federal requirements.

7.12 FINANCIAL MANAGEMENT

A. Borrower Reports to the Lender

The purpose of the borrower reporting requirements is to provide the lender with the information necessary to adequately monitor the guaranteed loan. The lender may require additional reporting for its own purposes. Borrower reporting requirements must be applied consistently to all GRRHP loans. The Agency also expects the lender to obtain additional information regarding the property through management reviews and physical inspections of the property. The lender must outline the complete reporting requirements and planned reviews and inspections in the servicing plan.

1. Annual Audited Financial Reports

Within 90 days of the end of the project's fiscal year, the borrower must submit to the lender an audited annual financial statement conducted in accordance with GAGAS. The program review requirements for the GAGAS audit can be found in Attachment 7-B. In addition to this report, the borrower must also certify that they are in compliance with the rent restrictions established in [7 CFR 3565.203]. Nonprofit borrowers reporting under OMB Circular A-133 must submit Audited Financial Reports within nine months of the close of the borrower's fiscal year.

The lender may allow the borrower to submit the initial audit that will cover a period of up to 18 months for projects whose first operating year was less than 6 months. The lender must notify the Agency in writing prior to the end of the project's fiscal year of the intent to allow the borrower to submit an extended initial audit.

2. Failure of the Borrower to Comply with Lender Reporting Requirements

The lender may require additional information from the borrower at any time if necessary to fulfill its reporting requirements to the Agency or to properly fulfill its oversight and monitoring responsibilities.

Failure on the part of the borrower to comply on a timely basis with the reporting requirements outlined in this handbook and any additional reporting requirements established by the lender in writing may result in penalties against the borrower ranging from denial of surplus cash distribution to acceleration of the mortgage. Exhibit 7-3 explains the inclusion in the handbook of a Supplemental Government Auditing Standards Guide.

Exhibit 7-3

Supplemental Government Auditing Standards Guide

In previous versions of the handbook, this exhibit was a guide for the program review requirements for the GAGAS audit. In an effort to provide more-detailed guidance to the industry, auditors, and our staff, the Agency took the initiative to revise the guide to make it easier to understand for those who use it. This new and improved guide is now available as Attachment 7-B.

B. Lender Reports to the Agency

The lender must periodically report to the Agency on each GRRHP loan in its portfolio. When compiled, these reports should provide the Agency with an assessment of the guaranteed loan portfolio's performance. The Agency will collect additional information on the lender's portfolio of guaranteed loans during the annual lender audit process. The Agency must diligently review all reports to ensure that the lender and borrower remain compliant with program requirements. The Agency should contact the lender to acknowledge receipt of the report and discuss any deficiencies and cures noted in the report. For any noted deficiencies, i.e., low debt service coverage ratio, inadequate funding levels in the reserves, failure to submit the report in a timely manner, the Agency should relay to the lender any and all steps that should be taken to cure the deficiencies. All reports submitted by the lender should be maintained in a loan servicing file docket established by the Agency and maintained in accordance with File Retention requirements.

Periodic reports include those listed below.

1. Annual Reports

Within 120 calendar days of the end of each project's fiscal year, the lender must submit a report to the Agency detailing their review of the project annual financial statement. The report must contain any findings related to the following items if deficiencies have been identified during the lender's annual review of the project:



- Any unresolved audit findings;

Exhibit 7-4

Classification System of RHS Projects

Class A

No specific problems with project.

Class B

Approved workout agreement in place and on schedule.

Class C

1. Unauthorized surplus cash distribution.
2. Required monthly/quarterly reports not submitted.
3. Deferred maintenance.
4. Below average rating from last lender inspection.
5. Unapproved workout agreement in place and on schedule.

Class D

1. Delinquent loan account.
2. Annual Financial Statement not submitted.
3. Delinquent reserve account.
4. Taxes not paid.
5. Insurance not paid.
6. High vacancy -- reduced rental revenue of 10 percent or more.
7. Health, safety, or environmental problems.
8. Non-compliance with Equal Opportunity and Fair Housing requirements.
9. Unsatisfactory rating from last lender inspection.
10. Substantial deferred maintenance.
11. Unauthorized owner/manager agent withdrawal from project funds.

- Outstanding physical and financial deficiencies. Such deficiencies should be ranked in accordance with the Agency Classification System (Exhibit 7-4);
- Underfunded reserves and escrows, including:
 - ◊ Tax and insurance escrows, and
 - ◊ Replacement reserve levels below \$1,000 per unit;
- Current debt service coverage ratios below 1.15;
- Vacancy levels greater than the original underwriting level;
- Tenant income and family size characteristics; and

- Information on unit rent levels and average project rents for the period.

In submitting the information required above, the lender must also certify that the borrower is in compliance with the rent restrictions established in [7 CFR 3565.203].

In the event that the guarantee is terminated prior to the end of original term of the guaranteed loan, i.e., a voluntary termination by the lender, the borrower will still be required to provide to the agency annual status reports to show evidence that the housing remains available for occupancy by low and moderate income households in accordance with 7 CFR 3565.352 or its successor regulations. Status reports will be sent via mail or electronic submission to the Rural Development State Office in which the project is located. The report will be due 120 days after the end of the project's fiscal year. The report should contain information on the physical condition of the property and tenant information such as income and family size.

2. Quarterly Reports

The lender must submit a quarterly report to the State Office using *Form RD 1980-41, "Guaranteed Loan Status Report"*, to detail the current status of the GRRHP loan. Lenders are strongly encouraged to submit quarterly status reports to the Agency using the Lenders Interactive Network Connection (LINC). The lender must designate a Security Administrator, who can then add other users to the LINC system. Lenders without LINC access must send a completed Form RD 1980-41, to the applicable State/Field Office. The LINC system is accessed at <https://usdalinc.sc.egov.usda.gov>. Additional guidance on the LINC system can be found on the Section 538 Guaranteed Rural Rental Housing Program SharePoint site at: <https://mfh.usda.net/MFH538a/default.aspx>. For all loans that are reported via the LINC system, the Rural Development office that services the GRRHP loans in its respective State should monitor the Guaranteed Loan System (GLS) to verify that the reports were received in a timely manner and to determine the status of the loan.

3. Monthly Reports

Construction loans guaranteed by the Agency must submit *Form RD 1980-41* monthly until the loan transitions to a guarantee of the permanent financing phase [and quarterly reports].

The lender must submit monthly reports to the Agency on all loans in its portfolio which are in monetary and/or technical default. *Form RD 1980-44, "Guaranteed Loan Borrower Default Status"*, must be submitted to the State Office for this purpose. Monthly reports for loans that are in monetary default may also be submitted electronically via LINC. In section 14 of *Form RD 1980-44*, the lender must also submit the following information:



- The reason for the default;
- The physical condition of the property;
- The occupancy rate of the property;
- The corrective action plan to cure the default;
- Anticipated cure date of default; and
- If applicable, date when the Agency should expect a workout plan (if one has not yet been submitted).

All loans reported in default must be serviced in accordance with Section 4 of this chapter, including the development of a workout plan in accordance with Agency requirements. The lender must continue to report on each loan that is in default until the default is cured. Reports submitted to the Agency should be reviewed by the specialist responsible for servicing GRRHP loans, making note of progress and any changes in the default.

4. Failure of the Lender to Comply with Agency Reporting Requirements

Failure of the lender to comply with Agency reporting requirements in a timely manner may result in revocation of lender approval and the transfer of all GRRHP loans to another approved lender. If the lender fails to comply with the Agency transfer requirements, the guarantee may be cancelled.

7.13 COMPLETING THE CAPITAL NEEDS ASSESSMENT AND RESERVE ANALYSIS

The purpose of the Capital Needs Assessment (CNA) and reserve analysis is to ensure that reserve levels will continue to meet the expected capital repair and replacement needs of the property.



A. The Capital Needs Assessment

A CNA must be completed during the underwriting of all loans involving rehabilitation and reviewed by the lender at least once every five years. The lender should use CNAs to determine adjustments to the reserve level requirements for all loans it underwrites (see Paragraph 7.7 D.).

B. Adjusting the Reserve Deposit Requirement

1. Increasing the Reserve Deposit

On an annual basis, the lender must review the reserve level and adjust the deposit requirements accordingly. If reserves have fallen below \$1,000 per unit, the lender should determine whether to require an increase in the monthly deposit amount to bring the reserve levels above this recommended threshold. In making this determination, the lender should weigh the need for the increased reserves against the financial security of the property.

2. Decreasing or Suspending the Reserve Requirement

In certain cases, the lender may choose to decrease or suspend the reserve requirement. This might happen if:

- Reserve levels are adequate, based on the lender's assessment of the CNA for the property; or
- The property is financially troubled and in need of the amount deposited in the reserve account to meet other monthly expenditures. (This situation should be documented in the workout plan.)

The lender will submit to the Agency *Form RD 1980-44* monthly with a current status for every loan where reserve account deposits are suspended.

7.14 PHYSICAL MAINTENANCE AND PROGRAM COMPLIANCE AND OVERSIGHT

The lender is responsible for monitoring the physical condition of the property and the borrower's compliance with the regulatory and programmatic requirements of the GRRHP. The lender must inspect the property annually to assess its physical condition and the borrower's compliance with program requirements outlined below. At a minimum, the lender must assess the following areas in its annual report to the State Office:

- The property's physical condition.
- The adequacy of the current CNA and the borrower's annual contribution level to the replacement reserve account.
- The borrower's compliance with the approved Affirmative Fair Housing Marketing Plan.
- The borrower's annual fair housing report.

A. Physical Standards and Inspections

1. Physical Standards

The lender must develop standards for physical inspections consistent with industry standards. Construction standards listed in RD Instruction 1924- A, §1924.5 (d) may be used as a guide.



2. Physical Inspection Reporting

The lender must inspect each property on an annual basis and report the summary findings to the Agency as a part of the lender's regular annual report. The first annual inspection must be completed prior to the expiration of the warranty (see Paragraph 5.11). The lender must use the Form RD 3560-11, "Multi-Family Housing Physical Inspection Report" to document the findings of the physical inspection and, when required by Paragraph 7.12 B.3., to report them to the Agency. . Photographs of the building (exterior and interior), units, common areas, grounds, etc., should be included in the physical inspection report.

3. Responding to Deficiencies

Lenders may allow borrowers 90 calendar days from receipt of the lender's physical inspection report to resolve the deficiencies and/or submit a corrective action plan. If deficiencies remain outstanding beyond the 90-day period, the lender must submit the complete physical inspection report to the Agency along with the lender's proposed action plan for resolving the deficiencies.



B. Capital Improvement Plans

It is the responsibility of the lender to establish standards for the development of capital improvement plans for each property. This format and process must be outlined in the approved servicing plan. A capital improvement plan (CIP) must be developed by the borrower if the lender determines that the property is physically troubled and the property's capital improvement needs are not captured within the most current version of the project's CNA. If developed, the CIP may be used in place of a CNA..

If the lender determines the property has serious physical deficiencies, the lender must report the findings to the Agency and submit a CIP as part of the regular quarterly reporting process.

C. Compliance With Other Federal Requirements

1. Affirmative Fair Housing Marketing Plan

As a part of the lender's annual monitoring and oversight responsibilities, the lender will monitor compliance with the Affirmative Fair Housing Marketing Plan (*Form HUD 935.2A*). If the lender discovers modifications are needed to the plan, such modifications should be suggested to the



borrower. The AFHMP should be updated regularly to reflect the borrower's marketing efforts. Borrowers who repeatedly fail to comply with the established plan must be reported to the Agency. Chapter 4 provides additional information with regard to this plan.

2. *Annual Fair Housing Reporting Requirements*

Section 526 of Public Law 100-242 of the Housing and Community Development Act of 1987 requires the Administrator to assess the extent to which RHS housing and community facilities programs comply with the Federal Fair Housing Act requirements. The Agency will require lenders to submit a report from the borrower on fair housing compliance as part of the annual audit. This report should detail, for each unit, gross income, race, national origin, head of household, gender, elderly, and disability status. This information is collected for statistical purposes only.



3. *Other Civil Rights Laws*

Exhibit 7-5 shows other civil rights laws with which GRRHP loans must comply. Lenders must understand the provisions of these laws, and must have a management plan to monitor compliance by their employees, contractors, borrowers, and management agents, as appropriate.

Interest credit is classified as Federal Financial Assistance. Therefore, borrowers with loans receiving interest credit must also comply with the civil rights laws in Exhibit 7-6.

In addition, all borrowers receiving interest credit must sign an assurance agreement (*Form RD 400-4*) and will be subject to civil rights compliance reviews, regularly scheduled no less than once every three years. Compliance reviews will be conducted in accordance with RD Instruction 1901-E and documented on *Form RD 400-8*, "*Compliance Review*". They must comply with the design requirements of the Uniform Federal Accessibility Standards, in addition to the HUD Accessibility Guidelines and the ADA Accessibility Guidelines. Also, borrowers who receive interest



credit must provide reasonable accommodations to tenants and prospective tenants at the expense of the borrower.

Exhibit 7-5

Major Civil Rights Laws Affecting All Multifamily Housing Loan and Grant Programs

- **American with Disabilities Act (ADA).** Guarantees equal opportunity for individuals with disabilities in employment, public accommodations, transportation, State and local government services, and telecommunications.
- **Equal Credit Opportunity Act (ECOA).** Prohibits discrimination in the extension of credit on the basis of race, color, religion, national origin, sex, marital status, age, income from public assistance, and exercise of rights under the Consumer Credit Protection Act.
- **Title VIII of the Civil Rights Act of 1968** (also known as the Fair Housing Act of 1988, as amended). Prohibits discrimination in the sale, rental, or financing of housing on the basis of race, color, religion, sex, national origin, familial status, or disability.
- **Executive Order 11246.** Nondiscrimination in Employment by Construction Contractors (and subcontractors) receiving Federal construction contracts and Federally assisted construction contracts in excess of \$10,000 – provides for equal employment opportunity without regard to race, color, religion, sex, or national origin. For purposes of this Executive Order, Federally assisted construction contracts includes any Federal program involving a grant, loan, insurance, or guarantee.
- **Executive Order 12898 — Environmental Justice.** Requires each Federal agency to make environmental justice a part of its mission by identifying and addressing disproportionately high and adverse human health or environmental effects of its programs, policies, and activities on minority and low-income populations. Section 504 of the Rehabilitation Act of 1973, Age Discrimination Act of 1975, Title IX of the Education Amendments of 1972, Title II of the Americans with Disabilities Act of 1990, as amended and Title VI of the Civil Rights Act of 1964.

Exhibit 7-6

**Civil Rights Laws Affecting
Federally Assisted Multifamily Housing Programs**

- **Section 504 of the Rehabilitation Act of 1973.** Prohibits discrimination in a Federally-assisted program on the basis of disability.
- **Age Discrimination Act of 1975.** Prohibits discrimination in a Federally-assisted program on the basis of age.
- **Title VI of the Civil Rights Act of 1964.** Prohibits discrimination in a Federally-assisted program on the basis of race, color, and national origin.
- **Title IX of the Education Amendments of 1972.** Prohibits discrimination on the basis of sex in education programs and activities receiving Federal financial assistance from Rural Development.
- **Executive Order 11063 as Amended by 12259.** Prohibits discrimination in Federally-assisted housing financing on the basis of race, color, religion, sex, or national origin.
- **Executive Order 11246.** Prohibits discrimination in employment by construction contractors (and subcontractors) receiving Federally-assisted construction contracts in excess of \$10,000. It provides for equal employment opportunity without regard to race, color, religion, sex, and national origin.
- **Title VIII of the Civil Rights Act of 1968 and Title II of the Americans with Disabilities Act of 1990, as amended.**

D. Compliance With Other Program Requirements

1. Regulatory Agreement Compliance

A regulatory agreement governing the relationship between the borrower and lender must be developed by the lender and executed by both the borrower and the lender. While the Agency will not be a party to the agreement, the agreement will state that the Agency may assume the role of the lender if necessary to force borrower compliance with the agreement.

In the case where the Agency assumes the property in the role of mortgagee-in- possession (MIP), the regulatory agreement will remain in force at the Agency's sole discretion.

The regulatory agreement must be transferable from borrower to borrower in the event that the property is transferred and transferable from lender to lender if the guarantee is transferred to an Agency approved lender.

This agreement must, at a minimum, stipulate the following:

- That it is binding upon the borrower and any of its successors and assigns, as well as upon the lender and any of its successors and assigns, for a period of the original duration of the guaranteed mortgage.
- That the borrower must make all payments due under the note and all payments to required escrows and reserves for future capital needs.
- That the borrower must maintain the project as affordable housing in accordance with the purposes and for the duration defined in the statute. The regulatory agreement must be properly recorded along with the mortgage, deed restriction or other recordable instrument acceptable to the Agency.
- That the borrower must maintain the project in good physical and financial condition at all times.
- That the borrower must maintain complete project books and financial records and provide the Agency and the lender with an annual audited financial statement within 90 calendar days of the end of the project's fiscal year. Nonprofit borrowers reporting under OMB Circular A-133 submit annual financial statements within nine months of the close of their fiscal year.



- That the borrower must make project books and financial records available for review by the USDA Inspector General, Agency Staff, and the General Accounting Office (GAO) or their representatives, upon appropriate notification.
- That the borrower must comply with the Affirmative Fair Housing Marketing Plan and all other Fair Housing requirements.
- That the borrower must comply with Civil Rights laws affecting Federally assisted multifamily housing programs and Title II of the Americans with Disabilities Act of 1990 as amended.
- That the borrower must operate as a single asset ownership entity.
- That the borrower must comply with applicable Federal, State, and local environmental laws.
- That the borrower must provide management satisfactory to the Agency and comply with the lender-approved management plan and agreement for the property.
- That the borrower will work with the lender in a workout situation.

2. Preservation of Affordable Housing

For the period of the original term of the guaranteed loan, the housing must remain available for occupancy in accordance with [7 *CFR* 3565.352]. This applies unless the housing is acquired by foreclosure or as an instrument in lieu of foreclosure or the Agency waives the applicability of this requirement after determining through a market study that the following three circumstances exist.

- There is no longer a need for low- and moderate-income housing in the market area in which the housing is located.
- Housing opportunities for low-income households and minorities will not be reduced as a result of the waiver.
- Additional Federal assistance will not be necessary as a result of the waiver.

All requests for removal of the affordable housing restrictions must first be made to the lender. The lender must assess the housing using the three criteria above and forward the borrower's request to the Agency, along with the lender's assessment of the property's compliance with the above tests. The Agency will make the final determination as to whether the occupancy restrictions may be terminated.

SECTION 4: SPECIAL SERVICING

7.15 OVERVIEW

In accordance with Paragraph 7.8, the lender must begin special servicing actions when a property is in default of the guaranteed loan.

7.16 ROLES AND RESPONSIBILITIES OF THE SERVICING LENDER

A. Development of a Workout Plan

At a minimum, a workout plan must be submitted to the Agency using the  workout plan format (see Exhibit 7-7) no later than 60 days after the lender has notified the borrower that they are in monetary and/or default under the regulatory agreement.

Exhibit 7-7

Information to be Included in a Workout Plan

Background information. This section describes the project’s location, type, and size.

Description of the problem. This section identifies the project’s deficiencies and needs, including specific compliance and financial concerns. It should identify the basic causes of the difficulties.

A plan to correct deficiencies. This plan must include the following information:

- Borrower actions needed to correct the problem(s).
- Resources needed in order to accomplish the correction, including those that will come from the lender and those that will come from the borrower.
- A timetable for taking action and applying the resources.
- A summary of the anticipated outcomes.

Agreement by borrower to provide periodic financial statements. This includes any income and expense reports and bank statements, if appropriate.

The signature of the borrower and the lender on the workout agreement.

A copy of the workout agreement must be sent to the State and National Office within 5 business days of execution.

Once the lender has submitted the workout plan to the State Office for Agency review, the lender and the borrower will be considered in compliance with the terms of the note for the purposes of the claims process outlined in Chapter 10. The time frames for submission of a claim and the disposition plan will not be applicable unless the borrower (or lender) falls out of compliance with the approved workout plan or if the workout plan expires before the borrower cures the default.

If the lender chooses not to pursue a workout plan with the borrower, the Agency will review this action prior to approval of the liquidation plan.

To ensure compliance with Section 2 of Chapter 12, the lender must notify the holder, if any, of the default and workout plan or foreclosure proceedings in a timely fashion.

B. Bankruptcy of Borrower

The lender is responsible for protecting the guaranteed loan and all collateral securing the loan in bankruptcy proceedings. These responsibilities include, but are not limited to, the following:

- The lender must file a proof of claim where necessary and all the necessary papers and pleadings concerning the case.
- The lender must participate in meetings of the creditors and all court proceedings.
- When permitted by the Bankruptcy Code, the lender must request modification of a reorganization plan whenever it appears that additional recoveries are likely.
- The lender must keep the Agency adequately and regularly informed in writing of all aspects of the proceedings.
- The lender must take whatever reasonable action necessary to protect the interest of the government including motions to dismiss, exceptions to discharge, and objections to exemptions.
- If the Agency determines that an independent appraisal of collateral is necessary, the lender, at its expense, must obtain an independent appraisal report using the guidance set forth in Chapter 3.

C. Loss Claims During Bankruptcy

When the loan is involved in bankruptcy proceedings, payment of loss claims may be made as defined in Chapter 10.

7.17 ROLES AND RESPONSIBILITIES OF THE BORROWER

This paragraph details the borrower responsibilities with regards to the workout plan.

A. Submission of Information to the Lender

During special servicing actions and the development of a workout plan, the lender can request information from the borrower. The lender may declare the borrower in default if the borrower fails to comply.

B. Development and Execution of the Workout Plan

The borrower must work with the lender to develop a workout plan for the lender's approval. This plan should be completed and ready for lender approval within 30 days of the date of default, in order to ensure that the lender has adequate time to approve the plan. A copy of the workout agreement must be sent to the State and National Office within 5 business days of execution. In developing a workout plan, the time frame for conclusion of the plan should not exceed two years. Extensions to that time frame may be approved by the Agency on a case-by-case basis.



C. Compliance With the Workout Plan

Once a plan is established, a borrower will be considered to be in compliance with program requirements so long as they remain in compliance with the workout plan. While the lender must report to the Agency monthly on the property, the timeline for submission of a claim and a liquidation plan may be delayed until such time as the workout plan expires or the borrower fails to comply with its terms.

If a borrower fails to comply with the terms of the agreement, the property will be considered in default, and the lender must begin processing a notice of liquidation. These procedures are outlined in Chapter 10.

7.18 SPECIAL SERVICING OPTIONS

A workout or special servicing plan may utilize any of the following tools to bring the loan into compliance. If a plan requires modification to the guarantee or a payment of claim by the Agency, the Agency must approve such action. The holder, if any, must be notified by the lender under all of the options presented below.

A. Loan Modifications

A loan modification requires State Office approval. A loan modification would include any change in the amount or term of the guarantee.

B. Partial Payment of Claim

A partial payment of claim is another tool that may be used to work out troubled loans. Under a partial payment of claim, the Agency pays a claim on a portion of the guaranteed loan, thereby reducing the debt that must be amortized. Partial payments must be approved by the National Office prior to the execution of the workout plan.

If a partial payment of claim is approved, the claim will be processed in accordance with the procedures outlined in Chapter 10.

C. Transfer of Physical Assets (TPA)

A TPA is a sale, gift, or other transfer of the property to another party where the original loan remains in place. In a special servicing situation, the TPA must be approved as outlined in Paragraph 7.9. All other changes in the ownership entity must be approved by the lender and recommended to the Agency for concurrence. Although a transfer and assumption is normally considered loan servicing, it should be processed in the same manner as a new loan.

D. Agency Approval of Reserve Releases

The Agency reserves the right to control reserve releases in a special servicing situation. Requests for the use of reserve funds on a workout plan must first be approved by the lender. On a case-by-case basis, the State Office will review requests for uses of reserve funds outside the scope of the eligible uses (e.g. use of reserve funds to pay taxes). In these situations, the borrower must submit the request to the lender. The lender will forward the request and any supporting documentation to the State Office with its recommendation. These requests will be approved on a case-by-case basis in the State Office.

E. Lender Recommendation of Enforcement Action

In situations where the lender believes that the borrower is in violation of regulatory requirements, the lender may recommend that the Agency take enforcement action against the borrower. Such actions may include suspension, debarment, limited denial of participation, or other administrative or judicial remedies.

7.19 Loan Modification (Interest Rate Reduction)

The borrower and lender may agree to a loan modification (interest rate reduction) that will reduce the interest rate when the action will improve the financial viability of the project and its operations. Lenders must get Agency approval prior to a loan modification (interest rate reduction).

The incumbent lender will certify and submit supporting documentation that:

- the borrower is in compliance with all program requirements. If the borrower is not in compliance, the lender must submit documentation to show how the modification will bring the borrower into compliance.
- the original term (maturity date and guarantee term) of the guaranteed loan will not be modified.

- the outstanding principal balance will not be modified
- there will not be a negative impact to the tenants.
- there are no asset management issues.
- lender's attorney will attest that the modification meets state law requirements. Any out-of-pocket costs incurred by the lender or the owner related to the modification will not be from project funds or loan proceeds.
- third party lender costs will not be added to the principal of the guaranteed loan.

If the loan modification (interest rate reduction) is approved by the Agency, the lender will be responsible for closing the transaction. Agency will review, verify and approve all amended closing documents, (if applicable such as, Mortgage Note, Deed of Trust, Promissory Note, Loan Note Guarantee, Consent Agreements).

The incumbent lender must submit to the Agency:

- a summary of the transaction detailing the projected change in interest rate (interest rate must be fixed), pro forma debt service coverage (after modification, must be equal to or greater than 1.15) and benefits to the property and borrower, including a projected debt service savings.
- most recent and interim financial statements and lender analysis.
- sources and uses statement. Any third party lender costs such as attorney fees, processing fees, title and recording cost must be disclosed.

The Agency shall do the following in response to the request for a loan modification (interest rate reduction):

- Review all documentation and provide an approval or denial response to the lender in writing within 30 business days of receipt of the request. Requests that are approved by the State Office require National Office concurrence.
- If the modification is approved, the Finance Office must be contacted to update GLS with the lower interest rate.

GRRHP Lender Servicing Compliance Checklist

✓	Required Report or Activity	Reporting Interval	When Due	Submitted to	Reg/HB Reference	Remarks
	Form RD 1980-24, "Request Interest Assistance/Interest Rate Buydown/Subsidy Payment to Guaranteed Loan Lender" with amortization schedule for the loan (for properties receiving interest credit payments)	Annually	Feb 28	State Office	HB 4.10 D.	State Office reviews and submits to Finance
	Borrower's annual audited financial statement	Annually	Within 90 days of borrower's fiscal year end	Lender	3565.351(d)(1) HB 7.12 A. 1.	Inspectable item in compliance reviews
	Borrower certification of compliance with the rent restrictions established in 7 CFR 3565.203	Annually	Within 90 days of borrower's fiscal year end	Lender	3565.351(d)(1) HB 7.12 A. 1.	Inspectable item in compliance reviews
	Lender's review of the borrower's annual audited financial statements	Annually	Within 120 days of borrower's fiscal year end	State Office	3565.351(d)(2) HB 7.12 B. 1.	
	Summary of the replacement reserve account withdrawal requests and related work completed with reserve funds	Annually	Within 120 days of borrower's fiscal year end	State Office	HB 7.7 D. 5.	
	Form RD 3560-11, "Department of Agriculture Multi-Family Housing Physical Inspection Report"	Annually	Within 120 days of borrower's fiscal year end	State Office	HB 7.14 A. 2.	
	Federal Fair Housing Act compliance report from the borrower as required by Section 526 of Public Law 100-242 of the Housing and Community Development Act of 1987	Annually	Within 120 days of borrower's fiscal year end	State Office	3565.351(a)(8) 3565.354 HB 7.14 B.	
	Review Affirmative Fair Housing Marketing Plan (Form HUD 935.2)	Annually	Within 120 days of borrower's fiscal year end	Lender	3565.353	Inspectable item in compliance reviews
	Form RD 1980-41, "Guaranteed Loan Status Report" (permanent loan phase)	Quarterly	Dec 31, Mar 31, Jun 30, Oct 31	State Office	HB 7.12 B. 2.	Lender copies the State Office
	Property under a Capital Improvement Plan	Quarterly	Dec 31, Mar 31, Jun 30, Oct 31	State Office	HB 7.14 B.	
	Form RD 1980-41, "Guaranteed Loan Status Report" (construction phase)	Monthly	Last day of the month	State Office	HB 5.20	Lender copies the State Office
	Deposits into insurance and tax escrow account (prorated share of annual property tax and property insurance payment)	Monthly	Monthly	Lender	3565.402(2) HB 7.7 B.	Inspectable item in compliance reviews
	Deposits into replacement reserve account for capital improvements	Monthly	Monthly	Lender	3565.402(2) HB 7.7 B.	Inspectable item in compliance reviews
	Form RD 1980-44, "Guaranteed Loan Borrower Default Status" (all loans which are in technical or monetary default or delinquency) until current	Monthly	Last day of the month	State Office	3565.351 (d)(2)(ii) HB 7.12 B. 3	Lender copies the State Office
	Monitor borrower's compliance with the Affirmative Fair Housing Marketing Plan (Form HUD 935.2). Borrowers who repeatedly fail to comply with the established plan must be reported	As needed	When non-compliance is identified	State Office	3565.351 (a)(8) HB 7.14 A.	Plan must be reviewed annually by Lender per 3565.353

ATTACHMENT 7-B

Supplemental Government Auditing Standards Guide

**GUARANTEED RURAL RENTAL HOUSING PROGRAM
(SECTION 538)
SUPPLEMENTAL GOVERNMENT AUDITING
STANDARDS GUIDE**

This guide is not intended to be a complete manual of procedures, nor is it intended to supplant the auditor's judgment of audit work required. Suggested audit procedures contained herein may not cover all circumstances or conditions encountered in a particular audit. The auditor should use professional judgment to tailor the procedures so that the audit objectives may be achieved. However, all applicable compliance requirements in this guide must be addressed by the auditor. If the auditor desires technical assistance pertaining to the GRRHP, its regulations or operations, the auditor should contact the Rural Development State Office, Local Office, or USDA Service Center, whose information is available at: http://www.rurdev.usda.gov/recd_map.html.

***NOTE:** The Agency requires the Procedure Notice (PN) citation date to be at the bottom of odd-numbered pages. Due to this fact, all footnote text can be found at the end of the attachment to ensure formatting consistency. This text is identified as “Endnotes.”

GUARANTEED RURAL RENTAL HOUSING PROGRAM (SECTION 538)

SUPPLEMENTAL GOVERNMENT AUDITING STANDARDS GUIDE

U.S. DEPARTMENT OF AGRICULTURE
RURAL HOUSING SERVICE
1400 INDEPENDENCE AVENUE, S.W.
WASHINGTON, D.C. 20410

Use of this guide is mandatory for audits of individuals, partnerships, limited partnerships, for-profit corporations, limited equity cooperatives, Indian tribes, and trusts participating in the U.S. Department of Agriculture Rural Housing Service Section 538 Guaranteed Rural Rental Housing Program (GRRHP).

Exemptions of use and reference of the guide apply to public agencies and non-profits organizations. These entity audits are to be conducted in accordance with the Single Audit Act of 1984, P.L. 98-502, and the Single Audit Act Amendments of 1996, P.L. 104-156; and its implementing guidance under the Office of Management and Budget (OMB) Circular A-133 *Audits of States, Local Governments, and Non-Profit Organizations*.

This guide also considers a risk-based approach for the applicability of use and reference by individuals, partnerships, limited partnerships, for-profit corporations, limited equity cooperatives, Indian tribes, and trusts. Specifically, use and reference of the guide is based on the unpaid principal loan balance for an individual project in the year in which the audit is to be conducted.

1. Consistent with the non-profit organization audit requirements stated in OMB Circular A-133, GRRHP projects with an aggregate of unpaid principal loan balance less than \$500,000 in a year, are not required to use or reference this guide. However, annual unaudited financial statements, certified by the Chief Financial Officer or Executive Officer are required to be submitted to the project's lender or servicer. This will significantly reduce audit costs and burden for smaller projects whose costs associated with obtaining the audit may exceed the benefit that would be derived from the process.

2. GRRHP projects with an aggregate of unpaid principal loan balance is equal to or greater than \$500,000 but less than \$2,000,000 in a year, may submit audited financial statements that are not conducted in accordance with Government Auditing Standards. However, the auditor must test and report on the projects compliance with specific GRRHP requirements noted in this guide. These projects are classified and referenced throughout the guide as “non-major” projects.

3. The use and reference of the guide is mandatory for GRRHP projects whose aggregate unpaid principal loan balance is equal to or exceeds \$2,000,000 in a year. These projects are classified and referenced throughout the guide as “major” projects.

Unpaid principal balance was used as the threshold criteria, as it is a good driver of determining the costs of doing an audit in comparison to USDA’s risk of exposure to defaulted loans or non compliant program activities.

This guide is divided into chapters. The first chapter discusses purpose, objective and applicability for the performance of the audit. Chapter 2 discusses audit planning and other considerations and establishes certain requirements for the performance of audit. Chapter 3 contains the required reporting requirements. Chapter 4 of the guide contains the compliance supplement for Guaranteed Rural Rental Housing Program (Section 538).

Each audit should be conducted in accordance with requirements of Chapters 1 through 3 and the applicable compliance supplement included in Chapter 4, with the exception of the aforementioned.

CHAPTER 1. GUIDE OVERVIEW

1-1 Overview

1-1.1 Purpose: This guide is to assist borrowers and their independent auditors, as well as lenders, servicers, and U.S. Department of Agriculture (USDA) Rural Housing Service (RHS) staff in performing and reviewing audits of projects issued a loan guarantee by the USDA RHS under its Section 538 Guaranteed Rural Rental Housing Program (GRRHP). Unless otherwise prohibited, these audits must be performed in accordance with the standards for financial audits of the U.S. Government Accountability Office's (GAO) Government Auditing Standards (GAS), issued by the Comptroller General of the United States, commonly referred to as generally accepted government auditing standards (GAGAS).

These standards are for use by auditors of government entities and entities that receive government funds and audit organizations performing GAGAS audits. GAGAS contain requirements and guidance dealing with ethics, independence, auditors' professional competence and judgment, quality control, the performance of field work, and reporting. Audit engagements performed under GAGAS provide information used for oversight, accountability, and improvements of government programs and operations. GAGAS contain requirements and guidance to assist auditors in objectively acquiring and evaluating sufficient, appropriate evidence and reporting the results. When auditors perform their work in this manner and comply with GAGAS in reporting the results, their work can lead to improved government management, better decision making and oversight, effective and efficient operations, and accountability for resources and results.

1-1.2 Objectives. The objectives of a USDA GRRHP audit are to assist lenders, servicers, and RHS staff in determining whether the project has: (a) provided financial data and reports that can be relied upon; (b) internal control in place to provide reasonable assurance that it is managing USDA funded programs in compliance with applicable laws and regulations; and (c) complied with the terms and conditions of Federal awards and guarantees, and thus expended Federal funds properly and with supporting documentation.

1-1.3 Applicability. This guide is effective for audits of fiscal years ending March 31, 2011 and thereafter.

GRRHP project audit reports are a primary tool used by lenders, servicers, and RHS staff to meet their stewardship responsibilities in overseeing these programs and assuring the integrity of the funds. Lenders, servicers, and RHS staff must act upon the areas of noncompliance and internal control weaknesses noted in these reports. To be of value, these reports must contain adequate information to give reported matters perspective and to allow the managers to take necessary corrective action.

CHAPTER 2. GENERAL GUIDANCE

2-1 General Guidance

Purpose: This chapter of the guide clarifies and heightens the emphasis of the GAGAS through standardized language that defines several¹ aspects the auditor's level of responsibilities, as well as provides awareness of those responsibility to borrowers, lenders, servicers, and RHS staff. In addition, this chapter of the guide discusses compliance with Fair Housing and Non-Discrimination regulations.

2-1.1 Auditor Qualifications. Independent auditor must meet the auditor qualifications of GAGAS, including the qualifications relating to organizational independence, and competence together with continuing professional education. Additionally, the audit organization is to meet the quality control standards of GAGAS. While GAGAS urge audit organizations to make their external quality control review reports available to appropriate oversight bodies, it is not necessary to submit the report to either the lender, servicer, USDA RHS or the state office unless requested to do so.

The standards on auditor qualifications in the GAGAS require that accountants and accounting firms comply with the applicable provisions of the public accountancy laws and rules of the jurisdictions in which they are licensed and where the audit is being conducted. If the project is located in a State outside the home State of the auditor, and the auditor performs substantial fieldwork in the project's State, the auditor should document his/her compliance with public accountancy laws of that State regarding licensing, in the audit working papers.

This guide does not impose additional licensing requirements beyond those established by the individual state board of accountancies (some states allow temporary practice without a license).

2-1.2 Audit Scope and Approach. The audit should be sufficiently comprehensive in scope to permit an expression of an opinion on the financial statements and supplemental data of the USDA GRRHP activity. The opinion should state whether the basic financial statements present fairly, in all material respects, the financial position of the project as of the date of the financial statements and the results of its operations and its cash flows for the period then ended in conformity with accounting principles generally accepted in the United States of America. In addition, the opinion should state that the supplemental data has been subjected to the audit procedures applied in the audit of the basic financial statements and whether it is fairly stated in all material respects in relation to the financial statements taken as a whole.

The GAGAS require the auditor to consider the project's internal control as part of planning and performing the audit and report on internal control. The auditor should report on internal control in accordance with Chapter 3 of the guide. Also, the auditor is required to test and report on the project's compliance with applicable USDA RHS GRRHP laws and regulations regardless of the amount of the loan guarantee.

The auditor's report on compliance should include an opinion on the project's compliance with specific requirements applicable to major projects. Reporting requirements are discussed further in Chapter 3. Major project means a project with a total unpaid loan principal balance equal to or exceeding \$2,000,000 during the applicable year of the period under audit. For projects with total unpaid loan principal equal to or greater than \$500,000 but less than \$2,000,000 for the period under audit (a non-major project), the auditor must also test and report on the entity's compliance with specific requirements. The auditor's report on compliance is described in Chapter 3. GAGAS require the reporting of all material instances of noncompliance and quantification in terms of dollar value, if appropriate.

2-1.4 Matters Requiring Immediate Action. The auditor should specifically assess the risk of material misstatement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider fraud risk factors contained in AICPA SAS No. 82, Consideration of Fraud in a Financial Statement Audit. Normally, an audit in accordance with generally accepted auditing standards does not include audit procedures specifically designed to detect illegal acts. However, procedures applied for the purpose of forming an opinion on the financial statements may bring possible illegal acts to the auditor's attention.

If the auditor becomes aware of illegal acts or fraud that have occurred or are likely to have occurred, the auditor should promptly prepare a separate written report and include all questioned costs. The auditor should submit this report to the USDA Inspector General for Audit, as the designated oversight official.

2-1.5 Planning the Audit. A letter of engagement between the project and the auditor shall be prepared. The letter should state that the audit is to be performed in accordance with generally accepted auditing standards, the Government Auditing Standards, and this audit guide. It should specify that the scope of the audit and the contents of the financial report meet the requirements of this audit guide. It should also specify that the auditor is required to provide the USDA Inspector General, Agency Staff and the GAO or their representatives, access to working papers or other documents to review the audit. Access to working papers by USDA and GAO representatives includes making necessary photocopies. Generally, the auditor should use professional judgment to determine the extent of testing necessary to support his/her opinion on the project's financial statements and to report on the project's compliance with applicable laws and regulations. Each of the applicable compliance requirements contained in this guide must be tested regardless of the amount of Federal financial assistance. Where the auditor decides not to perform detailed testing of a particular compliance requirement, the reasons therefore must be appropriately explained and documented in the working papers.

All material instances of noncompliance identified by the auditor must be reported as a finding, even in those cases where corrective action was taken by the project after the audit period. For guidance, consult the particular program chapter. The schedule of findings must include the following information for each finding, where applicable, as required by the GAGAS: (a) the number of items and dollar value of the population; (b) the number of items and the dollar value of the selected sample; and (c) the number of items and the dollar value of the instances of noncompliance. The auditor is required to obtain written representation from management that includes matters concerning compliance with program laws and regulations that have a material effect on the financial statements and the USDA GRRHP.

The auditor shall retain working papers and reports for a minimum of three years from the date of the audit report, unless the auditor is notified in writing by a USDA office or the GAO to extend the retention period. When auditors are aware that USDA or the project is contesting an audit finding, the auditor shall contact the parties contesting the audit finding for guidance prior to destruction of the working papers and report.

2-1.6 Consideration of Internal Control and Compliance. Overall guidance for the consideration of internal control, testing and reporting requirements for Federal financial assistance programs is provided in the GAGAS. The GAGAS require the auditor to obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

In addition, when auditing GRRHPs projects, the auditor should perform tests of controls to evaluate the effectiveness of the design and operation of internal control in preventing or detecting material noncompliance with the requirements of the GRRHP. The auditor should perform these procedures regardless of whether the auditor assesses the internal control risk below the maximum. The steps performed and conclusions reached should be clearly evidenced in the auditor's working papers. The working papers should clearly demonstrate the auditor's understanding and assessment of control risk related to internal control established for GRRHP activities. Tests may be omitted only in areas when internal control is likely to be ineffective in preventing or detecting noncompliance, in which case a significant deficiency or material weakness should be reported.

2-1.7 Corrective Action Plan. To assist the Department in resolving instances of noncompliance and material weaknesses in internal control identified by the auditor, the project is required to submit a corrective action plan with the auditor's report on USDA GRRHPs. In the corrective action plan, the project must describe the corrective action taken or planned in response to findings identified by the auditor. In addition, the project must comment on the status of corrective action taken on prior findings. The corrective action plan is considered a necessary part of the project audit requirement. Additional guidance concerning the corrective action plan is contained in Chapter 3 of this guide.

2-1.8 Fair Housing and Non-Discrimination. When performing compliance work in the fair housing and non-discrimination area, the following references should be used: Guaranteed Rural Rental Housing Program Origination And Servicing Handbook; 7 CFR Part 3565 (Guaranteed Rural Rental Housing Program); Consolidated Civil Rights Monitoring Requirements for Section 8; 24 CFR Part 1 (Title VI of the Civil Rights Act, Americans with Disabilities Act, and others) and Part 8 (Section 504 of the Rehabilitation Act); and 24 CFR Part 100, Age Discrimination Act of 1975, prohibits discrimination in a Federally-assisted program on the basis of age and Title IX of the Education amendments of 1975,

prohibits discrimination on the basis of sex to education programs and activities receiving Federal financial assistance from Rural Development. The Fair Housing Act (applicable to all housing in the nation). The Fair Housing Act prohibits discrimination based on race, color, religion, national origin, sex, familial status or disability in all aspects of the sale or rental of a dwelling (familial status refers to family composition, such as number and ages of children). The prohibitions extend to actions, which have disparate impact because of any of the prohibited bases.

CHAPTER 3. REPORTING REQUIREMENTS AND SAMPLE REPORTS

3-1 Reporting Requirements and Sample Reports

Purpose: This chapter clarifies, streamlines, and standardizes the audit reporting requirements, required by GAGAS or the GRRHP.

3-1.1 Reporting Requirements. GAGAS require that the auditor issue the following reports based on the audit of the financial statements: a report on the financial statements, a report on compliance with applicable laws and regulations, and a report on internal control. In addition, there are additional reports required to be issued in an audit conducted in accordance with this audit guide. The audit report should be issued to the project's governing body and/or top official, as appropriate. The report cover should clearly indicate the USDA GRRHP project and period(s) that were audited.

It is expected that the specific compliance requirements identified in this guide will cover those laws and regulations that, if not complied with, could have a direct and material effect on the financial statements. In such cases, the compliance reports (in Section C below) and illustrated in this guide are the only reports necessary for reporting on the project's compliance with laws and regulations. However, if the auditor, as part of the audit of the financial statements, considered laws and regulations in addition to those noted in this guide, for which noncompliance could have a direct and material effect on the financial statements, the auditor should also issue the compliance report in accordance with Government Auditing Standards.

The following reports are required to be submitted by the project:

- A. The auditor's report on the basic financial statements together with the auditor's report on accompanying supplemental information required by USDA, stating whether that supplemental information is fairly stated in all material respects in relation to the basic financial statements taken as a whole (Example A).
- B. The auditor's combined report on internal control as it relates to both financial reporting and administering the USDA GRRHP. It must identify any significant deficiencies and material weaknesses noted (Example B).
- C. A report on compliance with applicable laws and regulations that may have a direct and material effect on the USDA GRRHP including:
 - an opinion on compliance with specific requirements applicable to a major USDA GRRHP project (Example C)
 - a report on compliance with specific requirements applicable to a non-major USDA GRRHP project (Example D)
- D. When performing tests of compliance requirements contained in Chapter 4, the auditor should report on fair housing and nondiscrimination. For non-major projects, fair housing reporting should be included in the auditor's report. Where the project meets the criteria for a major project, the auditor's report on specific requirements applicable to fair housing should be separate (Example E) from the auditor's opinion on compliance with specific requirements applicable to major projects.
- E. The report on compliance should also identify and include all material instances of noncompliance. The findings should include an identification of all material questioned costs, as a result of noncompliance. In addition, the findings should contain adequate information necessary to facilitate the audit resolution process, i.e. the number of items and dollar value of the population, the number of items and the dollar value of the selected sample, and the number of items and the dollar value of the instances of noncompliance (Example F). Nonmaterial instances of noncompliance should be communicated to the project in accordance with the Government Auditing Standards.

- F. In the project's comments on audit resolution matters, the project should determine if significant findings from previous USDA required annual audits, USDA-OIG audits, USDA management reviews, or physical inspections have been corrected and disclose those which remain uncorrected at the time of the review (Example G). The auditor is required to follow up on prior audit findings, perform procedures to assess the reasonableness of the comments on audit resolution matters relating to USDA programs prepared by the project, and report, as a current-year audit finding, when the auditor concludes that the comments materially misrepresent the status of any prior audit finding(s).
- G. Any report from the auditors on illegal acts or fraud that have occurred or are likely to have occurred, including all questioned costs found as a result of these acts that the auditors become aware of, should be covered in a separate written report in accordance with the provisions of the Government Auditing Standards. This report should be sent to the USDA Inspector General for Audit. Illegal acts are to be reported on without regard to whether the condition giving rise to the questioned costs has been corrected or whether the project does or does not agree with the finding and questioned costs.
- H. A corrective action plan developed by the project, wherein the project officials describe the corrective action taken or planned in response to the findings identified by the auditor. The plan should also include comments on the corrective action taken on prior findings resulting from independent audits or relevant USDA-OIG audits and USDA program reviews (Example H).
- I. In addition to these reports, the borrower must also certify that they are in compliance with the rent restrictions established in [7 *CFR* 3565.203].

3-1.2 Auditor's Reports. The following are illustrations of reports on financial statements, on internal control, on compliance with specific requirements and the project's corrective action plan that may be issued in an audit in accordance with this guide. These reports are not meant to be all-inclusive; auditors should exercise professional judgment in tailoring their reports to the circumstances of individual audits.

Examples:

- A. Report on Audited Financial Statements and Supplemental Information.
- B. Report on Internal Control.
- C. Opinion on Compliance with Specific Requirements Applicable to a Major USDA GRRHP Project.
- D. Report on Compliance with Specific Requirements Applicable to a Non-major USDA GRRHP Project.
- E. Report on Compliance with Specific Requirements Applicable to Fair Housing and Non-Discrimination.
- F. Schedule of Findings and Questioned Costs.
- G. Project's Comments on Audit Resolution Matters Relating to USDA GRRHP.
- H. Corrective Action Plan

Example A- Applicable to major projects (unpaid principal loan balance equal to or greater than \$2,000,000)²

**REPORT ON AUDITED FINANCIAL STATEMENTS AND SUPPLEMENTAL
INFORMATION**

Independent Auditor's Report

To [the Entity]

Anytown, U.S.A.:

We have audited the accompanying balance sheet of [the Entity] as of Month Date, Year, and the related statements of income, changes in partners' capital and cash flows for the year then ended. These financial statements are the responsibility of the [the Entity's] management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit 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 of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of [the Entity] as of Month Date, Year, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with Government Auditing Standards, we have also issued our report(s) dated [date of report] on our consideration of [the Entity's] internal control and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. Those reports are an integral part of the audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.

The accompanying supplemental information (shown on pages XX-XX) is presented for the purposes of additional analysis and is not a required part of the basic financial statements of [the Entity]. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

CPA and Company
Certified Public Accountants

Anytown, U.S.A.
[Date]

Example B- Applicable to major projects (unpaid principal loan balance equal to or greater than \$2,000,000)³

The reference to major USDA GRRHPs here and throughout this report is used because the auditor's opinion on compliance runs to the major project. However, when required by the Guide the auditor still has the responsibility to test compliance with specific requirements applicable to non-major USDA GRRHP projects and issue the related non-major report, Report on Compliance with Specific Requirements Applicable to Non-major USDA GRRHP.

**Independent Auditor's Report on Internal Control
Combined Report Applicable to Internal Control over Financial Reporting Based on an
Audit of Financial Statements and Internal Control over Compliance for USDA GRRHP
No Material Weaknesses, No Significant Deficiencies Identified⁴**

[Addressee]

We have audited the financial statements of [the entity] as of and for the year ended [date] and have issued our report thereon, dated [date]. We have also audited [the entity's] compliance with requirements applicable to a major U.S. Department of Agriculture (USDA) Guaranteed Rural Rental Housing Program (GRRHP) project for the year ended [date], and have issued our reports thereon, dated [date].

We conducted our audits 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 GRRHP Supplemental Government Auditing Standard Guide (Guide), issued by the USDA Rural Housing Service.

Those standards and the Guide require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether [the entity] complied with laws and regulations, noncompliance with which would be material to a major USDA GRRHP.

Management of [the entity] is responsible for establishing and maintaining effective internal control over financial reporting and internal control over compliance. In planning and performing our audits of the financial statements and compliance, we considered [the entity's] internal control over financial reporting and its internal control over compliance with requirements that could have a direct and material effect on a major USDA GRRHP project as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements and compliance but not for the purpose of expressing an opinion on the effectiveness of [the entity's] internal control over financial reporting and internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of [the entity's] internal control over financial reporting and internal control over compliance.

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 (1) misstatements of the entity's financial statements or (2) noncompliance with applicable requirements of the USDA GRRHP on a timely basis. A material weakness is a deficiency or combination of deficiencies in internal control such that there is a reasonable possibility that (1) a material misstatement of the entity's financial statements or (2) material noncompliance with applicable requirements of the USDA GRRHP will not be prevented or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting and internal control over compliance was for the limited purpose described in the third paragraph of this report and was not designed to identify all deficiencies in internal control that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses as defined above.

This report is intended solely for the information and use of management, [identify the body or individuals charged with governance], others within the entity, and USDA and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]
[Date]

Example B-1 - Applicable to major projects (unpaid principal loan balance equal to or greater than \$2,000,000)

The reference to major USDA GRRHPs here and throughout this report is used because the auditor's opinion on compliance runs to the major project. However, when required by the Guide the auditor still has the responsibility to test compliance with specific requirements applicable to non-major USDA GRRHP projects and issue the related non-major report, Report on Compliance with Specific Requirements Applicable to Non-major USDA GRRHP.⁵

**Independent Auditor's Report on Internal Control
Combined Report Applicable to Internal Control over Financial Reporting Based on an
Audit of Financial Statements and Internal Control over Compliance for USDA GRRHP
Significant Deficiencies Were Identified--No Material Weaknesses Identified⁶**

[Addressee]

We have audited the financial statements of [the entity] as of and for the year ended [date], and have issued our report thereon, dated [date]. We have also audited [the entity's] compliance with requirements applicable to a major U.S. Department of Agriculture (USDA) Guaranteed Rural Rental Housing Program (GRRHP) project for the year ended [date], and have issued our reports thereon, dated [date].

We conducted our audits 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 GRRHP Supplemental Government Auditing Standards Guide (Guide), issued by the USDA Rural Housing Service.

Those standards and the Guide require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether [the entity] complied with laws and regulations, noncompliance with which would be material to a major USDA GRRHP.

Management of [the entity] is responsible for establishing and maintaining effective internal control over financial reporting and internal control over compliance. In planning and performing our audits of the financial statements and compliance, we considered [the entity's] internal control over financial reporting and its internal control over compliance with requirements that could have a direct and material effect on a major USDA GRRHP project as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements and compliance but not for the purpose of expressing an opinion on the effectiveness of [the entity's] internal control over financial reporting and internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of [the entity's] internal control over financial reporting and internal control over compliance.

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 (1) misstatements of the entity's financial statements or (2) noncompliance with applicable requirements of a USDA GRRHP on a timely basis. A material weakness is a deficiency or combination of deficiencies in internal control such that there is a reasonable possibility that (1) a material misstatement of the entity's financial statements or (2) material noncompliance with applicable requirements of the USDA GRRHP will not be prevented or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting and internal control over compliance was for the limited purpose described in the third paragraph of this report and was not designed to identify all deficiencies in internal control that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses as defined above. However, we identified certain deficiencies in internal control that we consider to be significant deficiencies. A significant deficiency is a deficiency or a combination of deficiencies in internal control that is less severe than a material weakness in internal control over financial reporting or a material weakness in internal control over compliance yet important enough to merit attention by those charged with governance. We consider the deficiencies described below to be significant deficiencies.

[Describe the significant deficiencies that were identified.]⁷

[The entity's] responses to the significant deficiencies identified in our audit are described above [are in the accompanying schedule of findings]. We did not audit [the entity's] responses, and, accordingly, we express no opinion on the responses.

This report is intended solely for the information and use of management, [identify the body or individuals charged with governance], others within the entity, and USDA and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

Example B-2- Applicable to major projects (unpaid principal loan balance equal to or greater than \$2,000,000)⁸

The reference to major USDA GRRHPs here and throughout this report is used because the auditor's opinion on compliance runs to the major project. However, when required by the Guide the auditor still has the responsibility to test compliance with specific requirements applicable to non-major USDA GRRHP transactions and issue the related non-major report, Report on Compliance with Specific Requirements Applicable to a Non-major USDA GRRHP project.

**Independent Auditors Report on Internal Control
Combined Report Applicable to Internal Control over Financial Reporting Based on an
Audit of Financial Statements and Internal Control over Compliance for USDA GRRHP
Material Weaknesses and Significant Deficiencies Were Identified⁹**

[Addressee]

We have audited the financial statements of [the entity] as of and for the year ended [date], and have issued our report thereon, dated [date]. We have also audited [the entity's] compliance with requirements applicable to a major U.S. Department of Agriculture (USDA) Guaranteed Rural Rental Housing Program (GRRHP) project for the year ended [date], and have issued our reports thereon, dated [date].

We conducted our audits 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 Supplemental Government Auditing Standards Guide (Guide), issued by the USDA Rural Housing Service.

Those standards and the Guide require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether [the entity] complied with laws and regulations, noncompliance with which would be material to a major USDA GRRHP.

Management of [the entity] is responsible for establishing and maintaining effective internal control over financial reporting and internal control over compliance. In planning and performing our audits of the financial statements and compliance, we considered [the entity's] internal control over financial reporting and its internal control over compliance with requirements that could have a direct and material effect on a major USDA GRRHP project as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements and on compliance but not for the purpose of expressing an opinion on the effectiveness of [the entity's] internal control over financial reporting and internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of [the entity's] internal control over financial reporting and internal control over compliance.

Our consideration of internal control over financial reporting and internal control over compliance was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses, and, therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses and other deficiencies that we consider to be significant deficiencies.¹⁰

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 (1) misstatements of the entity's financial statements or (2) noncompliance with applicable requirements of a USDA GRRHP on a timely basis. A material weakness is a deficiency or combination of deficiencies in internal control such that there is a reasonable possibility that (1) a material misstatement of the entity's financial statements or (2) material noncompliance with applicable requirements of the USDA GRRHP will not be prevented or detected and corrected on a timely basis.

We consider the following deficiencies in [the entity's] internal control to be material weaknesses: [Describe the material weaknesses that were identified.]¹¹

A significant deficiency is a deficiency or a combination of deficiencies in internal control that is less severe than a material weakness in internal control over financial reporting or a material weakness in internal control over compliance yet important enough to merit attention by those charged with governance. We consider the following deficiencies in [the entity's] internal control to be significant deficiencies.¹²

[Describe the significant deficiencies that were identified.]¹³

[The entity's] responses to the material weaknesses [and significant deficiencies] identified in our audit are described above [or in the accompanying schedule of findings]. We did not audit [the entity's] responses, and, accordingly, we express no opinion on the responses.

This report is intended solely for the information and use of management, [identify the body or individuals charged with governance], others within the entity, and USDA and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

EXAMPLE C- Applicable to major projects (unpaid principal loan balance equal to or greater than \$2,000,000)¹⁴

**INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH SPECIFIC
REQUIREMENTS APPLICABLE TO A MAJOR USDA GRRHP PROJECT**

To the Partners
[The Entity]
Anytown, U.S.A.:

We have audited the compliance of [the Entity] with the specific program requirements governing [list those requirements tested] that are applicable to each of its major USDA GRRHP, for the year ended [date]. Compliance with those requirements is the responsibility of [the Entity's] management. Our responsibility is to express an opinion on [the Entity's] compliance based on our audit.

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 GRRHP Supplemental Government Auditing Standard Guide(Guide)issued by the USDA Rural Housing Service.

Those standards and the Guide require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the requirements referred to above that could have a direct and material effect on a major USDA GRRP occurred. An audit includes examining, on a test basis, evidence about [the Entity'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. Our audit does not provide a legal determination of [the Entity's] compliance with those requirements.

In our opinion, the [Entity] complied, in all material respects, with the requirements referred to above that are applicable to each of its major USDA GRRP for the year ended [date].

This report is intended solely for the information of the audit committee, management, and the USDA and is not intended to be and should not be used by anyone other than these specified parties.

CPA and Company
Certified Public Accountants

Anytown, U.S.A.
[Date]

EXAMPLE D- Applicable to non-major projects (unpaid principal loan balance equal to or greater than \$500,000 but less than \$2,000,000)¹⁵

**INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH SPECIFIC
REQUIREMENTS APPLICABLE TO A NON-MAJOR USDA GRRHP PROJECT**

To the Partners
[The Entity]
Anytown, U.S.A.:

We have audited the financial statements of [the Entity] as of and for the year ended [date], and have issued our report thereon dated [date].

In connection with that audit and with our consideration of [the Entity's] internal control used to administer USDA GRRHP, as required by the GRRHP Supplemental Government Auditing Standard Guide (Guide) issued by the USDA Rural Housing Service, we selected certain transactions applicable to certain non-major USDA GRRHP for the year ended [date].

As required by the Guide, we performed auditing procedures to test compliance with the requirements governing [list those requirements tested] that are applicable to those transactions. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on [the Entity's] compliance with these requirements. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under the Guide. This report is intended solely for the information of the audit committee, management, and the USDA and is not intended to be and should not be used by anyone other than these specified parties.

CPA and Company
Certified Public Accountants

Anytown, U.S.A.
[Date]

EXAMPLE E- Applicable to non-major and major projects.

**INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH SPECIFIC
REQUIREMENTS APPLICABLE TO FAIR HOUSING AND NON-
DISCRIMINATION**

To the Partners
[The Entity]
Anytown, USA

We have applied procedures to test [the Entity's] compliance with Fair Housing and Non-Discrimination requirements applicable to its USDA GRRHP, for the year ended [date].

Our procedures were limited to the applicable compliance requirement described in the Supplemental Government Auditing Standards Guide (Guide), issued by the USDA Rural Housing Service. Our procedures were substantially less in scope than an audit, the objective of which would be the expression of an opinion on [the Entity's] compliance with the Fair Housing and Non-Discrimination requirements. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under the Guide.

This report is intended solely for the information and use of the audit committee, management, and the USDA and is not intended to be and should not be used by anyone other than these specified parties.

CPA and Company
Certified Public Accountants

Anytown, U.S.A.
[Date]

EXAMPLE F-- Applicable to non-major and major projects.

SCHEDULE OF FINDINGS AND QUESTIONED COSTS
(Should be attached to Auditor's Report on Compliance)

When the auditor identifies a finding, this schedule must include the following information for each finding, where applicable:

(a) The size and corresponding dollar value of the population, (b) the size and dollar value of the sample tested, and (c) the size and dollar value of the instances of noncompliance.

The Government Auditing Standards state that well-developed findings generally consist of the following attributes:¹⁶

-- **Statement of condition** - the nature of the deficiencies, e.g., a regulation not being followed, a control procedure not followed or one which is inadequate.

-- **Criteria** - what the project should be doing, e.g. the specific regulation, a prudent management practice, or an internal control procedure.

-- **Effect** - what happened as a result of the condition; this should be monetized in all possible instances and described as thoroughly as possible.

-- **Cause** - why the condition exists, e.g. the project was unaware of the regulation or internal control was not a high priority of the project.

-- **Recommendation** - what the project should do to correct the condition, normally addresses the cause e.g. develops procedures to implement regulation or follow established procedures.

The auditor should attempt to identify the condition, criteria, effect, and cause to provide sufficient information to USDA officials to permit timely and proper corrective action. These findings may also serve as a basis for USDA to conduct additional work. In addition, as part of the finding, the auditor is required to make a recommendation for corrective action to the project. As part of this report, the auditor is required to include the project's summary comments on the findings and recommendations in the report. In addition, the project is responsible for developing a separate corrective action plan (see Example H) based on the auditor's findings and recommendations and including the plan when submitting the auditor's report. If corrective action is not necessary, a statement by the auditor describing the reason it is not should accompany the audit report.

EXAMPLE G- Applicable to non-major and major projects.

**PROJECT'S COMMENTS ON AUDIT RESOLUTION MATTERS RELATING TO
USDA GRRHP***

The Owner has not taken corrective action on findings from prior audit report, number and title:

Finding No. 1 -

Status -

Finding No. 2 –

Status –

* -- This includes all prior audits, project review reports and state agency reports.

* -- The auditor may rely on management's representation as to the completeness of reports submitted during the audit period. The auditor does not have to independently confirm the completeness of audit and other reports received by management.

EXAMPLE H- Applicable to non-major and major projects.

CORRECTIVE ACTION PLAN

Name and Number of Project _____

Auditor/Audit Firm _____

Audit Period _____

The following is a recommended format to be followed by projects for submitting a corrective action plan:

Section I - Internal Control Review

A. Comments on Findings and Recommendations

The project should provide a statement of concurrence or non-concurrence with the findings and recommendations. If the project does not agree with a finding, specific information should be provided by the project to support its position. If the information is voluminous, an appendix may be attached to the submission.

B. Actions Taken or Planned

The project should detail actions taken or planned to correct deficiencies identified in the report. Appropriate documentation should be submitted for actions taken. For planned actions, projects should provide projected dates for completion of major tasks. Officials responsible for completing the proposed actions should also be identified. If the project believes a corrective action is not required, a statement describing the reasons should be included.

C. Status of Corrective Actions on Prior Findings

The project must comment on all prior findings whether or not corrective action has been completed. The project should provide a report on the status of corrective actions taken on prior findings that remain open. An update should be included on dates for completion of major tasks and responsible officials for any actions not completed. In addition, documentation should be submitted for any actions the project considers completed.

Section II - Compliance Review

A. Comments on Findings and Recommendations

(See Section I. A. above.)

B. Actions Taken or Planned

(See Section I. B.)

C. Status of Corrective Actions on Prior Findings

(See Section I. C.)

CHAPTER 4. COMPLIANCE REQUIREMENTS

4-1 COMPLIANCE REQUIREMENTS

Purpose: The intent of this chapter is to function as a GRRHP specific audit guide that enhance and clarify guidance for the consideration of compliance testing and reporting. This chapter is not intended to be a program-specific audit guide for non-profit organizations compliance with the A-133 requirements.

This chapter contains the USDA requirements for conducting the compliance portion of the annual financial audits of profit-motivated and limited-distribution entities participating in the USDA GRRHP, except for projects with an aggregate of unpaid principal loan balance less than \$500,000 in a year, of which whom are not required to use or reference this guide.

4-1.1 Reporting Requirements. The regulatory agreement for the project requires the owner to submit audited financial statements, prepared in accordance with the requirements of the Secretary, within 90 days after the end of the fiscal year. Although most regulatory agreements may indicate a required submission date of 60 days after the end of the fiscal year, 24 CFR [*Code of Federal Regulations*] 5.801, Uniform Financial Reporting Standards (UFRS), supersedes this requirement by giving projects 90 days to submit their financial statements. In addition to issuing an opinion, the basic financial statements, and supplemental (supporting) data, the auditor is required to issue, at a minimum, a report on the internal control structure and a report on compliance. The owner must certify to the completeness and accuracy of the financial statements. The management agent, if applicable, must certify to the management of the project. When circumstances prohibit the specified number of partners' or officers' certifying signatures, explanatory information should be provided with the audit report.

The auditor's role is to conduct and report the results of the audit in accordance with auditing standards generally accepted in the United States of America (GAAS) as issued by the American Institute of Certified Public Accountants (AICPA) and the standards applicable to financial audits contained in GAGAS. In that regard, the independent auditor shall

- A. Issue an independent auditor's report (refer to chapter 2, example A) on the ownership entity's basic financial statements. This report should cover the following items:
- Balance sheet.
 - Statement of profit and loss.
 - Statement of changes in partner's capital.¹⁷
 - Statement of cash flows.
-

- Footnotes to the basic financial statements, including descriptions of accounting policies.
- B. Issue an independent auditor's report (refer to chapter 2, example A) on the supplemental information. A paragraph may be added to the auditor's report on the basic financial statements, or a full report may be issued separately.¹⁸
- C. Issue any additional reports described in chapter 2.

4-2 Compliance Requirements

4-2.1 **Background.** This section of the chapter contains the USDA requirements for conducting the compliance portion of the annual financial audits of profit-motivated and limited-distribution projects in USDAs GRRHP.

4-2.2 **Compliance Requirements and Audit Areas.** The following sections contain suggested audit procedures that USDA 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.

1. Federal Financial Reports.

- a. **Compliance Requirement.** Projects are required to ensure that financial status reports contain reliable financial data and are presented in accordance with the terms of applicable agreements between the project and lender or servicer. The individual agreements contain the specific reporting requirements that the project must follow. USDA will usually require monthly reports whenever annual financial reviews, on-site reviews, or other information indicates that the project is experiencing financial or management difficulties or the owner/agent is suspected of noncompliance.
- b. **Suggested Audit Procedures.**
 - i. Identify all required financial reports by inquiry of the owner/management agent and review of agreements and correspondence with the lender or servicer. Request a copy of project submissions to USDA, the lender, or servicer during the period under audit.
 - ii. Obtain an understanding of the owner/management agent's procedures for preparing and reviewing the financial reports.
 - iii. Ascertain whether the GRRHP project is capitalized in the borrower's financial records at the total development cost, including the portion guaranteed by the Agency, and the finance contributed by the borrower, less depreciation.

- iv. Select samples of financial reports, other than those included in the annual financial statements, and determine whether the reports selected are prepared in accordance with the lender or servicer instructions.
- v. For the sample selected, determine whether significant data reported are accurate. Report all material differences between financial reports and project records.
- vi. Determine whether the project complied with reporting requirements.
- vii. Ascertain whether the borrower timely prepared and submitted audited financial statements for the previous year if required.
- viii. For years in which the project is being constructed, ascertain by reviewing the borrower's financial records whether the borrower contributed the required percentage toward the project's development cost, and whether any cash contribution was expended prior to loan funds.
- ix. Ascertain whether any liabilities were improperly charged to, or paid from, project operations for contributions made by the borrower equal to, or in excess of, the required contributions for development costs.

2. Fair Housing and Nondiscrimination.

- a. Compliance Requirement.** Owners and management agents are prohibited from discriminatory practices in accepting applications, renting units, and designating units or sections of a project for renting to prohibited bases in accordance with the Fair Housing Act and the provisions of the regulatory agreement.
 - b. Suggested Audit Procedures.**
 - i. Obtain an understanding of the owner/management agent's policies and procedures relating to marketing of the units; processing, approving, and rejecting applications; and providing reasonable accommodation to applicants and tenants with disabilities in accordance with Section 504 of the Rehabilitation Act of 1973, Title II of the Americans with Disabilities Act of 1990, as amended and in accordance with the requirements of applicable federal civil rights laws.
 - ii. Obtain a copy of the project's approved affirmative fair housing marketing plan, if applicable. Review the marketing plan for compliance with appropriate statutes and the regulatory agreement.
 - iii. Obtain documentation supporting whether the lender has determined modifications are needed to the plan and whether the project complied with the suggested modification. Provide project justifications for noncompliance.
 - iv. Obtain documentation supporting gross income, race, national origin, head of household, gender, elderly and disability status for each unit.
-

1. Validate the information obtained by a comparison to applicant submitted documents.
 2. Assess whether the information complies with Section 526 of Public Law 100-242 of the Housing and Community Development Act of 1987.
- v. Review a sample of the correspondence chronology files for the period under audit for correspondence evidencing litigation or potential litigation related to discriminatory rental practices.
 - vi. During the review of cash disbursements look for payments that would evidence actual or potential litigation for any discriminatory rental practices.
 - vii. During the review of tenant files, look for evidence of discriminatory practices.
 - viii. Determine that the USDA approved equal housing opportunity logo, slogan, or statement is displayed in marketing materials.

3. Mortgage Status.

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

b. Suggested Audit Procedures.

- i. 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.
- ii. Obtain an understanding of the owner's procedures for assuring prompt payment of the mortgage.
- iii. Determine whether all related mortgage and escrow payments were made by either
 1. Obtaining or preparing a schedule of the client's mortgage and escrow payments and withdrawals for the period under audit (the schedule should include the amount, including escrow items, and date each item was paid or disbursed. Determine whether monthly payments were made on time and the loan was current at the end of the fiscal year) or
 2. Confirming the outstanding loan balance and annual escrow account activity with the lender as of the project's fiscal year end (determine whether monthly payments were made on time and the loan was current at the end of the fiscal year).
- iv. 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.

- v. Ascertain whether the borrower is: (1) maintaining the required fidelity bond coverage; (2) maintaining adequate property, worker's compensation, liability, and flood (where applicable) insurance; and (3) timely paying real estate and other applicable personal property taxes.

4. Replacement Reserve.

- a. Compliance Requirement.** Borrowers, if required, shall establish a reserve for replacement account and make deposits in accordance with USDA requirements, usually the regulatory agreement. The reserve for replacement account is usually required to be under the control of the lender or servicer. Disbursements from the reserve for replacement fund may be made only after written consent is received from USDA. Reserve for replacement funds are to be invested in interest-bearing accounts for certain projects. Interest earned on these projects is required to be maintained in the reserve for replacement account.
 - b. Suggested Audit Procedures.**
 - i. Obtain an understanding of the project owner's deposit and maintenance requirements included in the regulatory agreement, business agreement and any amendments or other written agreements with USDA and determine whether there were any changes to the funding requirement by:
 - 1. Reviewing reserve funds for replacement authorizations, or
 - 2. Questioning the owner/management agent if any changes were made when rents were increased.
 - ii. Obtain an understanding of the project owner's procedures for depositing, maintaining, requesting, and disbursing reserve for replacement funds.
 - iii. Determine whether the reserve fund has been established in a federally insured depository under the control of the mortgagee, if required. For funds in excess of federally insured limits, determine whether the owner/management agent reviewed the depository quarterly to verify that it met USDA requirements.
 - iv. Using confirmation or the schedule prepared for the mortgage status compliance requirement; determine whether all required deposits to the reserve for replacement were made in compliance with USDA requirements and agreements. Ascertain whether the reserve account is current by comparing the actual amount in reserve to the amount that should have accumulated since the date the project began operation (see loan agreement), less any authorized withdrawals approved by the Agency.
 - v. Obtain a confirmation of the reserve account balance from the applicable
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- financial institution, also checking for any encumbrances against the reserves.
- vi. Determine whether all disbursements from the reserve for replacement account, identified in the mortgage confirmation or the schedule prepared, were properly authorized by the lender or servicer.
 - vii. Select a sample of repairs covered by funds from the reserve for replacement account. Trace the reimbursed amount to cancelled invoices and determine whether funds were used for the purpose authorized by USDA.

5. Distributions to Owners.

- a. Compliance Requirement.** Owners may not make, receive, and/or retain any distribution of assets or any income of any kind of the project except surplus cash and then only under certain conditions. Surplus cash distributions can only be made as of and after the end of an annual fiscal period. Surplus cash distributions cannot be made when the owner is in default under any of the terms of the regulatory agreement, the note, or mortgage. Surplus cash distributions cannot be made out of borrowed funds or if the owner has not complied with all outstanding notices, from the lender, servicer, or USDA for proper maintenance of the project. While a surplus cash distribution to the owner is not restricted as to the amount, Agency regulations require that the lender ensure that the property be in “good financial and physical condition and in compliance with the regulatory agreement” prior to any distribution of surplus cash.
- b. Suggested Audit Procedures**
 - i. Determine if the borrower withdrew surplus cash. For each withdrawal obtain the borrower request for the release of surplus cash and the corresponding Lender certification.
 - ii. Obtain an understanding of the owner/management agent’s procedures for determining surplus cash
 1. Scan minutes of board or partnership meetings for discussions authorizing distributions. 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 regulatory or business agreement. If any surplus cash existed after payment of general operating expenses, debt service requirements, and escrow and other reserve account installments, ascertain whether the borrower obtained written approval from the lender or servicer before withdrawing the funds.

2. Scan the bank statements for any deposit, from the project owners and/or related parties, which would evidence that incorrect surplus cash distributions or payments were made and that those funds were re-deposited into the project's accounts before the audit.
- iii. 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 surplus cash being reported to be on hand at the end of the reporting period, making funds available for distribution to the owners.

6. Cash Receipts

- a. **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. Most projects will have at least three bank accounts including a regular operating account, a reserve for replacement account, and a tenant security deposit account. The regular operating account is a general operating account in the name of the project, which is used for depositing receipts of the project other than those specifically designated for the security deposits account.
 - b. **Suggested Audit Procedures**
 - i. Obtain an understanding of the owner/management agent's procedures for handling cash receipts.
 - ii. Determine whether the project owner's written and actual procedures for receiving and depositing funds in the regular operating account/centralized account are in compliance with the regulatory agreement and USDA guidelines.
 - iii. Determine whether the account is exclusively in the name of the project except as allowed for centralized accounts.
 - iv. Select a sample of deposits from the cash receipts ledger and perform the following steps:
 1. Determine whether the deposits were made in a timely manner after receipt of funds and are in the name of the project. Usually tenant cash receipts are deposited daily during the heavy rent collection days during the first part of the month and when certain amounts of funds are accumulated during the rest of the month.
 2. Test the supporting documentation for each deposit in the sample and determine whether all funds that were received were properly accounted for and included in the deposit.
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3. Determine that all deposits in the books of account are in agreement with the related bank statements as to amounts and dates.
 4. Determine whether the deposits were posted to the appropriate general ledger accounts.
 5. Trace all amounts other than tenant/member rental receipts to any contracts, agreements, or other documentation and determine whether the amount that was received was properly deposited and posted to the appropriate account.
 6. Select samples of tenant/member rental receipts and trace the amount from the source documents to the individual tenant/member accounts receivable record and their executed leases.
 7. If any amounts are added to the account by way of an institution's memorandum or other type of document, determine the reason for that transaction and whether it was proper.
- v. 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.
- vi. 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:
1. Determine whether rent potential and vacancy loss were properly calculated.
 2. For all revenue accounts, scan the detailed general ledger. Review the supporting documentation for all material manual entries and unusual entries.
 3. 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.
- vii. Possible tests on the sample include but are not limited to the following:

1. Reviewing the move-out notice from the tenant.
2. Reviewing the documentation from the move-out inspection.
3. Determining whether the security deposit was refunded to the tenant.
4. 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.
5. Inspecting the vacant unit if the unit is still unoccupied.
6. Questioning site personal, including the resident manager and the building manager, to determine the period when the unit was vacant.
7. Reviewing work orders to determine the period when the unit was vacant.

viii. 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:

1. Obtain an understanding of the owner/management agent's procedures for collecting delinquent debt and policy for writing off debt.
2. Determine whether delinquent accounts are sufficiently pursued according to procedures.
3. 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.
4. Determine the reason for any activity on the tenant record after the debt was written off.

7. Cash Disbursements

- a. **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 of surplus cash as permitted, and repayment of owner advances from surplus cash or as authorized by the lender or servicer. Disbursements from a centralized account must clearly be traceable to each project. The actual cash position of each project in this account must be easily identifiable at all times without exception.
 - b. **Suggested Audit Procedures.**
 - i. Obtain an understanding of the project owner/management agent's procedures for withdrawing funds from the regular operating account
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- or centralized account and determine whether they are properly supported and used in accordance with the regulatory agreement.
- ii. Select a sample of disbursements from the cash disbursement ledger or similar record and perform the following steps:
 1. For centralized accounts, determine whether the disbursements were recorded in the books of the appropriate project in accordance with USDA guidelines. Review cash account balances of each project to ensure that balances are easily identifiable to each project. Also, determine whether any projects have a negative or zero balance, which could indicate an improper loan between projects.
 2. 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.
 3. Determine whether the disbursements were made on behalf of other projects or entities since project funds cannot be loaned or used for non- project purposes. Report instances even if amounts have been repaid.
 - iii. Determine whether the disbursements were properly charged to the correct account.
 1. Scan the cash disbursements journal for payments that would evidence actual or potential litigation for any discriminatory rental practices.
 2. If any amounts are withdrawn from the project account by way of an institution's memorandum or other type of document, determine the reason for that transaction and that it is proper.
 3. For accounts with balances in excess of FDIC-insured limits, determine the risk.
 - iv. For years in which loan funds were expended, either outright or through interim financing, test expenditures to determine if they were budgeted and were made for only authorized loan purposes within the prescribed loan limits and limitations on the use of loan funds. Note: Testing should be expanded, as appropriate, for expenditures involving parties having an identity of interest with the borrower (related parties).

- v. Test whether funds disbursed from the accounts were for actual, reasonable, and necessary expenditures incurred for authorized purposes, and if required monthly debt service payments and transfers to escrow and reserve accounts were made. Disbursements made for purposes not related to the GRRHP project, including loans to other projects or enterprises, and partnership or corporate legal, tax preparation, and accounting fees, are not authorized or allowable. Note: Testing should be expanded, as appropriate, for expenditures involving parties having an identity of interest with the borrower (related parties).

8. Rent Restrictions

- a. **Compliance Requirement.** The Agency has established certain rent restrictions to preserve affordability of GRRHP units over time. The rent restrictions for the program are as follows:
 - i. The monthly rent for any individual housing unit, including any tenant-paid utilities, must not exceed an amount equal to 1/12th of 30 percent of 115 percent of area median annual income, adjusted for family size; and
 - ii. On an annual basis, the average monthly rent for a project, taking into account all individual unit rents, including any tenant-paid utilities, must not exceed 1/12th of 30 percent of 100 percent of area median annual income, adjusted for family size.
- b. **Suggested Audit Procedures**
 - i. Obtain an understanding of how the estimate of tenant-paid utility costs was calculated.
 - ii. Obtain the established estimate of tenant-paid utility costs. The calculation for tenant paid utilities for each unit size and type of heating fuel must be made at initial occupancy when the rent structure is established. *Form RD 3560-7, "Multiple Family Housing Project Budget/Utility"* , may be used for this purpose.
 - iii. Determine if the analysis is updated annually or when information is received from utility companies of a utility cost increase.
 - iv. Ascertain if the rent structure has become distorted over time due to inaccurate utility expense estimates.

9. Tenant Security Deposits

- a. **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. Funds must not be commingled with
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tenants and for payment of expenses incurred by or on behalf of the tenant, not to exceed the amount to which the tenant is entitled. All disbursements must have supporting documentation. In addition, state and local governments may have specific regulations governing the handling of tenant security deposits.

b. Suggested Audit Procedures

- i. Obtain an understanding of the project owner's procedures, including state and local laws, and regulatory agreement and USDA requirements for establishment and maintenance of the security deposit account and making approved disbursements from that account.
- ii. 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.
- iii. Determine whether, at the end of the reporting period and throughout the period under review, the amount on deposit is at least equal to the outstanding obligations under the security deposit account.
- iv. 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 discredited to tenants and paid upon termination of tenancy.
- v. Select a sample of tenants that moved in and tenants that moved out during the period under review and perform the following steps:
 1. Determine whether security deposits were collected at the time of the initial lease and agree with the amount required in the lease agreement and regulations.
 2. Determine whether security deposits collected were deposited promptly in the security deposit account.
 3. Trace tenant balances reported on the balance sheet at the end of the fiscal year as the outstanding obligation to the tenant list of security deposits for the same period and determine if it agrees.
 4. Determine whether refunds and/or an itemized list of claims were provided to tenants within 30 days after move-out or as required by state or local law.
 5. Determine whether refunds were disbursed to the former tenant and in the appropriate amount. Determine the disposition of or proposed disposition of the amounts for checks outstanding for more than 60 days.

6. Identify disbursements from the security deposit bank account statement that do not appear to be tenant refunds to ensure that those disbursements were only made for payment of appropriate expenses incurred by the tenant or on behalf of the tenant.
 7. Determine whether forfeited security deposits applied to rents and damages were appropriately recorded as rental income.
- vi. Ascertain whether a separate bank account is maintained for tenant security deposits, and if sufficient funds are in the account to cover security deposits collected from current tenants. Obtain a confirmation of the tenant security deposit account balance from the applicable financial institution, also checking for any encumbrances against the funds. Test withdrawals to ensure they represent either refunds to tenants or transfers to the general operating accounts for lease violations.

10. Management Functions

- a. Compliance Requirement.** The owner is responsible for complying with all requirements of the regulatory agreement. 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 the Lender.
- b. Suggested Audit Procedures**
 - i. Obtain a copy of the most recent approved management agent's certification. Perform the following steps:
 1. Determine whether the lender or servicer has approved the owner or current management agent.
 2. Obtain a copy of the management entity profile, to identify additional identity-of-interest companies that were not included in the management agent certification for inclusion in the notes to the financial statements.
 3. Review maintenance contracts and major contracts and vendor invoices to determine whether there are additional identity-of interest relationships with the owner/agent that need to be reported and in the notes to the financial statements.
 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.
 5. For payments made to identity-of-interest companies, determine whether the amounts paid exceed the amounts ordinarily paid for such



services and supplies. The amounts ordinarily paid can be determined by comparing costs to similar disbursements noted during the cash disbursement analysis or from the auditors' knowledge of amounts generally paid for services and supplies in the same geographic area, gained through their audits of other area clients.

- ii. Determine whether the owner or management agent has responded to all management review reports, physical inspection reports, and inquiries regarding annual financial statements or monthly accounting reports within 30 days.
- iii. On a sample basis, test work orders and tenant complaints for timely follow up and compliance with management's procedures.
- iv. Determine whether the project is maintained in good repair and condition. If the units are subsidized, determine whether management's procedures ensure that units meet applicable housing quality standards.
- v. Inquire whether USDA or the lender/servicer has conducted routine unit and general property inspections. If findings were identified, determine whether corrective action was taken.
 1. Question management and scan revenue accounts for any fees charged to the project or residents for additional services. Conduct follow-up or corroboration of management's responses as considered necessary to ensure that fees charged agree with the management agent certification or have been approved.
- vi. Test whether the management services provided, compensation paid, and other management related expenses incurred were in accordance with the management plan and agreement.

11. Unauthorized Change of Ownership/Acquisition of Liabilities

- a. **Compliance Requirements.** Owners shall not, without the prior written consent, convey, assign, transfer, dispose of, or encumber any of the mortgaged property or permit the conveyance, transfer, or encumbrance of such property.
- b. **Suggested Audit Procedures**
 - i. 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 in the property. Review any agreements. Determine whether it has approved transactions or is in the process of approving transactions and report any instances of noncompliance.

- ii. 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 approval.
- iii. Ascertain whether the borrower has written documentation supporting a request to, and prior approval from, the Agency for any changes in stockholders, general partners, or trustees.
- iv. 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.
- v. Ascertain whether there were any changes in limited partners, and if so, whether the borrower has written documentation supporting a notification to the Agency.

12. Unauthorized Loans of Project Funds.

- a. Compliance Requirements.** Owners shall not, without the prior written consent, 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.
 - b. Suggested Audit Procedures.**
 - i. 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.
 - ii. Review the results of the audit procedures applied to specific accounts or other general procedures to identify the existence of any unauthorized transactions.
 - iii. 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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The financial documents are to be submitted to the lender or servicer using the following transmittal/checklist. The transmittal/checklist provides the lender or servicer with project information, the related auditor's information, and a preliminary observation of the items contained in the submission.

Required Transmittal/Checklist for Annual Submission of Financial Documents

Address to: Lender/Servicer

To whom it may concern:

The following information is being sent to support compliance with the United States Department of Agriculture Rural Housing Service Guaranteed Rural Rental Housing Program. If you have any questions regarding the items being sent, you may contact Mr./Mrs. _____ of the organization or me at telephone number _____. Our facsimile number is _____.

Complete items 1 through 7

- 1. Project name: _____
- 2. Project address: _____
- 3. Project tax identification no.: _____
- 4. Auditor's tax identification no.: _____
- 5. Auditor's contact person _____
and telephone number: _____

Place a checkmark by item(s) submitted

- 1. ___ Annual audited financial statement for period ended / / ___
- 2. ___ Report on Internal Control
- 3. ___ Opinion on Compliance with GRRHP Specific Requirements
- 4. ___ Report on Compliance with Specific Requirements Applicable to Fair Housing and Non-Discrimination
- 5. ___ Schedule of Findings and Questioned Costs (if appropriate)
- 6. ___ Project's Comments on Audit Resolution Matters Relating to USDA GRRHP (if appropriate)
- 7. ___ Corrective Action Plan (if appropriate)

Signature: _____ Date: _____
Type or _____ print _____ signature _____ name: _____
_____ Title: _____

ENDNOTES

¹ For the comprehensive listing and descriptions of all GAGAS requirements and standards, see GAO-07-731G Government Auditing Standards.

² Reference to Government Auditing Standards is not applicable in the Report on Audited Financial Statements and Supplemental Information for non-major projects.

³ Reference to Government Auditing Standards is not applicable for non-major projects.

⁴ See example B-I for an illustration of a report in which significant deficiencies were identified by the auditor but no material weaknesses were identified. See example B-2 for an illustration of a report in which both material weaknesses and significant deficiencies were identified. Example B-2 would also be used by the auditor for situations in which there were material weaknesses but no significant deficiencies were identified. Note that this combined report format is illustrative of one possible presentation. Auditors may choose to issue separate reports on internal control over financial reporting and internal control over compliance.

⁵ Reference to Government Auditing Standards is not applicable for non-major projects.

⁶ See example B for an illustration of a report in which no material weaknesses or significant deficiencies were identified by the auditor. See example B-I for an illustration of a report in which significant deficiencies were identified but no material weaknesses were identified. Note that this example (B-2) illustrates the reporting when both material weaknesses and significant deficiencies were identified. Example B-2 would also be used by the auditor for situations in which there were material weaknesses but no significant deficiencies were identified. Note that this combined report format is illustrative of one possible presentation. Auditors may choose to issue separate reports on internal control over financial reporting and internal control over compliance.

⁷ If the auditor includes the findings in a separate schedule versus in the body of the report, the third sentence of the previous paragraph would be replaced with language similar to the following: *However, we identified certain deficiencies in internal control that we consider to be significant deficiencies as described in the accompanying schedule of findings [list the item reference numbers related findings, for example findings 1, 2, and 3].*

⁸ Reference to Government Auditing Standards is not applicable for non-major projects.

⁹ See example B for an illustration of a report in which no material weaknesses or significant deficiencies were identified by the auditor. See example B-I for an illustration of a report in which significant deficiencies were identified but no material weaknesses were identified. Note that this example (B-2) illustrates the reporting when both material weaknesses and significant deficiencies were identified. Example B-2 would also be used by the auditor for situations in which there were material weaknesses but no significant deficiencies were identified. Note that this combined report format is illustrative of one possible presentation. Auditors may choose to issue separate reports on internal control over financial reporting and internal control over compliance.

¹⁰ If no significant deficiencies were identified, this sentence would read as follows:
However, as discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses.

¹¹ If the auditor includes the findings in a separate schedule versus in the body of the report the last sentence of the previous paragraph would be replaced with language similar to the following: *However, we identified certain deficiencies in internal control that we consider to be material weaknesses as described in the accompanying schedule of findings as items [list the reference numbers of the related findings, for example, findings 1, 2, and 3].*

¹² If no significant deficiencies were identified, this paragraph would be deleted along with the paragraph below as there would be no significant deficiencies to identify.

¹³ If the auditor includes the findings in a separate schedule versus in the body of the report, the last sentence of the previous paragraph would be replaced with language similar to the following: *We identified certain deficiencies in internal control that we consider to be significant deficiencies as described in the accompanying schedule of findings items [list the reference numbers of the related findings, for example, findings 1, 2, and 3].*

¹⁴ See Example D for Independent Auditor's Report On Compliance With Specific Requirements Applicable To Non-Major USDA GRRHP Project.

¹⁵ See Example C for the Independent Auditor's Report On Compliance With Specific Requirements Applicable To A Major USDA GRRHP Project.

¹⁶ Although the Government Auditing Standard requirements are not applicable to non-major projects, the projects should adopt the suggested format and content of the Schedule of Findings.

¹⁷ Or similarly titled report based on the type of participating ownership entity. For example, if a limited liability company owns the property, “statement of changes in members’ equity” should be discussed.

¹⁸ Refer to *AICPA Professional Standards, Volume 1, U.S. Auditing Standards*, AU §551.06e.
