CHAPTER 4: FINANCIAL MANAGEMENT

4.1 INTRODUCTION

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

The chapter is divided into five sections:

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

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

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

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

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

SECTION 1: PROJECT ACCOUNTING SYSTEM

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

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

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

- Method of accounting. The borrower is required to use the accrual method of accounting throughout the year for bookkeeping and budget preparations. Annual reporting must be convertible to the standards identified in §3560.308.

- When the accrual method of accounting is used, the accrual-to-cash adjustment must equal the difference between Beginning Cash Balance and Ending Cash Balance to ensure these balances match their respective Balance Sheet figures. The sole purpose of this adjustment is to reconcile a company's internal ledger, kept on an accrual basis, to the IRS forms which are on a cash basis.

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

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

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

  ◊ Accounts must be held in domestic institutions;

  ◊ Accounts must be held only in financial institution accounts insured by an agency of the Federal Government, or held in securities meeting the requirements of 7 CFR part 3560, subpart G;

  ◊ Funds maintained in an institution may not exceed the limit established for Federal deposit insurance. Funds exceeding the Federally insured limit under a Tax ID number must be moved to a different qualified banking institution that will ensure the funds unless the current financial institution provides additional surety, such as a collateral pledge that may already be in place; and

  ◊ Borrowers must maintain at least one demand deposit or checking account so that funds are always readily available to pay necessary operating expenses. Borrowers must be able to account for housing project funds with accounting methods or practices that maintain the proprietary identity of the funds for each project.

- **Use of funds.** Funds, other than those in the security deposit/membership fee or patron capital accounts, are considered assets of the property and must be held in trust by the borrower until used. The accounts serve as security, through transfers or assumptions for the Agency loan or grant, until all outstanding balances are satisfied.

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

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

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

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

  The borrower may combine funds from different projects owned by the same borrower with the same tax identification number or Social Security Number in the same bank account, as long as the accounting system segregates and tracks each project's funds separately. A statement issued by a Certified Public Accountant (CPA) stating that the accounting system is structured to meet the principle of separate accountability will be provided.

  If revenue or expenses are prorated among more than one project, then the management plan must document how revenue and expenses are prorated across projects. For example, the plan must document how costs for a computer system that serves several projects are allocated across the projects. The accounting system must track these prorated costs.

4.3 OVERVIEW OF ACCOUNTS

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

- General operating account;

- Real estate tax and insurance account (if not part of the general operating account or unless escrowed by the Agency);

- Reserve account (unless escrowed by the Agency in accordance with §3560.65);

- Tenant security deposit account

- Membership fee account (if applicable); and

- For cooperative projects, a patron capital account.

Each account serves a different purpose, as described in Section 2 and the project loan agreement or resolution.

SECTION 2: PROJECT ACCOUNTS

4.4 GENERAL OPERATING ACCOUNT

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

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

The period between initial occupancy and full rent-up in a project can be risky because rental income may not be sufficient to cover all operating costs, make payments on the Agency loan, and make required contributions to the reserve fund. To assist projects through this phase, the Agency requires the establishment of a fund for Initial Operating Capital by the borrower for each project. Approval of subsequent loans, transfer of ownership or other servicing actions may require additional deposits to the Operating Account and will be described in the loan, transfer or servicing approval.

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

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

- **Funding of Initial Operating Capital**

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

- **Accounting for Initial Operating Capital**

  When the project accounts are established, Initial Operating Capital is blended with other revenue and used for operating expenses. The borrower may leave an amount of money equal to the initial capitalization of the fund in the operating account. This money should not be treated as surplus funds in the operating account nor should it be transferred to reserves. Its presence in the operating account should not be used as justification for the MFH Servicing Official to deny a rent increase.

- **Duration of Initial Occupancy**

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

- **Repayment**

  ◊ **Agency Policy**

  The borrower may, with the consent of the Agency, withdraw its original contribution to the Initial Operating Capital in multiple annual installments or a single installment after the second year of the housing project operations and prior to the seventh full year of project operation, provided the borrower can satisfy Agency criteria for approving repayment. Repayment can only be made once the project has been operating for 2 years, and the project's operations and finances have stabilized. Repayment may be requested in one to five annual installments, until the borrower's contribution to Initial Operating Capital has been fully repaid and prior to the close of year seven. The borrower must be able to demonstrate that the project is financially stable, that repayment will not require a rent increase, and that the project is in compliance with Agency requirements. The financial condition of the project may preclude full repayment of Initial Operating Capital.

  ◊ **Borrower Submissions**

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

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

  - **Occupancy.** The occupancy rate for the project over the most recent 12 months has averaged at least 90 percent.

- **Contributions to Reserves.** Contributions to reserves are on schedule, less any authorized withdrawals.

- **Sufficient Income.** The project's financial position is stable. All accounts payables are less than 30 days old. When the amount of the repayment is subtracted from the general operating account, the ending cash balance still includes an amount equal to 20 percent of projected annual operating costs and required escrows for real estate taxes and insurance.

- **Impact on Rents:**

  - Repayment is acceptable if no rent increases are projected in the year the repayment is made.

  - A rent increase will not affect repayment if rents are increasing to cover increases in costs, such as wages, taxes, or insurance.

  - Repayment is denied if it creates a shortfall in operating income that must be made up by a rent increase and/or funded by the owner.

- **Physical Maintenance.** There are no outstanding deficiencies in management's physical maintenance of the housing project in accordance with 7 CFR 3560.354**.**

- **Compliance.** There are no outstanding compliance violations, and the project is not under a workout agreement.

◊ **Agency Processing**

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

- **Amount of Repayment**

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

Example – Initial Operating Capital

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

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

- **The Decision Process**

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

  - The MFH Servicing Official may decide to:

    - Permit repayment in the amount requested by the borrower;

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

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

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

  - The MFH Servicing Official updates Multi-Family Information System (MFIS) Tracked Accounts and Servicing Efforts to show the amount of the authorized repayment and the unpaid balance of Initial Operating Capital.

- **Other Borrower Advances**

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

  - A review of the documented circumstances and the project operating budget before any funds are advanced. The financial position of the project must not be jeopardized.

  - Funds are not immediately available from any of the following sources:

    - Reserve funds;
    - Initial operating capital; or
    - An imminent rent increase.

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

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

- Repayment of Advanced Loan Funds

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

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

The borrower's Return on Investment (ROI) is the annual amount of profit an owner operating on a limited or full-profit basis may receive from a project, as established in the loan agreement. When a property has a transfer of ownership, ROI is referred to as a Return to Owner (RTO) and is based upon the transfer underwriting analysis and approval conditions. The amount is calculated as a percentage of the owner's investment in the project.

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

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

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

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

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

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

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

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

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

4. The borrower may request the Return from surplus operating cash in the reserve account if the conditions set out in the loan agreement are met and the account balance is greater than the required deposits minus authorized withdrawals. If a property has a GAP account for the insurance deductible, this must be considered when reviewing the required reserve account balance. After the disbursement the reserve account actual balance must be equal to or greater than the required balance. The disbursement does not reduce the required balance.

C. Surplus Funds [7 CFR 3560.306]

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

Example- Payment of Return

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

Case 1: If the project had a negative cash flow after payment of operating and maintenance expenses, reserves, and debt service expenses during the fiscal year (FY) 20X7 but had $20,000 available in the general operating account, the Agency would approve a Return from funds available at the end of FY 20X7. In this example, "FY 20X7 RTO" would be noted in the comments section of *Form 3560-7*. This Return would be taken immediately after the end of the fiscal year, preferably January 20X8.
After the $1,000 RTO was paid, if all or a portion of the previous year (20X6) RTO is unpaid - it may be paid from the remaining surplus cash. Any remaining previous years unpaid RTO will then be written off.

Case 2: If the project had a negative cash flow during FY 20X7 but had only $5,000 available in the general operating account, the Agency would not approve a Return from funds available at the end of FY 20X7. This FY 20X7 RTO could be requested the following year if there is surplus cash to cover it, the 20X8 RTO is paid first and it does not cause a rent increase. The Return would be taken immediately after the end of the fiscal year, preferably January 20X9.

Case 3: Consider the same project as described above. During FY 20X7, the borrower believed that there would not be adequate cash to pay taxes at year end, so the borrower requested $2,000 from the reserve account for operating purposes; however, the project ended the year with $3,000 positive cash flow. In this case, the borrower can take the $1,000 without Agency permission, as they used a reserve withdrawal request to cover operating expenses. However, if the net cash amount was less than $2,000, the borrower can only take Return from surplus cash.

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

4.5 TAX AND INSURANCE ACCOUNT

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

4.6 RESERVE ACCOUNT

The reserve account is used primarily to pay for large, planned expenses for maintenance and improvements of capital items. It is funded through contributions from project operating funds. The reserves are not to be used as an alternative operating budget. The project's reserves must be held in a supervised bank account. The Agency must approve all withdrawals from the reserve account. Agency countersignature is not required if there is a Form RD 402-1A, "Sample Deposit Agreement", or a "Deposit Account Control Agreement" (DACA) executed by all parties after September 28, 2018.

The Agency may request an escrow account be established for the collection and disbursement of reserve account funds.

The administration of project reserves is covered in detail in Section 3 of this chapter.

4.7 SECURITY DEPOSIT OR MEMBERSHIP FEE ACCOUNT

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

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

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

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

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

4.8 PATRON CAPITAL ACCOUNT

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

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

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

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

4.9 PURPOSE OF RESERVES

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

Adequate replacement reserves are a critical component of a successful project. The reserves are not to be used as an alternative operating budget. Rents should reflect and cover the reasonable and customary costs of annual operating expenses of the property in the market. Annual reserve deposit for projects with Agency approved Capital Needs Assessments (CNA) will be adjusted as authorized in the loan, transfer or servicing approval.

4.10 RESERVE ACCOUNT REQUIREMENTS

The reserve account is a required account subject to the requirements set out in this paragraph, and subject to the Supervised Bank Account requirements of 7 CFR part 1902, subpart A, unless otherwise approved by the Agency. The borrower will initiate deposits in this project account, starting in the same month the first loan payment is due the Agency. As projects age, the required reserve account level may be adjusted to meet anticipated life-cycle needs, such as equipment and facility replacement costs, by amending the loan agreement/resolution. Refer to Attachment 4-B for guidance on the amendment.

Requirements for the reserve account include the following:

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

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

- Reserve funds are required to be placed in a supervised account. The Agency is no longer required to countersign approved withdrawals from reserve accounts as provided by 7 CFR 3560.306(e)(2) and 7 CFR 1902.4(a)(1) if there is a Form RD 402-1A, “Sample Deposit Agreement”, or a “Deposit Account Control Agreement” executed by all parties after September 28, 2018.

- Agency approval must be obtained prior to the withdrawal of any reserve account funds per 7 CFR 3560.306 and MFH Handbook (HB)-2-3560 Chapter 4, Section 3. If the Agency finds any unauthorized Reserve account usage, the Agency will take the appropriate servicing actions.

- Any amount in the reserve account that exceeds the total sum specified in the loan agreement or resolution may be transferred to the general operating account for authorized purposes only when it is agreed, between the borrower and the Agency, to be in excess of the requirement and there is a specific need for the excess funds. However, the MFH Servicing Official may direct the excess sum to be retained in the reserve account or applied as an extra payment on the loan. If a property has a GAP account for the insurance deductible, this must be considered when reviewing the required reserve account balance.

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

4.11 RESERVE INSTALLMENTS

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

The Agency may approve a change in the borrower/projects reserve account annual deposit amount based on the findings of an approved Capital Needs Assessment (CNA). The approval to change the annual deposit amount to the reserve account will take into consideration the housing project's approved budget and its ability to support a change to reserve account deposits without causing basic rents to exceed conventional rents for comparable units in the area. If the borrower requests a change in the project's annual reserve account deposits, the borrower must have a capital needs assessment prepared and submitted to the Agency to reflect the project's anticipated needs for replacement of capital equipment and systems. The cost for preparation of a CNA will be approved by the Agency as an eligible project expense for existing owners, provided that the cost of the assessment is reasonable and meets Agency requirements. (Note: CNAs required by transferees for ownership changes are not eligible for payment from the reserve account unless the transferee is also a non-profit entity and no additional third party is providing funds for acquisition or rehab.)

The Agency may approve a change in the borrower/projects reserve account annual deposit amount based on Operating Cost Adjustment Factor (OCAF) as published by The U.S. Department of Housing and Urban Development (HUD) annually for the state the project is located. This will require a modification to the Loan Agreement/Resolution (see Attachment 4-B-1) and the increase must be documented annually with the proposed budget submissions. The annual reserve account deposit will increase each year based on the most recent OCAF adjustment published by HUD. A CNA is not required for the implementation of the OCAF increase to the annual reserve account deposits.

The Agency may approve a borrower's request to increase the fully funded level of the reserve account to ensure sufficient funds are available to address the capital requirements of a Transition Plan or future capital improvements to the property. A CNA is not required to solely request an increase in the fully funded level of the reserve account.

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

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

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

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

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

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

- **GAP Account**. Difference between the Agency maximum deductible limit and the borrower's policy deductible.

4.12 RESERVE ACCOUNT PRINCIPLES

Reserve account funds are governed by the following principles:

A. Investment Vehicles and Institutions

Reserve account funds not immediately needed to pay for expenses or authorized purposes may be held as set out in this paragraph. Reserve account funds may be held in the form of:

◊ A checking, savings, negotiable order of withdrawal, or similar account at a federally-insured domestic institution, such as a bank, savings and loan, or credit union.

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

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

B. Limitations on Investments in Securities

Any securities must be:

◊ Backed by the U.S. Government or an Agency of the U.S. Government;

◊ Triple A-rated Government National Mortgage Association (GNMA)-collateralized tax-exempt bonds; or

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

C. Reporting Actual Costs of Securities

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

1. Security Sales

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

2. Forecasting Security Sales

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

3. Knowledge Required of Securities Investors

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

4. Financial Advisor Limitations

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

4.13 USE OF THE RESERVE ACCOUNT

A. Planned Use of Reserve Funds

The borrower will request approval for use of the reserve funds using *Form RD 3560-12, Request for Authorization to Withdraw Reserve Funds,* before funds are needed if items were not included on the approved capital budget. The borrower will request withdrawal from the reserve fund using Form RD 3560-12. Annual budgets are to include realistic routine income and expense levels to avoid the need to use reserve funds for routine expenses (operating shortfalls) not caused by emergencies or very unusual servicing situations. The Agency expects borrowers to anticipate and plan for major capital expenditures at least annually, including a careful review of any approved CNA. The MFH Servicing Official will monitor planned capital needs and expenditures to determine if revisions will be necessary and document the file accordingly.

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

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

B. Authorized Uses/Eligible Expenditures

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

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

- To address the capital requirements identified by the borrower's Transition Plan and other servicing tools. Loan funds may also be used for this purpose.

- Making permanent improvements to the housing project, such as installing an energy-conserving heat pump.

- For other purposes desired by the borrower, which in the judgment of the Agency will promote the loan purposes; strengthen the security of the loan; or facilitate, improve, or maintain the project and the payment of the loan without jeopardizing the loan or impairing the adequacy of the security.

- Facilitating payment of fees associated with the buying or selling of securities or maintaining a securities account.

- Meet loan obligations of the project in the event the amount available for debt service is not sufficient for the payments.

- Meet an emergency shortfall in operating expenses when the emergency is beyond the control of the borrower and threatens life, or the safety or the physical security of the project. Examples include an extreme weather disaster or reductions in rental income caused by changes in the rental market that affect other housing projects in the market as well. In cases of weather disasters, the project insurance coverage will be reviewed to determine if funding from insurance will be available for repairs. Suitable justification as to why the general operating account is insufficient is required.

- Payment of a return on investment at the end of the borrower's fiscal year, if such payment is from surplus operating cash in the reserve account. The borrower will use *Form RD 3560-12* to request this withdrawal.

- With Agency approval, borrowers operating on a for-profit or a limited-profit basis may make an annual withdrawal from the reserve account equal to no more than 25 percent of the interest earned on the reserve account during the prior year. The borrower will use *Form RD 3560-12 to* request the withdrawal and must provide documentation of the prior year interest earned. For example, in the report submitted for the period January 1, 20X9 through December 31, 20X9, the owner is entitled to 25 percent of the interest earned during calendar year 20X9. The borrower is not entitled to interest earnings from prior years.

- Other items considered eligible for draws from the reserve account include capital items listed in Attachment 4-A, Capital Expenditures.

C. Unanticipated Uses of Reserves

The Agency recognizes that not all capital expenditures can be predicted a year in advance. Sometimes a major piece of equipment will break down unexpectedly or a severe storm will create damage. Borrowers must seek Agency approval for the unforeseen use of reserves. In emergency situations when the borrower can demonstrate an imminent and serious threat to the health, safety, or physical security of the project, the borrower may request the Agency to post-approve the use of reserves. The Agency will only approve emergency withdrawals if the reserves are used for eligible expenses. If post-approval is requested, the bidding requirements, as described below, still apply. If the bid is obtained post-approval and is less than the expense, the difference will be reimbursed to the account by the borrower. Unforeseen circumstances may alter the approved CNA schedule adversely and require further review and modification to meet the reserve deposit schedule in the borrower's loan agreement /resolution. The MFH Servicing Official will review any loan, transfer or servicing conditions that may be impacted and develop a plan to reflect any modified schedule of findings or repairs.

D. Withdrawal Approval Process

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

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

- When an Agency approved Form RD 402-1A, "Sample Deposit Agreement" or "Deposit Account Control Agreement," other than Form RD 402-1 has been fully executed after September 28, 2018, the borrower may use electronic transfer of reserve funds upon receipt of Agency approval to withdraw reserve funds. After the reserve withdrawal is approved by the Agency, reserve funds can be electronically transferred to the operating account for disbursement. These funds will be recorded as a withdrawal from the reserve account on the annual financial report submission.

- Borrowers will notify the MFH Servicing Official of work completed within 5 days so that needed inspections may occur.

- Borrowers will submit a final invoice that describes the specific service and banking transaction if the amount is different than initially approved or was a preapproved capital budget item.

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

1. Bid Requirements

Expenditures of $10,000 or less for MFH properties with 24 units or less, or $25,000 or less for MFH properties with 25 units or more do not require multiple bids, even if it is an identity-of-interest (IOI) entity.

The expenditure of reserve funds for a project (all work included in one contract) estimated to cost more than $10,000 (for MFH properties with 24 units or less) or more than $25,000 (for MFH properties with 25 units or more) will require a minimum of two bids. When there is an IOI between the borrower or property manager and a bidder, a minimum of three bids must be submitted. The entity with the IOI must submit its bid directly to the MFH Servicing Official prior to the borrower requesting bids from other firms. Once the bids are received the borrower will submit the request using Form RD 3560-12 to the MFH Servicing Official with all bids attached.

An explanation of why the borrower was unable to obtain two non-IOI bids must be provided when appropriate.

2. Projects Involving Moderate Levels of Construction

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

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

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

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

After the project has been completed, the borrower notifies the MFH Servicing Official with actual invoice/cost. The MFH Servicing Official will perform an inspection of the work done to assure it has been completed in accordance with the contract/agreement or statement of work if applicable.

3. Projects Involving Large Levels of Construction

A project with large levels of construction involves substantial changes to the structure, replacement of major systems, and/or expenditures estimated in excess of $100,000. Such activities are subject to the design requirements of

Exhibit K of RD Instructions 1924-A and 1924-C. In addition to the items for bids specified above, the borrower must provide:

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

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

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

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

The Agency may conduct additional inspections as necessary.

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

4. Projects Involving Insurance Claim Proceeds

To alleviate redundancy and the administrative burden of processing insurance claim proceeds, when the insurance company selects a contractor to perform the mitigation or repairs, the Agency will no longer require the minimum bids.

- In instances where the insurance company selects a contractor to perform insurance proceed funded mitigation or repairs, the Agency agrees that the two-bid reserve account requirement is not applicable.
- In instances where the insurance company selects a contractor that has an Identity of Interest with the insurance company or owner, the Agency agrees that the 3-bid reserve account requirement is not applicable.

This is based on the insurance industry standard that the selected (preferred) contractor will not charge more than what the insurance company will pay and therefore the deductible is the only expense the property will incur.

The contractor and insurance company must comply with all state and local laws and local code enforcement officials.

If the insurance company receives executed contract documents, such as construction contracts, pay applications, change orders, warranties, inspection reports, etc. the MFH Servicing Specialist will request copies of these documents for the project file.

This does not apply to, or change the bid requirements for, reserve account requirements if the insurance company does not select the contractor on insurance claim mitigation or repairs. This guidance does not apply to reserve withdrawal requests that do not involve insurance claim proceeds.

Plans and specifications should be reviewed by Program Support Services, Architectural Services Branch, prior to the start of work. In all cases where there is substantial or major rehabilitation, the selected contractor must adhere to Section 504 of the Rehabilitation Act of 1973.

Insurance claim proceeds must be tracked by the MFH Servicing Official in the MFIS Tracked Account - Insurance Account.

SECTION 4: PROJECT BUDGETS

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

A. General Information

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

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

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

- Budgets must be reasonable and realistic. Revenues, vacancies and expenses must be consistent with past project budgets, historical actuals, current circumstances, and market conditions. Any differences must be due to legitimate operating needs of the project.
- Project expenses will include only expenses necessary to maintain successful projects. An example of an unnecessary expense is owner or manager entertainment expenses. Project expenses cannot be used for unearned personal benefit or gain, or for reimbursement of false or inaccurate expenses.
- The priority order of project expenditures must be:
    - Senior Position lien holder, if any;
    - Operating and maintenance expenses, including taxes and insurance;
    - Debt service to the Agency;

- o Reserve account deposits;
- o All accounts payable
- o Other authorized expenses; and
- o Return on the owner's investment or Non-Profit Asset Management Fee.

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

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

1. Part I - Cash Flow Statement

For budgeting purposes, the cash flow statement projects whether the property will generate enough revenues for all cash needs for the budget period. The proposed budget ending balance must be a positive cash balance and not cause an unwarranted rent increase, nor should it exceed the total of: (1) approximately 20 percent of Total O&M Expenses (Part I, line 16); (2) the amount held for taxes and insurance; (3) any initial operating capital during the first 7 years or until it is withdrawn, whichever comes first. Accrual method accounting will be considered with the annual financial reports and is discussed in Section 5 of this chapter.

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

A vacancy and contingency allowance is calculated from the previous 36-month historical vacancy rate of the property, and should not exceed the caps as identified below. If the historical vacancy rate is greater than established caps, the vacancy and contingency allowance is capped at the following levels:

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

- A Non-Profit Asset Management Fee may be requested by non-profits and cooperatives. Non-profit owners may request reimbursement for up to $7,500 per project for certain organizational expenses (typical asset management expenses directly attributable to ownership responsibilities), such as Errors and Omissions insurance and actual expenses prorated by the number of Rural Development units. Expense reimbursement may not be duplicated on multiple properties. Documentation of the actual expenses is required to support the requested payment amount. Examples of acceptable documentation for this expense include, but is not limited to:

  - ◊ A copy of the Errors and Omissions Insurance policy that reflects who is covered and the cost;
  - ◊ Documentation of hours, number of meetings, and the hourly wage rate used for Board of Director’s review.
  - ◊ The oversight functions include:
    - ▪ Board of Director’s review and approval of proposed budgets, including proposed repairs, outlays, and accruals;
    - ▪ Review of capital expenditures;
    - ▪ Approval of annual financial reports and considerations of any management comments noted; and
    - ▪ Long-term asset management reviews.

Any investor asset management fee, investor service fee, or similar fee may be paid solely from the annual Return to Owner and may not be paid from project operating funds. This is not the same as the Non-Profit Asset Management Fee.

Part II - Operating and Maintenance Expense Schedule

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

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

- Utilities include only utilities paid by the project. Utilities paid by the tenant are not included on this form.

- Administrative expenses are project expenses only and do not include expenses that a management firm incurs. The management fee and the services performed for the fee are defined in the 7CFR 3560.102 (i)(1), Management Certification and or Management Agreement. The Management Plan establishes the systems and procedures that will be employed on site to ensure that project operations comply with Agency requirements.

- Taxes and Insurance expenses include all project insurance and real estate taxes, or any special assessments or other taxes allowed.

2. Part III - Account Budgeting/Status

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

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

◊ **Beginning balance.** This is an estimate of the balance in the account as of the beginning of the proposed budget period. The MFH Servicing Official should review the beginning balance of the reserve account to ensure accuracy.

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

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

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

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

3. *Part IV - Rent Schedule and Utility Allowance*

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

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

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

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

4. *Part V- Annual Capital Budget*

The capital budget portion of Form RD 3560-7, Part V provides information on plans for capital improvements and will assist the Agency on utilization of the reserve account for future rent increase requests. It lists all the capital items in the project and provides space for the borrower to indicate their condition, address transition plan items and any needed improvements. The Annual Capital Budget allows capital items to either be expensed from operations or capitalized from the reserve.

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

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

5. *Part VI - Narrative, Signatures, Dates and Comments*

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

Proposed Budget Narrative:

The budget narrative provides a description of the budget and highlights important elements to aid MFH Servicing Officials in their review of the budget.

The budget narrative must be completed, or the budget will be considered incomplete and returned for correction.

◊ **Items to Be Covered in a Proposed Budget Narrative:**
The following information must be included in the budget narrative for it to be considered complete.
  - A brief description of the project and its status. The description should address key indicators of project status.
  - A statement of project compliance. Indicate any outstanding monitoring findings and the progress in addressing the problems.

The statement must address Section 504 accessibility compliance. If in Section 504 non-compliance, address steps to be taken to attain full compliance including budgeting items from the Transition Plan that will be funded and completed within the upcoming fiscal year.

- An explanation of projected capital expenditures and reserve withdrawals for the upcoming year and capital needs for the next three years.
- A description of the project's overall financial status and important factors contributing to the changes. (Vacancy, workout plan status, debt deferrals, servicing efforts.) If the analysis reveals that the subtotal for any operating expense category (maintenance and operating costs, utilities, administration, or taxes and insurance) exceeds the 10 percent tolerance threshold, the borrower will provide adequate documentation that the expenses for this category are reasonable and necessary. For example:

  - Costs are comparable to the costs for similar properties in the conventional market. In this example, the borrower might show that insurance costs for the same coverage at a conventional project are comparable to the costs for the project shown in the budget.

  - The factors contributing to the cost increases are beyond the borrower's control and the borrower is actively implementing cost-containment measures. For example, the project is subject to utility rate or tax increases.

  - The cost increase is needed to cover actions to address identified physical deficiencies that are not due to negligence by the borrower or the management agent. Physical deficiencies that are due to negligence by the borrower or the management agent are not acceptable reasons for a rent increase.

- ***Signatures:***

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

- ***Comments:***

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

C. Borrower Submission Requirements

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

- ***Complete Budget***

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

- ***Changes in Rents***

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

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

- ***Annual Utility Allowance Reviews***

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

  If all utilities are included in the rent (utilities are paid by the project), there is no utility allowance review.

  Setting Utility Allowances:

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

1. An average of tenant utility costs paid during the prior 12-month period will be used for the calculation.

2. Borrowers must establish utility allowances for each size and type of rental unit in the housing project based on utility costs.

3. Borrowers will request a change to the existing utility allowance if the proposed change is 10 percent or more.

4. A summary of the calculations must be submitted to the MFH Servicing Official along with the *Form RD 3560-7*.

5. The borrower must obtain the following documentation describing the utility allowances and keep in the project files:

   - **Rate Changes:** Documentation of the rate changes may include actual billing information or documentation from utility companies;

   - **Usage:** Documentation of a 12-month sampling of tenant utility usage from the utility company. A sampling will be dependent on the size of the project and will include every size of unit. If tenant utility information is unavailable from the utility company or only provided at cost, utility billings received by tenants are acceptable**.**

   - **No Changes:** Documentation of no change in utility rates has occurred during the period being reviewed. A public release from the utility provider indicating no change in rates has occurred during the period reviewed is acceptable. The borrower must indicate no changes to utility rates in the budget narrative.

- ***Tenant Notification and Comments***

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

  The Notice must inform the tenants that they have 20 calendar days to provide their comments to the Agency. If during this time the Agency receives any tenant comments, these must be immediately forwarded to the borrower with the identity of the tenant protected. This can be done by either paraphrasing the comments for the borrower or by removing any identifying information from the correspondence received from the tenant before forwarding it on to the borrower. The Agency will respond to the tenant that their comments will be considered in the review of the budget. Upon conclusion of the 20-day comment period, the Agency must notify the borrower of approval or denial within 10 days. If the Agency approves a rent or utility allowance increase request on which the comments were solicited, tenants will be notified of the rent or utility allowance change to be effective at least 30 calendar days from the date of the notification.

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

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

1. Form RD 3560-7 must be used to reflect the project's financial needs for the year and thereby rental charge requirements. Submission of the Form RD 3560-7 data through MINC is acceptable. A proposed operating budget must include:

- Proposed budget at proposed rents
- Operating and Maintenance Expense Schedule
- Rent Schedule and Utility Allowance
- Annual Capital budget
- Narrative explaining
  - Project status
  - Project compliance, including Section 504 accessibility
  - Rent and utility allowance change justification
  - Projected capital expenditures and reserve withdrawals
  - Outstanding findings
  - Servicing effort status (Work out plan/other debt/special note rent)
  - Project financial accountability and concerns
  - Account status (T&I, GOA, Reserve)
  - Any unique situations

2. Utility allowance review. Required documentation for utility costs as described earlier in this Chapter and Chapter 7.

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

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

- ***Documentation***

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

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

- ***Late Budget Submissions***

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

- ***Carry-Over Budgets***

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

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

- ***Mid-Year Budgets***

A Mid-Year Budget is a type of budget that is used if there is a change in rents or utilities at the project that is effective other than the first day of the project's fiscal year.

The borrower's submission must include operating income and expenses that would be expected for the next 12 months after the effective date of the budget. MFIS will prorate the budget correctly for analysis.

The MFH Servicing Official may add a MFIS Supervisory Activity for a proposed budget with a mid-year due date. The activity will allow the MFH Servicing Official to select the effective date of the mid-year budget. This process would also be used for transfers to establish the first budget, and if the annual proposed budget was not submitted and approved prior to the first day of the project's fiscal year and a Carry-Over budget went into effect.

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

Exhibit 4-2 Timeline Example for Carry-Over and Mid-Year Budgets	
1. No budget was received by 1-1-XXXX	MFIS creates a Carry-Over budget using a 1-1-XXXX approved date.
2. Budget transmitted 2-10-XX with rent change effective 6-1-XX	New budget in MFIS (Mid-Year budget) with due date prior to effective date of 6-1-XXXX

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

Exhibit 4-3
Schedule for Budget Submission and Review

Budgets Without Rent or Utility Allowance Change	
60 calendar days prior to end of the project's fiscal year *November 1**	Borrower submits all necessary budget documents to Agency. Within 30 calendar days of transmitted, the Agency must take action by approval or denial of the budget or contact the Borrower to request additional information or clarification.
30 calendar days prior to end of fiscal year *December 1*	Agency approves or denies the budget.** • If the budget was unacceptable, the borrower may submit additional information to address deficiencies within 10 calendar days. • Agency makes final approval or denial of budget within 20 calendar days of receipt of this additional information.
End of fiscal year *December 31*	Final approval or denial of the budget. If budget is denied, the current year's budget remains in effect.
Budgets With Rent or Utility Allowance Change	
90 calendar days prior to end of fiscal year *October 1**	Borrower notifies tenants of requested rent change *(Handbook Letter 203(3560)* and submits all necessary budget documents to Agency. • Tenants have 20 calendar day comment period to provide comments to Agency. • Within 30 calendar days of transmitted, the Agency must take action by approval or denial of the budget or contact the Borrower to request additional information or clarification. If no action is taken and the rent increase is $25 or less, it may be considered automatically approved.
60 calendar days prior to end of fiscal year *November 1*	Agency provides notice to the borrower of budget approval or denial.** • If the budget was unacceptable or incomplete, the borrower may submit additional information to address deficiencies within 10 calendar days. • Agency has 20 calendar days to review the additional information.
30 calendar days prior to end of fiscal year *December 1*	Agency gives final approval or denial of the budget. • Tenants will receive *Handbook Letter 204(3560)* notifying of RD approval of the rent or utility allowance change at least 30 calendar days prior to the effective date of the rent or utility allowance change. • If the rent change is denied, the borrower may submit a revised budget at previously approved rents with expenditures acceptable to the Agency. In the absence of such a revised budget, the current year's budget remains in effect.
Beginning of project's fiscal year *January 1*	New budget and rent increase take effect.

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

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

D. Agency Review Requirements

MFH Servicing Officials must take the steps shown in Exhibit 4-4, Steps in the Budget Review and Approval Process, when reviewing budgets.

Exhibit 4-4

Steps in the Budget Review Process

- Follow procedure for receipt of budgets;
- Prioritize budgets for review;
- Review outstanding monitoring findings;
- Review the budget for reasonableness, overall financial and physical health of the property;
- Review the rent or utility allowance change, if requested; and
- Approve or deny the budget.
- Update MFIS and Asset Management Survey (Risk Rating Tool) data

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

1. Receiving the Budget

Standard procedures for budget receipt will help MFH Servicing Officials track the progress of budgets through the review process and meet Agency deadlines. Further, intake procedures should help prioritize the review of budgets so that those with the highest priority (e.g., those with rent or utility allowance changes) receive the attention they need in a timely manner. The following steps are taken upon receipt of budget submissions:

◊ When hard copies of the *Form RD 3560-7* budget are submitted, the documents must be date stamped, entered into MFIS (complete received date and input the financial details), and forward to the appropriate MFH Servicing Official for review.

◊ When budgets are transmitted through MINC, the submission of a hard copy of *Form RD 3560-7* is not required. The MFH Servicing Official will find the budget under Industry Interface in MFIS. If the budget transmission is accepted, the system will complete the transmitted date for this item. The following items are needed for the budget to be accepted by the MFIS system:

◊ Effective day must be 1st of the month.

◊ Effective day must be within the fiscal year range.

The budget cannot be in approved status.

◊ The type of units identified in the rent schedule submitted must match the units identified in MFIS and must support all project units.

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

◊ Within 30 calendar days of transmitted, the Agency must take action by approval or denial of the budget or contact the Borrower to request additional information or clarification. Refer to Exhibit 4-1 for complete budget submission requirements.

◊ If the budget submission is complete, the MFH Servicing Official will input the received date in MFIS and the budget review should continue as described in the following sections. If the budget is incomplete, the MFH Servicing Official must take the steps described below.

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

If the budget submission is incomplete, the MFH Servicing Official must contact the borrower in writing, stating that the budget is incomplete, and discuss the deficiencies.

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

◊ If the borrower does not submit the requested information within a 10-day time period from the Agency's contact, the Agency cannot guarantee approval of the budget before the beginning of the new fiscal year. If the budget cannot be effective at the beginning of the project's fiscal year, the borrower must continue operations under the previous year's budget until a budget is approved. The borrower is not eligible for automatic approval as described in Paragraph 4.14 D, and the budget may be denied in accordance with 3560.303.

◊ Refer to Exhibit 4-3 for Agency review timeline. If the initial budget is denied, this schedule allows for a second review of the budget and approval (if appropriate) before the start of the fiscal year.

2. Prioritizing Budgets for Review

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

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

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

3. Reviewing Outstanding Monitoring Findings

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

- If the outstanding monitoring issues have been adequately addressed in the budget, the MFH Servicing Official should proceed with the review for reasonableness.

  If project outstanding monitoring issues have not been addressed, the budget documents should be returned to the borrower for revision.

4. Review the Budget for Reasonableness

If all outstanding compliance issues have been addressed, the Loan Servicer must review the budget for reasonableness using the steps outlined in Attachment 4-D Budget and Year End Analysis, to make a determination. These review items are automated in the MFIS budget analysis process. Attachment 4-D shows the items included in the analysis and how they are calculated.

- Review Form RD 3560-7 to verify that all appropriate line items are completed. Perform a quick assessment to ensure that they appear to be completed properly.

- Complete the budget analysis which is required prior to entering an "Approved" date in the Supervisory Activity of MFIS. The analysis will reflect areas of observations and review items which will require comments. Just because an item is brought out as an observation or review does not necessarily mean the budget cannot be approved.

  ◊ Observations are the results of a test performed that may be of importance to the MFH Servicing Official.

  ◊ Review items are the results of a test performed that require the MFH Servicing Official to enter comments as documentation of their review.

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

  ◊ Review administrative expenses for project operations exceeding 23 percent, or those typical for the area, of gross potential basic rents (gross potential rents) and revenues. Administrative expenses that exceed 23 percent of gross potential rents highlight a need for closer review for unnecessary expenditures. Excessive administrative expenses can result in inadequate funds to meet other essential project needs.

  ◊ Norms are also reviewed on the MFIS budget analysis. The Norms are based on Regional Groupings of "like" properties. This gives the MFH Servicing Official an analysis of how the property is performing compared to other "like" properties. The norm definitions and Regional Groupings are described in Attachment 4-D.

- Determine whether the ending cash balance exceeds the permissible limit. If it does, the MFH Servicing Official must conduct a more in-depth review of the estimated beginning cash balance noted on Part I, Line 31 of Form RD 3560-7, and of prior year's year-end report acceptance letter to determine if a realistic estimate of the operating and tax & insurance account balances for the beginning of the proposed fiscal year was used. And to determine if the projected ending surplus cash balance requires further action with the proposed budget.

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

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

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

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

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

  ◊ Has a CNA of the property been prepared? Does the budget match the prepared CNA?

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

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

5. *Review the of Rent or Utility Allowance Change Requests*

When the borrower submits a budget with a rent or utility allowance change request, the Agency must respond to the borrower within 30 calendar days of submission. If the Agency does not contact the borrower and the budget is eligible for automatic approval, the borrower may assume that any rent change request of $25 per month or less has been automatically approved. The MFH Servicing Official must complete the MFIS budget analysis, notify the borrower in writing, and update the Approval date in MFIS.

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

a. *Circumstances in which the Agency May Deny a Rent Increase Request*

The MFH Servicing Official may deny a rent increase request under the following circumstances:

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

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

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

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

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

b. Effective Dates of Change

The effective dates of any approved changes will coincide with the start of the project's fiscal year or the start of the season for labor-housing projects. Handbook Letter 204 (3560) will be sent to notify tenants of RD decision to approve rent or utility allowance change.

For notices to tenants, see Appendix 4.

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

The MFH Servicing Official may accept borrower requests for rent or utility allowance changes at times other than with the annual budget submission. Under special circumstances if a change is necessary to preserve the financial integrity of a project a change request may be considered. Such circumstances might be in the event of a natural disaster, property transfer or when workout procedures and servicing actions are necessary.

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

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

d. Approving Utility Allowances

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

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

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

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

Borrowers must notify the Agency of any HUD rent changes. Since HUD- and Agency-approved rental rates frequently differ, it may be necessary to have a 3-column budget in properties with HUD project-based Section 8 contracts. Refer to HB-2, Chapter 7, Exhibit 7-9 for rents applicable for each project type.

When reviewing the budget, if the MFH Servicing Official concludes that the HUD-authorized rent is more than what is needed to meet project expenses (Basic Rent), a lesser amount than the HUD rent must be approved for Basic Rent.

In accordance with Exhibit 4-5 Impact of Interest Credit Agreement on Ability to Cancel Interest Credit, Collect Overage, and Deposit Excess Funds in the Reserve Account, when the HUD contract rent exceeds Note Rate Rent, borrowers must deposit HUD funds equal to the difference between the Agency approved Note Rate Rent and the HUD approved rent into the reserve account for the housing project. The manager or borrower must use *Form RD 3560-29*, Notice of Payment Due Report (or MFIS Project Worksheet (Report PRJ2000)), to document the extra required deposit in the reserve account. The MFH Servicing Official will monitor this deposit when reviewing the year-end actuals.

If excess HUD rents accumulate in the reserve account beyond the fully funded level shown in the borrower's loan agreement or resolution, the MFH Servicing Official may reduce or cancel the interest credit on the project or increase the fully funded level with a change to the Loan Agreement/Resolution. The Agency may reinstate interest credit whenever HUD rent becomes lower than the Agency Note Rate Rent, determined by the Interest Credit Agreement. Refer to Exhibit 4-5.

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

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

Exhibit 4-5, "Impact of Interest Credit Agreement on Ability to Cancel Interest Credit, Collect Overage, and Deposit Excess Funds in the Reserve Account" provides a description of the rules that apply to each interest agreement form.

Exhibit 4-5
Impact of Interest Credit Agreement on Ability to Cancel Interest Credit, Collect Overage, and Deposit Excess Funds in the Reserve Account

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

6. *Approval or Denial of Budgets*

Once the budget analysis is complete, MFH Servicing Officials must notify the borrower whether the budget has been approved or denied.

a. Budget Approval

If a budget is received with reasonable operating expenses and a rent increase request to cover turnover costs and maintenance costs in line with comparable properties, the Agency should not unreasonably withhold approval. The MFH Servicing Official must consider the overall financial and physical health of the project. When market conditions do not allow for sufficient rents to fund both operating and capital needs, the workout authorities of 7 CFR 3560, (§ 3560.453) should be reviewed for their applicability in the situation.

If the MFH Servicing Official has determined that the budget represents reasonable costs and adequately addresses all outstanding compliance issues in the budget, the reserve account is current, and the rent change (if requested) is acceptable, the budget may be approved. To approve the budget, MFH Servicing Officials must acknowledge approval (*Form RD 3560-7*) in writing. The MFH Servicing Official must also enter the approval date in MFIS. Handbook Letter 204(3560) will be sent notifying tenants of RD's approval of the rent or utility allowance change at least 30 calendar days prior to the effective date of the rent or utility allowance change.

b. Automatic Budget Approval

In the case of automatic approval, the MFH Servicing Official must acknowledge approval of the proposed budget. The MFH Servicing Official must complete the MFIS budget analysis, notify the borrower in writing, and update the Approval date in MFIS.

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

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

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

◊ Vacancy rates are above the allowable threshold.

◊ Property is under a workout plan or debt deferral.

If a budget is not eligible for automatic approval and no decision is made prior to the beginning of the project's new fiscal year, the borrower must continue operations under the previous year's budget. If the Agency denies the budget submission, see paragraph (c). "Budget Denial" below.

In these cases, the Agency must continue to work with the borrower to address the requested increase. When an agreement is reached, a mid-year budget will take effect.

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

c. Budget Denial

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

◊ Prior to denial, the MFH Servicing Official must provide the borrower with a letter listing deficiencies.

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

◊ If the borrower fails to respond, the MFH Servicing Official must send the borrower a denial letter with appeal rights in accordance with Agency appeal procedures (Chapter 1) and inform the borrower that the previous year's budget remains in effect. The MFH Servicing Official must update MFIS with a "Denied" date.

◊ If the borrower responds, the MFH Servicing Official must review the new submissions within 20 calendar days of receipt, and either approve or deny the budget.

If the budget is approved based on the new submissions, the MFH Servicing Official must acknowledge approval. See paragraph (a) "Budget Approval" above.

- If the budget is denied based on the new submission, the MFH Servicing Official must send the borrower a letter stating the deficiencies and informing the borrower that the previous year's budget remains in effect. The borrower must be provided with appeal rights in accordance with Agency appeal procedures (Chapter 1). The MFH Servicing Official must update MFIS with a "Denied" date.

SECTION 5: REPORTING AND FINANCIAL EXAMINATION

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

A. Overview of Reports

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

- **Quarterly Reports.**

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

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

- **Monthly Reports.**

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

  MFH Servicing Officials may notify in writing the borrower to discontinue the monthly reporting requirement for projects that have demonstrated consistent compliance with program requirements over a sufficient time.

B. Review of Monthly and Quarterly Reports

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

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

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

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

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

◊ Update MFIS with "Received" date and "Initial Review" and/or "Final Review" date(s), as applicable.

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

A. General Requirements for All Borrowers: Annual Financial Reports

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

All borrowers who have a Section 515 Rural Rental Housing (RRH) loan or a Section 514 Off-Farm Labor Housing loan must comply with the financial reporting requirements of this section. The requirements are established based on combined Federal Financial Assistance and risk thresholds for each borrower. Projects with fiscal years ending 12-31-19 and after are to follow the reporting requirements outlined in this Section.

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

- Outstanding principal balance and deferred principal balance at the beginning of the fiscal year of a United States Department of Agriculture (USDA) Mortgage, a mortgage insured by the Federal Housing Administration (FHA) or HUD held mortgages and other Government insured loans (Including but not limited to HOME, and CBDG loans);

- Any USDA Rental Assistance or Project based Section 8 assistance received during the fiscal year;

- o Interest reduction payments received during the year (interest subsidy);
- o Federal grant funds received during the year and/or;
- o Outstanding principal balance at the beginning of the fiscal year of an existing USDA Section 538 Guaranteed Rural Rental Housing loan.

Funds the borrower entity receives which must comply with Federal statutes, regulations, or terms and conditions of Federal awards will be included as Federal Financial Assistance.

Exhibit 4-6 Year End Financial Reporting Requirements outlines the financial reporting requirements for specific types of properties.

Exhibit 4-6 **Year End Financial Reporting Requirements**			
For-Profit or Limited Profit			
Total Borrower Federal Financial Assistance*	Forms RD 3560-7 and 3560-10	Borrower Certification of Performance Standards	Uniform Administrative Requirements Audit required
RD Borrower with **less than $500,000** in Federal financial assistance	Yes	Yes	No
RD Borrower with **$500,000 or greater** in Federal financial assistance	Yes	Yes	Yes**
State and local Governments, Indian tribes and Non-Profit Organizations			
Total Borrower Federal Financial Assistance*	Forms RD 3560-7 and 3560-10	Borrower Certification of Performance Standards	Single Audit in accordance with 2 CFR part 200 subpart F
RD Borrower with **less than $1 million** in Federal financial assistance	Yes	Yes	No
RD Borrower with **$1 million or greater** in Federal financial assistance	Yes	Yes	Yes***

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

**Must be completed by an Independent CPA.

***In accordance with the Council of Financial Assistance Reform (CoFAR) uniform guidance. This Single Audit is in accordance with 2 CFR part 200 Appendix XI Compliance Supplement; and submitted to the Agency as part of the financial reporting requirements. Must be completed by an Independent CPA.

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

B. Budget Actuals and Balance Sheet

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

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

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

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

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

C. Borrower Certification of Performance Standards

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

The Borrower must self-certify:

- ◊ Required accounts are properly maintained and tracked separately;
- ◊ Payments from operating accounts are disclosed and accurately represented;
- ◊ Reserve Account is current and maintained in a supervised account and has an Agency approved Form RD 402-1 Deposit Agreement, or the alternate 402-1A Sample Deposit Agreement or Deposit Account Control Agreement executed after September 28, 2018; contributions are on schedule, the balance accounts for contributions less authorized withdrawals; and there are no encumbrances;
- ◊ The replacement reserve account was used for authorized purposes in accordance with 7 CFR 3560.306 (g);
- ◊ Tenant security deposit accounts are fully funded and are maintained in separate accounts;
- ◊ Payment of ROI was consistent with the terms of the applicable loan agreement or loan resolution;
- ◊ Borrower/grantee has maintained proper insurance in accordance with the requirements of 7 CFR 3560.105;
- ◊ All financial records are adequate and suitable for examination.
- ◊ There have been no changes in project ownership other than those approved by the Agency and identified in the certification. All current owners are to be identified in the Status Report of Ownership table on Attachment 4-F. All Non-Profit Organizations certify that the board is active and maintains oversight of the property; and
- ◊ Real estate taxes are paid in accordance with state and/or local requirements and are current.

D. Owner's Compilation of Prescribed Forms

For-profit or limited profit borrowers that receive less than $500,000 in combined federal financial assistance, for which there are no audit requirements per other agencies or agreements, will submit an annual owner certified compilation of prescribed forms containing Form RD 3560-7 and Form 3560-10 utilizing the accrual method of accounting in accordance with Statements on Standards for

Accounting and Review Services (SSARS) promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants (AICPA). Borrowers may use a CPA to complete this report of the prescribed forms (Attachment 4-K provides an example of an Independent Accountants Compilation report on RD Prescribed forms), or borrowers may provide Attachment 4-L, Owner Certified Prescribed Forms - Supporting Documentation Schedules.

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

For-profit or limited profit Borrowers that receive $500,000 or more in combined federal financial assistance must submit an independent auditors' report to include financial statements and notes to the financial statements, supplemental information containing Agency approved forms for project budgets and borrower balance sheets, a report on internal control over financial reporting and on compliance and other matters based on an audit of financial statements in accordance with Generally Accepted Government Auditing Standards; a report on compliance for each major program and internal control over compliance (if applicable). A CPA must perform the audited financial statements. Attachment 4-M provides a typical report and supporting documents.

Attachment 4-H is an example Engagement Letter which will be used by a CPA. This Engagement Letter should include the procedure, audit objectives to be performed and the fees associated with the service. There may be circumstances where the auditor may ask for information from Rural Development due to third party verification requirements. The MFH Servicing Official shall receive a complete copy of this signed Engagement Letter prior to releasing information to the CPA.

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

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

- Independent Auditor's Report
- Financial Statements
    - Balance Sheets
    - Statements of Operations (also known as Statements of Income (Loss))

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

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

1. State and local governments, Indian tribes, and Non-Profit Organizations that receive less than $1million in combined Federal financial assistance and there are no audit requirements per other agencies or agreements will submit an annual owner certified compilation of prescribed forms containing Forms 3560-7 and 3560-10 utilizing the accrual method of accounting in accordance with Statements on Standards for Account and Review Services. Borrowers may use a CPA to complete this report of the prescribed forms (Attachment 4-K provides an example of an Independent Accountants Compilation report on RD Prescribed forms), or Attachment 4-L, Owner Certified Prescribed Forms - Supporting Documentation Schedules.

2. State and local governments, Indian tribes, and Non-Profit Organizations that receive $1 million or more in combined federal financial assistance must submit audits in accordance with 2 CFR 200, Part F, and the Office of Management and Budget's (OMB) Uniform Administrative Requirements, Cost Principles and Audit Requirements for Federal Awards. Copies of the audit will be forwarded by the borrower to the MFH Servicing Official and the appropriate Federal cognizant agency for audit. Within USDA, the USDA, OIG fulfills "cognizant agency" for audit responsibilities, (see "cognizant agency" defined 7 CFR 3052.105).

Attachment 4-N is provided as an example of Single Audit requirements. The auditor may refer to the American Institute of Certified Public Accountants (AICPA) for additional guidance in meeting audit requirements.

Organizations subject to 2 CFR 200, Part F, must submit the single audit along with the borrower's certified performance standards (Attachment 4-F), Forms RD 3560-7, and 3560-10. Per Uniform Guidance the single audit should also be submitted using the Federal Audit Clearinghouse. The audit will not require the CPA to review tenant files, as this compliance test is being conducted by Agency staff during regularly scheduled supervisory visits and annual improper payment auditing.

G. Other Financial Reports

- **Year-End Narrative.**
  Statements from the borrower providing a description of the project's year-end financial, physical and compliance status that highlight important elements to aid the Agency with the review of the year-end reports (Exhibit 4-7).

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

- **Annual Financial Statements.**
  Another regulatory agency, legal entity, and/or other business agreement may require an audit in accordance with Generally Accepted Auditing Standards or Government Auditing Standards. Any project audits independently obtained by the borrower must be submitted to the Agency.

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

1. **Annual Financial Reporting Due Date**

   For-Profit or Limited Profit – Annual financial reports including *Form RD 3560-7* with 12 months of actual income and expenses, *Form RD 3560-10*, compilations of prescribed forms, certification of performance standards and audits, as appropriate, must be submitted to the Agency no later than 90 days following the close of the project fiscal year.
   State and local Governments, Indian tribes and Non-Profit Organizations – 2 CFR §200.512 allows the audit of Not-for-profits to be submitted within the earlier of 30 days after receipt of the auditor's report, or 9 months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit.
   If the annual financial reports cannot be submitted by the due date, the borrower must present a request for extension supported by evidence that delay is at the request of the auditor, and the request has a reasonable explanation of why an extension of the due date is needed. The MFH Servicing Official may authorize up to a 30-day extension of the due date.

   If an explanation is not forthcoming from the Borrower, or the explanation received is without good reason, or the MFH Servicing Official otherwise suspects fiscal difficulty, the MFH Servicing Official may request the borrower to submit to the Agency for review, the project bank statements for the general operating, reserve, and investment accounts covering the most recent 60-day period.

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

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

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

   MFH Servicing Officials must review financial reports within 60 days of receipt, in accordance with guidelines provided in Attachment 4-O to ensure that they meet Agency requirements. MFH Servicing Officials may complete the checklist provided as Attachment 4-O. In particular, the MFH Servicing Official must:

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

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

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

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

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

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

- Confirm the Year-End Narrative is complete and acceptable. Refer to Exhibit 4-7, Items to be Covered in the Year-End Narrative.

- If the MFH Servicing Official has determined that the annual financial reports are suitable, the reports may be accepted. The MFH Servicing Official must acknowledge acceptance of the annual financial reports in writing. The MFH Servicing Official must also enter the final reviewed date in MFIS and update the Asset Management Survey (Risk Rating Tool) data.

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

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Exhibit 4-7
Items to be Covered in the Year End Narrative

The Year End Narrative must be complete and acceptable, or the Annual Financial Reports will be considered incomplete and returned for correction.

- A brief description of the project and the year-end status, including financial and physical status. The description should address key indicators of current project status.
- A statement of project compliance. Indicate any outstanding monitoring findings and the methods for addressing the problems. Statement must address Section 504 accessibility compliance. If in non-compliance, address steps taken to attain full compliance including which items from the TP were funded and completed within the previous fiscal year.
- An explanation of capital expenditures, transfers from reserve account, and reserve withdrawals for the previous operating year, including a plan for those capital expenditure items budgeted for but were not completed during the year.
- A description of the property's overall financial status and important factors contributing to any changes. (Vacancy, workout plan status, debt deferrals, servicing efforts.) If the subtotal for any operating expense category (maintenance and operating costs, utilities, administration, or taxes and insurance) differs from last year's value by more than 10 percent, the borrower will provide adequate explanation for the expenses in this category.
- If the property is not in compliance with any performance standard noted on Attachment 4-F, one must state the property is not in compliance with the standard and provide the Agency with a statement about the non-compliance and the methods taken to correct the non-compliance.

3. MFIS Tracking Steps

MFIS tracking steps must be updated for each activity related to the year-end review.

Below are descriptions of tracking step in MFIS for the activity on Form RD 3560-7 (actual) and balance sheet.

- Received: this date is completed when all required documents are received by the MFH Servicing Official per the handbook, constituting a complete financial instrument.
- Initial Review: this date is completed after an initial MFIS analysis has been conducted, and the MFH Servicing Official determines that additional clarification or information is needed before the financial records are acceptable to the Agency.
- Final Review: this date is completed after the actuals are analyzed and the MFH Servicing Official determines they are acceptable to the Agency.

- Follow-up: this date is used as needed (for example, when additional clarification/information has been requested or an extension has been granted).

It is not required for both the initial review and final review dates to be completed, but a final review date is required to document that the Agency has determined the annual financial records of the project are acceptable.

4. MFIS Findings

Below are some examples of manual findings that may be associated with year-end reviews.

- Unacceptable (Form RD 3560-7 Actual). If this finding is used, a comment must be added to explain the outstanding issue(s). For example, if the reserve account is underfunded (i.e. – the required annual deposit was not made), a comment explaining the amount of the underfunded Tracked Account and fiscal year should be entered.

- Unauthorized RTO/Asset Mgmt Fee.

- Underfunded T&I Acct.

When the borrower provides adequate documentation to resolve the finding, the MFH Servicing Official must manually resolve the finding in MFIS.

ATTACHMENT 4-A
CAPITAL EXPENDITURES

TYPICAL REPLACEMENT RESERVE ACCOUNT USE

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

1. Unless shown in the operating budget, replacement of range hood, refrigerators, ranges, washer, dryers and other major appliances in the dwelling units.
2. Unless shown in the operating budget, flooring and carpeting.
3. Extensive replacement of kitchen and bathroom cabinets, vanities, sinks and countertops, bathroom tubs, toilets, and doors (exterior and interior).
4. Extensive unit clean up and repairs due to tenant death, misuse of unit, damage or vermin eradication.
5. Unless shown in the operating budget, window coverings – blinds, draperies.
6. Replacement or major overhaul of central air conditioning and heating systems, including cooling towers, water chilling units, furnaces, stokers, boilers, and fuel storage tanks.
7. Major plumbing and sanitary system repairs
8. Permanent improvements to the housing project, such as installing an energy-conserving heat pump.
9. Overhaul of elevator systems.
10. Systematic replacement of building or unit components.
11. Major roof repairs, including major replacements of gutters, downspouts, and related eaves or soffits.
12. Repainting of the entire building exterior.
13. Extensive replacement of siding.
14. Window system replacement or extensive window screen replacement.
15. Major landscape and grounds items, such as fencing, recreation areas, property signs.
16. Major repaving/resurfacing/seal coating (sidewalks, parking lots, and driveways).
17. Extensive replacement of exterior (lawn) sprinkler systems.
18. Capital requirements identified in transition plan.
19. Automation equipment located on site.
20. Shortfalls in operating expenses occurring on site beyond the control of the borrower and threatens life, safety, or the physical security of the project. Example: weather disaster.
21. Twenty-five percent of the interest earned on a reserve account during the prior year. [7 CFR 3560.306 (h)(3)].
22. Return on Investment according to 7 CFR 3560.305 (a)(2)(i) which states: "Surplus cash exists in either the general operating account as defined in 7 CFR 3560.306(d)(1) or the reserve account, if the balance is greater than the required deposits minus authorized withdrawals…" And must meet the requirement of 7 CFR 3560.306(h)(2)(ii) which states, "Payment of a return on investment at the end of the borrower's fiscal year if such payment comes from surplus operating funds in the reserve account."
23. Improvements to accommodate reasonable accommodation/modification requests.

24. The replacement reserve account should not be used to pay for turnover or routine maintenance costs. Turnover and routine maintenance expenses should appear in the operating budget except in extenuating circumstances, such as when a unit that has been damaged is in need of wall repair, door repair or replacement, etc.; deep filth; damage and cleanup due to a death in the unit; damage and cleanup due to the manufacture of drugs; dumpster rental when tenant leaves belongings including labor; bed bug or termite eradication.

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

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

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

3. All other provisions of the prior executed document referred to in paragraph 1 above shall remain in effect.

Optional Schedule (if applicable)

Annual Transfer	Beginning Date
$______________	________________
$______________	________________
$______________	________________
$______________	________________
$______________	________________
$______________	________________
$______________	________________
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$__________________ __________________
$__________________ __________________
$__________________ __________________
$__________________ __________________

Borrower Name: ____

______________________________ ______________________________
(Representative Name and Title) **(Date)**

______________________________ ______________________________
(Representative Name and Title) **(Date)**

Agency Approval:

____
(RD Representative Name and Title)

____
(Date)

ATTACHMENT 4-B-1
AMENDMENT TO LOAN AGREEMENT/RESOLUTION
RESERVE ACCOUNT REQUIREMENTS

1. **PARTIES AND TERMS DEFINED.** This amendment hereby modifies reserve account requirements contained in Form _______________ dated __________________ signed by ___________________________________, herein called "Borrower" with the United States of America acting through Rural Development, United States Department of Agriculture, herein called the "Government." This amendment is necessary due to the Borrower electing to allow for an annual adjustment to increase the reserve account annual deposits by Operating Cost Adjustment Factor (OCAF) as published by Housing & Urban Development (HUD) annually.
◊
2. **MODIFIED RESERVE ACCOUNT REQUIREMENTS.** Transfers at the increased rate of the annually published HUD OCAF adjustment shall be made to the Reserve Account beginning __________________ until the amount in the Reserve Account reaches the sum of **$**___________________, or such higher amount later agreed to with the Government and shall be resumed at any time necessary, because of disbursements from the Reserve Account to restore it to said sum. The annual OCAF rate increase to the reserve deposit will be implemented each year for the proposed budget submitted to the Agency after the annually published OCAF adjustment rate.
◊
3. Withdrawal and use of funds deposited to this account will be in accordance with 7 CFR part 3560. With prior consent of the Government, funds in the Reserve Account may be used by the Borrower as provided for in the original document referred to in paragraph 1.

Borrower Name: ____

Signed by:

________________________________ ____________________

(Borrower Representative Name and Title) Date

Agency Approval:

________________________________ ____________________

(RD Representative Name and Title) Date

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ATTACHMENT 4-C
ALLOWABLE AND UNALLOWABLE PROJECT EXPENSES

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

§3560.303(b) Allowable and unallowable project expenses and §3560.303(d) Determining if expenses are reasonable. Expenses charged to project operations, whether for management agent services or other expenses, *must be reasonable, typical, necessary and show a clear benefit to the residents of the property*. Services and expenses charged to the property must show value added and be for authorized purposes. If such value is not apparent, the service or expense should be further examined.

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

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

- *Housing Authorities should only include cost directly associated with the operations of the MFH financed property.*

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

- *On-site staff costs (including maintenance employees directly assigned) are project expenses. If staff is responsible for multiple properties, then their costs should be prorated between each property. Regional managers' costs are to be covered by the management fee.*
- *Payroll and fringe benefits expenses included in the proposed budget must agree with the number of employees, positions, salaries, fringe benefits, health plans, etc. in the management plan and the property must be able to cash flow with the included expense(s).*
- *On-Site personnel who oversee multiple properties must pro-rate the expense of benefits between properties. Wages will be charged per billing method to the property.*
- *Large increases in site payroll or site maintenance should be supported by management plan changes. RD does not have to approve a budget that includes positions that are not shown in the management plan.*
- *To be a project expense, tasks must be project specific in nature.*
- *Tenant service coordinator is an allowable project expense. Service Coordinators assess tenant needs, identifies and links tenants to needed services, assists with resourcing free tenant services or additional funding sources for these types of services, and educates tenants on the availability of resources and supportive services.*
- *Payment of supervisory positions are paid from the management fee bundle of services and not from project operations. See §3560.102(i)(1)(i).*

(A) Gross salary;
(B) Employer Federal Insurance Contributions Act (FICA) contribution;
(C) Federal unemployment tax;
(D) State unemployment tax;
(E) Workers' compensation insurance;
(F) Health insurance premiums;

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

(G) Cost of fidelity or comparable insurance;
(H) Leasing, performance incentive or annual bonuses, that are clearly provided for by the site manager salary contract;

-This expense is for ***project-specific site personnel*** *and should be included as part of the site compensation. Costs of fidelity bonds covering central office staff, and general liability directly related to protection of the funds and records of the borrower are covered as part of the management fee. See § 3560.102(i)(1)(xiii)(E).*
-Site manager incentives are to be identified in the management plan as part of the site manager's salary.

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

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

(J) Retirement benefits.

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

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

(iv) All outside account and auditing fees, if required by the Agency, directly related to the preparation of the annual audit, partnership tax returns, and Schedule K-1, as well as other outside reports and year-end reports to the Agency, or other governmental agency.

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

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

-Repair and maintenance expenses appear on the Form RD 3560-7 in Part II, lines 1-11. Capital expenses, which are discussed in §3560.103(c), should not appear in the operating repair and maintenance costs; capital budget expenses appear in Part V.
- Maintenance staff should not routinely be sent out from the main office to do one thing each day when it would be more efficient to combine trips or can be completed by the on-site maintenance person.
-There should be no manipulation of the budget or expenses to avoid taxes.
-The reserve account should not be used to pay for typical unit turnover or routine maintenance costs; these should appear in the operating budget. Excessive repairs due to (for example) death in the unit, drug production clean up or extreme vandalism is not typical unit turnover.
-MFH Servicing Officials should question unusually low maintenance and repairs costs, especially in an aging property.

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

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

(C) Contract repairs to the projects (e.g., heating and air conditioning, painting, roofing).
(D) Make ready expenses including painting and repairs, flooring replacement and appliance replacement as well as drapery or mini- blind replacement. (Turnover maintenance).

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

(F) Snow removal.

(G) Elevator repairs and maintenance contracts.

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

-Annual reviews updating of transition plans by management should be completed with budgets and actual financial reviews. An explanation for the lack of work and not following the transition plan schedule should be provided in the narrative.
-Having an independent third party review the property every 3 years for accessibility provides the borrower, management agent, and Agency with an additional opinion from a non-interested party.
- Management should review the existing plan annually with a year-end update.
-A knowledgeable source or third-party provider is considered one that is experienced, and well versed in Section 504 accessibility requirements, practices, and solutions.
-Future changes may occur to the property as a result of maintenance work, at which point, if it is not clear that the proper work is completed, a further self-evaluation and transition plan may be needed.
-If there is a change in the applicable standard or circumstances at the property the Transition plan should be updated.
-The cost of providing Limited English Proficiency (LEP) services is an allowable expense.

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

(J) Pest control services.

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

(K) Other related maintenance expenses.

-"Other maintenance expenses" is a broad category that should be carefully reviewed by MFH Servicing Officials to ensure that charges are appropriate and reasonable. Expenses that belong in other categories should be moved by the Borrower to ensure that the Agency is collecting the correct data on specific property costs.
-If the expense appears on Part II, line 10, it must be identified.

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

-"Sales tax" on management fees is not an allowable expense unless state law requires "sales tax".
-"Other Administrative" in general: MFH Servicing Officials should closely review this line item for potential abuse. "Other Administrative" should include only directly property-related administrative costs; for example, the

Section 538 Guarantee Fee is an allowable expense. A listing of the expenses must be provided with the narrative or in the Comments column.
-Bad debts should not appear in the O & M Expense Schedule:
-
-On year end actuals, account for bad debt (NSF checks) would be reflected as Miscellaneous (Part I, Line 27) with a comment to explain.
-Other fees and charges should appear in the appropriate line item (i.e., bank charges, HFA compliance fees, credit checks, etc.) Such expenses must be accompanied by a narrative with detailed explanation.
-For-profit borrowers are entitled to 25 percent of the interest earnings on the Reserve account in the prior year, which must be a Reserve withdrawal request; this amount should not be taken from the operating account. See §3560.306(h)(3).

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

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

(B) Photocopying or printing expense related to actual production of project brochures, marketing pieces, forms, reports, notices, and newsletters are allowable project expenses no matter what location or point of origin the work is performed including outsourcing the work to a professional printer.

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

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

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

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

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

Advertising costs does not include a portion of the central management office's website costs for listing project on their website or making tenant applications available on their website, etc. Management's website costs are not allowable project expenses.

(F) Postage expense to mail out rental applications, third-party (asset, income, and adjustments to income) verifications, application processing correspondence (acceptance or denial letters), mailing project invoice payments, required correspondence, report submittals to various regulatory authorities for the managed property are allowable project expenses no matter what location or point of origin the mail is generated.

This expense does not include normal or routine management company personnel responsibilities covered under §3560.102(i)(1)(xiii)(C).

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

(H) Expenses related to site utilities.

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

Items must be part of a proposed approved budget to be an eligible expense. Explain in Budget Narrative.

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

May include special assessments and service charges which are not based upon the value of the property and milage. Late fees due to mismanagement must be paid by Borrowers from non-project funds.

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

Costs of insurance coverage for Agent's office and operations and costs of insurance that protect the management agent or their staff, including, but not limited to, Employee Professional Liability Insurance (EPLI) or General Liability (Abuse/Molestation) coverage are covered as part of the management fee. See §3560.102(i)(1)(xiii)(E).

(L) All bookkeeping supplies and recordkeeping items related to costs of collecting rents on-site.

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

(M) All office supplies and copies related to costs of preparing and maintaining tenant files and processing tenant certifications to include electronic storage.

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

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

-Costs to be paid from the management fee include review of tenant certifications and submission of monthly rental assistance request, and overage. Submissions of payments where required. These costs are part of the salary expense to be paid by the management fee. § 3560.102(i)(1)(xi).

-Projects should not be double charged for "front-line fees" at a prorated rate and having personnel who are responsible for performing the same task being paid a salary is not acceptable.

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

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

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

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

(Q) Professional service contracts (audits, owner-certified submissions in accordance with § 3560.308(a)(2), tax returns, energy audits, utility allowances, architectural, construction, rehabilitation and inspection contracts, capital needs assessments (CNA), etc.)

-If costs appear unreasonable MFH Servicing Officials should review any professional services contracts.

-The Agency has no monthly unit inspection requirement.

-Inappropriate practices are covered under §3560.102(i)(4)(viii).

-The cost of <u>installation</u> of project-wide cable, satellite TV, or wi-fi/Internet, is an allowable project expense, provided that each apartment unit receives a separate billing for the service, and it is not included in the rent charge or utility allowance. The property will not pay for access by each unit, including vacant units. Management could negotiate a service fee for the property and collect the monthly fee from each tenant. The budget would reflect other income source from the tenants and a cable expense in O & M. With an explanation in the narrative or comments.

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

-Training for on-site staff should be appropriate to managing affordable housing with subsidies from RD, HUD, or LIHTC. Suspected abuses should require documentation of the course or certifications received.
-Site training planned or completed should be explained in the Budget Narrative.
-Site staff who oversee multiple properties must pro-rate the expense between properties.

-Borrowers who attend trainings do so at their own expense and it is not an allowable project expense.
-Management company meetings to discuss management policies are a management fee expense (see §3560.102(i)(1)(xiv), (xv), (xxiv) and (xxv).
-Expenses during training should be reasonable and not involve costs for items previously identified by the OIG audit, especially gifts, bonuses (other than that identified in the management plan as part of the site manager's salary), or alcohol. Training expenses may include reasonable hotel charges, meals, and snacks; such expenses should not be excessive.

(S) Legal fees if found not guilty of civil lawsuits, commercially reasonable legal expenses and costs for defending or settling lawsuits.

(vii) With prior Agency approval, cooperatives and Non-Profit Organizations may use housing project funds to reimburse actual and typical asset management expenses directly attributable to ownership responsibilities. Such expenses may include:

(A) Errors and omissions insurance policy for the Board of Directors. The cost must be prorated if the policy covers multiple Agency housing properties.
(B) Board of Directors review and approval of proposed Agency's annual operating budgets, including proposed repair and replacement outlays and accruals. The cost must be prorated if the review covers multiple Agency housing properties.
(C) Board of Directors review and approval of capital expenditures, financial statements, and consideration of any management comments noted. The cost must be prorated if the review covers multiple Agency housing properties.
(D) The cost must be prorated if the policy covers multiple Agency housing properties.

A Non-Profit Asset Management Fee may be requested by non-profits and cooperatives. Non-profit owners may request reimbursement for up to $7,500 per project for certain organizational expenses, such as Errors and Omissions insurance and actual expenses prorated by the number of Rural Development projects.

When reviewing the justification, and the organization expenses attributed to each property, the owner should make sure that the expenses are prorated across all of the properties, and each expense is not charged in full to each property. For example if the errors and omissions insurance policy for the Board of Directors is covering all the properties and costs $3,000, the $3,000 needs to be prorated for all of their non-profit properties and non-profit properties cannot charge $3,000 per property for the insurance policy.

(viii) Agency approved third party debt service for the project.

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

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

(ii) Purposes unrelated to the housing project;

(iii) Reimbursement of inaccurate or false claims;

(iv) Court ordered settlement agreements, court ordered decrees, legal fees, or other costs that result from the filing of civil rights complaints or legal action alleging the borrower, or a representative of the borrower, has committed a civil rights violation. It is inappropriate to charge for legal services to represent any interest other than the borrower's interest *(i.e.*, representing a general partner or limited partner to defend their individual owner interest is not allowable);

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

(v) Fines, penalties, and legal fees where the borrower or a borrower's representative has been found guilty of violating laws, including, but not limited to, civil rights, and building codes. Charging for payment of penalties including opposition legal fees resulting from an award finding improper actions on the part of the owner or management agent is generally an inappropriate project expense. The party responsible for the penalty generally pays such expense for violating the standards or by their insurance carriers.

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

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

(viii) Billing for parties or gifts to management agent staff.

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

(x) Billing the project for computer hardware, some software, and internal connections that are beyond the scope and size reasonably needed for the services supplied (*i.e.*, purchasing equipment or software for use by a site manager that is clearly beyond that needed to support project operations). Note that computer learning center activities benefiting tenants are not covered in this prohibition; or

(xi) Costs of tenant services.

-The cost of a tenant service coordinator is an allowable project expense. It is NOT an allowable cost for the project to pay for the actual supportive service. Supportive services might include computer classes, skill building classes, health and wellness classes, adult education, English as second language, foreign language classes, etc. These types of tenant services are not allowable project expenses.

§3560.303 (c) Priorities. The priority order of planned and actual budget expenditures will be:

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

§3560.305(a) includes the conditions on the return payment.
§3560.305(b) discusses when an unpaid ROI may be taken:
"An earned, but unpaid ROI for the previous year only may be requested by the borrower and authorized by the Agency under the provisions of §3560.305(a)(2) provided the current year's ROI has been paid first and a rent increase is not required to generate funds to pay the unpaid ROI."
§3560.306(h)(2)(ii) includes the conditions on when the ROI can be paid from the reserve account, and when §3560.306(g)(4) have been met. "Payment of a return on investment at the end of the borrower's fiscal year if such payment comes from surplus operating funds in the reserve account."

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

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

1. **Project Information**
   This area contains the Project Name, Borrower Name, State Code, Servicing Team Code, County Code, Borrower ID, Project Number, Classification, Budget Effective Date, Last Analysis Date, Project Unit counts, and Last Rent Change (year-end actual only). Vacancy data is displayed for each type of budget. Proposed budget shows the average vacancy over the last 36 months; the last 6 months; and the last month's average vacancy. Monthly, quarterly and year-end actual budgets show the vacancy covered by that period. The MFH Servicing Official needs to determine if the vacancy allowance is reasonable.

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

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

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

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

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

RETURN TO OWNER/SURPLUS CASH WORKSHEET

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

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

SURPLUS CASH	
Cash Available	$21,500
Subtract Cash Required	$17,000
Surplus Cash	**$ 4,500**

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

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

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

The MFH Servicing Official will review the request to determine if the proposed change is acceptable and will notify borrowers.

4. **Reserve Account Status**

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

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

The MFH Servicing Official will review amounts to determine if these amounts are adequate.

5. **Reserve Account Authorizations**

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

6. **Project Servicing Efforts**

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

7. **Review Findings**

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

8. **Physical Findings**

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

9. **Budget Analysis Results**

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

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

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

The following tests are common across multiple line items:

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

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

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

4. **10 PERCENT RULE** – for some Proposed and Year-End Actual line items
Proposed items - if proposed budget value differs from last year's value by more than 10 percent (even if last year's value was zero) MFIS will comment about a narrative explanation

- Actual items - if actual budget differs from proposed by 10 percent or more it is flagged for review.
- The system checks operating expenses and income sources to see if subtotals are more than 10 percent different from last years. If this is the case, determine if the budget narrative provides an adequate explanation for the unusual item.

5. **$12 RULE** – for direct comparison of numbers on some Proposed and Year-End Actual line items such as correct debt payment, correct reserve payment, owner's return on investment:

- If values differ by more than +- $12.00 then flag as a REVIEW item
- If values differ by less or equal to +- $12.00 then flag as an OBSERVATION item
- If any of these are unacceptable, the borrower will need to submit a new budget.

6. **COMMENT RULE** – for some Proposed and Year-End Actual line items

- OTHER type line items with a value require a comment
- LIST type line item with a value require a comment

7. **INHERITANCE RULE** – for some Proposed line items

- If last year's actual had a value and this years proposed does not have a value

8. **RATIO ANALYSIS** - are reflected in the Budget Analysis. Ratios are an effective tool for financial analysis. They prescribe various measures of actual operating performance. The ratios should be reviewed for a comparative analysis. The MFH Servicing Official should become familiar with these percentages as a comparative analysis and should consider utilizing the Hyperion MFH Budget Line Item Comparative Cost data report for their Region in their analysis. The ratios run in the MFIS Analysis Review are as follows:

  - Maintenance and Operating Expense / Total Operating & Maintenance
  - Utilities/Total Operating & Maintenance
  - Administrative/Rental Income
  - Total Operating & Maintenance/Rental Income
  - Per Unit Per Month Operating & Maintenance Expense
  - 3-year Resident Turnover Rate

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

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

The States are grouped into regions as follows:

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

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

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

Attachment 4-E
AUDIT PROGRAM

USED TO REPORT CONSTRUCTION COST ENGAGEMENTS.
(For additional guidance refer to HB-1-3560 Loan Origination Handbook.)

USDA

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

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

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

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

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

9/29/04
Date

TABLE OF CONTENTS

I. GENERAL

A. PURPOSE

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

B. BACKGROUND

Rural Development uses cost certifications to verify that borrowers spent loan funds for eligible and actual costs when constructing apartment complexes as part of the RRH Program.

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

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

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

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

C. PERTINENT REGULATIONS AND INSTRUCTIONS

Construction Cost:

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

- Rural Development Instruction 1924-A, and
- Rural Development 7 CFR 3560.

Management of Ongoing Operations:

Rural Development regulation 7 CFR 3560 provides details on allowable and unallowable operating costs, and places restrictions on the use of identity-of-interest companies and other activities related to managing RRH properties.

D. STANDARDS FOR CONDUCTING THE AGREED-UPON PROCEDURES ENGAGEMENTS

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

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

U.S. Department of Agriculture
Rural Development - Rural Housing Service
Director, Multi-Family Housing Processing
Division 1400 Independence Avenue, SW
Washington, D.C. 20250
Telephone: (202) 720-3773

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

E. OBJECTIVES

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

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

II. CONSTRUCTION COST ENGAGEMENTS

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

The procedures in this section are designed to identify ineligible expenses and fictitious charges to Form RD 1924-13. Per 7 CFR 1924 subpart A and the instructions for preparing *Form RD 1924-13* provide guidance on eligible construction costs.

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

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

These actions have resulted in significant amounts of overcharges to RRH properties. Sections 1924.13 (e) (1) (v) (H) and 1924.13 (e) (2) (viii) of RD Instruction 1924-A prohibit borrowers from receiving builder's profit for acting as the general contractor if more than 50 percent of the property is subcontracted to one subcontractor or 75 percent to three or fewer subcontractors. Sections 1924.13 (e)(1)(v) (I) and 1924.13 (e)(2)(viii) (D) of RD Instruction 1924-A Contractors, subcontractors, material suppliers, and any other individual or organization sharing an identity of interest and providing materials or services for the project must certify that it is a viable, ongoing trade or business qualified and properly licensed to undertake the work for which it intends to contract.

Agreed-Upon Procedures

1. Compare the total amount paid through the construction checking account (by adding the total amount from monthly statements) to the total amount of costs reported on *Form RD 1924-13*. Report any differences.
2. Examine selected checks, invoices, job cost ledgers, receiving documentation, etc., that support costs presented on *Form RD 1924-13* to ensure they were actually incurred to construct the project. (Note: Verify that checks have been cancelled and ensure that indirect costs are not included with the cost of labor and materials on *Form RD 1924-13*.)
3. Inspect selected checks held as retainage from subcontractors for evidence that they were actually paid by the bank. Confirmation with subcontractors may be necessary if cancelled checks are not available or not cancelled by the bank. (Note: Office of Inspector General audits have disclosed instances where checks were made to subcontractors, but never cashed.)
4. Compare the address on selected delivery documents and invoices (using the sample from audit step II.A.2.) to the project's address to ascertain whether materials and services were provided to the project under review. (Note: Office of Inspector General audits have disclosed instances where delivery was not made to the RRH project site.)
5. Examine selected cancelled checks related to accounts included in the "to be paid" column of *Form RD 1924-13* to determine the propriety of the costs reported. (Note: Office of Inspector General audits have disclosed instances where these costs were invoiced by identity-of-interest companies but were never actually paid by the borrower.)
6. Confirm payments with selected subcontractors and material suppliers and investigate any discrepancies. (Note: be alert for any discounts, rebates, or refunds that were provided to the contractor but not included on *Form RD 1924-13*.)
7. Inspect selected bid documentation to verify that the lowest bid submitted was accepted. If the lowest bid was not accepted, evaluate the justification for the higher bid. If documentation does not exist, report this and the reason why as a finding. (Note: be alert for "sweetheart contracts" and contracts to disclosed or undisclosed identity-of-interest companies.)
8. Compare selected subcontractor billings (invoices) to contract amounts. If billings were in excess of contractual terms, ascertain the reason for the higher expenses.

9. Obtain the number of subcontractors used during construction and calculate the percentages of subcontractors to ensure compliance with Rural Development requirements.[1]
10. Examine selected accounting records for undisclosed identity-of-interest companies. The practitioner should focus on transactions involving the use of one or two contractors/subcontractors, or if one contractor/subcontractor provided a significant percentage of materials or services.
11. Determine if identity-of-interest companies meet Rural Development requirements[2] of providing services to the general public.

    a. Question the general contractor/borrower about the business activities of any identity-of-interest company used and request evidence that the company provides services or materials to the general public.
    b. Review identity-of-interest records (e.g., sales records, invoices, receiving documents, etc.).
    c. Confirm by independent verification that identity-of-interest companies exist and provide services to the general public. (Note: This evidence could include listings in a telephone directory, advertisement to the public, etc. Also, be alert for "shell" companies that exist solely for processing invoices and adding markups to the original supplier's invoices. Markups made by identity-of- interest companies that do not provide services/supplies to entities other than the RRH property are not allowable.)
12. Compare equipment rental and supervision charges by identity-of-interest companies to independent rental companies to determine reasonableness[3] of charges. Report any significant variances.

    a. Question the borrower about the use of equipment during construction and how rental rates were established and time of use determined.
    b. Contact an independent rental company to determine commercial rental rates and compare them to the identity-of-interest charges.
    c. Examine borrower documentation (e.g., commercial rate lists, time sheets, construction schedules, etc.) to support the rates that were used and time that was charged for equipment rental fees. (Note: Office of Inspector General audits have disclosed that borrowers are charging rental fees when equipment is not in use.)
    d. Question the borrower about supervision charges.
    e. Verify that the borrower has documentation (e.g., timesheets or timecards, travel reports, payroll records, etc.) to support supervision charges.

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

Illustrative Auditor's Agreed-Upon Procedures Report

(*Form RD 1924-13*)

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

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

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

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

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

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

(Signature)

(DATE)

ATTACHMENT 4-F

Performance Standards
Borrower Self-Certification Letter

Date

USDA Rural Development Office
Address
Address

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

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

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

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

3. The reserve account(s):
    a. is on *(not on)* schedule with the Agency required minimum funding requirements;
    b. is either:
        i. ____ maintained in a supervised bank account that requires the Agency's countersignature on all withdrawals;
        ii. ____ maintained in a supervised bank account that has a Deposit Account Control Agreement fully executed after September 28, 2018;

    c. is on *(not on)* schedule with contributions to the reserve account for the current year with the Agency required minimum funding;
    d. has no *(has)* encumbrances on the reserve funds; and
    e. replacement reserve accounts were *(were not)* used only for authorized purposes in accordance with 7 CFR 3560.306(g).

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

5. The payment of owner return was:

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

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

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

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

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

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

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

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

[Signature of Borrower] ____________________________

PRINTED SIGNATURE ____________________________

DATE ____________________________

BORROWER ENTITY NAME ____________________________

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

STATUS REPORT OF OWNERSHIP

FISCAL YEAR ________

____

BORROWER NAME

TITLE or POSITION (*i.e.*- Board President (all non-profit Board Member info is not needed)**, Managing Member, GP or LP)**	**NAME**	**ADDRESS PHONE NUMBER & EMAIL ADDRESS**	**TAXPAYER ID NUMBER or SOCIAL SECURITY NUMBER** (not needed for non-profit Board President)

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

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

______________ ______________________________
Date Owner

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ATTACHMENT 4-G

RD MFH PROGRAM AUDIT DETERMINATION WORKSHEET

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

RD Borrower Name: ________________________ **Borrower ID:**____________________

RD projects associated with ID ______________________ ______________________
(List all – may need additional pages)

Federal Financial Assistance Received Current Year (See Section 4.16)

RD 515 Loan balances at beginning of FY ___________________ ______________________
Interest Subsidy ___________________ ______________________
RD Rental Assistance ___________________ ______________________
HUD Section 8 Assistance ___________________ ______________________
RD GRRH 538 Loan balance ___________________ ______________________
Other: ___________________ ___________________ ______________________

Total Federal Financial Assistance received from the borrower: $___________________

Step 2: Is the RD project owned by a State, Local Government, Indian tribe or not-for-profit entity?

No, go to step 3

Yes- Was $1million or greater, in the aggregate, in Federal Financial Assistance received?

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

No, go to Step 5.

Step 3: Did the borrower receive $500,000 or greater, in the aggregate, in Federal Financial Assistance?

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

No, go to Step 5.

Step 4: Are any of the individual programs identified in Step 1 equal to or greater than $500,000?

Yes, these program(s) are the property's major program(s). A major program report is required. Refer to Attachment 4-I.

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

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

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

No, Go to Step 6.

Step 6: Submit a compilation of prescribed forms as outlined in Chapter 4.16.

ATTACHMENT 4-H
Example Engagement Letter —For-Profit Entity
$500,000 or greater in Federal Financial Assistance

[CPA Firm's Letterhead]

Date, Year

Name
Company Name
Address
City, State Zip

We are pleased to confirm our understanding of the nature and limitations of the services our firm will provide for each of the Entities detailed in Exhibit A.

We will perform an audit of the balance sheet as of ***DATE, YEAR***, and the related statements of operations, changes in partners' equity and cash flows for the year then ended. Also, the supplementary financial information required by the *United States Department of Agriculture RD Handbook HB-2-3560* listed below will be subjected to the auditing procedures applied in our audit of the financial statements:

- Calculation of Management Fee
- Return to Owner
- Insurance Detail
- Changes in Rental Property Ownership
- Accrual to cash schedule

AUDIT OBJECTIVES

The objective of our audit is the expression of an opinion about whether the financial statements are fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America and to report on the fairness of the supplementary information referred to in the second paragraph when considered in relation to the financial statements taken as a whole. The objective also includes reporting on each Entity's Internal controls and its compliance with certain provisions of laws, regulations, contracts, and grant agreements in conformity with auditing standards generally accepted in the United States of America and as required by *Government Auditing Standards* and the *United States Department of Agriculture RD Handbook HB-2-3560*. Our audit will be conducted in accordance with auditing standards generally accepted in the United States of America, the standards for financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and the *United States Department of Agriculture RD Handbook HB-2-3560.*

AUDIT PROCEDURES - General

Our audit will include tests of the accounting records of each Entity and other procedures we consider necessary to enable us to express such an opinion and render the required reports. If our opinion is other than unqualified, we will discuss the reasons with you in advance. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or to issue a report as a result of this engagement.

The report on internal control and compliance will include a statement that the report is intended for the information and use of the partner, management, others within the organization and the United States Department of Agriculture Rural Development and is not intended to be and should not be used by anyone other than these specified parties.

The management of each Entity is responsible for establishing and maintaining effective internal control and for compliance with the provisions of applicable laws, regulations, contracts, and grant agreements. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of the controls. The objectives of internal control are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are executed in accordance with management's authorizations and recorded properly to permit the preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that Rural Development programs are managed in compliance with applicable laws and regulations and the provisions of contracts and grant agreements.

In planning and performing our audits, we will consider the internal control sufficient to plan each audit in order to determine the nature, timing, and extent of our auditing procedures for the purpose of expressing our opinions on the Entity's financial statements and on its compliance with specific requirements applicable to its Rural Development programs and to report on the internal control in accordance with the provisions of *Government Auditing Standards* and not to provide any assurance on the internal control.

We will obtain an understanding of the design of relevant controls and whether they have been placed in operation, and we will assess control risk. Tests of controls may be performed to test the effectiveness of certain controls we consider relevant to preventing and detecting errors and fraud that are material to the financial statements and to preventing and detecting misstatements resulting from illegal acts and other non-compliance matters that have a direct and material effect on the financial statements. (Tests of controls are required only if control risk is assessed below the maximum level.) Our tests, if performed, will be less in scope than would be necessary to render an opinion on internal control and, accordingly, no opinion will be expressed in our report on internal control issued pursuant to *Government Auditing Standards*.

We will perform tests of controls over compliance, as required by *Government Auditing Standards* and the *United States Department of Agriculture RD Handbook HB-2-3560*, to evaluate the effectiveness of the design and operation of controls that we consider relevant to preventing or detecting material non-compliance with specific requirements applicable to each Entity's Rural Development programs. Our tests will be less in scope than would be necessary to render an opinion on these controls and accordingly, no opinion will be expressed.

AUDIT PROCEDURES – Internal Control
Our audit will include obtaining an understanding of internal control sufficient to plan each audit and to determine the nature, timing, and extent of audit procedures to be performed. An audit is not designed to provide assurance on internal control or to identify deficiencies in internal control. However, during the audit, we will communicate to you, internal control related matters that are required to be communicated under professional standards.

Identifying and ensuring that each Entity complies with laws, regulations, contracts, and grant agreements is the responsibility of management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we will perform tests of each Entity's compliance with applicable laws and regulations, and the provisions of contracts and agreements, including grant agreements. However, the objective of those procedures will not be to provide an opinion on overall compliance, and we will not express such an opinion.

Our audits will be conducted in accordance with the standards referred to in the third paragraph. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether material non-compliance with the requirements described in the *United States Department of Agriculture RD Handbook HB-2-3560* that are applicable to its Rural Development programs occurred. The purpose of each audit will be to express an opinion on each Entity's compliance with specific requirements applicable to major programs listed in the previous sentence.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the account, and may include direct confirmation of cash, investments, loan balances, and certain other assets and liabilities by correspondence with certain individuals, creditors and financial institutions. We may also request written representations from your attorneys as part of each engagement, and they may bill you for responding to that inquiry. At the conclusion of each engagement, we will require a written representation letter from the owner and or management of each specific Entity that, among other things, will confirm management's responsibility for the presentation of the financial statements.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; therefore, our audits will involve judgment about the number of transactions to be examined and the areas to be tested. Also, we will plan and perform the audits to obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether from errors, fraudulent financial reporting, misappropriation of assets, or violations of laws or governmental regulations that are attributable to each Entity or to acts by management or employees on behalf of each Entity. Because the determination of abuse is subjective, *Government Auditing Standards* do not expect auditors to provide reasonable assurance of detecting abuse. As required by *Government Auditing Standards*, our audits will include tests of transactions related to federal awards programs for compliance with applicable laws and regulations and the provisions of contracts and agreements.

Because an audit is designed to provide reasonable, but not absolute, assurance and because we will not perform a detailed examination of all transactions, there is a risk that material misstatements or non-compliance may exist and not be detected by us. In addition, an audit is not designed to detect immaterial misstatements or violations of laws or governmental regulations that do not have a direct and material effect on the financial statements or on major programs. However, we will inform you, of any material errors and any fraudulent financial reporting or misappropriation of assets that comes to our attention. We will also inform you of any violations of laws or governmental regulations that come to our attention, unless clearly inconsequential. We will include such matters in the reports required for Rural Development audits. Our responsibility as auditors is limited to the period covered by our audit and does not extend to any later periods for which we are not engaged as auditors.

You are responsible for establishing and maintaining internal controls, including monitoring ongoing activities; for the selection and application of accounting principles; and for the fair presentation in the financial statements of financial position, changes in partners' capital, and cash flows in conformity with accounting principles generally accepted in the United States of America. You are also responsible for management decisions and functions; for designating a management-level individual with suitable skill, knowledge, or experience to oversee the tax services and any other non-attest services we provide; and for evaluating the adequacy and results of those services and accepting responsibility for them.

OTHER SERVICES

As part of our engagements:

We will not perform any management functions or make management decisions.

We will assist you and/or management in the calculation of depreciation expense and maintenance of fixed asset and depreciation records, however, you and/or management shall be responsible for determining the depreciation method, rate and life of each class of assets and determining salvage value, if any. You and/or management shall be solely responsible for the completeness and accuracy of the related fixed asset and depreciation schedules.

We will prepare a general ledger trial balance for use during each engagement. Our preparation of the trial balance will be limited to formatting information in the respective Entity's general ledger into a working trial balance.

We will also prepare federal, state and local income tax returns for the Entities listed in the attached Exhibit A for the year ended **DATE, YEAR**. You are responsible for the decisions and functions of your property, and for designating a competent employee to oversee these services.

You are responsible for evaluating the adequacy and results of the services performed and accepting responsibility for the results. You are also responsible for establishing and maintaining internal controls, including monitoring ongoing activities. You should be aware that, under the Internal Revenue Service Restructuring and Reform Act of 1998, certain information discussed by you with members of our firm who are authorized tax practitioners or their agents for the purpose of obtaining our firm's advice on tax matters is privileged from disclosure in any non-criminal tax matters before the IRS. Information compiled for the purpose of preparing a tax return is not privileged under common law because it is intended for disclosure to the IRS or others. The privilege will be waived if the communication is voluntarily disclosed to a third party. Professional standards require us to discuss matters that may affect the engagement with our firm personnel responsible for non-attest services, which includes tax services. The IRS might not take the position that such communication results in a waiver of privilege.

MANAGEMENT RESPONSIBILITIES

Management is responsible for making all financial records and related information available to us, including any significant vendor relationships in which the vendor has the responsibility for program compliance. We understand that you will provide us with such information required for each audit and that you are responsible for the accuracy and completeness of that information. Management's responsibilities include adjusting the financial statements to correct material misstatements and for confirming to us in the management representation letter that the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

Management is responsible for the design and implementation of programs and controls to prevent and detect fraud, and for informing us about all known or suspected fraud or illegal acts or illegal acts affecting each Entity involving management, employees who have significant roles in internal control, and others where the fraud or illegal acts could have a material effect on the financial statements. Your responsibilities include informing us of your knowledge of any allegations of fraud or suspected fraud or illegal acts affecting each Entity received in communications from employees, former employees, regulators, or others. In addition, management is responsible for identifying and ensuring that each Entity complies with applicable laws and regulations and for taking timely and appropriate steps to remedy any fraud, illegal acts, violations of contracts or grant agreements, or abuse that we may report.

As part of each audit, we will prepare a draft of your financial statements, supplementary financial information, and related notes. In accordance with *Government Auditing Standards*, you will be required to review and approve those financial statements prior to their issuance and have a responsibility to be in a position in fact and appearance to make an informed judgment on those financial statements. Further, you are required to designate a qualified management-level individual to be responsible and accountable for overseeing our services.

We will submit our report for each of the Entities in Exhibit A listing the procedures performed and our findings. Each report is intended solely for the use of the project's owners, the management agent and Rural Development, and should not be used by anyone other than these specified parties and take responsibility for the sufficiency of the procedures for their purposes. Our reports will contain a paragraph indicating that had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

At the conclusion of each engagement, we will require a representation letter from the owner and or management of each specific Entity that, among other things, will confirm management's responsibility for the presentation of Forms RD 3560-7 and 3560-10 in accordance with the criteria specified in 7 CFR part 3560 Section 303(b) and 7 CFR part 3560 Section 306, for the year ending DATE, YEAR and management's responsibility for compliance with the requirements of 7 CFR part 3560 Sections 308(a), 308(b) and 308(c).

During the course of each engagement, we shall request information and explanations from the owner and/or management regarding the respective Entity's operations, internal controls, compliance matters, future plans, specific transactions, and accounting system and procedures. We understand that your employees will prepare all cash, vendor, accounts payable and other confirmations we request and will work with our staff to locate any documents selected by us for testing. We will request written confirmation from financial institutions as part of each engagement, and they may bill you for responding to that inquiry.

At the conclusion of each engagement, we will require, as a precondition to the issuance of our report, that management reconfirm this information in a written representation letter. The procedures which we will perform in each engagement will be heavily influenced by the representations that we receive from you and/or management. Accordingly, false representations could cause us to expend unnecessary efforts or could cause a material error or a fraud to go undetected by our procedures. You acknowledge that as a condition of our agreement to perform each engagement, you and all members of your management, agree to the best of your knowledge and belief to be truthful, accurate, and complete in the representations you make to us during the course of each engagement and in the written representations provided to us at the completion of each engagement. In view of the foregoing, you agree that we shall not be responsible for any misstatements in the financial and compliance reports as a result of false or misleading representations that are made to us by you or your management. In addition, because our failure to detect material misstatements could cause others relying upon our report to incur damages, you and management further agree to indemnify and hold us harmless for any liability and all reasonable costs (including legal fees) that we may incur in connection with claims based upon our failure to detect material misstatements in the respective Entity's financial and compliance reports resulting from false or misleading representations made to us by you or any member of your management.

Management is also responsible to notify us in advance of your intent to print our reports in whole or in part, and to give us the opportunity to review any printed material containing our reports before its issuance.

The documentation for these engagements is the property of **CPA FIRM NAME** and constitutes confidential information. However, we may be requested to make certain documentation available to the United States Department of Agriculture acting through Rural Development, the Office of Inspector General (OIG) and the Government Accountability Office (GAO) or their representatives, pursuant to authority given to them by law or regulation. We will notify you of any such request. If requested, access to such documentation will be provided under the supervision of **CPA FIRM NAME** personnel. Furthermore, upon request, we may provide copies of selected documentation to Rural Development, OIG or GAO representatives. Rural Development, OIG and GAO may intend, or decide to distribute the copies or information contained therein to others, including other governmental agencies. We may also be requested to make certain documentation available to the investment partner(s)/member(s) or their representatives pursuant to authority given to them by the Partnership/Operating Agreement. Access to such documentation will be provided under the supervision of **CPA FIRM NAME**. Furthermore, upon request, we may provide photocopies of selected documentation to the investment partner(s)/member(s) or their representatives and they may intend or decide to distribute the photocopies or information contained therein to others, including governmental agencies.

Each engagement ends on delivery of our financial and compliance reports. Any follow-up services that might be required will be a separate, new engagement. The terms and conditions of that new engagement will be governed by a new, specific engagement letter for that service.

ENGAGEMENT ADMINISTRATION, FEES, AN OTHER

Our fees for these services are based upon the actual time spent at our standard hourly rates, travel, and other out-of-pocket costs such as report production, word processing, postage, etc. Our standard hourly rates vary according to the degree of responsibility involved and the experience level of the personnel assigned to each engagement. Our invoices for these fees will be rendered each month as work progresses and are payable on presentation. In accordance with our firm policies, work may be suspended if your account becomes XX days or more overdue and will not be resumed until your account is paid in full. If we elect to terminate our services for non-payment, each engagement will be deemed to have been completed even if we have not completed our report. You will be obligated to compensate us for all time expended and to reimburse us for all out-of-pocket expenditures through the date of termination. The suspension or termination of our work may result in adverse consequences to you including your failure to meet deadlines imposed by governments, lenders, or other third parties. You agree that we will not be responsible for your failure to meet such deadlines, or for penalties or interest that may be assessed against you resulting from such failure. Based on our preliminary estimate, the audit and tax procedure fees will be as detailed in Exhibit A. The fee estimate is based on anticipated cooperation from your personnel and the assumption that unexpected circumstances will not be encountered during the engagements. If significant additional time is necessary, we will discuss it with you and arrive at a new fee estimate before we incur the additional costs.

Government Auditing Standards require that we provide you with a copy of our most recent external peer review report and letter of comments, and any subsequent peer review reports and letters of comment received during the period of the contract. Our peer review report and letter of comments accompanies this letter.

We appreciate the privilege and opportunity to work with you and your staff during the completion of these important engagements. If the engagement letter terms are acceptable and in accordance with your understanding of each engagement, please sign the attached agreement and return the signed agreement page. Please retain the original letter and the client copy of the agreement page for your files. If you have any questions or comments regarding the terms of this engagement letter, please do not hesitate to contact us.

Very truly yours,

CPA FIRM NAME
Certified Public Accountants

EXHIBIT A

Entity and Fee Schedule
Year End DATE, YEAR

ENTITY NAME	FEE AMOUNT

Exhibit B

[CPA FIRM NAME] SERVICE AGREEMENT

Agreement to report on Rural Development Financial and Compliance Reports and prepare Federal, State & Local tax reporting forms for the Entities listed in the Exhibit A managed by Company Name as outlined in the CPA FIRM NAME engagement letter dated Date, Year.

To accept the schedule of fees in Exhibit A and the terms as stated in the attached engagement letter:

- Sign below,
- Return this page to us,
- Retain the original engagement letter and the client copy of this letter for your files.

By: ______________________________________ Date: ______________
(Signature)

____
(Name, Printed)

____
(Title)

ATTACHMENT 4-I

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

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

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

Major Program Determination/Defined – **Attachment 4-G** of Chapter 4: Financial Management has been developed to assist auditors on how to determine a major program in For-profit entities. Major program is defined as an individual assistance program for which expenditures equal or exceeded $500,000 during the applicable year.

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

Non-Major Program Testing – Under this attachment, there are no requirements to test non-major programs.

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

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

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

Attribute Sampling – Applies to all testing performed for the compliance component of an audit performed under this section. When planning to test a particular sample of transactions, the auditor should consider the specific audit objective to be achieved and determine whether the audit procedure or combination of procedures to be applied will achieve that objective. The size of a sample is necessary to provide sufficient evidential matter depends on both the objectives and the efficiency of the sample. All material instances of non-compliance, including those identified through sampling, must be reported as findings in the audit report.

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

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

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

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

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

Determining the Sample Size

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

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

Sample Size Table

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

Compliance sample size table

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

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

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

If the initial sample does not include a particular attribute being tested, typically there would be a need to have additional items included in the sample to address only that specific attribute.
Each compliance test performed should be evaluated separately for purposes of determining sample size. Professional judgment should be used to determine what tests are considered low versus high risk. When making the risk determination, it is important to understand the nature of the population.

Populations of 250 Items or Fewer

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

Testing and Evaluating Results

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

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

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

Audit Documentation

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

Technical Assistance

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

ATTACHMENT 4-J
COMPLIANCE REQUIREMENTS AND AUDIT AREAS

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

A. ***Mortgage Status.***

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

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

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

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

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

B. ***Replacement Reserve.***

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

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

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

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

c. Verify the yearend balance of the replacement reserve. In addition to the verification of the balance, verify with the financial institution that no encumbrances are being held on the reserve account.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

D. *Equity Skimming.*

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

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

E. *Cash Receipts.*

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

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

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

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

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

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

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

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

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

i. Determine whether rent potential and vacancy loss were properly calculated.
ii. For all revenue accounts, scan the detailed general ledger. Review the supporting documentation for all material manual entries and unusual entries.
iii. Determine the reason for the increase or cause of the high vacancy rate via discussion with management. The auditor may also want to select a sample of vacant units and perform tests to substantiate the high vacancy rate. Possible tests on the sample include but are not limited to the following:

(i) Reviewing the move-out notice from the tenant.
(ii) Reviewing the documentation from the move-out inspection.
(iii) Determining whether the security deposit was refunded to the tenant.
(iv) Reviewing the itemized list of damages and charges provided to the tenant, which was used to reduce the amount of security deposit due back to the tenant.
(v) Inspecting the vacant unit if the unit is still unoccupied.
(vi) Questioning site personnel, including the resident manager and the building manager, to determine the period when the unit was vacant.
(vii) Reviewing work orders to determine the period when the unit was vacant.

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

i. Obtain an understanding of the owner/management agent's procedures for collecting delinquent debt and policy for writing off debt.
ii. Determine whether delinquent accounts are sufficiently pursued according to procedures.
iii. Select a sample of accounts written off to bad debts expense and review supporting documentation to determine whether debt was written off in accordance with policy and generally accepted accounting principles.
iv. Determine the reason for any activity on the tenant record after the debt was written off.

F. <u>Cash Disbursements.</u>

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

2. ***<u>Suggested Audit Procedures.</u>***

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

   b. Select a sample of disbursements from the cash disbursement ledger or similar record related to Form RD 3560-7, Part II, line items 1-10 and 19-32 and perform the following steps:
      (1) Determine whether the disbursements are supported by approved invoices, bills, or other supporting documentation; the supporting documents are in the name of the project; and the costs are reasonable and necessary for the operation of the project. If the supporting documentation is not in the name of the project, determine whether only the portion applicable to the project was paid from project funds.
      (2) Determine whether the disbursements were made on behalf of other projects or entities since project funds cannot be loaned or used for non-project purposes. Report instances even if amounts have been repaid prior to the issuance of the audit report unless clearly inconsequential and was discovered in the normal course of internal control processes.
      (3) Determine whether the disbursements were properly charged to the correct account.
      (4) Determine whether the disbursement sampled items were allowable eligible project expenses (Attachment 4-C).

G. <u>Tenant Security Deposits.</u>

1. **<u>Compliance Requirement.</u>** 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 always equal or exceed the aggregate of all outstanding obligations under that account. In addition, state and local governments may have specific regulations governing the handling of tenant security deposits.

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

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

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

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

H. ***Management Functions.***

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

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

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

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

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

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

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

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

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

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

I. Unauthorized Change of Ownership/Acquisition of Liabilities.

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

2. Suggested Audit Procedures.

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

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

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

J. Unauthorized Loans of Project Funds.

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

2. Suggested Audit Procedures.

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

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

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

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

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

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

INDEPENDENT ACCOUNTANT'S COMPILATION REPORT

ABC LIMITED PARTNERSHIP
DBA ABC APARTMENTS
RD PROJECT NO: 00-000-000000000
COMPILATION OF PRESCRIBED FORMS
(WITH SUPPLEMENTAL INFORMATION)
AND INDEPENDENT ACCOUNTANT'S COMPILATION REPORT
DECEMBER 31, 20xx

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

Management is responsible for the accompanying financial statements of ABC Limited Partnership (a limited partnership), which comprise the balance sheet as of December 31, 20XX, and the related statements of income for the year then ended, included in the accompanying prescribed forms in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (We) did not audit or review the financial statements included in the accompanying prescribed forms nor was I (were we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on the financial statements included in the accompanying prescribed form.

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

The supplementary information is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information is the responsibility of management. The supplementary information was subject to my (our) compilation engagement. I (We) have not audited or reviewed the supplementary information and do not express an opinion, a conclusion, nor provide any assurance on such information.

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

Report Date

Form RD 3560-10
Multi-Family Housing Borrower Balance Sheet

See Independent Accountant's Compilation Report

Form RD 3560-7
Multi-Family Housing Project Budget

See Independent Accountant's Compilation Report

ABC Limited Partnership

SUPPORTING DOCUMENTATION TO RD FORMS 3560-10 AND 3560-7

Year ended December 31, 20XX

Accounts receivable (Form 3560-10, line 7)		
Accounts receivable - tenants	$	-
Accounts receivable - subsidy		-
Accounts receivable - other		-
	$	-
Notes payable - current detail (Form 3560-10, line 23)		
Prepaid rents	$	-
Accrued compilation fees		-
Accrued real estate taxes		-
Construction loan		-
Bridge loan		-
ABC loan		-
	$	-
Other detail (Form 3560-10, line 27)		
Due to partners	$	-
Development fee payable		-
	$	-
Accrual to cash adjustment (Form 3560-7, line 32)		
Accounts receivable	$	-
Accounts payable		-
Prepaid rent		-
Property management fee		-
Tenant security deposit		-
	$	-

See Independent Accountant's Compilation Report.

ATTACHMENT 4-L

OWNER CERTIFIED
PRESCRIBED FORMS
On the accrual method of accounting
Include RD Forms 3560-10 and 3560-7 and
SUPPORTING DOCUMENTATION SCHEDULES

1. Accounts Receivable (Form RD 3560-10, Line 7)	**Yr XXXX**	**Yr XXXX**
Accounts Receivable - Rental Subsidy	$ -	$ -
Accounts Receivable - Tenants	-	-
Accounts Receivable - Other	-	-
2. Notes Payable (Form RD 3560-10, Line 23)		
Accrued Mortgage Interest	$ -	$ -
Accrued Real Estate Taxes	-	-
Prepaid Rents	-	-
3. Other (Form RD 3560-10, Line 27)		
Due to Partners	$ -	$ -
4. Miscellaneous (Form RD 3560-7, Line 27)		
Bad Debts	$ -	$ -
Other	–	-
5. Accrual to Cash Adjustment (Form RD 3560-7, Line 32)		
Assets		
Accounts Receivable	$ -	$ -
Accounts Receivable - Other	-	-
Prepaid Expenses	-	-
Security Deposits	-	-
Liabilities		
Accounts Payable - Trade	-	-
Accrued Real Estate Taxes	-	-
Security Deposits & Prepaid Rents	-	-
Other Adjustments	-	-
20XX Mortgage Payment made in 20XX	-	-
Total Accrual to Cash Adjustment (Form RD 3560-7, Line 32)	$	

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ATTACHMENT 4-M

EXAMPLE REPORTS

1. **Independent Auditor's Report**

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

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

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

Audited Financial Statements

With Required Rural Development
Supplemental Information

ABC Apartments, LP

RHS Project Number: 00-000-000000000-00-0

December 31, 20x2 and 20x3

ABC Apartments, LP
RHS Project No. 00-000-000000000-00-0

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Independent Auditor's Report

To the Partners of
ABC Apartments, LP
City, State

USDA Rural Development

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Apartments, LP RHS Project No. 00-000-000000000-00-0 (Partnership), which comprise the balance sheets as of December 31, 20X2 and 20X1, and the related statements of income (loss), changes in partners' capital (deficit), and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

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

Report on Supplementary Information

Our audits were conducted for the purpose of forming an opinion on the financial statements as a whole. The accompanying supplementary information is presented for purposes of additional analysis as required by the *United States Department of Agriculture Rural Development.*

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

Reports Issued in Accordance with *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued a report dated March XX, 20X3 on our consideration of Partnership's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Partnership's internal control over financial reporting and compliance.

ABC Firm, LLC

Indianapolis, Indiana

March XX, 20X3

ABC Apartments, LP

RHS Project No. 00-000-000000000-00-0

Balance Sheets

December 31, 20X2 and 20X1

ASSETS

	20X2	20X1
Current Assets:		
Cash	$ -	$ -
Accounts receivable – tenant	$ -	$ -
Accounts receivable – subsidy	$ -	$ -
Prepaid expenses	$ -	$ -
Total Current Assets	$ -	$ -
Restricted Deposits and Funded Reserves:		
Tenant security deposits	$ -	$ -
Reserve for taxes and insurance	$ -	$ -
Reserve for replacements	$ -	$ -
Operating reserve	$ -	$ -
Total Restricted Deposits and Funded Reserves	$ -	$ -
Rental Property – At Cost:		
Land and improvements	$ -	$ -
Buildings and improvements	$ -	$ -
Furnishings and equipment	$ -	$ -
	$ -	$ -
Less: Accumulated depreciation	($ -)	($ -)
Net Rental Property	$ -	$ -
Other Assets:		
Capitalized costs – net	$ -	$ -
Total Other Assets	$ -	$ -
Total Assets	**$ -**	**$ -**

The accompanying notes are an integral part of the financial statements.

ABC Apartments, LP
RHS Project No. 00-000-000000000-00-0

Balance Sheets (continued)

December 31, 20X2 and 20X1

LIABILITIES AND PARTNERS' CAPITAL (DEFICIT)

	20X2	20X1
Current Liabilities		
Accounts payable - operations	$ -	$ -
Accrued mortgage interest	-	-
Accrued real estate taxes	-	-
Mortgage payable - current portion	-	-
Deferred revenue	-	-
Total current liabilities	-	-
Tenant Deposits Held In Trust		
Tenant deposits held in trust	-	-
Long-Term Liabilities		
Mortgage payable, net of current portion	-	-
Due to related parties	-	-
Total long-term liabilities	-	-
Total Liabilities	-	-
Total Partners' Capital (Deficit)	-	-
Total Liabilities and Partners' Capital (Deficit)	$ -	$ -

The accompanying notes are an integral part of the financial statements.

ABC Apartments, LP
RHS Project No. 00-000-000000000-00-0

Statements of Income (Loss)
For the Years Ended December 31, 20X2 and 20X1

	20X2	20X1
Rental Income		
Tenant payments	$ -	$ -
Tenant assistance payments	-	-
Total potential rental income	-	-
Vacancies	-	-
Total rental income	-	-
Other Income		
Interest income	-	-
Laundry and vending	-	-
Tenant charges	-	-
Other income	-	-
Total other income	-	-
Total income	-	-
Expenses		
Maintenance and operating	-	-
Utility	-	-
Administrative	-	-
Tax and insurance	-	-
Total expenses	-	-
Income from Operations	-	-
Non-Operating Income (Expense)		
Interest subsidy income	-	-
Interest expense	-	-
Depreciation expense	-	-
Total non-operating income (expense)	-	-
Net Income	$ -	$ -

The accompanying notes are an integral part of the financial statements.

ABC Apartments, LP
RHS Project No. 00-000-000000000-00-0

Statements of Changes in Partners' Capital (Deficit)
For the Years Ended December 31, 20X2 and 20X1

	20X2	20X1
Partners' Capital (Deficit), Beginning of Year	$ -	$ -
Net Income	-	-
Distributions	-	-
Partners' Capital (Deficit), End of Year	$ -	$ -

The accompanying notes are an integral part of the financial statements.

ABC Apartments, LP

RHS Project No. 00-000-000000000-00-0

Statements of Cash Flows
For the Years Ended December 31, 20X2 and 20X1

	20X2	20X1
Reconciliation of Net Income to Net Cash Provided by Operating Activities		
Net Income	$ -	$ -
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities		
Depreciation expense	-	-
Decrease (increase) in assets		
Prepaid expenses	-	-
Tenant deposits held in trust	-	-
Increase (decrease) in liabilities		
Accounts payable - operations	-	-
Accrued mortgage interest	-	-
Accrued real estate taxes	-	-
Tenant deposits held in trust	-	-
Net Cash Provided By Operating Activities	-	-
Cash Flow From Investing Activities		
Net withdrawals from the reserve for taxes and insurance	-	-
Purchase of fixed assets	-	-
Net Cash Used In Investing Activities	-	-
Cash Flow from Financing Activities		
Principal payments	-	-
Payments on deferred revenue	-	-
Proceeds on deferred revenue	-	-
Distributions	-	-
Net Cash Used In Financing Activities	-	-
Increase (Decrease) in Cash and Cash Equivalents	-	-
Cash and Cash Equivalents, Beginning of Year	-	-
Cash and Cash Equivalents, End of Year	$ -	$ -
Supplemental Disclosure		
Cash paid for interest	$ -	$ -

The accompanying notes are an integral part of the financial statements.

ABC Apartments, LP
RHS Project No. 00-000-000000000-00-0

Notes to the Financial Statements
For the Years Ended December 31, 20X2 and 20X1

Note 1 – Nature of Activities

ABC Apartments, LP RHS Project No. 00-000-000000000-00-0 (Partnership) was formed on June 1, 1908, under the laws of the State of New York, for the purpose of operating a XX-unit apartment community located in New York, New York. The community is financed by a United States Department of Agriculture Rural Development (RD) Section 515 Loan, and therefore is regulated by RD as to rent charges and operating methods. Under this program, Partnership provides housing to low-income and moderate-income families, subject to regulation by RD as to rental charges and operating methods. Lower rental charges to tenants are recovered by Partnership through rental and interest subsidies provided by RD.

Note 2 – Significant Accounting Policies

A summary of Partnership's significant accounting policies consistently applied in the preparation of the accompanying financial statements is as follows:

Basis of Accounting
Partnership's financial statements were prepared on the accrual basis of accounting.

Use of Estimates
The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of continent assets and liabilities at the date of the financial statements and the reported amounts of revenues, expenses, and other changes in partners' capital (deficit) during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents
For the statements of cash flows, all unrestricted investment instruments with original maturities of three months or less are cash and cash equivalents. As of December 31, 20X2 and 20X1, cash and cash equivalents consist of an operating checking account.

Subsequent Events
Partnership evaluated subsequent events through March XX, 20X3, which is the date the financial statements were available to be issued. This evaluation determined that there are no subsequent events that necessitated further disclosure in and/or adjustments to the accompanying financial statements.

ABC Apartments, LP

RHS Project No. 00-000-000000000-00-0

Note 2 – Significant Accounting Policies (continued)

<u>Tenant Receivable and Bad Debt</u>
Tenant rent charges for the current month are due on the first of the month. Tenants who are evicted or move out are charged with damages or cleaning fees, if applicable. Tenant receivable consists of amounts due for rental income, security deposits, or the charges for damages and cleaning fees. Partnership does not accrue interest on the tenant receivable balances.

Partnership has not established an allowance for doubtful accounts and does not use the reserve method for recognizing bad debts. Bad debts are treated as direct write-offs in the period management determines that collection is not probable.

<u>Tenant Security Deposits</u>
Partnership maintains accounts for security deposits received from tenants. The cash is restricted for reimbursement of the security deposits unless there is evidence of default by a tenant under the lease agreement.

<u>Tax and Insurance Reserve</u>
Tax and insurance reserve is restricted cash for payments of real estate taxes and insurance. Partnership is required to establish and maintain a reserve account. This account is used to receive monthly deposits sufficient to pay annual real estate taxes and insurance premiums that are paid from the account.

<u>Replacement Reserves</u>
In accordance with the loan agreement with RD, a reserve for replacement is to be funded $AMT annually until it reaches $AMT.

<u>Property and Equipment</u>
Property and equipment are recorded at cost. Depreciation is computed using the straight-line method of depreciation. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts, and any resulting gain or loss is recognized as income or loss for the period. The cost of maintenance and repairs is charged to expense as incurred and significant renewal and betterments are capitalized. Deductions are made for retirements resulting from renewals or betterments.

<u>Accrued Real Estate Taxes</u>
Partnership is subject to real estate and personal property taxes and pays one year in arrears. Partnership was assessed in 20X1 and made bi-annual payments in May 20X2 and November 20X2. Failure to make these payments could have resulted in additional penalties, interest, and liens. At December 31, 20X2 and 20X1, accrued real estate taxes represent an estimated amount to be paid in the subsequent year.

<u>Recognition of Rent Revenue</u>
Partnership recognized net rent revenue in the period in which the rent is earned. In accordance with the RD financial reporting requirements, potential rental income represents total possible rent revenue as if all units are 100 percent occupied during the year. Total rental income represents potential rental income less vacancies. Rents collected in advance are deferred until the rental income is earned.

ABC Apartments, LP
RHS Project No. 00-000-000000000-00-0

Note 2 – Significant Accounting Policies (continued)

Rental Assistance Payments

Partnership entered into a rental assistance contract for low-income families as provided by RD.

Advertising

Partnership expenses advertising costs as they incur. For the years ended December 31, 20X2 and 20X1, advertising and marketing expenses were $AMT and $AMT, respectively.

Income Taxes

No provision for federal or state income taxes was made in the financial statements as the federal and state income tax effect on Partnership's activities accrued to its partners.

Generally accepted accounting principles in the United States require Partnership to examine its tax positions for uncertain positions. Partnership is not aware of any tax positions that are more likely than not to change in the next twelve months, or that would not sustain an examination by applicable taxing authorities. Partnership's policy is to recognize penalties and interest as incurred in its statements of income (loss) as a component of operating expenses, and totaled $0 for December 31, 20X2 and 20X1. Partnership's federal and state income tax returns for fiscal years ended 20XX through 20XX are subject to examination by the applicable tax authorities, generally for three years after the later of the original or extended due date.

Impairment of Long-Lived Assets

In accordance with the provisions of accounting for the impairment or disposal of long-lived assets, Partnership reviews long-lived assets for impairments when circumstances indicate the carrying amount of an asset may not be recoverable based on the undiscounted future cash flows of the asset. If the carrying amount of an asset may not be recoverable, a write-down to fair value is recorded. Fair values are determined based on the discounted cash flows, quoted market values, or external appraisals, as applicable. Long-lived assets are reviewed for impairment at the individual asset or the asset group level for which the lowest level of independent cash flows can be identified.

Fair Value Measurements

Partnership adopted fair value measurements of financial assets and financial liabilities of non-financial items that are recognized or disclosed at fair value in the financial statements on a recurring basis. This establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to measurements involving significant unobservable inputs (Level 3 measurements).The three levels of the fair value hierarchy are as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that Partnership has the ability to access at the measurement date.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3 inputs are unobservable inputs for the asset or liability.

Note 2 – Significant Accounting Policies (continued)

The level in the fair value hierarchy within which a fair measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety. Partnership had no investments at December 31, 20X2 and 20X1 except for certificate of deposits.

Partnership operates in a heavily regulated environment that typically includes restrictions such as land use, rent regulations, government subsidies in the form of rental assistance through either rent subsidy or tenant vouchers, subsidized mortgage interest rates, and restrictions on selling or transferring.
A summary of the methods and significant assumptions used to estimate the fair values of financial instruments is as follows:

- Short-term financial instruments – The fair value of short-term financial instruments, including cash and cash equivalents, restricted deposits, accounts receivable, accounts payable and accrued liabilities approximate their carrying value due to the short-term nature of these instruments.
- Long-term financial instruments – The fair value of long-term financial instruments, including mortgage payable which approximates the carrying value in the accompanying financial statements based on current borrowing rates.

<u>Reclassifications</u>
Certain accounts in the 20X1 financial statements were reclassified for comparative purposes to conform with the presentation in the 20X2 financial statements. Total assets, liabilities, partners' capital (deficits), and net income are unchanged due to these reclassifications.

Note 3 – Mortgage Payable
The mortgage payable is payable to RD in monthly installments of $AMT at an interest rate of RATE% per annum and a term of # years, maturing on DATE. As part of the Loan Agreement, Partnership entered into an Interest Credit and Rental Assistance Agreement that effectively lowers the interest rate to approximately 1 percent over the term of the loan. The mortgage liability of Partnership is limited to the underlying value of the real estate collateral pledged. No partner is personally liable on the mortgage note payable. The original amount of the note payable was $AMT.

Estimated annual maturities of the mortgage notes payable are as follows:

20X3	$ AMT
20X4	AMT
20X5	AMT
20X6	AMT
20X7	AMT
Thereafter	AMT
	$ AMT

ABC Apartments, LP RHS
Project No. 00-000-000000000-00-0

NOTE 4 – DISTRIBUTION TO PARTNERS

Under the mortgage payable agreement, annual distributions to partners are limited by RD regulations to $AMT. During the years ended December 31, 20X2 and 20X1, $AMT and $AMT, respectively were distributed to the partners. Distributions are paid one year in arrears of being earned.

Note 5 – Related Party Transaction

Management Fee

Partnership entered into a management agreement with ABC Property Management (management agent), an identity of interest with the general partner, to manage the rental operations. The management agreement allows for a management fee based on per occupied unit per month. Property management fees were $AMT and $AMT during the years ended December 31, 20X2 and 20X1, respectively.

Management Services

Management agent provides administrative services to Partnership and was reimbursed $AMT and $AMT for the cost of site employee payroll, payroll taxes, and benefits during the years ended December 31, 20X2 and 20X1, respectively.

Legal Services

ABC Legal, an identity of interest with the general partner, performs legal services for Partnership. During the years ended December 31, 20X2 and 20X1, $AMT and $AMT, respectively, was incurred and expensed.

Advances from General Partner

A general partner made non-interest-bearing operating deficit loans of $AMT which are payable from the proceeds of the sale or refinancing of the rental property. At December 31, 20X2 and 20X1, Partnership owes the general partner $AMT and $AMT, respectively.

Note 6 – Current Vulnerability Due to Certain Concentrations

Concentration in Affordable Housing Market

Partnership's sole asset is ABC Apartments. Partnership's operations are concentrated in the affordable housing real estate market. In addition, Partnership operates in a heavily regulated environment. The operations of Partnership are subject to the administrative directives, rules, and regulations of federal, state, and local regulatory agencies, including, but not limited to, RD and the State Housing Agency. Such administrative directives, rules, and regulations are subject to change by an act of Congress or an administrative change mandated by RD or the State Housing Agency. Such changes may occur with little adequate funding to pay for the related cost, including the additional administrative burden, to comply with a change.

Concentration in Government Funding

Partnership received X percent and X percent of gross revenue from RD in the form of rental assistance and interest reduction subsidy payments during the years ended December 31, 20X2 and 20X1, respectively.

Concentration in Credit Risk

Partnership continually monitors its positions with, and the credit quality of, the financial institutions with which it invests. Financial instruments that potentially subject the company to concentration of credit risk consist principally of cash. Management believes Partnership placed all cash with high-credit quality financial institutions and that there is no significant concentration of credit risk with respect to cash.

ABC Apartments, LP RHS
Project No. 00-000-000000000-00-0

Schedule of Required Supplemental Information
For the Year Ended December 31, 20X2

1. Management Fee Calculation

The management fee is based on a fee per unit occupied by tenants during the month.

Total qualified units	-	
Less: Rent free units	-	
Vacancies	-	
Total occupied units		-
Fee per unit		$ -
Management fee expense		$ -

2. Insurance Disclosure

Partnership maintains insurance coverage as follows:

	Coverage period	Coverage
Property coverage on buildings	November 20X2 to October 20X3	$ -
Fidelity / employee dishonesty	March 20X2 to March 20X3	$ -

3. Return to Owner

In accordance with the loan agreement, the annual return to owner is as follows:

Maximum return to owner	$ -
Budgeted return to owner	$ -
Return to owner paid	$ -

4. Schedule of Changes in Fixed Assets

	Beginning Balance	Additions	Disposals	Ending Balance
Land	$ -	$ -	$ -	$ -
Buildings	-	-	-	-
Furniture and equipment	-	-	-	-
Total fixed assets	$ -	$ -	$ -	$ -
Accumulated depreciation				
Buildings	$ -	$ -	$ -	$ -
Furniture and equipment	-	-	-	-
Total accumulated depreciation	$ -	$ -	$ -	$ -

Fixed asset additions for the year ended December 31, 20X2

None

Fixed asset disposals for the year ended December 31, 20X2

None

See Independent Auditors report

ABC Apartments, LP RHS
Project No. 00-000-000000000-00-0

Schedules of Expenses
For the Years Ended December 31, 20X2 and 20X1

	20X2	20X1
Maintenance and Operating Expenses		
Maintenance and repairs - payroll	$ -	$ -
Maintenance and repairs - supplies	-	-
Maintenance and repairs - contract	-	-
Painting	-	-
Snow removal	-	-
Grounds	-	-
Services	-	-
Annual capital budget	-	-
Other operating expenses	-	-
Total maintenance and operating expenses	$ -	$ -
Utility Expenses		
Electricity	$ -	$ -
Water	-	-
Sewer	-	-
Fuel (Oil/Coal/Gas)	-	-
Garbage and trash removal	-	-
Other utilities	-	-
Total utility expenses	$ -	$ -
Administrative Expenses		
Site management payroll	$ -	$ -
Management fee	-	-
Project audit fee	-	-
Legal expense	-	-
Advertising	-	-
Telephone and answering service	-	-
Office supplies	-	-
Training expense	-	-
Health insurance and other employee benefits	-	-
Payroll taxes	-	-
Workers' compensation	-	-
Other administrative expenses	-	-
Total administrative expenses	$ -	$ -
Taxes and Insurance Expenses		
Real estate taxes	$ -	$ -
Property and liability insurance	-	-
Fidelity coverage insurance	-	-
Total taxes and insurance expenses	$ -	$ -

See Independent Auditors report

Project No. 00-000-000000000-00-0

Form RD 3560-10

Multi-Family Housing

Borrower Balance Sheet

See Independent Auditors report

ABC Apartments, LP RHS
Project No. 00-000-000000000-00-0

Form RD 3560-7

Multi-Family Housing

Project Budget

See Independent Auditors report

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

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

USDA Rural Development

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

Internal Control Over Financial Reporting

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

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

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

ABC Limited Partnership
Independent Auditors'
Report on Internal Control
Page Two

Compliance and Other Matters

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

Purpose of this Report

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

Firm's signature
City, State
DATE, YEAR

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

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

USDA Rural Development

Report on Compliance for Each Major RD Program

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

List the major program.

Name of Major RD Program	**Direct and Material Compliance Requirements**
Section 515 Rural Rental Housing Loan	Mortgage status, replacement reserve, return on investment or return to owner, equity skimming, cash receipts, cash disbursements, tenant security deposits, management functions, unauthorized change of ownership or acquisition of liabilities and unauthorized loans of project funds.

Management's Responsibility

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

Auditor's Responsibility

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

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

Opinion on Each Major RD Program

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

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

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

Report on Internal Control Over Compliance

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

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

.

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

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

Firm's signature
City, State
DATE,YEAR

ABC Apartments, LP RHS

Project No. 00-000-000000000-00-0

Schedule of Findings and Questioned Costs
For the Year Ended December 31, 20X2

For the Year Ended December 31, 20X2:

There were no findings or questioned costs for the year ended December 31, 20X2.

For the Year Ended December 31, 20X1:

There were no findings or questioned costs for the year ended December 31, 20X1.

ABC Apartments, LP RHS
Project No. 00-000-000000000-00-0

Schedule of Lead Auditor
For the Years Ended December 31, 20X2 and 20X1

Auditor Information:	ABC Firm, LLC Main Street, Suite 104 New York, New York 10017
Phone Number:	(000) 000-0000
Fax Number:	(000) 000-0000
Auditor Contact:	John Doe, CPA
Auditor Contact Title:	Member
Auditor Contact Email:	Jdoe@ABCfirm.com

Attachment 4-N

Year End Financial Reporting Requirements
State and Local Government, Indian Tribes and Non-Profit Organizations

Single Audit

The Single Audit is divided into two areas: Compliance and Financial.

The compliance component of a Single Audit covers the study and understanding (planning stage) as well as the testing and evaluation (exam stage) of the recipient with respect to federal assistance usage, operations and compliance with laws and regulations

The financial component is exactly like a financial audit of a non-Federal entity which includes the audit of the financial statements and accompanying notes.

Single Audit Component Reference /Checklist

Financial Statement(s) 2 CFR 200.510(a)
Opinion on Financial Statements 2 CFR 200.515(a)
Uniform Guidance Report on Internal Control 2 CFR 200.515(b) (major programs)
Uniform Guidance Report on Compliance 2 CFR 200.515(c) (major programs)
GAS Report on Internal Control 2 CFR 200.515(b)
Schedule of expenditures of Federal Awards 2 CFR 200.510(b) (Example provided)
Opinion or Disclaimer of Opinion on Schedule of Federal Awards 2 CFR 200.515(a)
GAS Report on Compliance 2 CFR 200.515(c)
Schedule of Findings and Questioned Costs 2 CFR 200.515(d) (Example provided)
Summary Schedule of Prior Audit Findings 2 CFR 200.511(b)
Corrective Action Plan (if findings) 2 CFR 200.511(c) (Example provided)

DEF Apartments NFP

Project No. 00-000-000000000-00-0

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
Year ended December 31, 20X7

Federal Grantor/ (Pass-through Grantor)/ Program Title	Federal CFDA Number	Agency or Pass-through Number	Federal Expenditures
U.S. Departments of Agriculture Rural Rental Housing Loans	10.415		$2,247,033
U.S. Departments of Agriculture Rural Rental Housing Loans	10.427		242,249
U.S. Departments of Agriculture Interest Assistance Programs	10.437		87, 046
Total			$ 2,576,328

1. Basis of Presentation

The accompanying schedule of expenditures of federal awards (the Schedule) includes the federal award activity of DEF Apartments under programs of the federal government for the year ended December 31, 20X7.

The information in this Schedule is presented in accordance with the requirements of Title 2 U.S. *Code of Federal Regulations* (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). Because the Schedule presents only a selected portion of the operations of the Project, it is not intended to and does not present the Project's financial position, changes in net assets, or cash flows.

2. Summary of Significant Accounting Policies

(a) Expenditures reported on the Schedule are reported on the accrual basis of accounting. Such expenditures are recognized following the cost principles contained in the Uniform Guidance, wherein certain types of expenditures are not allowable or are limited as to reimbursement.

(b) DEF Apartments NFP has elected not to use the 10 percent de minimus indirect cost rate as allowed under the Uniform Guidance.

(c) The outstanding balance of loan and loan guarantee programs at December 31, 20x7 with continuing compliance requirements which are reported as federal expenditures on the accompanying schedule of expenditures of Federal Awards was $2,229,088.

See Independent Auditor's Report

.

DEF Apartments NFP

Project No. 00-000-000000000-00-0

SCHEDULE OF FINDINGS
Year ended December 31, 20X7

Financial Statements

Type of auditor's report issued: *Unmodified*

Internal control over financial reporting:
Material weakness identified? ______Yes __X__ No

Significant deficiency identified not considered
to be material weaknesses? ______ Yes __X__ None

Non-compliance material to financial statements noted? ______ Yes __X__ No

Federal Awards

Type of auditor's report issued on compliance for
major programs:

Internal control over financial reporting:
Material weakness identified? ______ Yes __X__ No

Significant deficiency identified not considered
to be material weaknesses? ______ Yes __X__ None

Any audit findings disclosed that are required to be
reported in accordance with CFR Section
200.516(a)? ______ Yes __X__ No

Identification of major programs:

CFDA Number	Name of Federal Program or Cluster
10.415	Rural Rental Housing Loans

Dollar threshold used to distinguish between Type A
and Type B programs: $XX0, 0000

Auditee qualified as low-risk auditee? ______ Yes __X__ No

DEF Apartments NFP
Project No. 00-000-000000000-00-0

–

SCHEDULE OF FINDINGS, QUESTIONED COSTS, AND RECOMMENDATIONS
December 31, 20X7

Findings Financial Statements Audit

None noted

Findings and Questioned Costs Major Award Programs Audit

None noted

Findings and Questioned Costs Prior Years

None noted

Attachment 4-O

Agency Review of Annual Financial Reports

A guide to assist in the review and identify areas of risk that may need closer scrutiny.

Property Name: ____ Fiscal Year: ____________

Borrower Name: ____ Number of Units: ________

Date Complete Package Received: ____________________________ Revenue Units: _________

To Be Completed By Date (60 Days): __________________________ RA Units: ______________

Federal Financial Assistance (FFA) From Attachment 4-G: ________________________________

Borrower Submissions

☐ **Year End Narrative** (Exhibit 4-8) Must be complete and acceptable, or the Annual Financial Reports will be considered incomplete and returned for correction.

☐ **Borrower Self-Certification Of Performance Standards** (Attachment 4-F).

☐ **Form RD 3560-7** MFH Project Budget / Actuals (Through MINC Unless < 8 Units).

☐ **Form RD 3560-10** MFH Borrower Balance Sheet (Through MINC Unless < 8 Units).

☐ **RD MFH Program Audit Determination Worksheet** (Attachment 4-G).

☐ **Owner Certified Prescribed Forms** (Attachment 4-L) Needs to be submitted if an independent accountant does not assist with the preparation of the Forms RD 3560-7 and 3560-10 and an audit was not required.

☐ **Independent Accountants' Compilation Report** (Attachment 4-K) Only needed if an independent accountant assists with the preparation of Forms RD 3560-7 and 3560-10 and an audit was not performed.

☐ **Engagement Letter** (Attachment 4-H Example) Only needed for Limited/For Profit entities with $500,000 or more in Federal Financial Assistance.

☐ **Audited Financial Statement** (Attachment 4-M Example) Only for Limited/For Profit entities with $500,000 or more in Federal Financial Assistance, to be done in accordance with GAGAS, yellow book and HUD Office of Inspector General's (OIG) Consolidated Audit Guide standards.

☐ **Single Audit** (Attachment 4-N Example) Only for Non-Profit/Government/Tribes with $ 1 million or more in Federal Financial Assistance, to be done in accordance with 2 CFR 200 Part F.

MFIS Reports and Documents For The Review

☐ MFIS Report FIN1100 Year-End Actuals, run using fiscal year that is being reviewed.

☐ MFIS Report FIN1200 Balance Sheet, run using fiscal year that is being reviewed.

☐ MFIS Report FIN1700 – Budget History, run for most recent 3 years, leaving Fiscal Year as Current.

☐ MFIS Report FIN2100 – Project Reserve Account Checkbook & Project Outstanding Authorizations, run using fiscal year that is being reviewed.

☐ MFIS Report PRJ2000 – Project Worksheet, run using most recent date.

☐ MFIS Report PRJS4200 – Occupancy Trend, run using fiscal year that is being reviewed and also run using the three fiscal years ending with the year being reviewed.

☐ Form RD 3560-54 MFH Annual Statement of Loan Account As Of (Year Being Reviewed).

☐ Previous Year's Annual Financial Review.

☐ Last Reviewed Proposed Budget Letter

INTENDED FOR USE BY RD STAFF ONLY

BORROWER SELF-CERTIFICATION OF PERFORMANCE STANDARDS REVIEW

☐ Verify that it is formatted and contains all the information found in Attachment 4-F, the following numbering corresponds with the 4-F:

1. ☐ Yes ☐ No Are accounts properly maintained and are all four primary accounts checked? If they are not, follow-up on why and provide them with HB 2-3560, Chapter 4, Section 2 for guidance.
2. ☐ Yes ☐ No Are payments from the operating account disclosed and accurately represented? If No, find out why.
3. ☐ Yes ☐ No For reserve account items a – f, if the second space was checked for any of them, find out more details and provide them with HB-2-3560, Chapter 4, Section 3 for guidance.
4. ☐ Yes ☐ No If either (are not) spaces is checked, find out why and provide them with HB 2-3560, Chapter 7, Section 2 for guidance.
5. ☐ Yes ☐ No ☐ N/A If a return to owner was paid, was it done in accordance with Agency requirements? If they mark no, find out why. Check Form RD 3560-7, Part I, Line 23 Return To Owner to make sure it matches this certification, if it doesn't follow-up with the borrower. The Return To Owner guidance is found in HB-2-3560, Chapter 4, Section 2, Paragraph 4.4 B and guidance for the non-profit asset management fee is found in HB-2-3560, Chapter 4, Section 4, Paragraph 4.14 B 1, 4th bullet point.
6. ☐ Yes ☐ No Was insurance maintained with Agency requirements? They should mark that the borrower *has* maintained at least the Liability and Property Insurance but could have other insurance as well. They should have Fidelity Insurance unless the loan is to an individual or general partnership and they are managing the property and responsible for the financial activities. If they do not have Liability or Property Insurance (or earthquake or flood and you know they should), provide them with HB-2-3560, Chapter 3, Section 4. For guidance on Fidelity Insurance, provide them HB-2-3560, Chapter 3, Section 4, Paragraph 3.11.
7. ☐ Yes ☐ No Are financial records adequate and suitable for examination? If they mark no, find out why.
8. ☐ Review the Status Report of Ownership and compare it to what we have in MFIS by going to Customer Details / Project Borrowers / Customer / Select the Borrower on the left. The Status Report and the Borrower Members at the bottom of the page should match. If MFIS is missing anyone, check the organizational documents that we have on file and update MFIS if we know they are part of the organization. If the borrower made a change without our knowledge, provide them HB-3-3560, Chapter 5 and ask that they provide us proper documentation of the change. For a non-profit, if the Board of Directors is not active, follow-up and find out why.
9. ☐ Review the Form RD 3560-7 and verify that the Part II, Line 34 Real Estate Taxes actual amount is similar to the budget amount. If it is not or they indicate taxes are not current, follow-up with the borrower on why and provide them HB-2-3560, Chapter 3, Section 4, Paragraph 3.20 as guidance. *It is extremely important that you continue to follow-up with the borrower to bring the taxes current.* You should also contact the County Assessor's office for more information on the delinquency.

Comments on the Borrower Certification of Performance Standards:

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____

FORM 3560-7 MFH PROJECT BUDGET / ACTUALS REVIEW

☐ Review the MFIS Year End Actual Analysis. At a minimum you will need to review and analyze any items that are in red. You will need to check the Reviewed box and enter a comment when you are satisfied that there is a reasonable explanation provided. **Do not put nondescriptive comments like "Okay" or "Done", you need to provide an explanation**. The MFIS Analysis is a tool to help you review the yearend actuals, but you still need to do a thorough review of the financials yourself.

☐ All property expenses need to conform with Attachment 4-C Allowable and Unallowable Project Expenses. It is easiest to identify these during the Supervisory Visit, but you can also address them during the yearend actuals review if something looks questionable.

☐ Yes ☐ No Does the MFIS Rental Income Analysis show more than a small difference for Part I, Lines 1, Rental Income and Line 2, Rental Assistance? A small amount can be explained by mid-month move-ins and move-outs. For a larger amount, work with the borrower to document what the difference is from and make sure it is reasonable.

☐ Yes ☐ No Is there an amount in Part I, Line 11 Cash Non-Project? If it is for insurance proceeds, check Tracked Accounts to make sure it is recorded either in the reserve account or Other Tracked Accounts.

☐ Yes ☐ No Is there an amount in Part I, Line 12 Authorized Loan (Non-RHS)? If yes, does RD know the details of it? If not previously notified of this loan, RD will need to get more details and record it in MFIS Servicing Efforts.

☐ Yes ☐ No Is there an amount in Part I, Line 23 Return To Owner / Asset Management Fee? If no, no further review needed. If yes:

> ☐ For limited/full profit borrowers, does the amount meet the requirements outlined in HB-2, Chapter 4, Paragraph 4.4 B, including:
>
> > ☐ Yes ☐ No Was there a positive cash flow on Part I, Line 30? If no, see Paragraph 4.4 B 2.
> >
> > ☐ Yes ☐ No Did Line 23 have a comment indicating the year the return represents? If no, add that comment based upon the year provided in the Borrower Self Certification of Performance Standards.
> >
> > ☐ Yes ☐ No Is the amount equal to or less than the amount authorized in the borrower's Loan Agreement/Resolution? If no, investigate why.
> >
> > ☐ Yes ☐ No Based upon your review, is the borrower entitled to the RTO being paid? If no, request that the borrower return the funds to the property.
>
> ☐ For non-profit/government/tribal borrowers, does the amount meet the requirements outlined in HB-2-3560, Chapter 4, Section 4, Paragraph 4.14 B 1, 4th bullet point, including:
>
> > ☐ Yes ☐ No Is the amount equal to or less than $7,500. If no, investigate why.
> >
> > ☐ Yes ☐ No Is documentation of actual expenses provided? If no, request the documentation and if they can't provide it, they will need to return what can't be documented.

☐ Yes ☐ No Is there an amount in Part I, Line 25 Authorized Debt Payment (Non-RHS)? If there is, make sure RD has documentation of it in the file and that it is identified in MFIS Servicing Efforts.

☐ Yes ☐ No Is Part I, Line 30 Net Cash or Net Deficit a negative number? It is okay if it is negative for a year but check to make sure it is not a trend by checking the MFIS FIN1700 Budget History report and if it is, address this issue with them.

☐ Yes ☐ No Does the Part I, Line 32 Accrual To Cash Adjustment match the calculations provided in either Attachment K: Independent Accountants' Compilation Report, Attachment L: Owner Certified Prescribed Forms, or in an audit that was provided. If not, have them provide adjustments so that they do match.

☐ Yes ☐ No Does the MFIS Analysis show that there is Surplus Cash for the Part I, Line 33 Ending Cash Balance? If it does, provide them with the options outlined in HB-2-3560, Chapter 4, Paragraph 4.4 C. Under the current MFH policy, we are not accepting extra payments to the borrower's loan.

☐ Yes ☐ No Is the Part II, Line 20 Management Fee greater than the amount indicated for Total Accrual Fee in the MFIS Management Fees analysis? If it is, request management refund the difference to the property or justify why their figure is correct, providing them a copy of the Printed Mgmt Fee Report from the MFIS Analysis.

☐ Yes ☐ No Does Part II, Line 34 Real Estate Taxes have an amount similar to what was budgeted? If no, review what was indicated on the Borrowers Self Certification of Performance Standards and if the real estate taxes are delinquent, work with them to bring them current.

☐ Yes ☐ No Does Part II, Line 37 Property & Liability Insurance have an amount similar to what was budgeted? If no, review what was indicated on the Borrowers Self Certification of Performance Standards and determine if the property has adequate coverage as outlined in HB-2-3560, Chapter 3, Section 4.

☐ Yes ☐ No Do any of the Part II, Lines 11, 18, 33, 40 Subtotal Expenses and Line 41 Total O & M Expense vary by more than 10% of their budgeted amount? If they do, make sure an adequate explanation is provided.

☐ Part III, Reserve Account, review FIN2100 Project Reserve Account Checkbook:

> ☐ Yes ☐ No Does the report show that the reserve account is Fully Funded? If it is, then encourage the borrower to complete an Attachment 3-B, Amendment to Loan Agreement/Resolution Reserve Account Requirements, changing only the fully funded amount. If they have recently completed a CNA, then the yearly deposit amount can also be amended.
>
> ☐ Yes ☐ No Is the Transfer To Reserve (Part III, Line 2) total equal to or greater than the total Deposits on the report? If it isn't and it isn't Fully Funded, find out why.
>
> ☐ Yes ☐ No Are the Actual Deposits (Part III, Line 2) from the report greater than the Budgeted Transfer To Reserve (Part III, Line 2) plus the Actual Interest Income (Part I, Line 5)? If yes, find out why because they shouldn't be making extra deposits without a Capital Needs Assessment unless they were instructed to deposit excess operating account funds into the reserve account or they are catching up on a delinquent reserve account.
>
> ☐ Yes ☐ No Does the Transfer From Reserve (Part III, Line 7) match the total Withdrawals from the report? If they don't match investigate why. MFIS Tracked Accounts may need to have an entry made or deleted or the Form RD 3560-7 Actuals may need to be adjusted so that the amounts match.
>
> ☐ Yes ☐ No Is the Reserve Account Status Delinquent on the report? If it is, request that they bring it current within this budget cycle and if they can't, provide them with HB-3-3560, Chapter 10, Sections 3 and 4 to develop a work-out agreement.

☐ Yes ☐ No Does the Part III, Real Estate Tax & Insurance Escrow Account ending balance match the Real Estate Tax and Insurance Escrow figure shown on the MFIS Analysis (see the calculation using the Escrow Calculation link)? If it does not, request that they transfer the difference in amounts to or from the general operating account. If the required balance is larger, the difference should be transferred from the operating account to the escrow account. If the Budget Value is larger, the difference should be transferred from the escrow account to the operating account. Do not ask them to match the balance from the Escrow Calculation because that was the amount needed at the end of their fiscal year.

☐ Part V, Annual Capital Budget, compare actual figures against budget figures. If they budgeted for an item that we have listed as a physical finding and they did not correct it, find out why. They should be doing most of their capital improvements from the reserve account, see Attachment 4-A Capital Expenditures.

☐ Make sure all rows that have "Other", "Miscellaneous" or "List" have comments explaining what the expenses are for. These would include Part I, Lines 7 and 27; Part II, Lines 10, 17, 32 and 39; Part III, Lines 3, 5 and 6; and Part V, Lines with Other or List in them.

Comments on the 3560-7 Year End Actuals:

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FORM 3560-10 MFH BALANCE SHEET REVIEW

☐ Yes ☐ No Line 1 General Operating Account plus Lines 5 and 6 (Other) balances match the Beginning and Ending balances on the Form RD 3560-7, Part III General Operating Account. If they don't, find out what adjustments need to be made so that they do.

☐ Yes ☐ No Line 2 Real Estate Taxes & Insurance Account balances match the Beginning and Ending balances on the Form RD 3560-7, Part III Real Estate Tax And Ins Escrow. If they don't, find out what adjustments need to be made so that they do.

☐ Yes ☐ No Line 3 Reserve Account balances match the Form RD 3560-7, Part III, Line 1 Beginning Balance and Line 8 Ending Balance. If they don't, find out what adjustments need to be made so that they do.

☐ Yes ☐ No Line 4 Security Deposit Account balances match the Beginning and Ending balances on the Form RD 3560-7, Part III Tenant Security Deposit Account. If they don't, find out what adjustments need to be made so that they do.

☐ Yes ☐ No Is the Line 4 Security Deposit Assets equal to or greater than Line 24 Security Deposit Liabilities. If it is not, request that they transfer general operating account funds into the Security Deposit Account so that they are equal.

☐ Yes ☐ No Line 7 Accounts Receivable, did they provide a list of accounts receivable? Compare this list against last year's list to see if items are being carried over each year and address them if they are. Also have them provide an explanation for a large unexplained increase in amounts.

☐ Yes ☐ No Is there a change in Lines 13 Land and 14 Buildings? These normally don't change, if they do make sure the changes are justified. An example would be capital improvements to the building.

☐ Yes ☐ No Line 22 Accounts Payable, did they provide a list of accounts payable? Compare this list against last year's list to see if items are being carried over each year and address if them if they are. Also have them provide an explanation for a large unexplained increase in amounts.

☐ Yes ☐ No Is there a Line 23 Notes Payable? If there is an amount, make sure we have a record of who it is to and what the terms are and that it is recorded as either a Junior Lien or Subordination in MFIS Servicing Efforts. Note Payable to: ____

☐ Yes ☐ No Does Line 26 Notes Payable RD equal the balance found on the Form RD 3560-54 MFH Annual Statement of Loan Account As Of (Year Being Reviewed), if it doesn't, it will need to be corrected.

☐ Yes ☐ No Is there a Line 27 Other Long Term Liabilities, if there is an amount, make sure we have a record of who it is to and what the terms are and that it is recorded as either a Junior Lien or Subordination in MFIS Servicing Efforts. Liability to: ____

Comments on the 3560-10 Balance Sheet:

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FOR PROFIT AUDIT OR NON-PROFIT SINGLE AUDIT

☐ Yes ☐ N/A If an audit is received, review it using either the Project Financial Audit review guide (Attachment 4-P), for full/limited profit borrowers or the Project Financial Single Audit review guide (Attachment 4-Q) for non-profit, government entity or tribal borrowers.

REVIEWING OTHER ITEMS

☐ Yes ☐ No Were either the **Owner Certified Prescribed Forms** (Attachment 4-L) or the **Independent Accountants' Compilation Report** (Attachment 4-K) provided? One of them is required if an audit or single audit was not provided. If yes:

> ☐ Yes ☐ No Do the figures from the Attachment match the figures on the Forms 3560-7 and 3560-10? If they don't, request adjustments be made so that they do.

☐ Review MFIS Report FIN1700 Budget History – Compare the actual figures against the budgeted figures over the last couple of years. Focus on the Subtotal Categories first and if you see large discrepancies from year after year, take a closer look at the line items. If there are consistent large positive cash flows each year, they are inflating budget expenses, causing rents to be higher than they need to be. Identify where this is happening and address with them.

☐ Yes ☐ No Are Vacancies high for the property size? Look at MFIS Report PRJS4200 Occupancy Trend for the fiscal year being reviewed. Vacancies are considered high and should be addressed with the borrower when they are above 10% for properties with 16 or more units or above 15% for properties with 15 or few units for the fiscal year being reviewed. Compare this year with the three year vacancy rate to see if vacancies are improving or getting worse.

> Vacancy rate for year being reviewed: _____% Three year vacancy rate: _____%

☐ Yes ☐ No Is RA currently unused when it could be used? Review MFIS Report PRJ2000 Project Worksheet. If there is unused RA and they have an overburden tenant listed that doesn't have some other type of subsidy, have them assign the RA to the tenant that has the greatest need.

☐ Yes ☐ No Are there any open findings at the property? Check MFIS Findings and if there are any open items, address them in your letter.

☐ Yes ☐ No Are there any current servicing efforts at the property? Check MFIS Servicing Efforts for any unresolved servicing efforts that need action and if there are any, address them in your letter.

☐ Yes ☐ No Are there any past due or upcoming supervisory activities at the property? Check MFIS Supervisory Activities for any past due, follow-up or that are due in the next couple of months and if there are any, address them in your letter.

☐ Yes ☐ No Are there any outstanding items from the previous year's Annual Financial Review? If all items from last year's letter have not been addressed or if it isn't marked as Final Review in MFIS, follow-up with any outstanding items.

☐ Yes ☐ No Are there any outstanding items from the most recently reviewed Proposed Budget? If there are, follow-up on those items.

Comments on Other Items:

____
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____
____

COMPLETING THE REVIEW

☐ Go through the MFIS Analysis and make sure all items highlighted in red have the Reviewed boxes checked and that there are appropriate, descriptive explanations in the Comments fields. **Do not put nondescriptive comments like "Okay" or "Done", you need to provide an explanation**.

☐ If applicable, borrower has been notified that the Yearend Actuals are not acceptable and has until ____________________(30 days) to provide a response.

☐ Borrower has been notified that the Yearend Actuals are acceptable.

☐ Complete the Asset Management Survey in SharePoint.

☐ Documents have been saved to ECF.

☐ Update MFIS Supervisory Activities for the Borrower Self Certification, 3560-7 Actuals, 3560-10 Balance Sheet and if needed the Audit or Single Audit:

- ☐ Due: For Forms RD 3560-7, 3560-10 and for-profit audits, it should be 90 days after the end of their fiscal year, for non-profits/government/tribal audits, they are due 9 months after the end of their fiscal year.
- ☐ Received: Date item was received by RD except for the 3560-7 Actuals and 3560-10 Balance Sheet, for these enter the date all necessary items were received.
- ☐ Init Review: If something is missing, isn't correct or RD has questions about the document and the borrower needs to be contacted, enter the date of contact.
- ☐ Final Review: If the document is acceptable, enter the date you notify the borrower.
- ☐ Follow-up: If RD needs to contact the borrower for missing information, to correct something or if there are questions that need to be answered, enter the date a response is expected back.

Other General Comments:

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Attachment 4-P

FOR-PROFIT or LIMITED PROFIT BORROWER FINANCIAL AUDIT – REVIEW GUIDE
$500,000 or More in Federal Financial Assistance – Borrower Threshold
GAGAS (Generally Accepted Government Auditing Standards) Audit

This Borrower received $500,000 or more in Federal financial assistance? Attachment 4-G
__ No – no further action needed
__ Yes – Proceed with GAGAS Compliance Audit requirements and review below

Due: Within 90 days after end of Borrower's fiscal year.

Date Received ________________ Date Returned (if applicable) ______________ Date Reviewed _______________

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☐ Receive copy of signed Engagement Letter (required prior to releasing information to the CPA). Example – Attachment 4-H

An audit should consist of the following items at a minimum: Example Attachment 4-M

- ☐ Independent Auditor's Report (Auditor's Opinion)
- ☐ Financial Statements (issued in two-year comparative format)
  - ☐ Balance Sheets
  - ☐ Statements of Income (Loss)
  - ☐ Statements of Changes in Partner's Capital (Deficit)
  - ☐ Statements of Cash Flow
- ☐ Notes to Financial Statements
- ☐ Supplemental Information
  - ☐ Management Fee Calculation
  - ☐ Insurance Disclosure
  - ☐ Return to Owner
  - ☐ Changes in Rental Property (Fixed Assets)
  - ☐ Accrual to Cash Schedule (aka Accrual to Cash Adjustment)
  - ☐ Schedule of Expenses (optional)
  - ☐ Multiple-Family Housing Borrower Balance Sheet, Form RD 3560-10
  - ☐ Multiple-Family Housing Project Budget, Form RD 3560-7 and supporting documentation
  - ☐ Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards
  - ☐ Independent Auditor's Report on Compliance for Each Major RD Program and on Internal Control Over Compliance
  - ☐ Schedule of Findings, Questioned Costs, and Recommendations (current year and prior year)
  - ☐ Management Letter, if applicable
  - ☐ Schedule of Status of Prior Audit Findings, Questioned Costs, and Recommendations, if applicable
  - ☐ Corrective Action Plan, if applicable

Compliance Requirements and Audit Areas: Suggested audit procedures that RD believes should be performed. Refer to Attachment 4-J.

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A. Auditor's Opinion:

Disclosures are made both on the financial statements themselves and in the footnotes to the financial statements. We accept any of the below auditor opinions, but if it is a qualified or no opinion audit, address the exceptions or problems in the letter to the borrower.

- ☐ Unqualified Opinion – the financial statements are fairly and appropriately presented, without any identified exceptions, and in compliance with generally accepted accounting principles (GAAP)
- ☐ Qualified Opinion – the financial statements are fairly presented, with the exception of a specified area. A qualified opinion is generally still acceptable to lenders. More detailed review may be needed.
- ☐ Adverse Opinion – the financial statements are misrepresented, misstated, and do not accurately reflect the borrower's financial performance. More detailed review is needed.
- ☐ No Opinion (Disclaimer of Opinion) – the financial statements may be lacking, or there is insufficient cooperation from management. More detailed review is needed.

Comments:

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B. Financial Statements:

1) <u>Balance Sheets:</u>

- ☐ Assets are fairly stated in comparison to financial data submitted on Form RD 3560-10.
  - ☐ Restricted account(s) (Reserve Account) matches the amount submitted on Form RD 3560-10.
- ☐ Liabilities are fairly stated in comparison to financial data submitted on Form RD 3560-10.
- ☐ Security Deposit Asset account **<u>must</u>** equal or exceed Security Deposit Liability account. If not, the potential liability exceeds the cash amount in the Security Deposit bank account. Address discrepancy with management.
- ☐ Accounts Payables are fairly stated in comparison to financial data submitted on Form RD 3560-10.
- ☐ Notes Payables (current and long-term liabilities) is fairly stated in comparison to financial data submitted on Form RD 3560-10.
- ☐ Any increase in notes payables or new notes payables has been approved by RD.

2) <u>Statements of Income (Loss):</u>

- ☐ Income and expenses should be fairly stated in comparison to financial data submitted on Form RD 3560-7.

3) <u>Statements of Changes in Partner's Capital (Deficit):</u>

- ➢ Or similarly report title based on the type of participating ownership entity. For example, if a limited liability company owns the property, "Statement of Changes in Member's Equity" should be discussed.
- ➢ The allowable distribution is restricted as described in the Loan Agreement / Resolution. Distribution is further discussed in the RTO section of the Agency Review of Annual Financial Statements (Att. 4-O)

4) <u>Statements of Cash Flow:</u>

Helps us understand the inflows and outflows of cash over the 12 months of the financial statements.

Comments:

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Notes to Financial Statements:

The notes to financial statements (footnotes) are:

- ✓ Communication of information necessary for a fair presentation of the financial position and results of operations that are not readily apparent from, or not included in, the financial statements themselves.
- ✓ A synopsis preview of the financial status of property and will point out problems.
- ✓ An easily accessible place for complex definitions or calculations to be explained should a reader desire additional information.
- ✓ Reports the details and additional information that is left out of the main financial statements (balance sheet, income statement, and cash flow statement)
- ✓ An integral part of the overall financial statement review.

- ☐ Review comments regarding organizational structure. Any changes should be noted on Att 4-F.
- ☐ Review notes for any financial irregularities
- ☐ Review notes regarding Reserve Account - transfers and withdrawals should match MFIS tracked accounts
- ☐ Review notes for unauthorized loans or advances from owner (partners)
- ☐ Review notes to determine real estate taxes are paid current, if applicable.
- ☐ Review for changes in ownership. If any change, was it approved by RD? ☐ Yes ☐ No
- ☐ Was RTO fairly stated and approved by RD? ☐ Yes ☐ No
- ☐ Was the management fee calculated accurately? ☐ Yes ☐ No
- ☐ Review Identity of Interest (IOI) comments – has the Agency approved any identified IOI? ☐ Yes ☐ No

Comments:

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C. Supplemental Information:

Items 1 through 7 will be provided in the audit.

1) <u>Management Fee Calculation:</u>

- ☐ Per Occupied Unit Per Month (PUPM) does not exceed rate stated on Management Certification (Form RD 3560-13). [Reference: HB-2-3560, Attachment 3-F]
- ☐ If reporting "add-on" fees, confirm they do not exceed fees agreed on Management Certification (Form RD 3560-13). [Reference HB-2-3560, Exhibit 3-4]
- ☐ Management Fee Calculation does not exceed financial data submitted on Form RD 3560-7
- ☐ Utilize MFIS analysis (Mgmt Fee Report), if needed

2) <u>Insurance Disclosure:</u>

- ☐ Insurance coverage stated coincides with MFIS / Projects / Details / Insurance for corresponding fiscal year.

3) <u>Return to Owner (RTO):</u>

- ☐ Coincides with requirements of Loan Agreement / Loan Resolution. Analyzed in more detail in the Agency Review of Annual Financial Reports (Att. 4-O)

4) <u>Changes in Rental Property (Fixed Assets):</u>

- ☐ Review to determine if any unapproved sale or acquisition occurred during the fiscal year

5) <u>Accrual to Cash Schedule:</u> provides a listing of the auditor's calculation of accrual to cash adjustment

6) Multiple-Family Housing Borrower Balance Sheet, Form RD 3560-10: matches Form RD 3560-10 financial data transmitted to RD

7) Multiple-Family Housing Project Budget, Form RD 3560-7: matches Form RD 3560-7 financial data transmitted to RD

8) Schedule of Expenses: (optional) Provides a breakdown of expenses to coincide with expenses submitted on Form RD 3560-7

Comments:

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D. Independent Auditor's Reports and Schedule of Findings:

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

☐ Review for noted deficiencies and material weaknesses

List if any deficiencies or weaknesses are noted:

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____
____
____

2) Independent Auditor's Report on Compliance for Each Major RD Program and on Internal Control Over Compliance: (Required by the Consolidated Audit Guide for Audits of RD Programs)

☐ A major program is defined as an individual assistance program for which expenditures equaled or exceeded $500,000 during the applicable fiscal year or a project had an outstanding RD direct loan or RD guaranteed loan balance equal to or exceeding $500,000 as of the end of the period under audit.

☐ If a major program is identified, borrower has complied in all material respects with the compliance requirements.

3) Schedule of Findings, Questioned Costs, and Recommendations:
(Comparative - current year and prior year):

☐ Review for noted findings and questioned costs

☐ Note if those identified have been corrected by the borrower

List if any findings or questioned costs not corrected by the borrower:

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4) Management Letter, if applicable:

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5) Schedule of Status of Prior Audit Findings, Questioned Costs, and Recommendations, if applicable:

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6) Corrective Action Plan, if applicable:

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Noted Concerns in Audit:

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Update Supervisory Activities in MFIS: (changes are needed to MFIS, the Missing Data Rules, and ECF classifications for these instructions to be accurate.

☐ Audit (For-Profit) – Received date entered in MFIS
☐ Audit (For-Profit) – Reviewed date entered in MFIS
MFIS Message: Click “OK” to schedule the Audit activity for the following year
MFIS Message: Click “Cancel” to process the Audit activity update but NOT schedule the Audit activity for the following year
☐ Audit (For-Profit) – Follow-up date entered in MFIS, if additional information or clarification is needed

****

HELPFUL TERMS:

Corporation (for-profit): A corporation is made up of shareholders or members. They are governed by their articles of incorporation and bylaws. Nearly every corporation has a board of directors, which is charged with managing the business affairs of the corporation as provided in the bylaws. Under limited circumstances, a shareholder agreement can eliminate the board of directors and transfer the exercise of corporate powers directly to the shareholders. Officers are appointed by the board of directors, in accordance with the bylaws, and the same person may hold multiple officers. Officers have the authority to perform the duties described by the bylaws. In all circumstances signature authority is governed by the articles of incorporation and bylaws.

General Partnership: A general partnership is a business arrangement by which two or more individuals agree to share in all assets, profits, and financial and legal liabilities of a jointly owned business. In a general partnership, partners agree to unlimited liability, meaning liabilities are not capped and can be paid through the seizure of an owner's assets. Furthermore, any partner may be sued for the business's debts. Typically, these are “older” formed partnerships.

Limited Liability Company (LLC): A limited liability company is made up of member(s) and/or manager(s). Management of an LLC is generally vested in managers, as provided by the operating agreement. Non-managers of an LLC are called "members." LLCs are governed by articles of organization, which may provide regulations governing the company’s internal affairs, but the LLC may also have an operating agreement, which may further provide limitations or authorizations possessed by the members or managers. Generally, if the articles of organization provide for management of the LLC in the managers, then the managers are the only agents of the LLC for ordinary business purposes, and the members may not act as an agent of the

LLC. In an LLC members and managers are not liable for the LLCs debts, and members and managers cannot be held personally liable in court for an obligation of the LLC.

Limited Liability Limited Partnership (LLLP): A limited liability limited partnership (LLLP) is a type of partnership which **combines the limited liability of an LLP with the two-tiered governance of a Limited Partnership**. Regarding the ability to sign documents and bind the partnership, an LLLP is governed just as a Limited Partnership.

Limited Liability Partnership (LLP): A limited liability partnership (LLP) is a type of partnership where all partners have limited liability. All partners can also partake in management activities. This is unlike a limited partnership, where at least one **general partner** must have unlimited liability and **limited partners** cannot be part of management.

Limited Partnership (LP): A limited partnership (LP) is a type of partnership made up of two or more partners (general partner(s) and limited partner(s)). The **general partner** oversees and runs the business while **limited partners** do not partake in managing the business. However, the **general partner** has unlimited liability for the debt, and any **limited partners** have limited liability up to the amount of their investment.

Partnership Asset Management Fee (Asset Management Fee): A fee, stated in the Limited Partnership Agreement or Partnership Agreement, which is paid for managing the affairs of the partnership. As noted in HB-2-3560, Chapter 4.14 B., "Any investor asset management fee, investor service fee, or similar fee may be paid solely from the annual Return to Owner and may not be paid from property operating funds. This is not the same as the Non-Profit Asset Management Fee."

Attachment 4-Q

NON-PROFIT, STATE and LOCAL GOVERNMENT, OR TRIBES BORROWER FINANCIAL AUDIT REVIEW GUIDE $1 million or More of Federal Financial Assistance – Borrower Threshold In Accordance with 2 CFR part 200 subpart F (OMB Uniform Guidance: Cost Principles, Audit and Administrative Requirement for Federal Awards)

This Borrower received $1 million or more in Federal financial assistance? Attachment 4-G
__ No – no further action needed
__ Yes – Proceed with Single Audit requirements and review below

Due: Within the <u>earlier of</u> 30 days after receipt of the auditor's report, or 9 months after the end of the Borrower's fiscal year.

Date Received _______________ Date Returned (if applicable) ________________ Date Reviewed _______________

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Per Uniform Guidance the single audit should also be submitted using the Federal Audit Clearinghouse.

☐ Receive copy of <u>signed</u> Engagement Letter (required prior to releasing information to the CPA).

A Single Audit consists of:
- Financial component - consists of a financial audit, same as the for-profit entity, (audit of financial statements and accompanying notes).
- Compliance component – the auditor must determine whether the auditee (Borrower) has complied with Federal statutes, regulations, and the terms and conditions of the Federal awards that may have a direct and material effect on each of its major programs.

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

☐ Independent Auditor's Report (Auditor's Opinion)
☐ Financial Statements <u>(issued in two-year comparative format)</u>
  ☐ Balance Sheets
  ☐ Statements of Income (Loss)
  ☐ Statements of Changes in Partner's Capital (Deficit)
  ☐ Statements of Cash Flow
☐ Notes to Financial Statements
☐ Supplemental Information
  ☐ Management Fee Calculation
  ☐ Insurance Disclosure
  ☐ Return to Owner
  ☐ Changes in Rental Property (Fixed Assets)
  ☐ Accrual to Cash Schedule (aka Accrual to Cash Adjustment)
  ☐ Schedule of Expenses (optional)
  ☐ Multiple-Family Housing Borrower Balance Sheet, Form RD 3560-1
  ☐ Multiple-Family Housing Project Budget, Form RD 3560-7 and supporting documentation

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

- ☐ Independent Auditor's Report on Compliance for Each Major RD Program and on Internal Control Over Compliance
- ☐ Schedule of Expenditures of Federal Awards
- ☐ Schedule of Findings (Schedule of Findings, Questioned Costs, and Recommendations)
- ☐ Management Letter, if applicable
  - ☐ Schedule of Status of Prior Audit Findings, Questioned Costs, and Recommendations, if applicable
- ☐ Corrective Action Plan, if applicable

E. Auditor's Opinion:

Disclosures are made both on the financial statements themselves and in the footnotes to the financial statements. We accept any of the below auditor opinions, but if it is a qualified or no opinion audit, address the exceptions or problems in the letter to the borrower.

- ☐ Unqualified Opinion – the financial statements are fairly and appropriately presented, without any identified exceptions, and in compliance with generally accepted accounting principles (GAAP)
- ☐ Qualified Opinion – the financial statements are fairly presented, with the exception of a specified area. A qualified opinion is generally still acceptable to lenders. More detailed review may be needed.
- ☐ Adverse Opinion – the financial statements are misrepresented, misstated, and do not accurately reflect the borrower's financial performance. More detailed review is needed.
- ☐ No Opinion (Disclaimer of Opinion) – the financial statements may be lacking, or there is insufficient cooperation from management. More detailed review is needed.

Comments:

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F. Financial Statements:

5) <u>Balance Sheets:</u>

- ☐ Assets are fairly stated in comparison to financial data submitted on Form RD 3560-10.
- ☐ Restricted account(s) (Reserve Account) matches the amount submitted on Form RD 3560-10.
- ☐ Liabilities are fairly stated in comparison to financial data submitted on Form RD 3560-10.
- ☐ Security Deposit Asset account **<u>must</u>** equal or exceed Security Deposit Liability account. If not, the potential liability exceeds the cash amount in the Security Deposit bank account. Address discrepancy with management.
- ☐ Accounts Payables are fairly stated in comparison to financial data submitted on Form RD 3560-10.
- ☐ Notes Payables (current and long-term liabilities) is fairly stated in comparison to financial data submitted on Form RD 3560-10.
- ☐ Any increase in notes payables or new notes payables has been approved by RD.

6) <u>Statements of Income (Loss):</u>

- ☐ Income and expenses should be fairly stated in comparison to financial data submitted on Form RD 3560-7.

7) <u>Statements of Changes in Partner's Capital (Deficit):</u>

- ➢ Or similarly report title based on the type of participating ownership entity. For example, if a limited liability company owns the property, "Statement of Changes in Member's Equity" should be discussed.
- ➢ The allowable distribution is restricted as described in the Loan Agreement / Resolution. Distribution is further discussed in the RTO section of the Agency Review of Annual Financial Statements (Attachment. 4-O)

8) <u>Statements of Cash Flow:</u>

Helps us understand the inflows and outflows of cash over the 12 months of the financial statements.

Comments:

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G. Notes to Financial Statements:

The notes to financial statements (footnotes) are:

- Communication of information necessary for a fair presentation of the financial position and results of operations that are not readily apparent from, or not included in, the financial statements themselves.
- A synopsis preview of the financial status of property and will point out problems.
- An easily accessible place for complex definitions or calculations to be explained should a reader desire additional information.
- Reports the details and additional information that is left out of the main financial statements (balance sheet, income statement, and cash flow statement)
- An integral part of the overall financial statement review.

- ☐ Review comments regarding organizational structure. Any changes should be noted on Attachment 4-F.
- ☐ Review notes for any financial irregularities.
- ☐ Review notes regarding Reserve Account - transfers and withdrawals should match MFIS tracked accounts.
- ☐ Review notes for unauthorized loans or advances from owner (partners).
- ☐ Review notes to determine real estate taxes are paid current, if applicable.
- ☐ Review for changes in ownership. If any change, was it approved by RD? ☐ Yes ☐ No
- ☐ Was RTO fairly stated and approved by RD? ☐ Yes ☐ No
- ☐ Was the management fee calculated accurately? ☐ Yes ☐ No
- ☐ Review Identity of Interest (IOI) comments – has the Agency approved any identified IOI? ☐ Yes ☐ No

Comments:

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H. Independent Auditor's Reports and Schedule of Findings:

7) <u>Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards:</u>

☐ Review for noted deficiencies and material weaknesses

List if any deficiencies or weaknesses are noted:

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8) <u>Independent Auditor's Report on Compliance for Each Major RD Program and on Internal Control Over Compliance:</u>

(Required by the Consolidated Audit Guide for Audits of RD Programs)

- ☐ A major program is defined as an individual assistance program for which expenditures equaled or exceeded $500,000 during the applicable fiscal year or a project had an outstanding RD direct loan or RD guaranteed loan balance equal to or exceeding $500,000 as of the end of the period under audit.
- ☐ If a major program is identified, borrower has complied in all material respects with the compliance requirements.

9) Schedule of Expenditures of Federal Awards: lists the Federal awards expended for each individual Federal program and the CFDA (Catalog of Federal Domestic Assistance) number for each program area. (Examples: CFDA #10.415 – Rural Rental Housing Loans, CFDA #10.427 - Rural Rental Assistance Payments; CFDA #10.437 – Interest Assistance Programs; CFDA #10.438 – Section 538 Rural Rental Housing Guaranteed Loans)

10) Schedule of Findings:
- Findings related to Financial Statements – Auditor's Opinion (unqualified, qualified, adverse, disclaimer of opinion).
- If material weakness identified in internal control of financial statements.
- A statement as to whether the audit disclosed any non-compliance that is material to the financial statements.
- Type of report the auditor issued on compliance for major programs.
- A statement as to whether the audit disclosed any audit findings that the auditor is required to report under § 200.516 (a).
- Identification of major programs by listing each individual major program.
- The dollar threshold used to distinguish between Type A and Type B programs.
- A statement as to whether the auditee (Borrower) qualified as a low-risk auditee under § 200.520.

11) Schedule of Findings, Questioned Costs, and Recommendations:
(Comparative - current year and prior year):
- ☐ Review for noted findings and questioned costs
- ☐ Note if those identified have been corrected by the borrower

List if any findings or questioned costs not corrected by the borrower:

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12) Management Letter, if applicable:

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13) Schedule of Status of Prior Audit Findings, Questioned Costs, and Recommendations, if applicable:

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14) Corrective Action Plan, if applicable:

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Noted Concerns in Audit:

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Update Supervisory Activities in MFIS: (changes are needed to MFIS, the Missing Data Rules, and ECF classifications for these instructions to be accurate.

☐ Single Audit (Non-Profit) – Received date entered in MFIS
☐ Single Audit (Non-Profit) – Reviewed date entered in MFIS
MFIS Message: Click “OK” to schedule the Single Audit activity for the following year
MFIS Message: Click “Cancel” to process the Single Audit activity update but NOT schedule the Single Audit activity for the following year
☐ Single Audit (Non-Profit) – Follow-up date entered in MFIS, if additional information or clarification is needed

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Attachment 4-R

Agency Review Guide for Proposed Budgets

(This is a guide only – refer to HB-2-3560, Chapter 4,
Chapter 7, and 7 CFR 3560)

A guide to assist in the planning and review of a project's financial operation for the coming year.

Property Name: ________________________________ Fiscal Year: ____________

Borrower Name: ________________________________ Number of Units: _________

Date Complete Package Received: __________________ Revenue Units: __________

Date Initial Review to be Completed By (30 Days): _________________ RA Units: ______________

I. Borrower Submission for a Complete Package:

- ☐ **Form RD 3560-7**, MFH Project Budget (submitted through MINC if 8 or more units)
- ☐ **Budget narrative** – provides a description of the budget and highlights important elements to aid the Agency with the review of the budget (see HB-2-3560, 4.14 B. *5*. & Exhibit 4-1)
- ☐ **Rent change documentation** – needed if a change in rent (increase or decrease) is proposed. Must be based on a realistic projected budget. (see Exhibit 4-1) The budget narrative must clearly explain the necessity for the change requested.
- ☐ **Tenant notification** - HB Letter 203, Notice to Tenants of Proposed Rent and Utility Allowance Change *(if applicable)*
- ☐ **Utility allowance review** - (if applicable) conducted annually to determine whether any change needs to be made. The budget narrative should indicate change or no change to utility rates. A 12-month sampling for each unit size and type is used for the average calculation (see HB-2-3560, 4.14 C. and Chapter 7)
- ☐ **Other information** – any information the borrower or Agency believes is necessary to justify the proposed rent and/or utility allowance change request and support a reasonable and realistic proposal.

Within 30 days of receipt of the complete budget package, the Agency must take action by approval or denial of the budget or contact the Borrower or Management Agent to request additional information or clarification. (HB-2, 4.14 D. 2. & D. 6 b.)

II. MFIS Reports and Agency Documents helpful for the Review:

- ☐ **MFIS Report FIN1700 Budget History**, run using the "Current" FY when reviewing proposed budgets and select Excel as Report Options. After opening the excel document, Hide columns A through M and column O. To the right of the last column, (column AB) title the column "3-year average", on line 2 create a formula to calculate the 3-year average for the three "Actl Bdgt" columns, for example **=(U2+X2+AA2)/3** copy and paste this formula in all rows of column AB through line 75, "Ttl O@M Exps (11+18+33+40)".
- ☐ **PRJS4200 Occupancy Trend**, run using the most recent 36-month date span and "un-check" the Summaries Report box.
- ☐ **Previous year's proposed budget letter/review and previous year's annual financial review -** determine if servicing follow up is needed or if items need to be addressed in this year's proposed budget.

☐ **Loan Agreement(s) or Loan Resolution(s) (including any Amendments)** - determine if the proposed annual transfer to the reserve account and proposed RTO are the correct amounts. If there is an existing SWOP, these proposed amounts may have been modified in the SWOP.

☐ **Promissory Note(s), Re-amortization Agreement(s), Assumption Agreement(s), Interest Credit Agreement(s), or AMAS M1FI screen(s)** for all outstanding loans - determine if the proposed note payment and subsidized payments are correct.)

☐ **Rent Calculation Spreadsheet Tool** – optional, if needed to confirm proposed Basic and Note rents are correct

☐ **504 Self-Evaluation/Transition Plan and/or CNA** (Capital Needs Assessment) - determine if capital budget items are planned and on schedule

III. Preliminary Budget Review (HB-2, 4.14)

a. Are all sections of the budget completed (i.e. Part I, II, III, IV, and V.)? If not, request management agent to correct and retransmit the proposed budget.	Yes ☐ No ☐
b. Does Budget Narrative address all items required by Exhibit 4-1? If not, request missing items from management agent. Depending on missing items, management may need to retransmit the proposed budget.	Yes ☐ No ☐
c. Has the borrower addressed the outstanding findings of the last supervisory visit, site inspection, and compliance review? Review MFIS Findings, if there are any open physical findings, review the latest FRM2100 Report, and compliance review. If items have not been resolved or are not addressed in proposed budget or budget narrative, an explanation may be needed from management.	Yes ☐ No ☐ N/A ☐
d. Has the borrower completed all of the 504 Self-Evaluation & Transition Plan requirements? 1. If no, is the Transition Plan on schedule? 2. If not on schedule, are the past & current year items fully addressed with the current budget? *3.* See UL dated January4, 2022, Section 504 of the Rehabilitation Act of 1973 Compliance in Rural Development Multi-Family Housing Properties.	Yes ☐ No ☐ N/A ☐
e. In the budget narrative, has the borrower addressed the outstanding issues from the most recent year-end report acceptance letter? Review the last year-end report acceptance letter from RD. If not corrected or addressed in proposed budget narrative, request explanation from management. If the outstanding issues should be addressed in the proposed budget, request management to correct and retransmit the proposed budget.	Yes ☐ No ☐ N/A ☐
f. Review previous year's proposed budget letter to determine if there are any items that need to be addressed in this year's proposed budget.	

IV. **Reasonableness Analysis (HB-2, 4.14 D. *4*):** Review the MFIS Budget Analysis. The MFIS Budget Analysis is a tool to assist you with the review of the proposed budget, however, a thorough review is still needed. For any "Reason" noted in red you must check the Reviewed box and enter a comment explaining why the noted analysis item is acceptable to the Agency. **Nondescriptive comments, such as "Okay" or "Done" are not acceptable.**

a. (Form RD 3560-7) Review operating subtotals, and income sources utilizing MFIS Analysis tool: If the MFIS Budget Analysis determines a subtotal is greater than 10% different than last year's proposed budget, the **"Reason"** will be red and provide you with the specific percentage of difference from last year's proposed budget. You must enter an explanation in the MFIS Analysis comment box.	>10% difference from last year's proposed budget? Yes ☐ No ☐
b. Compare the 3 yr historical average (FIN 1700) of actual expenses to the proposed budget: Are the proposed budget subtotals comparable to the 3-year historical actual expenses, considering reasonable inflation? Does the budget narrative provide an explanation? If not, an explanation may be needed from management. Review proposed expenses to ensure they are not artificially inflated.	Yes ☐ No ☐
c. Sub-Total Administrative Expenses (Part II, line 33) Does it exceed 23% of rental income? (see 3560.102 (i) (3)(iii) (A).) If yes, investigate further and review HB-2, Attachment 4-C, *Allowable and Unallowable Project Expenses* to ensure only allowable expenses are proposed. If the % is comparable to the "norm," it may be acceptable, if not, further documentation may be needed from management to determine if administrative expenses are reasonable, considering reasonable inflation. 1. Does management fee PUPM (Part II, line 20) agree with Agency approved Management Certification? If not, it must either be corrected in the proposed budget and retransmitted; or a new Management Certification is needed. (Proposed management fee can be based on 100% occupancy; or based on the % of occupancy proposed in Part I, Line 8.) 2. Review any proposed management fee add-ons (HB-2 3.8 B.) – do conditions exist at the property to necessitate add-on fees? These must be approved by the Agency. 3. Does site manager fee correspond to Management Plan? If not, proposed budget must be corrected and retransmitted.	Yes ☐ No ☐ Yes ☐ No ☐ Yes ☐ No ☐ Yes ☐ No ☐
d. Review Vacancy Allowance for Reasonableness (4.14 B. *1.*) (Form RD 3560-7, Part I, line 8) - The goal is to have a budget with a reasonable projected vacancy, which means the budgeted vacancy may need to exceed the cap. 1. Is the proposed vacancy comparable to the most recent 36-month historical vacancy at the property? (Answer should be yes) If there is a vacancy concern, review PRJS4200 to determine if on-going concern, or showing recent improvement? 2. If vacancy exceeds the cap noted in the right panel - must have an approved SWOP to budget above the cap. IF SWOP will be in force during the majority of the proposed budget year, the budgeted vacancy will be based on the workout plan.	Vacancy Caps: ➢ 15 or fewer units, 15% ➢ more than 15 units, 10% Yes ☐ No ☐ ____ % - 36-month historical vacancy average ____ % - Proposed vacancy allowance

e. Review Utility Allowance (UA) (4.14 C.) 1. Has required documentation (per 4.14 C.) been provided to justify the proposed tenant utility allowance, if applicable? If no, request additional documentation from management agent. **a.** Does proposed utility allowance noted in HB Letter #203 match the utility allowance in Part IV of the proposed budget, Form RD 3560-7? **b.** Is 12-month average will be used for the calculation: i. Sampling of each size of unit. ii. Summary of calculations is provided. **c.** Utility rate change – provide documentation from utility company, if applicable. 2. Change in utility costs: Existing UA x .1 = 10% change in UA a. 10% or more change – borrower required to make a change. b. Less than 10% - optional for borrower to make change.	Yes ☐ No ☐ N/A ☐ (If N/A, skip this section) Yes ☐ No ☐ Yes ☐ No ☐ Yes ☐ No ☐ N/A ☐

V. Cash Uses - Does the budget reflect:

a. Is correct debt payment proposed? Review all existing loan documents 1. RD debt (Part I, line 17), compare to MFIS Projects /Details screen, if discrepancy then refer to Promissory Note, Assumption Agreement (or Re-amortization Agreement) & Interest Credit Agreement, and/or AMAS screens M1FI and/or M1JI 2. Other authorized non-RHS debt (Part I, Line 25*)*, review MFIS Servicing Efforts for 538 loan, Subordination, Jr Lien, or Loan Advance from Borrower, and/or compare to 3rd party loan documents a. If debt payments do not match, confirm RD has approved the non-RHS debt via ECF or other research using the file or other means. b. If non-RHS debt was not approved by RD, investigate, document and determine course of action. c. If debt payments on budget are incorrect, they must retransmit a corrected proposed budget. d. If not noted in MFIS Servicing Efforts, update MFIS as needed.	Yes ☐ No ☐ Yes ☐ No ☐
b. Is correct owner's return on investment (return to owner – RTO) proposed? (Part I, line 23) (HB-2 4.4 B) Confirm via MFIS – Projects / Details screen, if discrepancy then refer to Loan Agreement/Resolution and correct MFIS, if needed. RTO is not authorized if SWOP is in place for the coming fiscal year– see HB-3, 10.20; and RTO not allowed for non-profit owners. **c. Is non-profit Asset Management Fee proposed?** (Part I, Line 23) (HB-2, 4.14 B. 1) May be requested by non-profit borrowers, up to $7,500 of actual expenses per property for certain organizational costs (i.e. – Errors & Omissions insurance, Board of Director's oversight functions).	Yes ☐ No ☐ Yes ☐ No ☐

d. Is a Miscellaneous cash use proposed in the Cash Flow? (Part I, line 27) If yes, an explanation or comment must be provided to identify the miscellaneous use. This should be rarely used on a proposed budget.	Yes ☐ No ☐

VI. Cash Flow & Ending Cash Balance (HB-2, 4.14 B. *1*.)

The proposed budget ending balance should be a positive cash balance and not cause an unwarranted rent increase, nor should it exceed the total of approximately 20% of Total O&M expenses.

a. Is cash flow negative? (Part I, line 30) 1. A negative cash flow may be acceptable if there is sufficient operating cash, and it does not appear to represent a trend that cannot be corrected; or if surplus O&M cash is used to compensate for the deficit. ▪ This should not happen often. Do not let the property's operating cash continue to be depleted due to negative cash flow. Address the problem, such as a needed rent increase, or address issues at the property, etc. 2. If there is a negative cash flow, does the operating account still have a positive ending balance? If not, review income and expenses to suggest revisions to management for a positive cash flow.	Yes ☐ No ☐ Yes ☐ No ☐
b. Does the ending cash balance project surplus cash? Review MFIS Analysis for calculation of surplus O&M cash. If yes, review prior year's year-end report acceptance letter. If there was surplus O&M cash at the year-end, has management utilized it as recommended in the acceptance letter? If not, follow-up with management on the use of last year's surplus cash. ▪ RD may require a rent decrease.	Yes ☐ No ☐

VII. Review Reserve Account (HB-2, Chapter 4, Section 3)

Adequate replacement reserves are a critical component of a successful project. The intent of the reserve account is not to be used as an alternative operating budget (i.e. – a habit of operating shortfalls being paid with Reserve Account withdrawals). Rents should reflect and cover the reasonable and customary costs of annual operating expenses of the property in the market. Annual reserve deposit for projects with Agency approved Capital Needs Assessments (CNA) may be adjusted as authorized in the loan, transfer or servicing approval.

a. Is the proposed beginning reserve account cash balance reasonable based on the prior year's ending reserve account cash balance, and the current year's deposits and withdrawals? If not, confirm with management the proposed beginning cash balance is based on the current balance less projected reserve deposits and withdrawals for the remainder of the current fiscal year.	Yes ☐ No ☐
b. Is correct annual transfer to reserve proposed? (Part I, line 22) - Verify via MFIS Tracked Accounts (or Tracked Accounts > Future Funding) reflects the annual budget amount. If a discrepancy, refer to Loan Agreement/Resolution (or Amendment), or SWOP (as SWOP may allow modified transfer amount). If transfer is incorrect, management agent must retransmit a corrected proposed budget.	Yes ☐ No ☐ Yes ☐ No ☐

Has the reserve account reached the fully funded amount? Attachment 4-B, *Amendment to Loan Agreement/Resolution Reserve Account Requirements*, should be utilized to increase the fully funded level. (See HB-2, 4.11)	
c. **Are repairs planned that were identified or recommended from the most recent site inspection?** If not, an explanation from management agent may be needed. If revision is needed, they must retransmit the proposed budget.	Yes ☐ No ☐ N/A ☐
d. **If Borrower has Capital Needs Assessment (CNA) or 504 Transition Plan are they budgeting for capital improvements on schedule with the CNA and 504 Transition Plan?** If not, request explanation from management agent. If revision is needed, they must retransmit the proposed budget.	Yes ☐ No ☐ N/A ☐
e. **Is transfer from reserve account included in capital budget (Part V.) and described in narrative?** If not, an explanation from management agent may be needed.	Yes ☐ No ☐ N/A ☐

VIII. Review Rent Change (HB-2, 4.14 C. and Exhibit 4-3): Agency recommendation is for a borrower to propose a % rent increase every year instead of a large % rent increase every several years. Changes in rental rates will apply to all units in a property. (HB-2, 7.12)

a. As a guide, how do the proposed Basic rents compare to the HUD FMR rents? 1. If they exceed HUD FMR rent, will the proposed rents adversely affect the marketability of the property? 2. If yes, review with management to determine if expenses can be reduced. 3. If expenses cannot be reduced the proposed budget may not be acceptable.	Yes ☐ No ☐
b. Is this a project-based HUD Section 8/515 property? (HB-2, 7.14, Exhibit 7-9 and Exhibit 4-5) 1. RD has the responsibility to review and approve project budgets on an annual basis based on need to meet cash flow and expense requirements. 2. RD will not take into account HUD's automatic annual OCAF adjustment for Section 8 contract rents when reviewing the budget.	Yes ☐ No ☐
c. Is the rent spread between the different unit sizes consistent with the amount Management states the rent change will be? This is either: 1. The same dollar amount for all unit sizes (bedroom sizes), OR 2. The same percentage of rent change for the various unit sizes, OR 3. Is based on the square footage of the various unit sizes, OR 4. Is based on the approved CRCU rents at the time of a transfer, or MPR deal.	Yes ☐ No ☐
d. Is the rent difference between Basic and Note Rate rent correct? 1. If MPR tools exist at the property (i.e. -deferred loan, soft-second loan, etc.) see the MPR Rent Structure Tool to ensure the correct loan payments are used to calculate Note Rate Rents. 2. The difference between Basic Rent and Note Rent is that Note rent is calculated using the same operating expenses as Basic Rent, EXCEPT the debt payment is using the interest rate shown on the Promissory Note(s), Assumption Agreement(s), or Re-amortization Agreements(s), instead of the Interest Credit Agreement. 3. Rent Calculation Tools are provided as an SOP Job Aid.	Yes ☐ No ☐

IX. Special Servicing Actions (HB-3, Chapter 10, Section 3 & 4)

a. Is a Workout Agreement in place and up to date? If yes, does the proposed budget continue to implement the goals of the Workout Agreement? If no, see item b.	Yes ☐ No ☐
b. Is a Workout Agreement expired, expiring or needs renegotiated; or is a Workout Agreement needed? (If there are financial or physical findings, such as underfunded reserve, underfunded T&I, delinquency, vacancy, deferred maintenance, etc., a Workout Agreement is needed if the finding cannot be corrected. (Recommended format - HB-3, Chapter 10, Exhibit 10-3.)	Yes ☐ No ☐
c. Does project have a Special Note Rate (SNR)? If yes, it must be reviewed annually at the time of budget review, see HB 3, 10.31. If the local market conditions have not changed (may be provided by the borrower or management agent) since the SNR was implemented, then no change is made to the SNR. (The SNR rent is based on an interest rate less than Note, but not lower than 2%)	Yes ☐ No ☐

X. Budget Approval / Denial (HB-2, 4.14 D. *6.* & Exhibit 4-3):

Tenants have 20-calendar days from the date of Notice to provide comments to the Agency. Budgets

Date of RD Review	**Approved:**	**Action To Be Taken:**
1st Review Date: __________	☐ Yes ☐ No	**If Budget is approved:** • Send letter (or email) to the borrower acknowledging budget approval, include any due or past due items found in MFIS Supervisory Activities. AND: • If approved rent change was increased or utility allowance was decreased from the original Notice, MFH Servicing Official must send HB Letter 204 to the Borrower to deliver to tenants. • If approved rent is same or less than the original Notice, or approved utility allowance is more than original Notice, no additional Notice is needed from the Agency. **If Budget is not approved:** • Send Review Letter Requesting Additional Information. 10-day Follow-up date: _______ • Post 10-day Follow-up date in MFIS, Supervisory Activities, Proposed Budget • If Borrower responds to 1st Review Letter, conduct 2nd Review • If Borrower does not respond to 1st Review Letter, discuss with Team Lead for denial of budget after 10 days and give appeal rights (Attachment 1-B). ○ Post "Denied" date in MFIS, Supervisory Activities, Proposed Budget ○ After 30-day appeal rights expire, send Servicing Letter (SL) #1. Enter "Servicing Letter" task in MFIS – Servicing Efforts. Associate Finding 0096, Unacceptable Proposed Budget, to the SL#1. Continue servicing (HB-3,
2nd Review Date: __________	☐ Yes ☐ No	**If Budget is approved, follow the steps noted above in 1st Review.** **If Budget is not approved, follow the steps noted above in 1st Review.**
3rd Review Date: __________	☐ Yes ☐ No	**If Budget is approved, follow the steps noted above in 1st Review.** **If Budget is not approved (discuss with Team Lead):** • Send Letter Denying Proposed Budget and give appeal rights (Attachment 1-B). ○ Post "Denied" date in MFIS, Supervisory Activities, Proposed Budget ○ After 30-day appeal rights expire, send Servicing Letter #1. Enter "Servicing Letter" task in MFIS – Servicing Efforts. Associate Finding 0096, Unacceptable Proposed Budget, to the SL#1. Continue servicing (HB-3, 10.10).

CAN be reviewed during the 20-day comment period, but they CANNOT be approved or denied during this 20-day period.

XI. Completing the Review:

☐ MFIS Analysis – all items in red must be reviewed, the box “checked”, and explanation comments entered and updated.

☐ Update MFIS Supervisory Activities for the Proposed Budget:

☐ Received: date complete proposed budget information was received.

☐ Approved: date MFH Servicing Official approves budget

☐ Denied: if applicable – date MFH Servicing Official denies budget (must give appeal rights)

☐ Follow-up: as needed, enter requested response date for any requested documentation, information, and clarification items. Remove follow-up date once budget is approved.

☐ Combine budget and all supporting documents in to **one pdf** and upload to ECF.

☐ If SWOP received, enter Servicing Effort in MFIS with appropriate approval and follow-up dates and associate Servicing Effort with Finding(s)

☐ If SNR annual review was conducted, extend follow-up date for the next annual review on the Servicing Effort – Special Note Rent in MFIS

☐ If prior Management Certification, Form RD 3560-13, has expired, or will expire at the end of the current fiscal year, or if new fees are proposed in accordance with Attachment 3-F, a new management certification is needed for RD’s review and approval. If Management Certification is received, update MFIS Supervisory Activity - Management Certification:

☐ If there is an open Due Date entry, enter Received date, Effective date, Approved date, and Expiration date (if applicable)

☐ If there is no open Due Date entry, Add the Supervisory Activity – Management Certification and enter Received date, Effective date, Approved date, and Expiration date (if applicable)

Notes/Comments:

RD Reviewer’s Signature & Date: ____