CHAPTER *3.* HUD Multifamily Housing Programs

3-1. **Background.** This chapter contains the U.S. Department of Housing and Urban Development's (HUD) requirements for conducting the compliance portion of the annual financial audits of profit-motivated and limited-distribution entities participating in HUD's Federal Housing Administration (FHA) multifamily housing programs *except for hospitals, which are covered by chapter 4 of this guide.*

*For audits performed under this chapter, which include many different types of projects, the required compliance testing must be done for each project on an individual basis except when the project is owned and/or managed by an entity that owns and/or manages multiple HUD/FHA-assisted projects. When this condition exists, audit guide compliance sections, paragraph 3-5.J, Tenant Application, Eligibility, and Recertification; paragraph 3-5.L, Tenant Security Deposits; and paragraph 3-5.M, Management Functions, can be audited on an individual project basis or can be sampled using a group project-basis sample (defined later in this section) if

A. The same system is used by management for the compliance section for all projects selected for inclusion in this group project-based sample.

B. For the projects that are to be included in the population and sample, the compliance section has the same supervisor for all projects, the procedures followed are identical, and the test of internal controls did not disclose any weaknesses.

C. The owner(s) agrees to the project-based sample method.

D. The auditor fully documents in the work papers the above information upon which the determination was made, including the owner's signed agreement.

All other compliance sections except for the three cited above must be performed on each project.

When a condition or weakness is found during the testing that is required to be reported, it must be reported in the audit report for each project in the population. Reference should be made to each report that contains that type finding. If dollars are involved, only the dollars belonging to that specific project should be included in that project's audit finding. For example, significant deficiencies found or findings developed must be included in the audit report for all projects that were grouped for the group project-based population. The* *following illustrates wording that can be used. "This internal control problem applies to and is reported in 15 audit reports, 5 for projects owned by companies related to the X Housing Cooperation and 10 projects owned by two unrelated owners. The total disallowed cost is $450,000, of which $100,000 applies to this project, and $200,000 applies to the other 4 projects owned by companies related to the X Housing Cooperation and $150,000 applies to the 10 projects owned by the two unrelated owners." Additionally, nonmaterial instances of noncompliance must be reported in a management letter or other written correspondence for each project in the population (reporting requirements are included in paragraph 3-8 of this chapter).

A group project-based sample must include at least 20 percent of the projects with no less than a minimum of four projects to be reviewed each year for compliance with audit steps contained in sections 3-5J, 3-5L, and 3-5M. This will result in each project in the population being reviewed at least every five years or less for those compliance sections. The following examples illustrate this point:

> Example 1. An auditor has 50 projects in the population that are to be audited, and the conditions permit the auditor to use group project-based sampling. The auditor would test 20 percent or 10 projects since this amount is greater than four.
>
> Example 2. An auditor has 10 projects in the population that are to be audited, and the conditions permit the auditor to use group project-based sampling. The auditor would test the minimum of four projects since 20 percent would only be two projects.

Specific projects from the population may be added to the sample based on a risk analysis or for any other reason. However, any specific project shall not be counted as a part of the 20 percent or minimum sample of four for that year.

If the auditor elects to use the project-based sampling method, the sampling schedule and system for selecting must be included in the work papers so auditors can later ensure that all projects in the population will continue to be audited systematically.

The auditor's opinion on compliance is to be provided for each individual project, and the compliance testing must support the opinion for each individual project and not the group as a whole.

Practitioners with nonprofit projects as clients, who participate in HUD/FHA multifamily housing programs covered by the Single Audit Act, are to conduct audits in accordance with Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local**

**Governments and Non-Profit Organizations*, and with the requirements contained in OMB Circular A-133's, *Compliance Supplement*, which can be found on the OMB Web site

http://www.whitehouse.gov/omb/grants/grants_circulars.html.

This chapter is not intended to be a program-specific audit guide for compliance with the A-133 requirements. If the *Compliance Supplement* includes the program that is being audited, the guidance in the supplement is to be used. If the *Compliance Supplement* does not include the program that is being audited, part 7 of the supplement provides guidance on how to identify the applicable compliance requirements to test. Paragraph 1d of part 7 states "If there is an audit guidance issued by the Federal agency's Office of Inspector General (OIG), the auditor may wish to consider this guidance in identifying the program objectives, program procedures, and compliance requirements." This guide should be used only for that purpose.

3-2. **Reference Material.** The following is the reference material that was in effect at the time this audit guide was issued. It is the auditor's responsibility to use the procedures that were in effect during the period covered by the audit.

The audit procedures that are established in this guide are based on the procedures that were in effect when the guide was written. The auditor must determine the procedures that were in effect during the audit period which their client was to follow. The auditor must conform those procedures to the audit steps in this guide. Changes, as found necessary, must be made to the audit steps.

Throughout this chapter, reference is made to handbooks, using the base handbook number without the revision number (i.e., REV-1, REV-6, etc.). This will enable periodic updates to paragraph 3-2 should any of the material referenced below be revised, causing a change to documents' revision number, rather than revising the entire handbook/chapter, since the base handbook number would not change. Also, the auditor should ensure that the updated reference, listed in this paragraph, is used for performing the audit. The versions listed below were those in effect at the time this audit guide was issued. If reference to a handbook is needed in the audit report, the auditor should ensure that the entire updated reference, including the current revision number, is used.

Document	Title
HUD Handbook 4370.2, REV-1	Financial Operations and Accounting Procedures for Insured Multifamily Projects*

*HUD Handbook 4350.3, REV-1	Occupancy Requirements of Subsidized Multifamily Housing Programs
HUD Handbook 4370.1, REV-2	Reviewing Annual and Monthly Financial Statements
HUD Handbook 4381.5, REV-2, CHG-2	The Management Agent Handbook
HUD Handbook 4350.1	Multifamily Asset Management and Project Servicing
Not numbered	M2M Program Operating Procedures Guide Located at Web site: http://www.hud.gov/offices/hsg/omhar/readingrm/opglinks.cfm

Reference material may be obtained by accessing HUD's Client Information and Policy System (HUDCLIPS) at the following Web site:

http://www.hudclips.org/

Reference material may also be ordered from HUD's direct distribution system by telephone, (800) 767-7468; in a letter addressed to HUD, Customer Service Center, Room B-100, 451 Seventh St., SW, Washington, DC 20410; or by fax, (202) 708-2313.*

3-3. **Reporting Requirements.** The regulatory agreement for the project requires the owner to submit audited financial statements, prepared in accordance with the requirements of the Secretary, within 90 days after the end of the fiscal year. *Although most regulatory agreements may indicate a required submission date of 60 days after the end of the fiscal year, 24 CFR [*Code of Federal Regulations*] 5.801, Uniform Financial Reporting Standards (UFRS), supersedes this requirement by giving projects 90 days to submit their financial statements*. In addition to issuing an opinion, the basic financial statements, and supplemental (supporting) data, the auditor is required to issue, at a minimum, a report on the internal control structure and a report on compliance. The owner must certify to the completeness and accuracy of the financial statements. The management agent, if applicable, must certify to the management of the project. *The owner and management agent certifications are to be made in accordance with the requirements of HUD Handbook 4370.2, paragraphs 3-7 and 3-8. When circumstances prohibit the specified number of partners' or officers' certifying signatures, explanatory information should be provided with the audit report.

The auditor's role is to conduct and report the results of the audit in accordance with auditing standards generally accepted in the United States of America (GAAS) as issued by the American Institute of Certified Public Accountants (AICPA) and the standards* *applicable to financial audits contained in the generally accepted government auditing standards (GAGAS) issued by the Comptroller General of the United States. It is the owner's responsibility to file an accurate electronic submission with the Real Estate Assessment Center (REAC). In that regard, the independent auditor shall*

A. Issue an independent auditor's report (refer to chapter 2, example A) on the ownership entity's basic financial statements. This report should cover the following items:

- Balance sheet.
- *Statement of profit and loss.*
- Statement of changes in partner's capital.[1]
- Statement of cash flows.
- Footnotes to the basic financial statements, including descriptions of accounting policies.

B. Issue an independent auditor's report (refer to chapter 2, example A) on the supplemental information. A paragraph may be added to the auditor's report on the basic financial statements, or a full report may be issued separately.[2] *Supplemental information includes the REAC financial data templates, which essentially include support and detail for specific accounts included in the basic financial statement data and certain other information as required by HUD Handbook 4370.2, chapter 3, and as further described in REAC's *Guidelines on Reporting and Attestation Requirements of Uniform Financial Reporting Standards* (UFRS) located on REAC's Web site. The Web address is

http://www.hud.gov/offices/reac/products/fass/mf_doc.cfm.

Use of the guidelines is mandatory for all engagements covered under UFRS.

The financial data templates are further defined in the appendixes of the *Industry User Guide for Financial Assessment Subsystem – Multifamily Housing* (FASSUB). The Industry User Guide is available at the following Web address:

http://www.hud.gov/offices/reac/products/fass/fassmf_guide.cfm.

*

[1] Or similarly titled report based on the type of participating ownership entity. For example, if a limited liability company owns the property, "statement of changes in members' equity" should be discussed.

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

C. Issue any additional reports described in chapter 2.

3-4. **<u>*Sample Selection.</u>** According to the Government Auditing Standards, published by the Government Accountability Office (GAO), the third fieldwork standard for financial audits states:

> The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

Audit sampling, when properly applied, can provide sufficient appropriate evidence to support the audit opinion.

Audit sampling is defined as the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class. There are two general approaches to audit sampling: nonstatistical and statistical. Both approaches require the auditor to use professional judgment in planning, performing, and evaluating a sample and in relating the audit evidence produced by the sample to other audit evidence when forming a conclusion about the related account balance or class of transactions.

It is important that the sample selected be representative of the population. The size of a sample necessary to provide sufficient audit evidence depends on both the objectives and the efficiency of the sample. Because of the previous inconsistency in the application of the sampling process in auditing HUD programs, OIG convened a panel consisting of representatives from OIG, HUD REAC, AICPA, and several auditing firms with significant HUD experience to discuss the issue and potential solutions. Based on the feedback from that panel, OIG decided and all participants agreed that attribute sampling[3] is the appropriate sampling methodology for use in auditing programs using this chapter to provide consistency and to assure adequate coverage to support the audit opinions rendered.

The attribute sampling method of selecting a sample is to be used anytime in this chapter a statement is made that a sample is to be selected. If the auditor is of the opinion that another sampling method should be used for a particular audit; for example, when the objective is to sample transaction dollar values for purposes of statistically estimating over/understatements (variable sampling methodology), the working papers must contain justification for the methodology used. Appendix A to this chapter provides additional*

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[3] Until such time as OIG decides to extend this approach to other chapters, attribute sampling will only apply to audits performed using chapter 3.

*information on attribute sampling. The sample sizes stated in appendix A are to be the minimum sample sizes to be used regardless of the methodology the auditor uses in lieu of attribute sampling.

3-5. **Compliance Requirements and Audit Areas.** The following sections contain suggested audit procedures that HUD 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.*

A. Federal Financial Reports.

1. **Compliance Requirement.** Projects are required to ensure that financial status reports contain reliable financial data and are presented in accordance with the terms of applicable agreements between the project and HUD. The individual agreements contain the specific reporting requirements that the project must follow. *HUD will usually require monthly reports whenever annual financial reviews, on-site reviews, or other information indicates that the project is experiencing financial or management difficulties or the owner/agent is suspected of noncompliance (HUD Handbook 4370.1, chapter 3). The type of annual statements can vary by program. HUD Handbooks 4370.2 and 4350.1 provide detailed guidance as to which owners must submit financial statements and the types of statements that are required.*

2. **Suggested Audit Procedures.**

   a. Identify all required financial reports by inquiry of the owner/management agent and review of agreements and correspondence with HUD. Request a copy of auditee submissions to HUD during the period under audit.

   b. Obtain an understanding of the owner/management agent's procedures for preparing and reviewing the financial reports.

   c. Select a sample of financial reports, other than those included in the annual financial statements, and determine whether the reports selected are prepared in accordance with HUD instructions.

d. For the sample selected, determine whether significant data reported are accurate. Report all material differences between financial reports and project records.

e. *Determine whether the project complied with HUD's reporting requirements.*

B. Fair Housing and Nondiscrimination.

1. Compliance Requirement. Owners and management agents are prohibited from discriminatory practices in accepting applications, renting units, and designating units or sections of a project for renting to prohibited bases in accordance with the Fair Housing Act and the provisions of the regulatory agreement.

2. Suggested Audit Procedures.

a. Obtain a copy of the project's approved affirmative fair housing marketing plan, if applicable. Review the marketing plan for compliance with appropriate statutes and the regulatory agreement. Section 232 projects will not have an affirmative fair housing marketing plan but have a regulatory obligation not to discriminate.

b. Obtain an understanding of the owner/management agent's policies and procedures relating to marketing of the units; processing, approving, and rejecting applications; and providing reasonable accommodation to applicants and tenants with disabilities in accordance with the requirements of applicable federal civil rights laws *and the Americans with Disabilities Act.*

c. *Obtain a copy of the project's tenant selection plan as required by HUD Handbook 4350.3. Review the plan for compliance with the handbook and perform the following steps:

(1) Determine whether there are indications of any discriminatory practices such as prohibited screening practices based on

i. Race, color, religion, sex, national origin, age, family status, or disability;*

ii. *Segments of population, e.g., welfare recipients, single-parent household;

iii. Income;

iv. Lack of rental history; or

v. Other civil rights and nondiscrimination requirements listed in Handbook 4350.3.

(2) Determine whether the plan is updated every five years.*

d. Determine whether procedures were placed in operation as established by the owner/management agent through inquiry and physical examination of documentary evidence. Documentation can vary based on the procedures established.

e. Review a sample of the correspondence chronology files for the period under audit for correspondence evidencing litigation or potential litigation related to discriminatory rental practices.

f. *During the review of cash disbursements under audit step 3-5.I.1.2.c, look for payments that would evidence actual or potential litigation for any discriminatory rental practices.

g. During the review of tenant files under audit step 3-5.J.1.2.e(16), look for evidence of discriminatory practices.*

h. Determine that the HUD-approved equal housing opportunity logo, slogan, or statement is displayed in marketing materials.

C. <u>Mortgage Status.</u>

1. <u>Compliance Requirement</u>. Owners shall promptly make all payments due under the note and mortgage.

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

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. *Determine whether all related mortgage and escrow payments were made by either*

(1) Obtaining or preparing a schedule of the client's mortgage and escrow payments and withdrawals for the period under audit (the schedule should include the amount, including escrow items, and date each item was paid or disbursed. Determine whether monthly payments were made on time and the loan was current at the end of the fiscal year) or

(2) Confirming the outstanding loan balance and annual escrow account activity with the lender as of the project's fiscal year end (determine whether monthly payments were made on time and the loan was current at the end of the fiscal year).

d. 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.

D. Replacement Reserve.

1. Compliance Requirement. Owners, if required, shall establish a reserve for replacement account and make deposits in accordance with HUD requirements, usually the regulatory agreement *or business agreement*. The reserve for replacement account is usually required to be under the control of the lender. Disbursements from the reserve for replacement fund may be made only after written consent is received from HUD.

Reserve for replacement funds are to be invested in interest-bearing accounts for certain projects. Interest earned on these projects is required to be maintained in the reserve for replacement account. For other projects, HUD strongly encourages owners to invest the reserve for replacement funds. The mortgagee is authorized to invest funds in excess of $100,000 (the Federal Deposit Insurance Corporation (FDIC) federally insured limit) in approved securities and/or financial institutions as long as it follows the requirements in HUD Handbook 4350.1, paragraph 4-22. Interest on those investments is *considered project funds and may not be disbursed directly to owners or directly to any individual associated with the project. All interest must flow through the project accounts and be disclosed in the accounting records.*

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

a. Obtain an understanding of the project owner's deposit and maintenance requirements included in the regulatory agreement,*business agreement* and any amendments or other written agreements with HUD and determine whether there were any changes to the funding requirement by

(1) *Reviewing Form HUD-9250, Reserve Funds for Replacement Authorization, or

(2) Questioning the owner/management agent if any changes were made when rents were increased. Increases will be documented on Form HUD-92458, Rent Schedule Low Rent Housing.*

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

c. Determine whether the reserve fund has been established in a federally insured depository under the control of the mortgagee, if required. *For funds in excess of federally insured limits, determine whether the owner/management agent reviewed the depository quarterly to verify that it met HUD requirements as described in HUD Handbook 4350.1.

d. Using confirmation or the schedule prepared for the mortgage status compliance requirement in 3-5.C.2.c, determine whether all required deposits to the reserve for replacement were made in compliance with HUD requirements and agreements.*

e. Determine whether all disbursements from the reserve for replacement account, identified in the mortgage confirmation or the schedule prepared in 3-5.C.2.c, were properly authorized by HUD.

f. *Select a sample of repairs covered by funds from the reserve for replacement account. Trace the reimbursed amount to cancelled* *invoices and determine whether funds were used for the purpose authorized by HUD.

g. For projects for which HUD requires funds to be invested, determine whether funds were invested and interest was only withdrawn with HUD approval.

h. For projects for which HUD does not require funds to be invested, determine whether funds were invested. Perform the following steps:

(1). If funds were not invested, determine why and consider including a comment in the management letter or other auditor communication.

(2). If funds were invested, determine whether interest was disbursed to the project by the lender and if so, whether the interest was deposited into project accounts and recorded in the project's accounting records.

(3). If funds were invested, determine whether interest was disbursed directly to owners or any individual associated with the project in violation of HUD requirements.*

E. <u>Residual Receipts.</u>

1. <u>Compliance Requirement</u>. *Non-profit owners and owners of limited distribution projects, Section 202 projects, and Section 811 projects* shall establish a residual receipts account and make deposits into the account in accordance with HUD requirements *within 90 days after the close of the fiscal year.* Disbursements from such fund may be made only after written consent is received from HUD.

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

a. Obtain a copy of the project's regulatory agreement and any amendments or other HUD business agreements, to identify the project owner's requirements for making deposits into the residual receipts fund and copies of the surplus cash calculations from the end of the prior audit period and semiannual period, as applicable.

b. Obtain an understanding of the owner/management agent's procedures for determining and depositing residual receipts.

c. *Determine whether the surplus cash calculations were prepared in accordance with the regulatory agreement and other HUD guidance.

d. Determine whether the project deposited all required amounts into the residual receipts account for the period under audit according to the surplus cash calculation(s)*.

e. Using the confirmation or the alternative schedule prepared for the mortgage status compliance requirement in 3-5C2c, determine whether residual receipts were deposited in the residual receipts account within *90* days after the end of the fiscal year or semiannual period, if applicable.

f. *Determine whether disbursements from the residual receipts account, identified on the confirmation or alternative schedule prepared in 3-5.C.2.c, were properly authorized by HUD and used for the purpose intended*.

F. Distributions to Owners.

1. Compliance Requirement. Owners may not make, receive, and/or retain any distribution of assets or any income of any kind of the project except surplus cash and then only under certain conditions. Surplus cash distributions can only be made as of and after the end of a semiannual or annual fiscal period. Surplus cash distributions cannot be made when the owner is in default under any of the terms of the regulatory agreement, the note, or mortgage. *Surplus cash distributions cannot be made out of borrowed funds or if the owner has not complied with all outstanding notices, from HUD or from the mortgagee, for proper maintenance of the project.* The allowable distribution for limited distribution owners is further restricted to a percentage of the owner's initial equity investment as described in the regulatory agreement, business agreement or subsequent HUD-approved agreements *with the balance of surplus cash required to be deposited in a residual receipts account (see steps 3-5.E).*

2. Suggested Audit Procedures.

a. Obtain a copy of the project's regulatory agreement, business agreement and any amendments or associated documents to determine the owner's rights for receiving distributions and surplus cash calculations for the prior fiscal period and semiannual period, if applicable.

b. *Obtain an understanding of the owner/management agent’s procedures for determining surplus cash and making distributions.*

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

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

e. *Determine whether the surplus cash calculations were prepared in accordance with the regulatory or business agreement and other HUD guidance.

f. Determine whether distributions taken during the audit period exceeded the amounts calculated and/or authorized for that period.*

g. Scan cash disbursements for evidence of any payments made to the project owners *or related parties. Scan journal entries for unexplained decreases in accounts payable, notes payable, and related interest to project owners or related parties. Determine whether the owner/management agent paid partnership management fees, asset management fees, incentive management fees, and write-offs of related party receivables from funds other than surplus cash or distributions.

h. Scan the bank statements for any deposit, from the project owners 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 before the audit.

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

G. *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. Appendix B includes areas disclosed in audit reports in which equity skimming was found in the operations of multifamily projects.

2. **Suggested Audit Procedures.** In the various compliance areas in this chapter, we have included audit steps that are designed to disclose equity skimming. The auditor should be aware of the conditions noted in appendix B and modify any of the audit steps based on the policies/procedures of the auditee.

H. 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. The project's owner must verify that depositories where it maintains funds in excess of $100,000 meet certain conditions as outlined in chapter 2 of HUD Handbook 4370.2.

   Most projects will have at least three bank accounts including a regular operating account, a reserve for replacement account (held by the mortgagee, see paragraph 3-5.D for audit steps), and a tenant security deposit account (see paragraph 3-5.L for audit steps). Non-profits and limited distribution projects will also have a residual receipts account (see paragraph 3-5.E for audit steps).

   The regular operating account is a general operating account in the name of the project, which is used for depositing receipts of the project other than those specifically designated for the security deposits account. A centralized account can only be used as provided for in chapter 2 of HUD Handbook 4270.2.*

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

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

   b. Determine whether the project owner's written and actual procedures for receiving and depositing funds in the regular operating account/centralized account are in compliance with the regulatory agreement and chapter 2 of HUD Handbook 4370.2.

   c. Determine whether the account is exclusively in the name of the project except as allowed by HUD Handbook 4370.2 for centralized accounts.

   d. Select a sample of deposits from the cash receipts ledger and perform the following steps:

   (1) Determine whether the deposits were made in a timely manner after receipt of funds and are in the name of the project. Usually tenant cash receipts are deposited daily during the heavy rent collection days during the first part of the month and when certain amounts of funds are accumulated during the rest of the month.

   (2) Test the supporting documentation for each deposit in the sample and determine whether all funds that were received were properly accounted for and included in the deposit.

   (3) Determine that all deposits in the books of account are in agreement with the related bank statements as to amounts and dates.

   (4) Determine whether the deposits were posted to the appropriate general ledger accounts.

   (5) Trace all amounts other than tenant/member rental receipts to any contracts, agreements, or other documentation and determine whether the amount that was received was properly deposited and posted to the appropriate account.

   (6) Select a sample of tenant/member rental receipts and trace the amount from the source documents to the individual* *tenant/member accounts receivable record and their executed leases.

(7) If any amounts are added to the account by way of an institution's memorandum or other type of document, determine the reason for that transaction and whether it was proper.

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 personal, 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.

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

I. *Cash Disbursements.

1. **Compliance Requirement.** All disbursements from the regular operating account must be supported by approved invoices, bills, or other supporting documentation. Project funds should only be used to pay for mortgage payments, required deposits to the reserve for replacement fund, reasonable expenses necessary for the operation and maintenance of the project, distributions of surplus cash as permitted, and repayment of owner advances from surplus cash or as authorized by HUD. Disbursements from a centralized account must clearly be traceable to each project. The actual cash position of each project in this account must be easily identifiable at all times without exception.

2. **Suggested Audit Procedures.**

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

   b. Select a sample of disbursements from the cash disbursement ledger or similar record and perform the following steps:

   (1) For centralized accounts, determine whether the disbursements were recorded in the books of the appropriate project in accordance with HUD Handbook 4370.2. Review cash account balances of each project to ensure that balances are easily identifiable to each project. Also, determine whether any projects have a negative or zero balance, which could indicate an improper loan between projects.

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

(3) *Determine whether the disbursements were made on behalf of other projects or entities since project funds cannot be loaned or used for nonproject purposes. Report instances even if amounts have been repaid.

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

c. Scan the cash disbursements journal for payments that would evidence actual or potential litigation for any discriminatory rental practices.

d. If any amounts are withdrawn from the project account by way of an institution's memorandum or other type of document, determine the reason for that transaction and that it is proper.

e. For accounts with balances in excess of FDIC-insured limits, determine whether the owner or management agent followed the steps outlined in chapter 2 of HUD Handbook 4370.2 to determine the eligibility of the financial institution.

J. Tenant Application, Eligibility, and Recertification.

1. Compliance Requirement. Owners who participate in HUD's rent subsidy programs are responsible for accepting applications, maintaining a waiting list, determining eligibility, calculating the tenant's contribution toward rent and utilities, calculating subsidy, and recertifying the tenant annually in accordance with HUD requirements.

2. Suggested Audit Procedures.

a. Obtain a copy of the housing assistance payments contracts or equivalent subsidy contracts with any amendments to determine the owner's responsibilities in this compliance area.

b. Obtain an understanding of the owner/management agent's procedures for accepting applications, managing the waiting list, determining initial eligibility, determining a tenant's rent and subsidy, and recertifying annually and determine whether they are in compliance with the provisions in HUD Handbook 4350.3.*

c. *Review the results of any field reviews performed covering tenant application, eligibility, and recertification activity. Consider the impact on the audit steps to be preformed. If deficiencies were disclosed, additional testing should be performed on current activity to determine whether the problem has been corrected or corrective action was put in place.

d. Select a sample of applicants that were selected from the waiting list during the fiscal year. The sample should include some tenants that were denied admission. Perform the following steps at a minimum:

(1). Determine whether applicants were selected in the correct order.

(2). Determine whether preferences granted were verified before admitting the applicant as a tenant, if applicable.

(3). Determine whether the waiting list was purged. If so, determine whether it was done in accordance with written procedures.

(4). For denied applicants, determine whether the following documentation was maintained:

i. The reason the applicant was denied admittance in accordance with the tenant selection plan and that the reason was properly supported.

ii. Any indication of discriminatory rental practices or if the applicant threatened or entered litigation because of discriminatory practices.

iii. The rejection letter provided to the applicant advising the applicant of his/her right to appeal.

e. Select a sample of tenant files. The sample should include some recently admitted tenants as well as some tenants who no longer reside at the project. The requirements below are covered in HUD Handbook 4350.3. The auditor should review the Handbook to determine whether requirements have been added or removed to ensure completeness of* *review in this area. Perform a minimum of the following steps, as applicable:

(1) Determine whether all appropriate parties signed the application.

(2) Determine whether household members were correctly identified and the head, cohead, and all tenants age 18 and older signed the applicant's/tenant's consent to the release of information, Form HUD 9887-A.

(3) Determine whether the owner/management agent verified Social Security numbers of all occupants six years of age and older, disability status, waiting list preferences, and income and allowances for adjusted income (refer to Handbook 4350.3, appendix 3, for additional information on acceptable form of verification).

(4) Determine whether the resident rights and responsibilities were acknowledged.

(5) Determine whether citizenship declaration or eligible immigrant status was obtained.

(6) Determine whether all adult tenants were screened for criminal and drug background checks as well as sex offender registration.

(7) Determine whether the correct HUD model lease and addendums were used and correctly signed/executed.

(8) Determine whether the appropriate security deposit and prorated rent were correctly calculated and collected.

(9) Determine whether the appropriate security deposit and prepaid rent were returned within 30 days after move-out.

(10) Determine whether the owner's certification of compliance with HUD's tenant eligibility and rent procedures, Form HUD-50059, was completed correctly.*

(11) *Determine whether move-in and move-out inspection forms were completed.

(12) Determine whether the computation of the tenant's contribution toward rent and utilities and the subsidized portion of the tenant's monthly rent were properly calculated.

(13) Determine whether the initial certification and the last recertification forms were completed correctly and were accurate (Form HUD-50059).

(14) Verify that the Section 8 rents charged and paid did not exceed the contract rents approved by HUD.

(15) Trace the housing assistance payment calculated in the tenant file to the amount charged to HUD in the monthly voucher request.

(16) For those tenants who were evicted, determine whether

i. The basis for the eviction was in accordance with the established rental policy, or

ii. The tenant was evicted for any discriminatory reasons.

(17) Determine whether any evidence is contained in the file indicating that any improper or inaccurate information was discovered while determining tenant eligibility or rent calculation. If so, determine that the owner followed the guidance in HUD Handbook 4350.3 pertaining to overpayment of a subsidy and follow up on suspected fraud.

K. Units Leased to Extremely Low-Income Families.

1. **Compliance Requirement.** For each project assisted under a contract for project-based Section 8 assistance, the owner must lease not fewer than 40 percent of the dwelling units to extremely low-income families (HUD Handbook 4350.3, chapter 3, and chapter 4, paragraph 4-5).

2. **Suggested Audit Procedures.***

a. *Select a sample of Section 8 tenants or use the sample selected in step 3-5.J above if all tenants in that sample receive subsidy. For the sample items selected,

(1) Obtain a copy of the tenant selection plan for a description of the methodology the owner uses in income targeting.

(2) Obtain an understanding of the owner/management agent's procedures for implementing that plan and determine whether the procedures properly implement the tenant selection plan.

b. Determine whether at least 40 percent of the units that became available during the period under review served extremely low-income families.

(1) If the tenant files that were stated in the owner's income target determination were in the sample selected, determine that extremely low-income families occupied those units.

(2) If none of the extremely low-income families were in the sample selected, select a separate sample from the owner's determination documentation and determine whether the units were rented to extremely low-income families.

c. If the 40 percent has not been reached and the owner is renting units to other eligible families, determine whether the owner has documented its marketing efforts to target extremely low-income families.

L. Tenant Security Deposits.

1. Compliance Requirement. Funds collected as a security deposit shall be kept in the name of the project, separate and apart from all other funds of the project in a trust account. The amount of this account shall at all times equal or exceed the aggregate of all outstanding obligations under that account. Funds must not be commingled with funds from any other projects. All disbursements from the security deposit account must be only for refunds to tenants and for payment of expenses incurred by or on behalf of the tenant, not to exceed the amount to which the tenant is entitled. All disbursements must have supporting documentation. In addition, state and local governments may have specific regulations governing the handling of tenant security deposits.*

2. *Suggested Audit Procedures.

a. Obtain an understanding of the project owner's procedures, including state and local laws, and regulatory agreement and HUD requirements (HUD Handbook 4370.2, chapter 2) 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, at the end of the reporting period and throughout the period under review, the amount on deposit is at least equal to the outstanding obligations under the security deposit account.

d. 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.

e. Select a sample of tenants that moved in and tenants that moved out during the period under review and perform the following steps:

(1) Determine whether security deposits were collected at the time of the initial lease and agree with the amount required in the lease agreement and regulations.

(2) Determine whether security deposits collected were deposited promptly in the security deposit account.

(3) Trace tenant balances reported on the balance sheet at the end of the fiscal year as the outstanding obligation to the tenant list of security deposits for the same period and determine if it agrees.

(4) Determine whether refunds and/or an itemized list of claims were provided to tenants within 30 days after move-out or as required by state or local law. *

(5) *Determine whether refunds were disbursed to the former tenant and in the appropriate amount. Determine the disposition of or proposed disposition of the amounts for checks outstanding for more than 60 days.

(6) Identify disbursements from the security deposit bank account statement that do not appear to be tenant refunds to ensure that those disbursements were only made for payment of appropriate expenses incurred by the tenant or on behalf of the tenant.

(7) Determine whether forfeited security deposits applied to rents and damages were appropriately recorded as rental income.*

M. Management Functions.

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

2. Suggested Audit Procedures.

a. Obtain a copy of the most recent HUD-approved management agent's certification (Form HUD-9839-A, B, or C, as appropriate). Perform the following steps:

(1). Determine whether HUD has approved the owner or current management agent.

(2). If the project owner's/management agent's certification, Form HUD-9839-B, was used, determine whether companies that have an identity-of-interest relationship with the owner (item 12) have been reported in the notes to the financial statements.

(3). Obtain a copy of the management entity profile, Form HUD-9832, to identify additional identity-of-interest companies *(items 11a and b) that were not included in the management* *agent certification for inclusion in the notes to the financial statements.*

(4). Review maintenance contracts and major contracts and vendor invoices to determine whether there are additional identity-of-interest relationships with the owner/agent that need to be reported to HUD and in the notes to the financial statements.

(5). 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.

(6). *For payments made to identity-of-interest companies, determine whether the amounts paid exceed the amounts ordinarily paid for such services and supplies. The amounts ordinarily paid can be determined by comparing costs to similar disbursements noted during the cash disbursement analysis or from the auditors' knowledge of amounts generally paid for services and supplies in the same geographic area, gained through their audits of other area clients.*

b. Determine whether the owner or the management agent has obtained a fidelity bond in accordance with chapter 2.14 of HUD Handbook 4381.5.

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

d. Determine whether liability coverage is sufficient as determined by chapter 21 of HUD Handbook 4350.1.

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

f. *On a sample basis, test work orders and tenant complaints for timely follow up and compliance with management's procedures. Handbook 4381.5 states that whenever possible, owners/agents should take* *immediate action to address problems or concerns registered by the resident.

g. Determine whether the project is maintained in good repair and condition. If the units are subsidized, determine whether management's procedures ensure that units meet applicable housing quality standards.

h. Inquire whether HUD, a contract administrator, or the lender has conducted routine unit and general property inspections. If findings were identified, determine whether corrective action was taken.

i. Question management and scan revenue accounts for any fees charged to the project or residents for additional services. Conduct followup or corroboration of management's responses as considered necessary to ensure that fees charged agree with the management agent certification or have been approved by HUD.*

N. Unauthorized Change of Ownership/Acquisition of Liabilities.

1. Compliance Requirements. Owners shall not, without the prior written consent of HUD, 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[4] in the property. Review any agreements. Determine whether HUD has approved transactions or is in the process of approving transactions and report any instances of noncompliance.

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

c. *Report any other instances of unauthorized conveyance, assignment, transfer, disposal, or encumbrance of any of the mortgaged property or*

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

assets of or beneficial interest in the property identified during the course of the audit.

O. Unauthorized Loans of Project Funds.

1. **Compliance Requirements.** Owners shall not, without the prior written consent of HUD, 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.*

P. *Excess Income.

1. **Compliance Requirements.** Owners of properties with mortgages insured under Section 236 of the National Housing Act must submit excess income within 10 days of the end of the month in which it was collected.

2. **Suggested Audit Procedures.**

   a. Obtain copies of the monthly report of excess income, Form HUD-93094, for the period under review and any approval letters from HUD regarding retention of excess income.

   b. *Select a sample of the reports and determine whether the reports were prepared in accordance with HUD instructions.*

c. *For the sample items selected, determine whether the client remitted the full amount collected to HUD in accordance with HUD instructions and in a timely manner.

d. If excess income was not remitted to HUD, determine whether funds were retained in accordance with HUD approval and funds were used for the intended purpose.

Q. Leased Nursing Homes.

1. Compliance Requirements. Owners may enter into lease agreements to operate the facility, in which case the operator will be required to execute a regulatory agreement (HUD 92466-NHL) with HUD before the note is endorsed for insurance. The regulatory agreement requires lease payments to be sufficient to pay all mortgage payments including payments to reserves for taxes, insurance, etc., and payments to the reserve for replacements. If at the end of any fiscal year, payments under the lease have not been sufficient to pay for the above items, the owner and operator/lessee, upon request in writing from HUD, shall renegotiate the amounts due under the lease so that the lease payments shall be sufficient to pay for such items. In addition, the operator/lessee shall provide HUD, within 30 days of request, a financial report, in a form satisfactory to HUD, covering the operations of the mortgaged property and of the project.

The regulatory agreement also requires the operator/lessee to not sublease the project and maintain it in good repair. The owner's regulatory agreement requires the owner to make mortgage payments and reserve deposits. These responsibilities cannot be assigned.

2. Suggested Audit Procedures.

a. Obtain a copy of the lease agreement, as may be amended, to operate the facility, if applicable, and the executed regulatory agreements (there will be one for the owner and one for the operator/lessee).

b. Determine whether the owner received lease payments in a timely manner.

c. Determine whether the total lease payments were adequate to cover the debt service (including tax and insurance escrows) and reserve for replacement deposits.*

d. *Obtain maintenance logs, inspection reports, and other data to determine that the lessee has properly maintained the project. On a sample basis, review that documentation to determine whether the lessee made repairs to the project to properly maintain the property in accordance with housing quality standards. Visual inspection of the common areas and grounds should be made.

e. Determine whether major changes have been made to the project without HUD approval.

f. Determine whether the owner or operator/lessee complied with nondiscrimination, equal opportunity, or other requirements of state or local law or of HUD/FHA.

g. Examine the terms of the lease to determine whether responsibility for making mortgage payments and reserve deposits has been assigned/delegated to the lessee. Verify that payments were made by the owner.

3-6. Mark-to-Market Program (M2M).

In 1997, Congress established the Mark-to-Market Program (M2M) to help preserve the availability and affordability of low-income rental housing while reducing the cost to the federal government of rental assistance provided to low-income households using project-based Section 8 funds. Under this program, HUD resets the rents to the prevailing market level and restructures the property's mortgage debt, if needed, to permit a positive cash flow. The operations of M2M projects are to be audited using the steps in section 3-5 in addition to the following audit procedures. The auditor must obtain the business agreement and conform the requirements in that agreement to the audit steps in this section. Changes, as found necessary, should be made to the audit steps since these steps were established based on the M2M procedures stated in the M2M Program Operating Procedure Guide which may be different from those set forth in the Business Agreement.

A. Capital Recovery Payments for M2M Projects.

1. Compliance Requirements. In most M2M transactions, owners are required to invest new money either out-of-pocket or through borrowing. These funds cannot be provided through a loan secured by the project assets. In return, the owner receives capital recovery payments. These payments provide a market* *rate of return to owners on the new money invested and may only be collected when certain conditions are met. This requirement is not applicable to cooperatives.

2. **Suggested Audit Procedures.**

   a. Obtain a copy of the restructuring commitment and other restructuring documents to determine whether the owner invested new funds as required, including any new funds for reserves, repairs, transaction costs, or similar property costs.

   b. Obtain a copy of the source documents identifying the interest rate and payments period for the capital recovery payments. Obtain or prepare an amortization schedule of the payments showing the amount advanced for the restructuring, interest rate, and payment period. Determine whether the capital recovery payment is being paid as authorized over the applicable period of 7-10 years.

   c. Determine whether the terms and conditions of the capital recovery payments listed below were met on a monthly basis.

      (1). All expenses are paid, and there are no material accrued payables.

      (2). The first mortgage is current.

      (3). The property is in acceptable physical condition (the most recent REAC score is at least 60 or the multifamily HUB or program center has accepted the owner's proposal for curing a less favorable score).

      (4). There are no unresolved HUD audit or management findings, including any finding that the owner is not in compliance with the rehabilitation escrow deposit agreement.

      (5). The project's most recently issued audited financial statements reflected positive surplus cash, and any payables shown as due on the surplus cash schedule have been paid.*

(6). *If funds are not available, payment will accrue until surplus cash becomes available. Interest is paid on the accrued amount.*

B. *Incentive Performance Fee for M2M Projects.

1. **Compliance Requirements.** The incentive performance fee is provided to recognize owner equity and as an incentive for demonstrating operating efficiencies. This fee is a percentage, generally 3 percent, of annual effective gross income with a floor of $100 and a ceiling of $200 per unit per year. The owner can collect this payment annually if certain conditions are met. The percentage can be increased or decreased by the participating administrative entity to establish a fee within the maximum and minimum limitations.

2. **Suggested Audit Procedures.**

   a. Obtain a copy of the restructuring commitment and other restructuring documents and determine the incentive performance fee percentage.

   b. Determine whether the terms and conditions of payment listed below were met for the annual period during which the owner collected the incentive performance fee.

   (1). All expenses are paid, and there are no material accrued payables.

   (2). The first mortgage is current.

   (3). The property is in acceptable physical condition (the most recent REAC score is at least 60 or the multifamily HUB or program center has accepted the owner's proposal for curing a less favorable score).

   (4). There are no unresolved HUD audit or management findings, including any finding that the owner is not in compliance with the rehabilitation escrow deposit agreement.

   (5). Only funds available after payment of the expenses, debt service on any first mortgage, and any capital recovery* *payment were used. If funds are not available, payment cannot accrue.

C. <u>Distribution of Surplus Cash for M2M Projects.</u>

1. **<u>Compliance Requirements.</u>** After payment of all operating expenses, debt service on any first mortgage, any capital recovery payment, and the incentive performance fee, the owner will receive up to 25 percent of the remaining surplus cash annually. The remainder of surplus cash will be paid toward the M2M second (or third) mortgage. Since requirements in the Business Agreements my vary from the procedures contained in the M2M Program Operating Procedure Guide which were used to establish the audit steps listed below, the auditor must obtain a copy of the Business Agreement and compare it to the audit guide steps and make the changes deemed appropriate,

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

   a. Obtain a copy of the restructuring commitment and other restructuring documents and determine the requirements and/or restrictions that exist for the capital recovery payment, the incentive performance fee, and the M2M (surplus cash) note payment and distributions

   b. Review the prior-year surplus cash computation and note that the owner distribution does not exceed 25 percent of the surplus cash available for distribution or the percentage determined by Office of Affordable Housing Preservation.

   c. Determine that the M2M (surplus cash) note payment and distributions were paid after all required payments were made and that the capital recovery payment and incentive performance fee were properly made as determined in audit steps 3-6.A and 3-6.B.

D. <u>Special Rules for Cooperatives.</u>

1. **<u>Compliance Requirements</u>.** For cooperatives, additional requirements are included in the audit procedures listed below. The compliance requirements in 3-6.B and 3-6.C also apply to cooperatives. Capital recovery payments listed in 3-6.A do not apply.

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

a. *Obtain a copy of the restructuring commitment and other restructuring documents and note the additional operating reserve requirement.

b. Determine whether the cooperative is in compliance with the annual escrow deposit of 3 percent of annual operating expenses plus principal and interest and mortgage insurance premium.

c. Determine whether the surplus cash and the incentive performance fee of the cooperative were deposited in a separate residual receipts account.

d. Determine whether withdrawals from the residual receipts account for the period under audit were approved by the multifamily HUB or program center director and were used for the purpose requested.

3-7. Section 236 Decoupling Projects.

1. Compliance Requirements. As a condition for receiving continued interest reduction payments (IRP) under section 236(e)(2) and section 236(b), the owner agrees to operate the project in accordance with all low-income affordability restrictions for the period identified by the use agreement.

2. Suggested Audit Procedures.

a. Obtain a copy of the applicable IRP agreement, any use agreements, and Housing Notice 00-8, *Guidelines for Continuation of Interest Reduction Payments after Refinancing*, and related notices for reinstatement and extension.

b. On a sample basis, review tenant files and ensure that the owner is in compliance with the low-income affordability restrictions for the period covered by the IRP and use agreements.

3-8. Audit Finding Reporting.

All instances of conditions contained in Appendix B, material noncompliance with any HUD requirement or regulations which result in material questioned or disallowed cost and/or, deficiencies in internal control, instances of fraud or illegal acts, or contract violations that were disclosed during the audit process must be reported as findings in the* *audit report. All nonmaterial instances of noncompliance disclosed during the audit process must be reported separately to management. Such reporting must be in writing in a management letter or other type of written communication, and form and date of written communication must be mentioned in the independent auditor's report. Noncompliance, deficiencies, or violations that were corrected before the issuance of the audit report must be included in the report as resolved findings or in a management letter or other written communication depending on their materiality.

A. Content of Finding.

Findings are to be presented in accordance with the standards and requirements of GAGAS. Refer to chapter 2 for further information on the information that is to be included in a finding.

B. Corrective Action Not Started or in Process.

When the project's management has not started to correct the findings or is in the process of correcting a finding at the time of report issuance, the auditee can include a description of the action completed and the action remaining to be taken in the auditee's response to the finding, stated in the auditee's comment section of the finding and in the corrective action plan.

C. Corrective Action Completed.

When the project's management has corrected a finding, the action taken should be included in the auditee's response to the finding, stated in the auditee's comment section of the finding and in the corrective action plan, and should be validated by the auditor. The auditor's recommendation in the finding should state the results of the auditor's validation testing. In addition, the auditor could include any additional recommendations that he/she believes are necessary based on the auditor's validation of that action.

D. Reporting When Using the Group Project-Based Sample Method.

When a condition or weakness is found in one of the projects in the sample, during the audit testing, that is required to be reported in a finding, it must be reported in the audit report for each project in the population from which the sample was drawn. Reference should be made to each report that contains that type finding. If dollars are involved, only the dollars belonging to that specific project should be included in that project's audit finding. For example, the following illustrates wording that can be used: "This internal control problem applies to and is reported in 15 audit reports, 5 for projects* *owned by companies related to the X Housing Cooperation and 10 projects owned by two unrelated owners. The total disallowed cost is $450,000, of which $100,000 applies to this project, and $200,000 applies to the other 4 projects owned by companies related to the X Housing Cooperation and $150,000 applies to the 10 projects owned by the two unrelated owners."

If the condition is only to be reported in the management letter or other written communication, it must be communicated similarly in all projects of the population from which the sample was drawn.

3-9. Technical Assistance Needed.

The Office of Asset Management is responsible for answering programmatic questions for the programs being audited using the procedures outlined in this chapter. Programmatic questions on audits performed using this chapter should be referred to that office, (202) 402-3730.

REAC is responsible for the Financial Assessment Subsystem (FASS). Questions regarding that system are to be referred to REAC's technical assistance center, (888) 245-4860.*

*Appendix A

Attribute Sampling

When planning to test a particular sample of transactions, the auditor should consider the specific audit objective to be achieved and should determine whether the audit procedure, or combination of procedures, to be applied will achieve that objective. The size of a sample necessary to provide sufficient evidential matter depends on both the objectives and the efficiency of the sample. As noted in section 3-8 of this chapter, all material instances of noncompliance, including those identified through sampling, must be reported as findings in the audit report.

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

Before beginning testing, the auditor must understand and document what attribute and/or assertions are being tested. The auditor needs to identify and document the appropriate population and should also perform procedures (e.g., reconciliations, inquiry) to ensure that the population from which the samples are 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 (i.e., reconciliations, loan files, cash disbursements, cash receipts, etc.).

When selecting the sample of individual items, auditors must ensure that the sample is representative of the universe for the compliance requirement being tested.

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

Determining the Sample Size.*

*To determine attribute testing sample sizes, the auditor needs to determine the value for three inputs: desired confidence level, tolerable exception rate, and expected exception rate.

Desired Confidence. Auditors should obtain a high degree of assurance by using a confidence level of 90, 95, or 99 percent.

Tolerable Exception Rate. A 5-10 percent exception rate is acceptable.

Expected Exception Rate. No exceptions should be accepted.

Materiality. Using attribute testing, monetary materiality or tolerable misstatement is not a necessary input for determining sample size.

Sample Size Table. Using the preferences above and an attribute sampling software program, if a high level of assurance is defined as 90 percent confidence and tolerable exception rate is 5 or 10 percent with an expectation of zero exceptions, the sample size is 48 or 23 (respectively for 5 and 10 percent exception rates), which is rounded to 50 and 25 below. Similarly, using 95 percent confidence, zero exceptions, and a 5 or 10 percent tolerable exception rate, the sample size is 64 or 32, which is rounded to 65 and 35 below.

Compliance sample size table

Importance/significance of the attribute being tested	Confidence level	Tolerable rate	Minimum sample size for populations over 200
Low	90%	5%	50
Low	90%	10%	25
High	95%	5%	65
High	95%	10%	35

This table is illustrative but 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. Such qualitative factors may include but are not limited to

- **(1).** First year the auditor audited an entity.
- **(2).** Larger, decentralized entities.
- **(3).** High number of findings in the past.
- **(4).** Significant deficiencies or material weaknesses in the past.*

(5). *Poor internal controls.
(6). Extremely high volume of activity in a particular compliance requirement.
(7). High project employee turnover in a particular area or department.

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

Each compliance test performed should be evaluated separately for purposes of determining sample size. Judgment should be used to determine what tests are considered low risk and which are considered high risk. When making the determination of high or low risk, it will be important to understand the population.

Populations of 200 or Fewer Items.

When performing compliance testing of populations of fewer than 200 items, the following guidance is provided. Generally examine at least

(1). 20 items when the population being tested contains between 100 and 199 items,
(2). 10 items when the population being tested contains between 50 and 99 items,
(3). Five items when the population being tested contains between 20 and 49 items, and
(4). Fewer than five items for smaller populations

As noted above, these are suggested minimum sample sizes, and there may be quantitative factors used to determine the sample size to be used.

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, then the auditor has achieved a high degree of confidence that the attribute/assertion is 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 material compliance findings, significant deficiencies, or material weaknesses in internal control. It is not necessary to expand testing when exceptions are found. All exceptions must be reported. Refer to paragraph 3-8 for reporting requirements using this audit guide.

In cases in which an exception is found, the auditor must determine whether the individual exception is material enough to be included in the report. If it is determined that an exception* *is not material enough to be reported as a finding, the auditor may want to apply additional procedures to evaluate the magnitude of the exception.

The auditor should 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.

Work Paper Documentation Needed.

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

Technical Assistance Available.

Technical guidance on audit sampling is available in the following documents:

SAS No. 39. *Audit Sampling* (AICPA)
SAS No 111. Amendment to **SAS No. 39**, Audit Sampling (AICPA, *Professional Standards,* vol. 1, AU sec. 350), as amended
AICPA Audit Guide. *Audit Sampling,* New Edition as of April 1, 2001
AICPA Audit Guide. *Government Auditing Standards*
SAS No. 74. *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards, vol. 1, AU sec. 801)**

*__Appendix B__

Information on Equity Skimming

This appendix discusses conditions that were found in audits of multifamily programs that are categorized as equity skimming. This information is included to help establish an understanding of equity skimming conditions.

Equity skimming is considered to be a fraud, which can be prosecuted through either criminal or civil statutes. When the auditor suspects equity skimming exists, the auditor must contact OIG's National Single Audit Coordinator, at 215-430-6733, to discuss the auditor's findings and the method used to report them.

Review of Cash Disbursements and Expense Accounts. A review of cash disbursements and/or expense accounts of projects revealed use of project funds to pay for

(a). Maintenance, administrative, or other expenses of the owner, other programs, or other projects.

(b). Debts of the owners or management agent.

(c). Loans to owners, principals, or affiliate companies.

(d). Mortgages and related expenses not related to the project.

(e). Personal expenses, such as food, clothing, entertainment of wife and friends, private car expenses, etc., on a project credit card.

(f). Individual partner tax preparation or counseling fees (the preparation of the project tax return may be paid from operations).

(g). Legal fees for handling disputes among partners.

(h). Expenses related to arranging the sale of the project or part of the project.

(i). Splitting of fees with the management agent or others who provide services to the project. This can be an illegal kickback whereby a company agrees to refund a portion of its fees to an owner in return for awarding the management or services contract to the company.*

(j). *Theft of funds in which owners or management agents may write checks to themselves or relatives and not try to hide the fact that they have taken the funds.

(k). Expenses to identity-of-interest companies when

(1). The identity-of-interest company is a conduit for the purchase of materials and supplies and adds on an excessive percentage markup beyond what it needs to cover its own costs.

(2). The identity-of-interest company is paid for labor and materials to repair the project but is using on-site maintenance staff and/or materials to do the work.

(3). The identity-of-interest company is leasing equipment to the project at rates significantly in excess of those charged on the open market.

(4). No work was ever done. The identity-of-interest company may not actually exist, and the bank account may be used to launder funds.

(5). The cost for property and liability insurance for the project is in excess of prices charged on the open market or for coverage that is inadequate to protect HUD's interests.

(6). The identity-of-interest company provides insurance for the property under a blanket policy covering several HUD and non-HUD properties. The owner or management agent may be prorating an excessive amount to the HUD properties and using the excess reimbursement to offset insurance costs for its non-HUD projects or as a means to divert project funds.

<u>Review of Project Income.</u>

A review of cash receipts and/or revenue accounts of projects revealed that

(a). Rental units were used for owner activities without HUD approval and no rent was collected for the unit.

(b). Income from contracted services such as laundry services, cell tower leases, and cable fees to tenants was retained by the owner.

(c). Units were recorded as vacant but were actually rented. The rent received was split between the owner and the management agent.*