



U. S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

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February 15, 2005

Owner  
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***Subject: Mark to Market (M2M) Full Restructure Financial Reporting and Compliance***

*Dear (Owner/Agent) and/or Owner's CPA:*

On October 1, 2004 HUD created the Office of Affordable Housing Preservation (OAHP) as the successor to OMHAR in the administration of the Mark to Market (M2M) program, including oversight of the portfolio of HUD-held Mortgage Restructuring Notes ("MRNs") and Contingent Repayment Notes ("CRNs"), and the portfolio of similar notes from the Portfolio Reengineering Demonstration Program ("Demo Notes"). In this capacity OAHP routinely reviews post-M2M property operations and financial reporting to ensure accurate calculation of surplus cash and resulting payments on the MRNs, CRNs, and Demo Notes.

We address below some unique accounting issues associated with this portfolio. A letter covering important and substantially different topics in post-M2M accounting was sent last year. Based on feedback, and a significantly lower incidence of M2M accounting errors in the 2003 financials, the Q&A proved timely and useful to owners and accountants as they prepared Annual Financial Statements (the letter is available on OAHP's website at: <http://www.hud.gov/offices/hsg/omhar/owners/postm2m.doc>); we trust that the following will be equally valuable. [Most of the issues addressed here are not applicable to projects restructured under the Portfolio Reengineering Demonstration Program; please send Demo-specific questions to [resourcedesk@oahp.net](mailto:resourcedesk@oahp.net).]

***1. Q: If earned, when can I take distribution of CRP and IPF payments, and must I wait for permission from HUD to do so?***

CRP is made in monthly payments from property funds to the owner as earned, assuming all preconditions are met, including that "all Project expenses are paid." IPF is payable to the owner at the end of the accounting year, assuming all preconditions have been met. None of these payments require explicit permission in advance from HUD. However, by submitting an AFS reflecting that IPF was earned, or that CRPs were paid, the owner is certifying that those preconditions were met. (See also the 2004 Q&A for clarification of CRP and IPF preconditions and calculation.) Improper CRP/IPF payments are violations of the Regulatory Agreement (Rider) and can result in enforcement remedies including acceleration of the MRN/CRN. Additionally, improper payment may result in the issuance by HUD of an audit or management finding that, until resolved, would prohibit payment of future CRP and IPF.

If a financial review by HUD concludes that CRP and/or IPF were paid when preconditions had *not* been met, any improperly distributed amounts will have to be repaid to the project accounts, which will increase the Surplus Cash and resulting payments due on the Mortgage Restructuring Note. The owner will be invoiced for any amounts due on the Note that result from such a review and recalculation, and these amounts become due and payable when invoiced. An adjusted computation of Surplus Cash must be included in the following year's AFS (do not re-file the AFS for the year in question).

**2. Q: My M2M Restructuring and post-M2M Section 8 contract call for annual OCAF adjustments to rents, as well as Reserve for Replacements deposits. How do these occur? How do I account for them?**  
 Post-M2M rents are expected to increase, and are limited in increase, by the OCAF. Adjustments will be processed as provided in the HAP contract and the Section 8 Renewal Guide; the annual adjustment process must be initiated by the property owner. The Renewal Guide also requires an annual OCAF adjustment to the Reserve for Replacement (R4R) deposits (except in the few cases where the sole source of the R4R deposits is the reuse of fixed-stream Section 236 IRP funds). This adjustment will be reflected annually on form 9250, provided to the owner by the Multifamily Project Manager.

**3. Q: How should owners manage withdrawals from the Reserve for Replacements, so as not to adversely impact Surplus Cash in a post-M2M project?**

Generally, properties will achieve Surplus Cash over time when they are operating with positive cash flow, but there are timing issues that can affect Surplus Cash, especially in the year following the M2M closing. Owners wishing to take the benefit of the IPF and CRP should consider, for example, that restricted escrows (such as the Reserve for Replacements and the Rehabilitation Escrow) are *not* included in available cash for calculating Surplus Cash, therefore:

- Reserve for Replacement withdrawals must be **approved** by HUD or its authorized agent **before** the end of the fiscal period or the effect will be to diminish Surplus Cash;
- Rehabilitation expenditures that are covered by the Rehabilitation Escrow must have been reimbursed **before** the end of the fiscal year to have a neutral effect on Surplus Cash;
- If insured loss reimbursements can be managed to achieve reimbursement before the end of the fiscal period, this will also neutralize the otherwise negative effect on Surplus Cash;

As a result, while owners should not change their physical management and operation of the property in consideration of these issues, they may find it advisable to manage the submissions for reimbursement to reasonably assure that there are not large reimbursements in process at the end of the fiscal period.

**4. Q: After closing the M2M restructure I sold the subject project via a Transfer of Physical Assets (TPA). Am I required to file a partial year AFS for the year in which the TPA was completed? Can I collect a partial year CRP and IPF? Am I required to include a Surplus Cash Schedule in the partial year AFS, and am I obligated to make an MRN payment if there is Surplus Cash?**

Yes, you are required to file a partial year AFS because all closed Full M2M projects are subject to a M2M Regulatory Agreement. The seller's obligation to file a partial year AFS is also referenced in the TPA Application (HUD-92266). The seller's partial year AFS should cover the period from the beginning of the fiscal year to the day before the property transfer closes. Note that the TPA purchaser is also required to submit a partial year AFS to cover from the date the property transfer closes until the end of the purchaser's fiscal year end. The CRP and IPF, if earned, are prorated for the portion of the year reported; a Calculation of Surplus Cash must be completed as of the date of sale, and a payment to the MRN must be made per the terms of the Note if Surplus Cash was available as of the date of TPA.

**5. Q. In the year of the M2M closing, how do I account for the prorated portions of the year pre- and post-M2M, and how do I calculate Surplus Cash for the partial year?**

In the full year *after* a M2M closing, the old rules regarding distributions and accrued distributions no longer apply. The old regulatory agreement is set aside, and the owner must follow the rules in the M2M documents. In the year of M2M closing, however, the owner is subject to both the original regulatory requirements *and* the new M2M requirements. The owner has two accounting options available during the year of closing:

1. The owner may choose to follow the new M2M requirements for the entire year. If this option is chosen, surplus cash would be computed at the end of the year and any surplus cash would be distributed in accordance with the M2M documents. Please note, the Incentive Performance Fee must be prorated; The owner would only be entitled to a fee based on gross collections beginning

from the date of the M2M closing through the end of the fiscal year.

2. The owner may choose to perform a special computation of surplus cash as of the date of M2M closing. This special computation of surplus cash would allow the owner to take any distributions they may be entitled to under the old regulatory agreement. The special computation would be in addition to the year-end computation of surplus cash. Both computations must be a part of the audited financial statements, and must be reported to HUD via the Real Estate Assessment Center's FASS system. The owner would report the special computation using the FASS account numbers S1400-010 through S1400-250, the account numbers normally associated with a semiannual computation of surplus cash. If the special computation indicates that the owner is entitled to a distribution, then the amount available for distribution should be counted as a current obligation on the year-end computation of surplus cash. This will prevent the funds from being subject to the MRN payment calculation. The owner may distribute these funds any time during the next fiscal year.

**Exception:** If the M2M closing occurs during the last half of the fiscal year, the owner may be entitled to a mid-year distribution under the existing regulatory agreement. In these instances, the audited financial statements would contain 3 computations of surplus cash (the semiannual computation, the special M2M closing computation, and the yearend computation). The owner would use the semiannual surplus cash FASS account numbers to report the semiannual computation. The special M2M closing computation would have to be submitted as part of the notes to financial statements.

**6. Q. How are accrued interest and unpaid principal balance of the M2M Mortgage Restructuring Notes and Contingent Repayment Notes reflected in the AFS?**

Any MRN / CRN principal balance that is to be paid from current Surplus Cash should be shown as a short term obligation in the AFS (FASS account 2172 Other Mortgages Payable Short Term). The long term portion of the unpaid principal balance of MRN / CRN should be reflected in the AFS (FASS account 2232). The accrued interest on the MRN / CRN should be shown in FASS account 2132 – Accrued Interest Payable – Other mortgages.

**7. Q: How should Capital Recovery Payments (CRPs) be reflected in the AFS?**

In the AFS, the owner's investment (on which the CRPs provide a return) is treated as a loan, with the interest rate and term determined in the M2M underwriting. Each monthly payment is treated as having principal and interest portions. CRP payments during a fiscal year are reported on the Statement of Cash Flows in FASS accounts S1200-417 (principal portion) and S1200-195 (interest portion). At the end of a fiscal year, the loan will have a remaining principal balance (some of which is to be paid within twelve months and is reflected as a current liability reflected in FASS account 2179, with the balance being a long term liability reflected in FASS account 2329). If any payments have become due but have not been paid as of fiscal year end, there will also be accrued interest payable, which should be shown in FASS account 2139 – Accrued Interest Payable – Capital Recovery Payment (M2M). CRP payments that are due but that have not been paid may be included as obligations on the computation of surplus cash only if, as of fiscal year end, the preconditions for payment had been satisfied.

Accountants are asked to make use of footnotes regarding CRPs, including the M2M closing date, the original amount of the owner's investment, the interest rate, the number of payments, and the payment amount. The footnote should also note the number of payments that have come due, the number of payments that were made during the fiscal year, and the total number of payments that have been made (from the M2M closing through the end of the fiscal year).

**8. Q. How, where, and when do I send payments for my M2M Note (MRN – Mortgage Restructuring Note, or CRN – Contingent Repayment Note)?**

MRN or CRN payments are due within 10 days of the AFS due date. The mailing address is included in

each MRN and CRN; Payments should be **payable to FHA**, and sent to the Chicago payment lockbox at :

Multifamily Payment Service Center  
PO Box 70764  
Chicago, IL 60673

All payments should clearly identify the property name and FHA number, and the nature of the payment (P&I payment for which accounting year, R4R deposit, etc).

**9. Q: I have received correspondence from HUD contractors on post-M2M issues. Has HUD engaged contractors to assist in the review and analysis of AFS and M2M Notes payments?**

Yes. Representatives from HUD contractors may directly contact a property owner only when expressly directed to do so by HUD. RER Solutions, Inc. (and its subcontractor Value Recovery Group), have been retained as OAHP's portfolio management advisor, responsible for financial review and analysis of projects to ensure appropriate calculation of Surplus Cash and subsequent MRN and CRN payments.

DP Services, Inc. has been retained as the notes servicer and cash manager for the M2M Notes portfolio, responsible for monthly statements, billings and collections, and collection and management of escrows when HUD's note is in first lien position. If HUD's analysis of submitted financials results in recalculated Surplus Cash and MRN/CRN payments, supplemental billings for amounts due will be from DP Services, Inc., or directly from HUD.

**10. Q. If there is additional information regarding explanations or calculations of accounts, can those be included in the footnotes, and will those be accessible to HUD and OAHP?**

HUD and its contractors find supplemental footnote information in the annual financial statement filings very valuable in understanding underlying calculations and accounting treatment of M2M items. Accountants are strongly encouraged to make use of footnotes in the AFS for all projects. For projects closed prior to 2000 in the Portfolio Reengineering Program Demonstration program, explanations of the calculation of "Net Cash" are very helpful in reconciling Notes payments.

The M2M Regulatory Agreement and Notes cause very few changes to property accounting, however it is important to understand how to implement and account for the post-M2M financial structure; This guidance is offered as a resource in that regard. For more information on the M2M process, visit the OAHP website at <http://www.hud.gov/offices/hsg/omhar/>. For questions regarding financial statement filing via the FASS system, contact the REAC Technical Assistance Center (TAC) at 800-245-4860 or <http://www.hud.gov/offices/react/support/tac.cfm>

Sincerely,

Charles H. Williams  
Deputy Assistant Secretary  
Office of Affordable Housing Preservation