

Mixed-Finance and Joint Venture Accounting

One of the more complex reporting issues that many PHAs will encounter when converting from HUD's regulatory basis of accounting to GAAP, involves transactions where a combination of public and private funds are used to develop public housing units. Upon completion, the units are often owned by an entity other than the participating PHA.

Further complicating matters, HUD regulations permit a wide range of ownership and transaction structures to accommodate this type of activity. Accordingly, this issue of the REAC's *PHA GAAP Flyer* will provide PHAs and their advisors with guidance on the GAAP reporting requirements for mixed-financed, joint ventures and similar type transactions.

After a discussion on the general reporting requirements, a case study is presented to help illustrate the proper application of GAAP for a sample mixed-finance transaction. However, due to the uniqueness of each arrangement, the REAC recommends that PHAs consult with their auditors/professional advisors to determine the proper accounting treatment for their particular transactions.

MIXED-FINANCE TRANSACTIONS

Regulatory Authority

On May 2, 1996, HUD published in the Federal Register (Volume 61, Number 86 as amended at Volume 61 Number 141, July 22, 1996) regulations which effectively authorize PHAs to use a combination of private financing and public

housing development/modernization funds to develop public housing units (24 CFR Part 941, Subpart F). HUD uses the term "mixed-finance" to describe this type of development method.

Under the provisions of Subpart F, ownership scenarios can range from the PHA or its development partner(s) holding no ownership interest, a partial ownership interest, or 100 percent of the ownership interest in the units being developed. Furthermore, the regulations allow PHAs to enter into a partnership or other contractual arrangements with a third-party entity for the purpose of developing and/or owning public housing units.

Exhibit 1 lists the various types of legal entities that might participate in mixed-finance public housing transactions.

In addition to qualifying as a mixed-finance transaction under Subpart F, the contractual arrangement between the PHA and its partner(s), and the resultant ownership entity, in some instances, may constitute a joint venture under GAAP.



"Due to the uniqueness of each arrangement, the REAC recommends that PHAs consult with their auditors/professional advisors to determine the proper accounting treatment for their particular mixed-finance transactions."

Exhibit 1: Potential Participants

- Individual
- Partnership
- Limited Partnership
- Corporation
- Limited Liability Company

Joint Ventures

According to GASBS-14, a joint venture is defined as:

“A legal entity or other organization that results from a contractual arrangement and that is owned, operated, or governed by two or more participants as a separate and specific activity subject to joint control in which the participants retain (a) an **ongoing financial interest** or (b) an **ongoing financial responsibility**.”

Under GASBS-14, joint control means that no single participant has the ability to unilaterally control the financial or operating policies of the joint venture. In instances where the organization is jointly controlled but the participants do not have an ongoing financial interest or ongoing financial responsibility, the organization is accounted for as a *jointly governed organization* - rather than a joint venture (see discussion on page 8).

GASBS-14 indicates that an ongoing financial interest in an organization includes an **equity interest** and any other arrangement that causes a participating PHA to have access to the joint venture’s resources. A PHA has an ongoing financial responsibility for a joint venture if it is obligated in some manner for the debts of the joint venture, or if the joint venture’s continued existence depends on continued funding by the PHA.

A joint venture is only one of several potential reporting scenarios for mixed-finance transactions. As will be further illustrated, the type of ownership entity and contractual arrangement between the PHA and its partner(s) will significantly influence how a PHA accounts for mixed-finance transactions. In the following section we will discuss potential reporting scenarios for mixed-finance transactions under GAAP.

THE FINANCIAL REPORTING ENTITY

One of the challenges facing a PHA when preparing financial statements in accordance with GAAP relates to determining what entities should be included in the organization’s financial statements. Unlike commercial accounting – governmental GAAP does not provide accountants with “ownership” percentages to use as guides when determining what entities should be consolidated with the primary reporting entity. Instead, PHAs should refer to GASBS-14, *The Financial Reporting Entity*, to determining how to report for entities that participate in mixed-finance transactions.

GASBS-14 defines a governmental financial reporting entity as follows:

“...the financial reporting entity consists of (a) the primary government, (b) organizations for which the primary government is financially accountable, and (c) other organizations for which the nature and significance of their relationship with

the primary government are such that exclusion would cause the reporting entity’s financial statements to be misleading or incomplete.”

Although GASBS-14 was written from the perspective of the primary government, its requirements apply to the separately issued financial statements of government component units, joint ventures, jointly governed organizations, and other stand-alone governments.

Depending on the terms of the transaction, mixed-finance arrangements could be accounted for under any of the reporting scenarios listed in *Exhibit 2*.

Exhibit 2: Types of GASBS -14 Reporting Scenarios

- Primary Government
- Discretely Presented Component Unit
- Blended Component Unit
- Related Organization
- Joint Venture
- Jointly Governed Organization

Therefore, as a first step, PHAs should gather and review any and all contracts, partnership agreements, corporate documents, annual contribution contracts (ACCs), regulatory agreements, operating agreements or other legal documents related to the mixed-finance transaction in question. The provisions in

those documents should be compared to the reporting requirements of GASBS-14. A review of the GASBS-14 requirements for each potential reporting scenario follows.

PRIMARY GOVERNMENT

GASBS-14 defines a primary government as follows:

“A primary government is any state government or general purpose local government (municipality or county). A primary government is also a special-purpose government (for example, a school district or a park district) that meets all of the following criteria:

- a. It has a separately elected governing body.
- b. It is **legally separate**.
- c. It is **fiscally independent** of other state and local governments.”

According to GASBS-14, a primary government consists of all the organizations that make up its legal entity. All funds, organizations, institutions, agencies, departments, and offices that are not legally separate are, for financial reporting purposes, part of a primary government. Furthermore, as nucleus

of the financial reporting entity, the primary government generally is the focal point for the users of the financial statements.¹

A typical PHA generally does not meet the definition of a primary government as presented above. PHAs normally are not state governments or general-purpose local governments. In most instances, a PHA's governing body is not separately elected – rather it is appointed by a local government's mayor and/or city council. Therefore, PHAs generally don't qualify as a special-purpose government. In addition, in some instances, a PHA may be reported as a component unit of a state or local government (see discussion on component units to follow). Nevertheless, when a PHA issues separate financial statements, under the provisions of GASBS-14, it is treated like the primary government. According to GASBS-14:

“Although the nucleus of a financial reporting entity usually is a primary government, an organization other than a primary government (such as other stand-alone government) serves as a nucleus for its reporting entity when it issues financial statements.”

GASBS-14 defines stand-alone governments as legally separate government organizations that (a) do not have a separately elected governing body and (b) do not meet the definition of a component unit. Therefore, regardless of whether the PHA is reported as a component unit of another government, or if the PHA is a separate stand-alone government, a PHA should apply the provisions of GASBS-14 as if it were a primary government - when it issues separate financial statements. In essence, GASBS-14 is applied in layers “from the bottom up.” That is, each component unit “layer” should apply the definition and display provisions to its own component unit financial reports.²

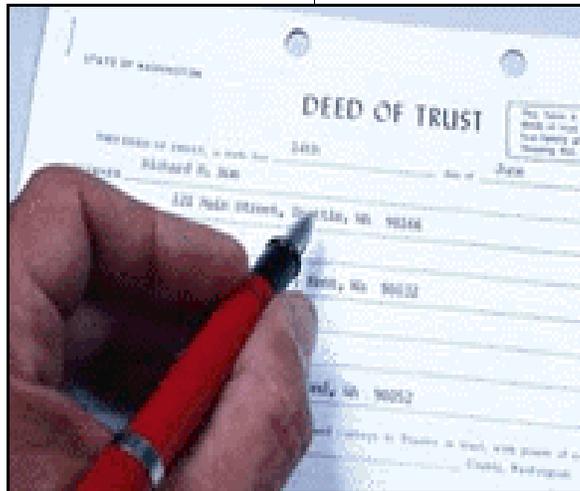
For the purpose of this discussion it is assumed that PHAs, whether component units of another government or stand-alone entities, will issue separate stand-alone financial statements when reporting to HUD in accordance with the requirements of the *Public Housing Assessment System Final Rule* (24 CFR Parts 901 and 902) and the *Uniform Financial Reporting Standards for HUD Housing Programs; Final Rule* (24 CFR Part 5, et al.).

Although not typical, when a mixed-finance transaction is structured so that a legally separate organization is not created and the PHA retains 100 percent ownership of the units being developed, the PHAs should account for the transaction as part

of the primary government. In all other instances, the PHA must determine if the participating organization(s) should be accounted for as a component unit.

COMPONENT UNITS

Component units are organizations that are legally separate from the PHA for which PHA officials are financially accountable. According to GASBS-14, component units may be a governmental organization (except those that meet the definition of a primary government), a nonprofit corporation, or a for-profit corporation.



Additionally, component units can be other organizations for which the nature and significance of their relationship with the PHA are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete³. **Exhibit 3** on the following page provides PHAs with a flow chart, adapted from GASBS-14, outlining the tests for determining how a potential component unit should be reported in a PHA's financial statements. An explanation of those tests follows.

Legally Separate

“Component units are organizations that are legally separate from the PHA for which PHA officials are financially accountable.”

According to GASBS-14, an organization is legally separate if it is created as a body corporate or a body corporate and politic or if it otherwise possesses the corporate powers that would distinguish it as being legally separate from the PHA. In general, corporate powers give an organization the capacity to have a name; the right to sue and be sued in its own name without recourse to a state or local governmental unit; and the right to buy, sell, lease, and mortgage property in its own name. The corporate powers granted to a separate organization are enumerated in its corporate charter or in the legislation authorizing its creation.

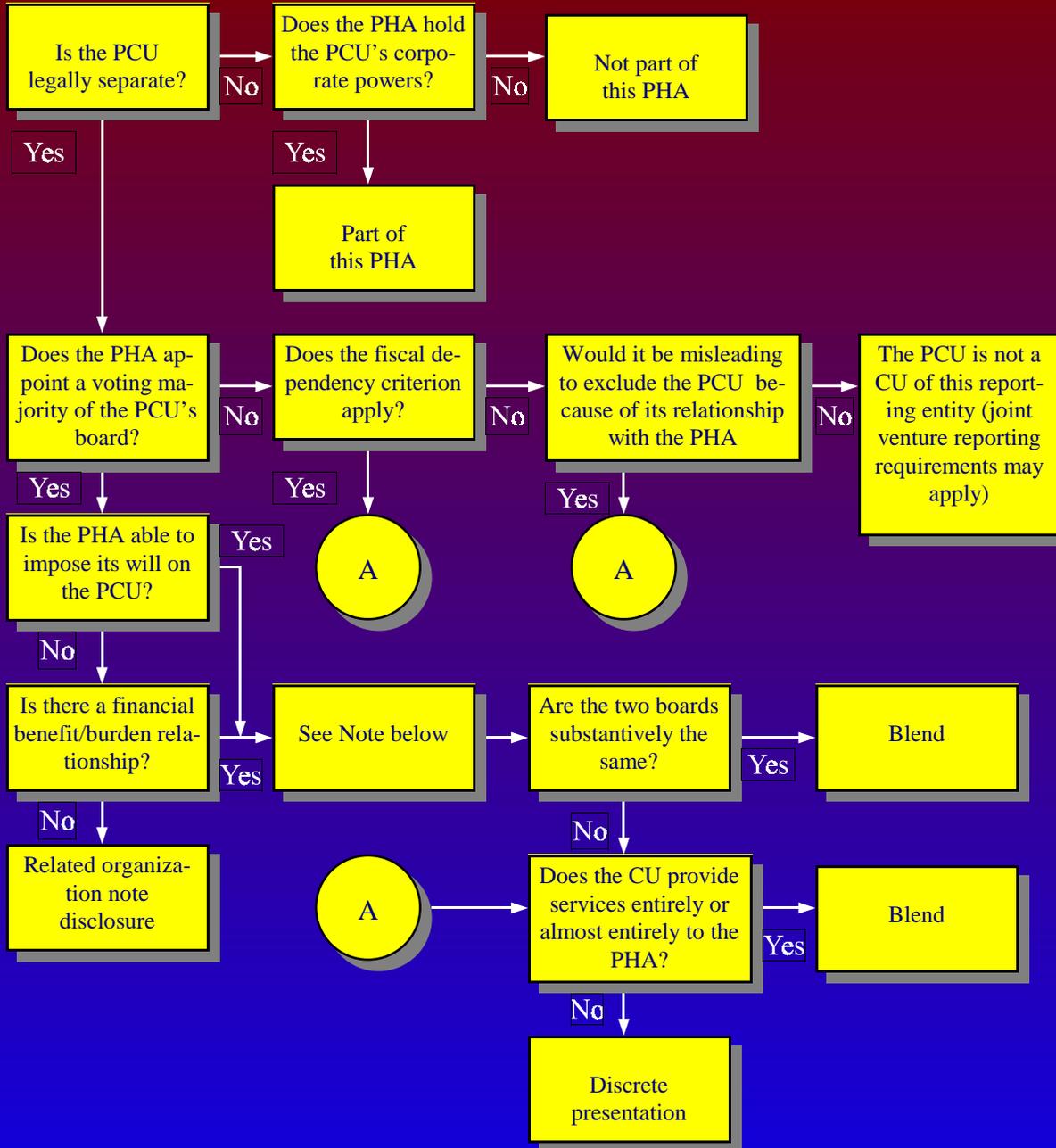
Financially Accountable

Under GASBS-14 a PHA is financially accountable for a separate organization under the following circumstances:

- a. The PHA appoints a voting majority of the organization's governing body and (1) it is able to impose its will on that organization or (2) there is a potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the primary government.
- b. The PHA may be financially accountable if an organization is fiscally dependent on the PHA regardless of whether the organization has (1) a separately elected gov-

Exhibit 3: Flowchart for Evaluating Potential Component Units of a PHA

(Source - GASBS 14, Appendix C - as adapted for PHAs)



PCU = Potential component unit CU = Component unit PHA = Public Housing Authority

Note: A potential component unit for which a PHA is financially accountable may be fiscally dependent on another government. An organization should be included as a component unit of only one reporting entity. Professional judgement should be used to determine the most appropriate reporting entity.

erning board, (2) a governing board appointed by a higher level of government, or (3) a jointly appointed board.

A PHA generally has a voting majority if it appoints a simple majority of the organization’s governing board members. However, if financial decisions require the approval of more than a simple majority, the PHA is not accountable for the organization. In addition, a PHA’s appointment authority should be substantive for accountability to exist. For example, if the number of candidates is severely limited by the nominating process a PHA’s authority may not be substantive.

According to GASBS-14, a PHA has the ability to impose its will on an organization if it can significantly influence the programs, projects, activities, or level of service performed or provided by the organization. The existence of any one of the following conditions clearly indicates that a PHA has the ability to impose its will on an organization:

- a. The ability to remove appointed members of the organization’s governing board at will.
- b. The ability to modify or approve the budget of the organization.
- c. The ability to modify or approve rate or fee changes affecting revenues.
- d. The ability to veto, overrule, or modify the decisions (other than those in b and c) of the organization’s governing body.
- e. The ability to appoint, hire, reassign, or dismiss those persons responsible for the day-to-day operations (management) of the organization.



Financial Benefit to or Burden on a Primary Government

According to the GASB, the benefit or burden to a PHA may be demonstrated in several ways, such as legal entitlements or obligations or reflection of the benefits or burden in decisions made by the PHA or agreements between the PHA and the organization. GASBS-14 indicates that an organization has a financial benefit or burdened relationship with a PHA if any one of the following conditions exists:

- a. The PHA is legally entitled to or can otherwise access the organization’s resources.
- b. The PHA is legally obligated or has otherwise assumed the obligation to finance the deficits of, or provide financial support to, the organization.
- c. The PHA is obligated in some manner for the debt of the organization.

GASBS-14 notes that the effect of the financial benefits or burdens on the PHA can be either direct or indirect. A direct financial benefit or burden occurs when a PHA itself is entitled to the resources or is obligated for the deficits or debts of the organization. An indirect benefit or burden exists if one or more of the PHA’s component units is entitled to the resources or is obligated for the deficits or debts of the organization.

Fiscal Dependency

Under the provisions of GASBS-14, a PHA may be fiscally accountable for an entity that participates in a mixed-finance transaction regardless of whether that entity has a separately elected governing board, a board appointed by another government, or a jointly appointed board. The fiscal accountability in these cases is a result of the entity’s fiscal dependency on the PHA. An entity participating in a mixed-finance transaction is fiscally dependent on the PHA if fails any for the following tests for fiscal independence:

- a. The entity is able to determine its budget without the PHA having the substantive authority to approve and modify that budget.
- b. The entity is able to set rates or charges without substantive approval by the PHA.
- c. The entity is able to issue bonded debt without substantive approval by its PHA partner.

Other Organizations that are Included in the Reporting Entity

Although GASBS-14 uses financial accountability as the benchmark for including organizations in the reporting entity, the standard also includes a provision for including entities for which the PHA is not financially accountable. According to the standard, PHA’s should report any entity participating in a mixed-finance transaction as a component unit if its relationships with the PHA are so significant that its exclusion would render the PHA’s financial statements misleading, even though the financial accountability requirement is not met. GASBS-14 concludes that ultimately the decision to include certain component units is a matter of professional judgement. However, GASBS-14 notes that the decision to include certain component units should be based on the nature and the significance of the relationship between the organization and the PHA.

Financial Statement Display of Component Units

If it is determined, based on the tests outlined in *Exhibit 3*, that an entity participating in a mixed-finance transaction should be reported as a component unit, the next step is to determine the

proper financial statement display. According to the requirements of GASBS-14, component units should be presented either discretely from the PHA or blended with the PHA. Most component units will be displayed in a PHA's financial statements using discrete presentation. However, due to the closeness of their relationships with the PHA some component units should be blended as though they are part of the PHA.

DISCRETELY PRESENTED COMPONENT UNITS

GASBS-14 defines discrete presentation as follows:

“The method of reporting financial data of component units in a column(s) separate from the financial data of the primary government. An integral part of this method of presentation is that individual component unit supporting information is required to be provided either in condensed financial statements within the notes to the reporting entity’s financial statements, or in combining statements in the General Purpose Financial Statements.”

Unless a component unit passes the blending tests outlined in *Exhibit 3* and the discussion to follow; it should be discretely presented in the PHA’s financial statements.

The standard allows a PHA’s combined balance sheet to include one or more columns to display the combined balance sheets of the discretely presented component units. A single column may be used regardless of whether the component units use governmental or proprietary fund accounting. The discrete column(s) should be located to the right of the PHA’s financial data and labeled with descriptive column headings.

Therefore, in general, PHAs should report the balance sheet items of a discretely presented component unit in the Financial Data Schedule (FDS) column labeled Component Units (see the HUD GAAP Conversion Guide at www.hud.gov/react/gaap-con.pdf).

Similarly, the income and expense items of a discretely presented component unit should be reported in the FDS column labeled Component Units. This information is also recorded in the far right column of the PHA’s financial statements so the reader can distinguish between the financial information of the PHA and that of the discretely presented component unit(s).

BLENDED COMPONENT UNITS

Under the method known as “blending” the component unit’s financial data is reported with that of the primary government. GASBS-14 defines blended component units as follows:

“The method of reporting financial data of a component unit that presents the component unit’s balances and transactions in a manner similar to the presentation of the balances and transactions of the primary government.”

The GASB notes that although it is desirable for financial statement users to be able to distinguish between a primary government and its component units, there are nevertheless some component units that, despite being legally separate from the primary government, are so intertwined with the primary government that they are, in substance, the same as the primary government. According to GASBS-14, a component unit should be presented in the reporting entity’s financial statements using the blending method in either of the following circumstances.



“PHAs should report the balance sheet items of a discretely presented component unit in the Financial Data Schedule column labeled Component Units.”

a. The component unit’s governing body is substantively the same as the governing body of the PHA.

b. The component unit provides services entirely, or almost entirely, to the PHA or otherwise exclusively, or almost exclusively, benefits the PHA even though it does not provide services directly to it. The

essence of this type of arrangement is much the same as an internal service fund – the goods or services are provided to the government itself rather than to the citizenry. Usually the services provided by the blended component units are financing services provided solely to the primary government. Other component units that should be blended are those that exclusively, or almost exclusively, benefit the PHA by providing services indirectly.

For the purpose of completing the FDS, if an entity participating in a mixed-finance transaction meets the definition of a blended component unit, the results of its operations should be combined with that of the PHA and reported by program type in the FDS. For example, if a blended component unit receives development funds for the purpose of developing public housing units, those funds should be reported in column designated for development grant funds. Similarly, if the blended component unit receives HOPE VI funds to develop public housing units, those funds should be accounted for in the FDS column

designated for HOPE VI grants.

Furthermore, it is assumed that all component units, whether discretely presented or blended, will be reported using enterprise fund accounting. REAC, in a previous addition of the *PHA GAAP Flyer* (www.hud.gov/reac/flyer/flyer1.html) concluded that in most, if not all instances, PHAs should use proprietary fund accounting to record the results of their operations. It is the REAC's position that proprietary fund accounting also applies to component units.

Reporting Periods

In certain instances the PHA and its component units may have different reporting periods. While GASBS-14 encourages primary governments and its components to have common fiscal year ends, in practice this is often difficult to achieve.

If the PHA and its component unit(s) have different fiscal year ends, then the PHA should incorporate the financial statements for the component unit's fiscal year ending during the PHA's fiscal year without prorations. However, if the component unit's fiscal year ends within the first quarter of the PHA's subsequent fiscal year, GASBS-14 allows PHAs to incorporate those statements instead. Naturally, this should only be done if the timely and accurate presentation of the financial statements is not affected.

If, because of the differences in fiscal year ends, there are inconsistencies in the amounts reported as due to or due from, transfer to or transfer from, and so forth, the nature and amount of those transactions should be disclosed in the notes to the financial statements. The fiscal year of the component unit(s) should be consisted from year to year, and changes in fiscal years should be disclosed.

Often, the mixed-finance arrangement between PHAs and their partners will not meet the tests required for component unit reporting. Still, in some instances PHA officials may appoint some, or all, governing board members of an entity participating in the mixed-finance transaction. These entities are classified as Related Organizations.

RELATED ORGANIZATIONS

In instances where the PHA has appointed a voting majority of the mixed-finance entity's board, but is not financially accountable for the entity, the PHA does not record the entity's transactions in the FDS. Rather, GASBS-14 requires the PHA to disclose in the footnotes to the financial statements the nature of its accountability for the organization.

JOINT VENTURES

When a PHA's arrangement with its mixed-finance partner qualifies as a joint venture (see previous discussion on joint ventures) the financial accounting and reporting for the transaction is determined by whether the PHA has an equity interest in the joint venture. According to GASBS-14, a PHA has an equity interest if it owns shares of the joint venture's stock or otherwise has an explicit, measurable right to the net resources of a joint venture that is usually based on an investment of financial or capital resources by the PHA. An equity interest may or may not change over time as a result of an interest in the net income or loss of the joint venture. GASBS-14 notes that an equity interest is explicit and measurable if the joint venture agreement stipulates that the participants have a present future claim to the net resources of the joint venture and sets forth the method to determine the participants' shares of the joint venture's net resources.⁴



“PHAs who use enterprise fund accounting should record their equity interest in a joint venture on FDS line 176, Investment in Joint Ventures..”

If, after reviewing the joint venture agreement, it is determined that the PHA has an equity interest, that interest should be reported as an asset of the fund holding the interest. Furthermore, the reporting of this asset will differ depending on whether the fund uses proprietary or governmental fund accounting.

Proprietary Fund

PHAs who use enterprise fund accounting (see GAAP Flyer 1) should record their equity interest in a joint venture on FDS line 176, Investment in Joint Ventures. PHAs should record their initial investment in a joint venture at cost. If the joint venture agreement includes a provision whereby the PHA shares in the net income or loss of the joint venture, the PHA should adjust the investment account according to its share of net income (loss) from the joint venture. The corresponding income statement entry should be recorded on FDS line 711, Investment Income (Loss). Thus, the method used by PHAs to account for an investment in a joint venture is similar to the equity method used by commercial enterprises. Accordingly, any profit or loss recorded by the joint venture from transactions with the PHA should be eliminated before recording the PHA's share of profits and losses in the investment account.

Governmental Funds

While HUD has concluded that most, if not all PHAs should use enterprise fund accounting to record the results of their operations (see GAAP Flyer 1), it is still possible that the source of a PHA's investment in a joint venture may come from

a governmental fund. In those instances, the accounting for the PHA's investment in the joint venture is handled differently than the method previously described for proprietary funds. GASBS-14 requires that governmental funds use a different method because the equity interest in a joint venture does not meet the definition of a financial resource (see NCGAS-1) and, therefore, would not be recorded as an asset of the participating governmental fund.

Instead, PHA should report their equity investment in the joint venture in the general fixed asset account group (GFAAG). This amount should be recorded on FDS line 176, Investment in Joint Ventures. The amount that should be reported on this line is the total equity interest adjusted for any portion of the equity interest included in the balance sheet of the corresponding governmental fund. Thus, the combination of amounts reported in the governmental funds and in the GFAAG should equal the total equity interest in the net assets of the joint venture. Governmental fund operating statements should report changes in joint venture equity interest only to the extent that the amounts received or receivable from the joint venture or the amounts paid or payable to the joint venture satisfy the revenue or expenditure recognition criteria for governmental funds.⁵

Joint Venture Disclosure Requirements

According to GASBS-14 the following disclosures in the notes to the financial statements are required regardless of whether the PHA has an equity interest in the joint venture:

- a A general description of each joint venture, including:
 - 1 Description of the participating PHA's ongoing financial interest (including its equity interest, if applicable) or ongoing financial responsibility. This disclosure should also include information to allow the reader to evaluate whether the joint venture is accumulating significant financial resources or is experiencing fiscal stress that may cause an additional financial benefit to or burden on the participating government in the future.
 - 2 Information about the availability of separate financial statements of the joint venture.
- b The participating PHA should also disclose any other information relevant to the joint venture from the broad perspective of the participating PHA's overall footnote presentation.

Undivided Interests

According to GASBS-14, an undivided interest is an arrange-

ment that resembles a joint venture but no entity or organization is created by the participants. An undivided interest is an ownership arrangement in which two or more parties own property in which title is held individually to the extent of each party's interest. Implied in the definition is that each participant is also liable for specific, identifiable obligations (if any) of the operation. Because an undivided interest is not a legal entity, borrowing to finance its operations often is done individually by each participant. An additional consequence of the absence of a formal organizational structure is that there is no entity with assets, liabilities, expenditures/expenses, and revenues-and thus, equity-to allocate to participants. A PHA participating in this type of arrangement should report its assets, liabilities, expenditures/expenses, and revenues that are associated with the joint operation on the associated FDS line items.



JOINTLY GOVERNED ORGANIZATIONS

GASBS-14 recognizes that the laws in many states provide for the creation of regional governments or other multigovernmental arrangements that are governed by representatives from each of the governments that create the organizations. These organizations may appear similar to joint ventures-they provide goods or services to the citizenry of two or more governments-but many do not meet the definition of a joint venture because there is no ongoing financial interest or responsibility by the participating governments.⁶

“According to GASBS-14, an undivided interest is an arrangement that resembles a joint venture but no entity or organization is created by the participants.”

In the section to follow a case study is presented to help illustrate the proper application of GAAP for a sample PHA participating in a mixed-finance transaction.

¹ GASB Statement No. 14, *The Financial Reporting Entity*, page 5, Governmental Accounting Standards Board, June 1991.
² GASB Statement No. 14, *The Financial Reporting Entity*, page 27, Governmental Accounting Standards Board, June 1991
³ GASB Statement No. 14, *The Financial Reporting Entity*, page 8, Governmental Accounting Standards Board, June 1991.
⁴ GASB Statement No. 14, *The Financial Reporting Entity*, page 30, Governmental Accounting Standards Board, June 1991.
⁵ GASB Statement No. 14, *The Financial Reporting Entity*, page 32, Governmental Accounting Standards Board, June 1991.
⁶ GASB Statement No. 14, *The Financial Reporting Entity*,

CASE STUDY - SAMPLE MIXED-FINANCE TRANSACTION

The following case study is presented to help illustrate the basic steps that a PHA should follow to determine the proper accounting for a mixed-finance transaction under GAAP. The reader may find it helpful to refer to the *Flowchart for Evaluating Potential Component Units of a PHA* (included in *Exhibit 4* of this flyer at page 11) while reviewing the case study.

CASE STUDY FACTS

- ◆ In accordance with the provisions of *24 CFR Part 941, Subpart F*, the West Burlington Housing Authority (WBHA) entered into an agreement with Vargas Properties Limited Partnership whereby WBHA agreed to provide a grant for the construction of a development known as Falcon Apartments in exchange for a commitment on the part of Vargas Properties to operate the units as public housing for a period of forty years, subject to the availability of congressional funding for HUD's low rent program.
- ◆ WBHA at no time holds an ownership interest in Falcon Apartments and finances only a portion of the entire development. Furthermore, neither WBHA or any of its component units hold an ownership interest in Vargas Properties Limited Partnership.
- ◆ WBHA pays its portion of the construction draw prorated according to its contribution to the total development costs, pursuant to the *Master Disbursing Agreement*. The first mortgagor puts together the documentation for the draw that includes a line item breakdown of the use of funds and submits it to WBHA along with other project documentation (such as Davis Bacon compliance). WBHA sends its portion of the draw to the title company for distribution.
- ◆ After construction is complete, ownership of Falcon Apartments is held solely by Vargas Properties Limited Partnership.
- ◆ Vargas Properties executed a *Declaration of Covenants* that stipulates, among other things, that Vargas Properties will operate the public housing units for a period of forty years. The covenants "run" with the property and all future conveyances are subject to them. HUD has agreed, pursuant to a *Consent Decree*, to provide an *Annual Contributions Contract* (ACC) for operating subsidy.
- ◆ Vargas Properties executed a *Regulatory and Operating Agreement* which details the obligations between the



owner, WBHA, and the local sponsoring agency. According to this document, Vargas Properties has agreed to set aside a certain number of units at Falcon Apartments in accordance with the 1937 Housing Act, the ACC and the *Consent Decree*.

- ◆ WBHA did **not** appoint any members to Vargas Properties Limited Partnership's governing body and is not involved in any way with the management of that entity.

- ◆ WBHA's approval is required for Vargas Properties' portion of its budget that relates to the public housing units covered under the ACC. This amounts to 40 percent of the total units at Falcon Apartments.

ACCOUNTING FOR THE TRANSACTION DURING CONSTRUCTION

In effect, the grant provided by WBHA - under the provisions of *24 CFR Part 941, Subpart F* - to Vargas Properties is a pass-through grant. That is, federal grant money passes through WBHA and was used by Vargas Properties to develop the complex known as Falcon Apartments. The accounting for pass-through grants is covered in GASBS-24, *Accounting and Financial Reporting for Certain Grants and other Financial Assistance*. According to GASBS-24, as a general rule, cash pass-through grants should be recognized as revenue and expenditures or expenses in a governmental, proprietary, or trust fund. However, GASBS-24 provides that in those infrequent cases where a recipient government only serves as a cash conduit, the grant should be reported in an agency fund. According to the 1994 *Governmental Accounting, Auditing and Financial Reporting* (GAAFR or the "blue book") - based on guidance from GASBS-24 - an agency fund should be used to account for grants meeting the following criteria:

- The government functions solely as an agent for some other government in collecting and forwarding funds
- The government undertakes no responsibility for subrecipient monitoring for specific requirements,
- The government is not responsible for determining the eligibility of recipients,
- The government has no discretion in the allocation of grant funds and
- The government is not liable for grant repayments.

However, since WBHA was responsible for determining the eligibility of the recipient (Vargas Properties Limited Partnership), the criteria listed above were not met. Therefore, during the construction phase of the project, WBHA should record the

revenues and expenditures or expenses of the grant in a governmental, proprietary or trust fund. According to HUD's GAAP Flyer 1, in most, if not all instances, PHAs should use enterprise fund accounting to record the results of their operations. Accordingly, WBHA accounted for the pass-through grant funds used for this mixed-finance transaction in its enterprise fund.

DETERMINE IF THE OWNERSHIP ENTITY IS A POTENTIAL COMPONENT UNIT

As illustrated in *Exhibit 3, Flowchart for Evaluating Potential Component Units of a PHA* (see page 4), near the end of each reporting period, WBHA prepares a checklist for each potential component units (PCU) to determine the proper accounting under GASBS-14. A step by step analysis of the evaluation follows:

Vargas Properties is a Legally Separate Organization

The first test under GASBS-14 is to determine if the potential component unit is a legally separate organization. The PCU is generally considered to be legally separate if it pass any of the following three tests:

- 1 *Does the PCU have the capacity to have its own name?* The answer for Vargas Properties is yes.
- 2 *Does the PCU have the right to sue and be sued in its own name without resource to a state or local governmental unit?* The answer for Vargas Properties is yes.
- 3 *Does the PCU have the right to buy, sell, lease, and mortgage property in its own name?* The answer for Vargas Properties is yes.

Since Vargas Properties passed all three tests it is considered a legally separate organization and, therefore, WBHA followed the flowchart to the next question, "Does the PHA appoint a voting majority of the PCU's board?"

Voting Majority Not Appointed by WBHA

According to the facts of this case, WBHA did not appoint the voting majority to Vargas Properties' board. In fact, WBHA did not participate in any way in this process. Therefore, Vargas Properties failed this test and, therefore WBHA applied the next test, "Does the fiscal dependency criterion apply?"

Vargas Properties is Fiscally Dependent on WBHA

According to GASBS-14, Vargas Properties is considered fiscally dependent on WBHA if it fails any of the following three tests:

- 1 *Vargas Properties is able to determine its budget without WBHA having the substantive authority to approve and modify that budget.* Here is where it gets tricky. Accord-

ing to the facts of the case, 40 percent of the units at Falcon Apartments are covered under the ACC. WBHA's approval is required for the portion of Vargas Properties' budget that relates to those units. Is 40 percent of the units at Falcon Apartments considered substantive under the provisions of GASBS-14? To answer this question requires judgement on the part of WBHA and their auditors. WBHA and their auditors both concluded that approving the budget for 40 percent of the units at Falcon Apartments constituted "substantive" approval. Therefore, WBHA indicated that Vargas Properties did not have the ability to determine its own budget.

- 2 *The entity is able to set rates or charges without substantive approval by the WBHA.* Again, this test is tricky. Clearly, to raise rents on public housing units would require the approval of both HUD and WBHA and would require a modification to the ACC. However, the question again relates to whether or not 40 percent of the units at the development amounts to substantive. As noted in point one above, WBHA and their auditors concluded that Vargas Properties did not have the ability to set its own rates.
- 3 *The entity is able to issue bonded debt without approval by WBHA.* WBHA concluded that based on their review of the underlying legal documents, Vargas Properties was able to issue bonded debt without the approval of WBHA.

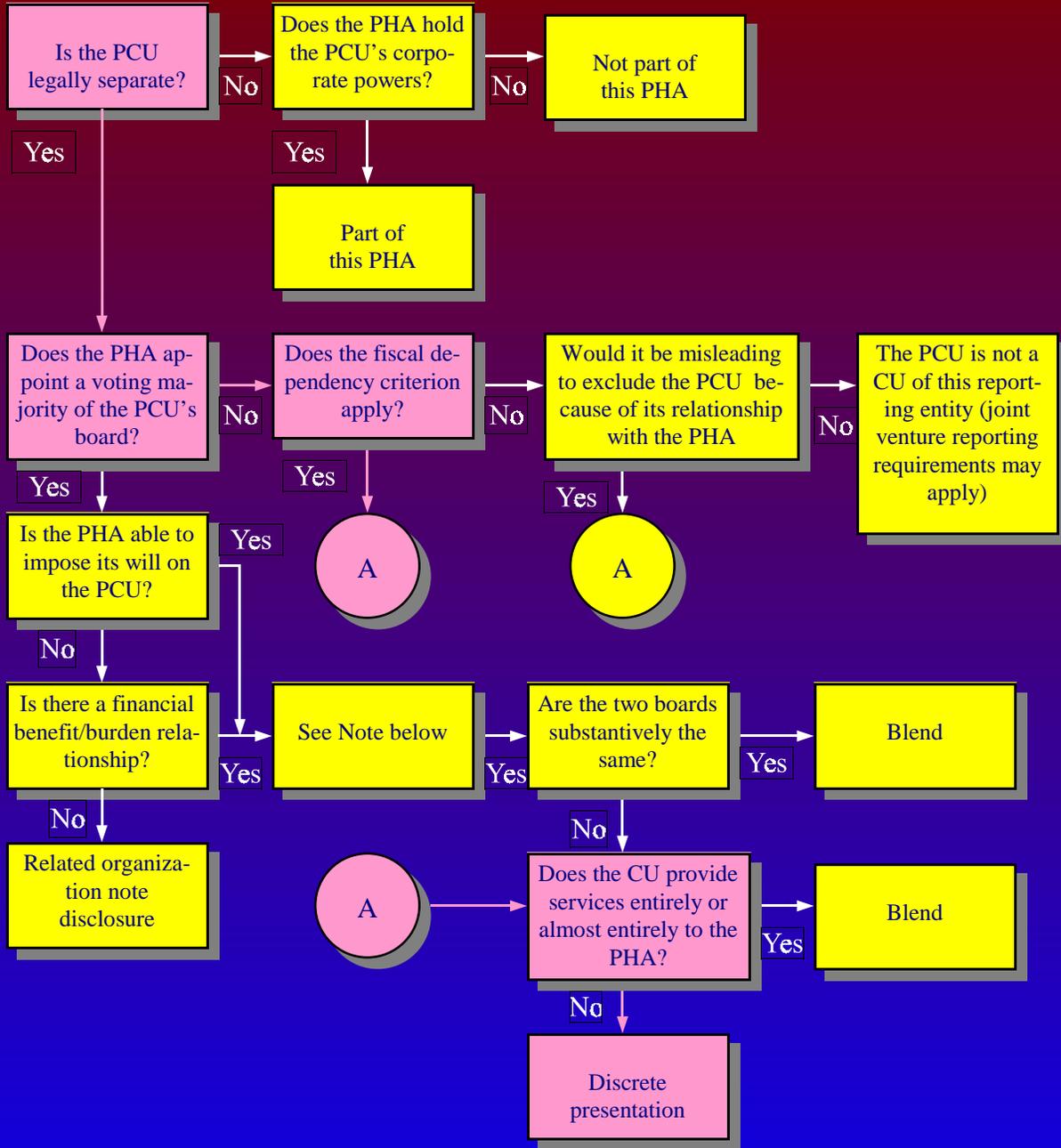
As the above tests illustrate, even after reviewing the professional standards, PHAs and their auditors are often required to make accounting decisions based on professional judgement and the facts of each particular case. For example, if the number of subsidized units at Falcon Apartments was only 10 percent of the total, it is likely that WBHA would have concluded that the amount was not substantive and, therefore, would have concluded that Vargas Properties passed all three tests discussed above. However, since Vargas Properties failed tests one and two, WBHA now must determine how to present Vargas Properties Limited Partnership in its financial statements.

Vargas Properties Should be Discretely Presented

Based on the tests discussed above, WBHA determined that Vargas Properties is fiscally dependent. Therefore, it is considered a component unit of WBHA. The final test required by GASBS-14 is to determine if Vargas Properties provides services entirely or almost entirely to WBHA. If the answer is yes, then Vargas Properties would be "blended" with the operations of WBHA. However, since the facts of this case indicate that Vargas Properties provides sixty percent of its services to tenants not participating in HUD's low rent program, WBHA and their auditors concluded that Vargas Properties should be discretely presented in WBHA's financial statements. For a through discussion on the differences between discrete and blended presentation in a governmental entities financial statements, please refer to page 6 of this flyer or GASBS-14.

Exhibit 4: Flowchart for Evaluating Potential Component Units of a PHA - Case Study Sample Mixed-Finance Transaction - The West Burlington Housing Authority

(Source - GASBS 14, Appendix C - as adapted for PHAs)



PCU = Potential component unit CU = Component unit PHA = Public Housing Authority

Note: A potential component unit for which a PHA is financially accountable may be fiscally dependent on another government. An organization should be included as a component unit of only one reporting entity. Professional judgement should be used to determine the most appropriate reporting entity.

 = Decision path selected by WBHA in the Case Study example presented on pages 9 and 10.