Consolidated Audit Guide for Audits of HUD Programs

Handbook (2000.4)

Office of the Inspector General

2016

Paragraph Page

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APPENDIX

CHAPTER 1. GENERAL AUDIT GUIDANCE

1-1. **Purpose.** This audit guide is to assist the independent auditor (auditor) in performing audits of profit-motivated entities that are subject to the U.S. Department of Housing and Urban Development's (HUD) uniform financial reporting standards set forth in 24 CFR (Code of Federal Regulations) Part 5, Subpart H; and 24 CFR Part 202.5(g) and related mortgagee letters. HUD requires an audit that consists of two components: a financial statement audit of the entity and a compliance audit of the entity's major HUD programs. The audit must be performed in accordance with generally accepted auditing standards (GAAS), issued by the American Institute of Certified Public Accountants (AICPA), and generally accepted government auditing standards (GAGAS), issued by the Comptroller General of the United States. For Securities and Exchange Commission registrants, the financial statement audit may be performed in accordance with the standards of the Public Company Accounting Oversight Board (PCAOB) and GAGAS. Additionally, the compliance audit is to be conducted in accordance with this audit guide, which requires that the auditor perform procedures that enable the auditor to opine on whether the entity has complied with laws, regulations, and the provisions of contracts or grant agreements applicable to its major HUD programs.

The use of this audit guide is mandatory for audits of all for-profit participants; however, this audit guide is not intended to be a complete manual of audit procedures for the compliance audit. The audit guide is not intended to cover all situations that may exist or replace the auditor's judgment of audit work required to meet GAAS and GAGAS. It is meant to supplement those standards with information specific to HUD programs. Suggested audit procedures contained herein might not cover all circumstances or conditions encountered in a particular audit. The auditor should use professional judgment to tailor the procedures so that the audit objectives are met. However, auditors must address all compliance requirements in this audit guide that could have a direct and material effect on a major HUD-assisted program. If the auditor determines that certain procedures for a compliance requirement will not to be performed, the rationale for the exclusion must be explained and documented in the audit documentation in support of the auditor's report. An example would be a situation in which circumstances pertaining to the auditee are such that the auditee is not subject to a particular requirement.

This audit guide is divided into chapters. This chapter, chapter 1, documents the purpose, background, and requirements for performing a HUD-required audit. It also includes other matters the auditor should consider in preparing for the audit. Chapter 2 contains the reporting requirements. Both chapters 1 and 2 apply to all audits covered by this audit guide. Each of the remaining chapters contains procedures for auditing compliance with specific HUD program requirements.

Chapters 3 through the remainder of the guide contain references to relevant compliance requirements that were in effect at the time each chapter was issued. Auditors should recognize that compliance requirements change periodically and that delays will occur between such changes and revisions to this audit guide. Moreover, auditors should

recognize that there may be provisions of contracts and grant agreements that are not specified in law, regulation, or other HUD requirements contained in HUD handbooks, notices, and mortgagee letters; therefore, the specifics of such are not included in this audit guide. Accordingly, the auditor should perform reasonable procedures to ensure that compliance requirements are current and to determine whether there are any additional provisions of contracts and grant agreements that should be covered by an audit under this audit guide. Reasonable procedures would be inquiry of auditee management and review of the contracts and grant agreements for major programs. HUD documents are available in the HUD Client Information and Policy System (HUDCLIPS), at the following Internet address:

http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/

If the auditor desires technical assistance pertaining to HUD programs, regulations, or operations, the auditor should contact the particular HUD headquarters or field program offices listed in the applicable chapter or contact the office responsible for monitoring or overseeing the activities of the auditee.

1-2. Use of This Audit Guide for Audits of States, Local Governments, and Nonprofit Organizations. Governmental and nonprofit entities also participate in some of the HUD programs covered in chapters 3 through 7 of this audit guide. These entities are subject to the audit requirements in Office of Management and Budget (OMB) Circular A-133, and auditors should normally use OMB's Compliance Supplement to perform the audit and not this audit guide. However, in instances in which a program is not included in the OMB Compliance Supplement but is covered in this audit guide, the auditor should use the compliance requirements and suggested audit procedures in this audit guide for purposes of building an audit program using the guidance in part 7 of the OMB Compliance Supplement.

1-3. Audit Scope and Approach.

A. Financial Statement Audit.

The financial statement audit should be planned to be sufficiently comprehensive in scope to permit an expression of an opinion on the financial statements and an in-relation-to opinion on the supplementary information of the HUD-assisted activity as referenced in the relevant chapters in this audit guide.

GAAS requires that a sufficient understanding of internal controls be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed. In fulfilling the audit requirement relating to an understanding of internal controls and assessing the level of control risk, the auditor should follow, at a minimum, the guidance contained in the AICPA's Codification of Statements on Auditing Standards (AU-C) Section 315, "Understanding the Entity and Its Environment and Assessing

the Risks of Material Misstatement." GAGAS provides an additional requirement for reporting on internal control over financial reporting (see chapter 2 of this audit guide).

B. Compliance Audit.

This audit guide requires an opinion on the auditee's compliance with specific requirements applicable to each major program included in the audit. The auditor should use the following information to determine whether a program is considered to be a major program for the type of audit being performed using a specific audit guide chapter.

- **Chapters 3 and 4**: A major program is defined as an individual assistance program for which expenditures equaled or exceeded $500,000 during the applicable year or a project or hospital that had an outstanding HUD-insured or HUD-guaranteed loan balance equal to or exceeding $500,000 as of the end of the period under audit.

- **Chapter 5**: No major program designation is needed.

- **Chapter 6**: A Government National Mortgage Association (Ginnie Mae) issuer's Ginnie Mae program is considered major if the issuer had a servicing portfolio or had any remaining principal balance at the end of the audit period.

- **Chapter 7**: A Federal Housing Administration (FHA)-approved lender's program is considered major regardless of the amount of loans originated or serviced during the period under audit. However, for lenders having combined originations and a servicing portfolio of less than $2 million, the opinion on compliance need cover only the compliance requirements in chapter 7, section 7-5(A), Quality Control Plan, and 7-5(G), Lender Annual Recertification, Adjusted Net Worth, Liquidity, and Licensing.

The auditor is also to consider the auditee's internal control over compliance as part of the compliance audit. The audit documentation should clearly demonstrate the auditor's understanding and assessment of control risk related to internal controls over compliance established for HUD-assisted activities. When auditing HUD programs, the auditor should perform tests of controls to evaluate the effectiveness of the design and operation of internal controls in preventing or detecting material noncompliance with the direct and material requirements of the major HUD-assisted programs. The auditor should perform these procedures regardless of whether the auditor assesses the internal control risk to be below the maximum. The steps performed and conclusions reached should be clearly stated in the audit documentation. Tests may be omitted only in areas in which internal controls are likely to be ineffective in preventing or detecting noncompliance; in which case, instances of the deficiencies are to be reported as findings.

1-4. Sample Selection.

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 a population. The auditor uses 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.

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, the Office of Inspector General (OIG) convened a panel consisting of representatives from OIG, HUD's Real Estate Assessment Center, the AICPA, and several auditing firms with significant HUD experience to discuss the issue and potential solutions. All participants agreed that attribute sampling is the appropriate sampling methodology for use in auditing programs using this guide to provide consistency and ensure adequate coverage to support the audit opinions rendered. This sampling approach has since been endorsed by the AICPA in its Audit Guide for Government Auditing Standards and A-133 Audits.

Whenever a sample is selected to test compliance or to test controls over compliance as part of an audit performed in accordance with this guide, HUD requires that an attribute sampling methodology be used. This requirement is to provide consistency and ensure adequate coverage to support the audit opinions rendered. Appendix A to chapter 1 of this guide, "Attribute Sampling," applies to all audits performed in accordance with this guide. It provides additional information on attribute sampling and minimum sample sizes. The sample sizes stated in appendix A are mandatory and are the minimum sample sizes to be used for all samples selected.

Further information about applying attribute sampling in an audit of Federal programs can be found in the AICPA's Audit Guide for Government Auditing Standards and A-133 Audits. Auditors may substitute an approach from the AICPA's audit guide for the approach described in appendix A, provided that the resulting sample size is equal to or greater than the minimum sample sizes in appendix A.

1-5. Planning the Audit.

A. Engagement Letter. A written letter of engagement between the auditee and the auditor is required and must contain the following mandatory information:

1. That the audit is to be performed in accordance with GAAS; GAGAS; and the current version of HUD's audit guide, HUD Handbook 2000.04.

2. The estimated date the audit report will be delivered to the auditee. Good coordination between the auditee and auditor is important to ensure timely delivery of the audit report, considering that managers from HUD may hold up advances and other funding approvals, etc., until the audit report is received.

Note that it is the auditee's responsibility to ensure that the audit is completed within the time requirements set forth in its contracts or agreements with HUD and that the conditions stated in the engagement letter are met. However, the auditor should consider the causes for any delays to determine whether they form the basis for an audit finding.

3. That the auditor is required to provide the HUD Secretary or his or her designee, the HUD Inspector General, and the U.S. Government Accountability Office (GAO) or their representatives access to audit documentation or any other documents needed to review the audit (hardcopy or electronic). Access to audit documentation by HUD and GAO representatives includes making necessary photocopies of hardcopy audit documentation or other documents or electronic copies of electronic audit documentation.

4. That if the auditor becomes aware of noncompliance with provisions of laws, regulations, contracts, and grant agreements or fraud that has occurred or is likely to occur, the auditor is required to bring such acts to the attention of the appropriate level of management. In addition, as required in chapter 2 of this audit guide, the auditor may be required to contact the HUD single audit coordinator to discuss matters relating to fraud or equity skimming. Based on that discussion, the auditor may be requested to prepare a written report on all known or likely fraud that has occurred. Acceptance of the engagement letter grants the auditor permission to contact the HUD single audit coordinator and discuss the conditions noted.

5. That if the program being audited requires electronic submission of the financial and compliance data to HUD, the responsibilities of the auditor and the auditee should be included as follows:

a. The auditee is responsible for making the electronic submission to HUD.

b. The auditor under a separate agreed-upon procedure engagement is responsible for applying procedures to ensure that the data submitted agree with the auditee's hardcopies of the supporting documentation.

6. A description of the scope of the planned audit and contents of the report as set forth in chapter 2 of the audit guide.

7. If applicable, that the auditee grants permission for the successor auditor to discuss and review the predecessor auditor's audit documentation and for the

auditee to make the appropriate arrangements. Normally the auditor, before issuing an engagement letter, will contact the predecessor auditor to review the predecessor auditor's audit documentation files supporting the prior financial statement audit and any findings included in the predecessor auditor's compliance report. The auditor may also need to discuss with the predecessor auditor matters that are not adequately explained or documented in the audit documentation or a preexisting condition the auditor notes in his or her review that was not in the prior audit report. If the predecessor auditor refuses to allow the successor auditor access to that information or to discuss such matters, the successor auditor should include in the engagement letter that the auditee grants permission for the successor auditor to discuss and review the prior audit documentation and for the auditee to make the appropriate arrangements.

8. A list of the information the auditor wants the auditee to provide for the audit and the requested delivery date of those items.

B. Testing. The auditor should use professional judgment to determine the extent of testing necessary to support his or her opinion on the auditee's financial statements and to report on the auditee's internal controls and on compliance with applicable laws and regulations. A dual-purpose sample may be used for testing compliance and internal controls over compliance. When a single sample is used to meet more than one audit objective, testing for each audit objective must follow the minimum sample size requirements. All compliance requirements contained in this audit guide that relate to a major program must be addressed.

For audits of entities subject to chapter 3 of the guide, please refer to that chapter for testing considerations in situations in which the project is owned or managed by an entity that owns or manages multiple HUD-assisted projects.

C. Reporting. Please refer to chapter 2. The applicable HUD program office establishes the due dates for submission of the audit reporting package to HUD and generally will not grant exceptions except in extraordinary circumstances. Requests to extend the due date for submission of the audit reporting package should <u>not</u> be directed to OIG.

D. Management Representations. The auditor is required to obtain written representations from management that include matters concerning compliance with program laws and regulations that have a material effect on the financial statements and each HUD-assisted program and all compliance violations or issues regardless of their materiality, as well as management's responsibilities for establishing and maintaining effective control over financial reporting and internal control over compliance.

E. Audit Documentation. The auditor must retain audit documentation (previously referred to as audit working papers) and reports for a minimum of 6 years from the

submission of the audit report to HUD, unless the auditor is notified in writing by HUD or GAO to extend the retention period. When an auditor becomes aware that HUD or the auditee is contesting an audit finding in the report, the auditor may contact the single audit coordinator for further guidance regarding the length of time the related audit documentation should be held before destruction of that audit documentation and report.

1-6. **Withdrawal From or Termination of an Engagement.** On occasion, an auditor's engagement may be terminated by the auditee after the audit is initiated, or the auditor may withdraw from the engagement. This termination or withdrawal could occur for a number of reasons. When this happens, the auditor is to advise the OIG single audit coordinator and the HUD servicing program office in writing. The written notification (letter or report) is to provide a detailed explanation for the withdrawal or termination. If fraud or equity skimming that may exist is the reason for the withdrawal or termination, the auditor is to follow the guidance in paragraph 2-5 of chapter 2 of this audit guide. The following are the officials who are to be notified based on the audit guide chapter being used to audit the HUD-funded activity.

Program audited based on audit guide chapter no.	Official to be contacted
3	Deputy Assistant Secretary for Multifamily Housing Deputy Assistant Secretary for Healthcare Programs (for audits of nursing homes, intermediate care facilities, and board and care homes with mortgages insured under Section 232 of the National Housing Act)
4	Deputy Assistant Secretary for Healthcare Programs
5	Deputy Assistant Secretary for Multifamily Housing Deputy Assistant Secretary for Healthcare Programs (for audits of nursing homes, intermediate care facilities, and board and care homes with mortgages insured under Section 232 of the National Housing Act)
6	Executive Vice President of Ginnie Mae
7	Director, Office of Lender Approval and Recertification Division
3 through 7	HUD OIG Single Audit Coordinator

Contact information for the positions listed above can be found on HUD's Internet site. HUD OIG's Single Audit Coordinator can be contacted at the following email address:

HUDOIGSingleAuditCoordinator@hudoig.gov

1-7. **Quality Control Review of Audits.** HUD OIG and HUD's Real Estate Assessment Center have implemented procedures for evaluating audits performed by non-Federal auditors. As part of this evaluation of completed audits, the supporting audit documentation must be made available upon request. To facilitate these requests, the transmittal letter of the audit report should include the name, office, address, and telephone number of the lead person conducting the audit (usually the engagement partner) and the auditor's Federal employer identification number.

Whenever HUD's evaluation of an audit report or audit documentation discloses inadequacies, the auditor may be asked to take corrective action. If HUD determines that the audit report or the audit documentation is substandard or contains major inadequacies, HUD may also consider any or all of the following actions, including but not limited to: (1) filing a complaint against the auditor with the AICPA, the appropriate State board of accountancy, or both; (2) recommending that HUD suspend or debar the auditor from further participation in Federal programs; or (3) referring the case to the U.S. Department of Justice for possible civil or criminal prosecution.

1-8. **External Peer Review.** As required by GAGAS, audit organizations performing audits pursuant to this guide should obtain an external peer review at least once every 3 years. It is not necessary to submit the peer review report to HUD or HUD OIG unless requested to do so by representatives of those offices or specifically required to do so in other chapters of this audit guide.

Appendix A

Attribute Sampling

This appendix applies to all testing performed for the compliance component of an audit performed using this audit guide.

When planning to test a particular sample of transactions, the auditor should consider the specific audit objective to be achieved and determine whether the audit procedure or combination of procedures to be applied will achieve that objective. The size of a sample necessary to provide sufficient evidential matter depends on both the objectives and the efficiency of the sample. 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 testing begins, the auditor must understand and document what attributes and assertions are being tested. The auditor needs to identify and document the appropriate population and should also perform procedures (for example, reconciliations or inquiry) to ensure that the population from which the sample is selected is complete.

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

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

The auditor should also clearly define what would be considered an exception. A single exception would indicate 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. The compliance sample size table below is based on the following assumptions:

- **Desired confidence.** Auditors should obtain the appropriate level of assurance by using a confidence level of 90 or 95 percent.
- **Tolerable exception rate.** A 5-10 percent exception rate is acceptable.
- **Expected exception rate.** No exceptions should be expected.

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

Sample Size Table.

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

Compliance sample size table

Importance or significance of the attribute being tested	Confidence level	Tolerable rate	Minimum sample size for populations over 250
Low to normal	90%	5%	50
Low to normal	90%	10%	25
High	95%	5%	65
High	95%	10%	35

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

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

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

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

Populations of 250 Items or Fewer.

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

Testing and Evaluating Results.

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

If there are observed exceptions, the auditor should investigate the nature and cause of the exceptions to determine whether the exceptions are immaterial or represent material compliance findings or significant deficiencies or material weaknesses in internal control. It is not necessary to expand testing when exceptions are found. Refer to chapter 2 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 report as a compliance violation. The auditor should also consider whether the lack of an effective internal control constitutes a significant deficiency or a material weakness and document the basis for an unqualified opinion if a finding is determined to be a significant deficiency or material weakness.

Audit Documentation.

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

Technical Assistance.

Technical guidance on audit sampling is available in the AICPA's Audit Guide for Government Auditing Standards and A-133 Audits. Auditors may substitute an approach from the AICPA's audit guide for the approach described above, provided that the resulting sample size is equal to or greater than the above minimum sample sizes.

CHAPTER 2 REPORTING REQUIREMENTS AND SAMPLE REPORTS

2-1 Background. This chapter discusses the reporting requirements that result from the performance of the financial statement and compliance audit conducted in accordance with the U.S. Department of Housing and Urban Development (HUD) Consolidated Audit Guide (referred to as "audit guide" throughout this chapter). First, such audits should be conducted in accordance with generally accepted auditing standards (GAAS), issued by the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA), and generally accepted government auditing standards, issued by the U.S. Government Accountability Office (GAO) (also referred to as the Yellow Book or GAGAS). Second, a compliance audit should be conducted in accordance with this audit guide of the entity's compliance with applicable laws and regulations that could have a direct and material effect on a major HUD-assisted program. As part of this compliance audit, the auditor opines on compliance with requirements that could have a direct and material effect on each major program and reports on internal control over compliance.

Certain entities subject to this audit guide are also required to have their financial statement audits conducted in accordance with the standards established by the Public Company Accounting Oversight Board (PCAOB). For those entities, certain reports illustrated in this chapter should be modified. For a notice on the use of PCAOB standards with GAGAS, refer to the GAO Web site (http://www.gao.gov).

2-2 Report Issuance. Items A-E of the audit report package described in paragraph 2-4 below are to be prepared and issued by the auditor to the auditee's management and those charged with governance as appropriate. The report cover should clearly indicate the HUD program activities and period(s) audited. The auditor may issue the required reports separately or simultaneously to the auditee (refer to section 2-4 for additional information on the report package).

2-3 Report Distribution.

A. HUD Management. The auditee is to file the audit report package (or portions thereof) with the applicable HUD management office electronically or by hardcopy according to the particular program requirements. Normally, the management office that should receive the report package is the office responsible for monitoring the auditee's performance.

1. Hardcopy Submission. Some program offices do not have the capability of receiving electronically submitted reports so a hardcopy is required to be submitted. Auditors should refer to the relevant program office guidance for current report submission capabilities and requirements. In a hardcopy submission, all parts of the audit report package must be included in the initial transmission to the HUD management office. In addition, an accompanying transmittal letter is to include the name, office address, and telephone number of the lead person conducting the

audit, usually the engagement partner, and the auditor's Federal employer identification number.

2. **Electronic Submission.** Under the provisions of the Uniform Financial Reporting Standards regulation (24 CFR (Code of Federal Regulations) Part 5, Subpart H), some of the HUD program offices require that certain financial information derived from the auditee's annual audit be submitted electronically to HUD via the Internet. At the time this chapter was published, audit reports for programs covered under chapters 3 and 7 of this audit guide required electronic submissions. Responsibilities for report submission rest with the auditee, but the auditor is required to attest that the electronic submission agrees with the report issued to the auditee. Auditors should refer to the relevant program office guidance for specific electronic report submission requirements.

B. HUD Office of Inspector General. The report package is not to be submitted to the Office of Inspector General (OIG) unless it is specifically requested by OIG. However, if applicable and if the auditor is required by GAGAS or this audit guide to report fraud directly, the report on fraud is to be sent to OIG's single audit coordinator at the following Email address:

HUDOIGSingleAuditCoordinator@hudoig.gov

Please refer to paragraph 2-5 for more information.

2-4 Required Report Package. The following reports and schedules are required to be included in the report package.

A. Independent Auditor's Report on Financial Statements and Supplementary Information (See Section 2-6, Example A). This is the auditor's report on the financial statements of the entity administering the HUD program and any supplementary information specified by the particular HUD program requirements. In addition to the auditor's report on the financial statements, the auditor's reporting on the supplementary information should be in accordance with AICPA AU-C section 725, Supplementary Information in Relation to the Financial Statements as a Whole, and state whether that supplementary information is fairly stated in all material respects in relation to the financial statements as a whole (example A, paragraph 2-6). The reporting on supplementary information may be presented either in the report on the financial statements or in a separate stand-alone report.

B. Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of the Financial Statements Performed in Accordance With Government Auditing Standards (See Section 2-6, Example B). GAGAS states that when providing an opinion or disclaimer of an opinion on the financial statements, the auditor should also report on internal control

over financial reporting and on compliance with provisions of laws, regulations, contracts, or grant agreements that have a material effect on the financial statements. It also states that auditors should include a description of the scope of the auditor's testing of internal control over financial reporting and of compliance with provisions of laws, regulations, contracts, or grant agreements. Auditors should also state in the reports whether the tests they performed provided sufficient, appropriate evidence to support opinions on the effectiveness of internal control and on compliance with provisions of laws, regulations, contracts, or grant agreements. GAGAS also states that the auditor should report, as applicable to the objectives of the audit:

- Significant deficiencies and material weaknesses in internal control over financial reporting.
- Instances of fraud and noncompliance with provisions of laws or regulations that have a material effect on the audit and any other instances that warrant the attention of those charged with governance.
- Noncompliance with provisions of contracts or grant agreements that has a material effect on the audit.
- Abuse that has a material effect on the audit.

C. Independent Auditor's Report on Compliance With Requirements That Could Have a Direct and Material Effect on Each Major HUD Program and on Internal Control Over Compliance Based on an Audit in Accordance With the HUD Consolidated Audit Guide (See Section 2-6, Example C).[1] For HUD programs meeting the dollar thresholds for major programs established in chapter 1 of this audit guide, the auditor is required to express an opinion or disclaim an opinion on compliance with laws, regulations, and the provisions of contracts or grant agreements applicable to major HUD programs.[2] The report on compliance with requirements applicable to major HUD programs expresses the auditor's opinion (or disclaimer of opinion) on whether the auditee complied with the requirements that if noncompliance occurred, could have a direct and material effect on a major program. Additionally, the auditor should report any significant deficiencies and material weaknesses in internal control over compliance that were noted. AICPA AU-C section 935, Compliance Audits, provides requirements and guidance when reporting on compliance and internal control over compliance.

GAAS and GAGAS set forth the minimum requirements for reporting noncompliance. To the extent that HUD requires additional reporting (for example, reporting immaterial

[1] This report is not required for entities having no major programs.

[2] Consistent with requirements for audits of entities subject to Office of Management and Budget Circular A-133, separate reporting on compliance with respect to nonmajor HUD programs has been eliminated. Also, separate reporting on compliance with specific requirements applicable to fair housing and nondiscrimination has been eliminated. Auditors are reminded that under GAGAS, auditors continue to be responsible for reporting instances of noncompliance that could have a material effect on the audit.

findings and including any management letter in the submission), subsequent chapters in this audit guide describe the materiality thresholds required for reporting noncompliance, and the auditor should refer to each relevant chapter for guidance.

Significant deficiencies, material weaknesses, and material instances of noncompliance are required to be identified in the body of the report on compliance and internal control over compliance (which can be accomplished by a brief description and a reference to related finding numbers) and detailed in a separate schedule of findings, questioned costs, and recommendations, using the elements of a finding as outlined in GAGAS and the additional requirements set forth in this audit guide (see subsection D below and example D in paragraph 2-6). The auditee should provide its response to each finding, as outlined in subsection D below, which the auditor includes in the schedule of findings, questioned costs, and recommendations. It is the auditee's responsibility to include the action taken or to be taken in a corrective action plan issued apart from and outside the audit report (see paragraph 2-4.G below and example F in paragraph 2-6). The corrective action plan is not to be included in or as a part of the schedule of findings, questioned costs, and recommendations.

D. <u>Schedule of Findings, Questioned Costs, and Recommendations (See Section 2-6, Example D)</u>. This schedule, prepared by the auditor, is to be included in the audit report package when findings are presented. It is to be arranged in two parts: "Corrective Action Not Started or in Process" or "Corrective Action Completed." This distinction is based on management's representation included in the management representation letter. If the audit resulted in no findings, the schedule of findings, questioned costs, and recommendations should still be included in the audit report package and should include only the following statement:

> Our audit disclosed no findings that are required to be reported herein under the HUD Consolidated Audit Guide.

Regardless of whether the auditee has started correcting the deficient condition stated in the finding, is in the process of correcting it, or has corrected it, the auditor is to include the finding in the report with all required elements, and the auditee is to include the information in the corrective action plan. The auditor should not delay the issuance of the report so that the auditee can correct the deficient conditions.

1. **<u>Corrective Action Not Started or in Process</u>.** Many times when the auditee is presented with draft findings, management will start to take action to correct the deficient condition. When this action is underway before the report's issuance, the auditee should include a description of the actions completed and the actions remaining to be taken in management's response section of the finding.

2. **<u>Corrective Action Completed</u>.** Many times when the auditee is presented with draft findings, management will start to take action and complete that action,

correcting the deficient condition before the issuance of the auditor's report. When this occurs, the auditee should include a description of the action taken and completed in the management's response section of the finding. The auditor's recommendation section should follow the auditee's comment section, and in it, the auditor should state whether he or she confirmed that the auditee completed the corrective action as stated in the response. If the auditor has validated the corrective action, the auditor may include any additional recommendations he or she believes necessary based on the validation of that action.

3. **Reporting When Using the "Group Project-Based Sample" Method.** As outlined in chapter 3, the auditor may use the "group project-based sample" method when the owner or management agent owns several projects. When the auditor elects to use this sampling method, if a condition is noted that is to be reported in a finding in the report or a comment in the management letter or other written auditor communication, it must be reported in all audit reports for all projects that were in the population from which the sample was drawn.

4. **Content of Finding.** Each finding must include all of the following information as appropriate:[3]

   a. **Numbering the Findings.** Each finding is to be numbered using the year followed by a consecutive number (201X-1, 201X-2, 201X-3, etc.).

   b. **Questioned Costs.** Each finding must identify known questioned costs of items resulting from errors or noncompliance that are quantifiable. Identification of these costs should not be limited to only those costs that potentially are to be repaid. If costs are not quantifiable or are unknown, the auditor should so state and indicate the reasons for that determination.

   c. **Information on Universe and Population Size.** Each finding must include the description and size of the universe and population and information to provide a proper perspective for judging the prevalence and consequences of the audit findings (for example, whether the audit findings represent an isolated instance or a systemic problem). When appropriate, the instances identified should be related to the universe and the number of cases examined and quantified in terms of dollar value.

   d. **Sample Size Information**. If the error was discovered as a result of a sampling procedure, the size and dollar amount of the sample selected and tested must be included.

[3] All elements may not be relevant for findings that are internal control deficiencies only.

e. **Noncompliance Information.** The number of instances of noncompliance in the sample and the dollar amount of the noncompliance must be included.

f. **Condition.**[4] The condition is the situation that exists. It is determined and documented during the audit.

g. **Criteria.** Criteria are the laws, regulations, contracts, grant agreements, standards, measures, expected performance, defined business practices, and benchmarks against which performance is compared or evaluated. Criteria identify the required or desired state or expectation with respect to the program or operation. Criteria provide a context for evaluating evidence and understanding the findings.

h. **Cause.** The cause identifies the reason or explanation for the condition or the factor or factors responsible for the difference between the situation that exists (condition) and the required or desired state (criteria), which may also serve as a basis for recommendations for corrective action(s). Common factors include poorly designed policies, procedures, or criteria; inconsistent, incomplete, or incorrect implementation; or factors beyond the control of program management. Auditors may assess whether the evidence provides a reasonable and convincing argument for why the stated cause is the key factor or factors contributing to the difference between the condition and the criteria.

i. **Effect or Potential Effect.** The effect is a clear, logical link to establish the impact or potential impact of the difference between the situation that exists (condition) and the required or desired state (criteria). The effect or potential effect identifies the outcomes or consequences of the condition. When the audit objectives include identifying the actual or potential consequences of a condition that varies (either positively or negatively) from the criteria identified in the audit, "effect" is a measure of those consequences. Effect or potential effect may be used to demonstrate the need for corrective action in response to identified problems or relevant risks.

j. **Recommendations.** Recommendations are the auditor's written suggestions for specific auditee action to correct a deficient condition, prevent recurrence of the condition, or alleviate the adverse effects of a condition. Each recommendation for each finding is to be consecutively lettered (a, b, c, etc.) and prefixed with the finding number. For example, two recommendations to finding 1 would be

[4] The definitions of condition, criteria, cause, and effect or potential effect are taken from the December 2011 revision of the Yellow Book. Additional information on the content of a finding is set forth in the Yellow Book and can be obtained at the GAO Web site (http://www.gao.gov).

201X-1-a, 201X-1-b, and two recommendations to finding 2 would be 201X-2-a, 201X-2-b.

k. **Reporting Views of Responsible Officials.** Auditors should obtain and report the views of responsible officials concerning the findings, conclusions, and recommendations, which should include the auditee's planned corrective action(s). GAGAS provide additional guidance on this finding element. This element of a finding reported in the schedule of findings, questioned costs, and recommendations is different from the separate corrective action plan the auditee is required to prepare, which is described further in paragraph 2-4.G.

E. Management Letter. Certain chapters in this audit guide require the auditor to communicate all nonmaterial noncompliance to management in writing. A management letter or other type of written auditor communication to management may be used to report such noncompliance. If auditors issued or intend to issue a management letter (or other similar written communication) for this purpose, their report is to refer to that communication by name and the actual or planned date of issuance. Note that a management letter should not be used to report material findings that were resolved before the audit report was issued. Such findings are to be reported as findings in the auditor's report (by reference to finding numbers) and on the schedule of findings, questioned costs, and recommendations under the category "Corrective Actions Completed."

F. Schedule of the Status of Prior Audit Findings, Questioned Costs, and Recommendations. This schedule is to be prepared by the auditee and is to be included in the audit report package. This schedule must be prepared by the auditee in connection with the audit for the year following the year that an audit report package was issued with audit findings. The schedule should address all findings that were in the prior year report, including whether any questioned costs were paid or otherwise resolved by HUD. A description of the prior audit finding, along with the current status, should be included for each finding. If a finding is no longer relevant, the schedule should note the reason(s). See example E in paragraph 2-6 for an illustrative schedule of the status of prior audit findings.

The auditor should inquire about any audits, attestations, studies, or reviews conducted by HUD OIG, HUD management, a contract administrator, or any other Federal agency that directly relate to the current year audit of the entity's financial statements. Any findings from such reviews should also be included by the auditee in this schedule even if corrective action has already occurred. A description of the prior audit finding, along with the current status, should be included for each finding. The auditor may rely on management's representation as to reports issued during the audit period. The auditor does not have to independently confirm the completeness of all reports listed by the auditee with outside sources.

The auditor should follow up on prior audit findings reported by the auditee, perform procedures to assess the reasonableness of the schedule, and report as a current year finding when the auditor concludes that the schedule materially misrepresents the status of any prior audit finding. If uncorrected, the finding should be repeated as a current finding and so stated on the schedule of the status of prior audit findings with the finding referenced to the current finding number.

G. <u>Corrective Action Plan.</u> A corrective action plan (CAP) is to be prepared by the auditee, and it should be transmitted to HUD as a separate part of the audit report package. The CAP is to be a separate and distinct document from the views of responsible officials included with each finding in the schedule of findings, questioned costs, and recommendations. Using the format in example F, paragraph 2-6, the auditee official is to describe the corrective action(s) taken or planned in response to the current year finding(s) identified by the auditor. It should include task(s), subtask(s), and date(s) for the completion of the action. If funds need to be returned to the program from non-Federal sources, the plan should include information on the method of reimbursement, source of funds, and repayment schedule.

When the schedule of the status of prior audit findings identifies prior findings as unresolved or "open," the CAP should include comments on the corrective action taken and the action that will be taken on the open prior findings (see example E, paragraph 2-6, for an illustrative schedule of the status of prior audit findings).

The auditee is to express its agreement or disagreement with the content of the finding, and if the auditee disagrees with the finding, it is to fully explain the points of that disagreement with specific information to support its position. If the information is voluminous, an appendix may be attached to the audit report package.

Also, the auditee is to express its agreement or disagreement with each recommendation. If there is disagreement with the recommended course of action, the auditee should explain the points of that disagreement and propose an alternative action that would accomplish the same goal.

In addition to the above CAP requirements related to reported findings, the Office of Lender Activities requires the submission of a CAP as a separate part of the audit report package for all issues included in a management letter when such a letter is issued for audits that are performed under chapter 7 of this audit guide.

2-5 <u>Reporting on Fraud or Equity Skimming</u>. On occasion during the course of an audit performed in accordance with this audit guide, the auditor may conclude that fraud either has occurred or is likely to have occurred. In the case of an audit performed under chapter 3 or 4 of this audit guide, fraud could include equity skimming, which is the willful misuse of any part of the rent, assets, proceeds, income, or other funds derived from the project covered by the mortgage, business agreement, regulatory agreement, or other type of

agreement for any purpose other than to meet actual or necessary expenses of the project. For a common understanding of what equity skimming is, please refer to appendix B of chapter 3.

When such acts are noted, the auditor should follow the requirements of GAGAS in considering what to report and the extent to which information should be included in publically available reports. In circumstances in which GAGAS requires the auditor to report directly to HUD, the auditor should direct such reporting to the HUD OIG single audit coordinator.

GAGAS specifies that when entity management fails to satisfy legal or regulatory requirements to report fraud to external parties specified in law or regulation, the auditor should first communicate the failure to report such information to those charged with governance. If the audited entity still does not report this information to the specified external parties as soon as practicable after the auditor's communication with those charged with governance, the auditor should report the information directly to the specified external parties.

However, many entities subject to audit under this audit guide lack an appropriate governance structure, and the auditor may, in effect, be reporting management's failure to the same individuals responsible for the fraud. In such cases, the auditor is required to report the matter directly to HUD by contacting the single audit coordinator, preferably before the auditor leaves the audit site.

Auditors are encouraged to initially communicate with the single audit coordinator to facilitate resolution as to the information to be included in the audit reporting package, report format, documentation requested to be transmitted to the single audit coordinator outside the report, and the distribution of the report.

2-6 **Illustrative Reporting Examples.** Included below are illustrations of the auditor's reports issued in connection with audits conducted in accordance with this audit guide. The illustrations also present examples of the other items typically issued in connection with an audit conducted in accordance with this audit guide and submitted as part of or along with the audit report package as stated in this chapter, including a schedule of findings, questioned costs, and recommendations; a schedule of the status of prior audit findings; and a CAP. These illustrations are not meant to be all inclusive. Auditors should exercise professional judgment in tailoring their reports to the circumstances of individual audits.

The letters A-F below correspond to the letters of the examples that follow.

A. Independent auditor's report on financial statements and supplementary information.

B. Independent auditor's report on internal control over financial reporting and on compliance and other matters based on an audit of financial statements performed in accordance with government auditing standards.

C. Independent auditor's report on compliance with requirements that could have a direct and material effect on each major HUD program and on internal control over compliance based on an audit in accordance with the HUD Consolidated Audit Guide.

D. Schedule of findings, questioned costs, and recommendations.

E. Schedule of the status of prior audit findings, questioned costs, and recommendations (an auditee responsibility).

F. Corrective action plan (an auditee responsibility and, as noted in paragraph 2-4.D, transmitted as a separate part of the audit report package).

Example A

Unmodified Opinion on Financial Statements Accompanied by Other Information

Independent Auditor's Report

[*Appropriate Addressee*]

Report on the Financial Statements

We have audited the accompanying financial statements[1] of Example Entity, which comprise the balance sheet as of December 31, 201X, and the related statements of income and expense, changes in partner's capital, and cash flows[2] for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility[3]

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*,[4] issued by the Comptroller General of the United

[1] If the entity being audited prepares consolidated financial statements, this paragraph and other references to those financial statements in the report should be modified to refer to the consolidated financial statements. See AU-C 700, *Forming an Opinion and Reporting on Financial Statements* (AICPA, *Professional Standards*), for an illustration of an auditor's report on consolidated financial statements.

[2] The description of the financial statements in this sentence is illustrative and should be modified to reflect the actual financial statements presented by the entity. For example, while a reference to a statement of changes in partner's capital may be appropriate for an entity subject to Chapter 3 of this audit guide, it may not be appropriate for an entity subject to Chapter 7 of this audit guide.

[3] Certain entities subject to this audit guide are required to have their financial statements audited in accordance with the standards established by the Public Company Accounting Oversight Board (PCAOB). For such entities, modifications to this report may be necessary. For more information on the use of PCAOB standards with *Government Auditing Standards*, refer to Chapter 2 of *Government Auditing Standards* and the Government Accountability Office Web site at: www.gao.gov/yellowbook.

[4] For financial audits performed in accordance with *Government Auditing Standards*, Chapters 1–4 of *Government Auditing Standards* apply. If the financial statements include organizational units that are not required to have a *Government Auditing Standards* audit, the auditor should consider modifying this paragraph. Chapter 4 of the

States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[5] Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Example Entity, as of December 31, 201X, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

AICPA Audit and Accounting Guide, Government Auditing Standards *and Circular A-133 Audits*, provides an illustration of the wording for such a modification.

[5] In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the organization's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances." In addition, the next sentence, "Accordingly, we express no such opinion." would not be included.

Other Matters

Other Information [6] [7]

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The [*identify accompanying supplementary information such as the adjusted net worth computation, HUD-required financial data templates*[8] *and the other information such as such as other schedules voluntarily provided by management*] are presented for purposes of additional analysis and are not a required part of the financial statements.

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[6] This section, within the "Other Matters" section of the report, is intended to include the reporting on supplementary information when the auditor is engaged to provide an "in-relation-to" opinion on supplementary information and also when explanatory language will be provided relating to other information when the auditor is disclaiming an opinion on the other information. This illustration provides example language for both supplementary information and other information reporting. See footnote 8 for modified wording that could be used in situations where the auditor is providing an in-relation-to opinion on supplementary information and there is no disclaimer on other information. Finally, the caption provided in this illustration is one way an auditor could title the section. Alternatively, the auditor could title it "Supplementary and Other Information," "Supplementary Information," or "Accompanying Information."

[7] This illustration assumes that the auditor has been engaged to provide an "in relation to" opinion on supplementary information, the auditor is issuing an unmodified opinion on the financial statements, and the auditor has concluded that the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. If the auditor has issued an opinion other than unmodified on the financial statements, see the guidance in AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*) . Additionally, the other information reporting contained within this section provides an example of explanatory language that the auditor may use to disclaim an opinion on other information. Note there is no required reporting on other information under AU-C section 720, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*). If there is no other information contained in the document containing the audited financial statements or if the auditor chooses not to include the disclaimer, the references to other information in this section would be deleted and replaced with the following:

> ***Other Information***
>
> Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The [*identify accompanying supplementary information such as the net worth computation or HUD-required financial data templates)*] is presented for purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated, in all material respects, in relation to the financial statements as a whole.

[8] Certain chapters of this audit guide require the auditor to report on supplementary information in relation to the audited financial statements. Each chapter of this audit guide provides more detail on the information required to be reported on in this manner.

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

The [*identify accompanying other information*] has not been subjected to the auditing procedures applied in the audit of the financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

Other Reporting Required by *Government Auditing Standards*[9]

In accordance with *Government Auditing Standards*, we have also issued our report dated [*date of report*] on our consideration of Example Entity's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters.[10] The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance.[11] That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Example Entity's internal control over financial reporting and compliance.

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

[9] Paragraph .37 of AU-C section 700 provides that the section related to an auditor's other reporting responsibilities should be subtitled "Report on Other Legal and Regulatory Requirements" or otherwise, as appropriate to the contents of the section. An example of an alternative title describing the reporting required by *Government Auditing Standards* is illustrated here.

[10] Chapter 4 of *Government Auditing Standards* discusses noncompliance and other matters—that is, certain fraud and abuse—for which *Government Auditing Standards* requires reporting in the auditor's report.

[11] This sentence should be modified if the auditor is providing an opinion on internal control over financial reporting or on compliance in the *Government Auditing Standards* report.

Example B

Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

(No Material Weaknesses Identified, No Significant Deficiencies Identified, No Reportable Instances of Noncompliance or Other Matters Identified)[1]

Independent Auditor's Report

[*Appropriate Addressee*]

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*[2] issued by the Comptroller General of the United States,[3] the financial statements of Example Entity, which comprise the balance sheet as of December 31, 201X, and the related statements of income and expense, changes in partner's capital, and cash flows[4] for the year then ended and the related notes to the financial statements, and have issued our report thereon dated March 15, 201X.[5]

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[1] Auditors may use the portions of examples B, B-1 and B-2 that apply to a specific auditee situation. For example, if the auditor has identified significant deficiencies but has not identified instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, the internal control section of example B-1 may be used along with the compliance and other matters section of this report. Alternatively, if the auditor has not identified significant deficiencies but has identified instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, the internal control section of this report may be used along with the compliance section of example B-1. See example B-2 for illustrative reporting for situations in which the auditor has also identified material weaknesses. The AICPA Audit Guide, Government Auditing Standards *and Circular A-133 Audits*, provides additional guidance on other *Government Auditing Standards* reporting matters that may not be covered in these report illustrations.

[2] For financial audits performed in accordance with *Government Auditing Standards*, chapters 1–4 of *Government Auditing Standards* apply.

[3] If the financial statements include organizational units that are not required to have a *Government Auditing Standards* audit, the auditor should consider modifying this paragraph. Chapter 4 of the AICPA Audit and Accounting Guide, Government Auditing Standards *and Circular A-133 Audits*, provides an illustration of the wording for such a modification.

[4] The description of the financial statements in this sentence is illustrative and should be modified to reflect the actual financial statements presented by the entity. For example, while a reference to a statement of changes in partner's capital may be appropriate for an entity subject to Chapter 3 of this audit guide, it may not be appropriate for an entity subject to Chapter 7 of this audit guide.

[5] If the auditor expressed a modified opinion on the financial statements (i.e., a qualified opinion, an adverse opinion, or a disclaimer of opinion), the auditor should include a statement describing the nature of the modification.

Internal Control over Financial Reporting[6] [7]

In planning and performing our audit of the financial statements, we considered Example Entity's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Example Entity's internal control. Accordingly, we do not express an opinion on the effectiveness of Example Entity's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

The auditor may include certain additional communications when the auditor included such additional communications in the auditor's report on the financial statements that are not modifications to the auditor's opinion. For example, if the auditor included an emphasis-of-matter paragraph in the auditor's report on the financial statements because of an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time, the auditor may also include mention of the additional communication here.

[6] *Government Auditing Standards* permits, but does not require, auditors to express an opinion on internal control over financial reporting or on compliance if sufficient work was performed.

[7] This report sequences the reporting on internal control over financial reporting before the reporting on compliance and other matters. However, the illustrative reports on compliance and internal control over compliance (Examples C, C-1, and C-2) sequence the reporting on compliance before the reporting on internal control over compliance. Auditors may present the internal control and compliance sections of the *Government Auditing Standards* and the HUD compliance reports in whichever sequence better meets their needs.

Compliance and Other Matters[8]

As part of obtaining reasonable assurance about whether Example Entity's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.[9]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*][10]

[8] *Other matters* are certain findings of fraud or abuse. As per industry practice, the reference to "other matters" in both the heading and the following paragraph typically appears in all reports, even if the report does not present or refer to findings of fraud or abuse or even if the only findings of fraud or abuse are presented in or referred to from the section on internal control over financial reporting.

[9] This paragraph conforms to paragraph .11 of AU-C section 905, *Alert that Restricts the Use of the Auditor's Written Communication* (AICPA, *Professional Standards*), which provides for a "purpose" alert in lieu of a "restricted use" alert for certain communications issued under *Government Auditing Standards*. See AU-C section 905 for additional guidance.

[10] Because this report relates to the audit of the financial statements, and is based on the generally accepted auditing standards audit procedures performed, it is subject to the provisions of AU-C section 700. Therefore, it should be dated the same date as the auditor's report on the financial statements, which according to paragraph .41 of AU-C section 700 is "no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements."

Example B-1

Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

(No Material Weaknesses Identified; Significant Deficiencies Identified; and Reportable Instances of Noncompliance and Other Matters Identified)[11]

Independent Auditor's Report

[*Appropriate Addressee*]

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*[12] issued by the Comptroller General of the United States,[13] the financial statements of Example Entity, which comprise the balance sheet as of December 31, 201X, and the related statements of income and expense, changes in partner's capital, and cash flows [14] for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated March 15, 201X.[15]

Internal Control over Financial Reporting [16] [17]

In planning and performing our audit of the financial statements, we considered Example Entity's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Example Entity's internal control. Accordingly, we do not express an opinion on the effectiveness of Example Entity's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that

[11] See footnote 1, Example B.

[12] See footnote 2, Example B.

[13] See footnote 3, Example B.

[14] See footnote 4, Example B.

[15] See footnote 5, Example B.

[16] See footnote 6, Example B.

[17] See footnote 7, Example B.

there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified. We did identify certain deficiencies in internal control, described in the accompanying [*include the title of the schedule in which the findings are reported (e.g., schedule of findings, questioned costs, and recommendations)*] that we consider to be significant deficiencies. [*List the reference numbers of the related findings, for example, 201X-1, 201X-3, and 201X-4*].[18]

Compliance and Other Matters [19]

As part of obtaining reasonable assurance about whether Example Entity's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* [20] and which are described in the accompanying [*include the title of the schedule in which the findings are reported (e.g., schedule of findings, questioned costs, and recommendations)*] as items [*list the reference numbers of the related findings, for example, 201X-2 and 201X-5*].[21]

Example Entity's Response to Findings

Example Entity's response to the findings identified in our audit are described in the accompanying [*include the title of the schedule in which the findings are reported (e.g.,*

[18] Chapter 2 of this audit guide requires that the auditor identify each finding with a reference number that consists of the year followed by a consecutive number.

[19] See footnote 8, Example B.

[20] Chapter 4 of *Government Auditing Standards* discusses the criteria for reporting fraud; noncompliance with provisions of laws, regulations, contracts and grant agreements; and abuse.

[21] See footnote 18.

schedule of findings, questioned costs, and recommendations)]. Example Entity's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.[22]

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.[23]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*] [24]

[22] Although the auditor does not audit management's responses to identified findings, the auditor does have certain responsibilities related to reporting the views of responsible officials under Chapter 4 of *Government Auditing Standards* and Chapter 2 of this audit guide.

[23] See footnote 9, Example B.

[24] See footnote 10, Example B.

Example B-2

Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

(Material Weaknesses and Significant Deficiencies Identified; and Reportable Instances of Noncompliance and Other Matters Identified)[25]

Independent Auditor's Report

[*Appropriate Addressee*]

We have audited, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*[26] issued by the Comptroller General of the United States,[27] the financial statements of Example Entity, which comprise the balance sheet as of December 31, 201X, and the related statements of income and expense, changes in partner's capital, and cash flows[28] for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated March 15, 201X.[29]

Internal Control over Financial Reporting [30] [31]

In planning and performing our audit of the financial statements, we considered Example Entity's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Example Entity's internal control. Accordingly, we do not express an opinion on the effectiveness of Example Entity's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as

[25] See footnote 1, Example B.

[26] See footnote 2, Example B.

[27] See footnote 3, Example B.

[28] See footnote 4, Example B.

[29] See footnote 5, Example B.

[30] See footnote 6, Example B.

[31] See footnote 7, Example B.

described in the accompanying [*include the title of the schedule in which the findings are reported (e.g., schedule of findings, questioned costs, and recommendations*], we identified certain deficiencies in internal control that we consider to be material weaknesses and significant deficiencies.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. We consider the deficiencies described in the accompanying [*include the title of the schedule in which the findings are reported (e.g., schedule of findings, questioned costs, and recommendations)*] to be material weaknesses. [*List the reference numbers of the related findings, for example, 201X-1, 201X-3, and 201X-4*].[32]

A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies described in the accompanying [*include the title of the schedule in which the findings are reported (e.g. schedule of findings questioned costs, and recommendations)*] to be significant deficiencies. (*List the reference numbers of the related findings, for example, 201X-2 and 201X-5.*)][33]

Compliance and Other Matters [34]

As part of obtaining reasonable assurance about whether Example Entity's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* [35] and which are described in the accompanying [*include the title of the schedule in which the findings are*

[32] See footnote 18, Example B-1.

[33] See footnote 18, Example B-1.

[34] See footnote 8, Example B.

[35] See footnote 20, Example B-1.

reported (e.g., schedule of findings, questioned costs, and recommendations)] as items [*list the reference numbers of the related findings, for example, 201X-6 and 201X-7*].[36]

Example Entity's Response to Findings

Example Entity's response to the findings identified in our audit are described in the accompanying [*include the title of the schedule in which the findings are reported (e.g., schedule of findings, questioned costs, and recommendations)*]. Example Entity's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.[37]

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.[38]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*] [39]

[36] See footnote 18, Example B-1.

[37] See footnote 22, Example B-1.

[38] See footnote 9, Example B.

[39] See footnote 10, Example B.

Example C

Report on Compliance for Each Major HUD Program and Report on Internal Control over Compliance Required by the *Consolidated Audit Guide for Audits of HUD Programs*[1]

(*Unmodified Opinion on Compliance; No Material Weaknesses or Significant Deficiencies in Internal Control Over Compliance Identified*)[2]

Independent Auditor's Report

[*Appropriate Addressee*]

Report on Compliance for Each Major HUD Program[3]

We have audited Example Entity's compliance with the compliance requirements described in the *Consolidated Audit Guide for Audits of HUD Programs* (the audit guide) that could have a direct and material effect[4] on each of Example Entity's major U.S. Department of Housing and Urban Development (HUD) programs for the year ended

[1] Note that this combined report format is illustrative of one possible presentation. As noted in AU-C 935, *Compliance Audits* (AICPA, *Professional Standards*), the auditor may also choose to issue the reporting on internal control over compliance in a separate report.

[2] Examples C, C-1 and C-2 are intended to provide illustrations for various situations. Auditors, using professional judgment, may adapt these examples to other situations not specifically addressed within the illustrations. For example, if the auditor is expressing an unmodified opinion on compliance and has identified significant deficiencies, but no material weaknesses, the compliance section of this example may be used along with the internal control section of example C-1. See also AU-C section 935 for additional reporting guidance.

[3] For auditees that only have one major HUD program, all references to "each major HUD program" within this report should be revised to refer to one major HUD program. For example, this heading could be revised to read "Report on Compliance for Major HUD Program." Other references to "each of Example Entity's major HUD programs" and "each major HUD program" could be revised to "Example Entity's major HUD program" and "the major HUD program." Alternatively, the report could refer to a single major HUD program by its specific name throughout the report.

[4] AU-C section 935 defines *applicable compliance requirements* as the compliance requirements that are subject to the compliance audit. According to the *Consolidated Audit Guide for Audits of HUD Programs* (the audit guide), the auditor's report on compliance with requirements applicable to HUD programs expresses the auditor's opinion (or disclaimer of opinion) on whether the auditee complied with the requirements that if noncompliance occurred, could have a direct and material effect on a major HUD program. Therefore, in a compliance audit performed in accordance with the audit guide, the *applicable compliance requirements*, as the term is used in AU-C section 935, are those that could have a direct and material effect on a major HUD program. Accordingly, for the purpose of adapting AU-C section 935 to a compliance audit performed in accordance with the audit guide, the term *applicable* has been replaced by *direct and material* when referencing such compliance requirements in this report.

December 31, 201X. Example Entity's major HUD programs and the related direct and material compliance requirements are as follows: [5]

Name of Major HUD Programs	Direct and Material Compliance Requirements
[Insert the name of the major HUD Program]	*[List the direct and material compliance requirements tested.]*
[Insert the name of the major HUD Program]	*[List the direct and material compliance requirements tested.]*

Management's Responsibility

Management is responsible for compliance with the requirements of laws, regulations, contracts, and grants applicable to its HUD programs.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for each of Example Entity's major HUD programs based on our audit of the compliance requirements referred to above. We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and the audit guide. Those standards and the audit guide require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the compliance requirements referred to above that could have a direct and material effect on a major HUD program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

We believe that our audit provides a reasonable basis for our opinion on compliance for each major HUD program. However, our audit does not provide a legal determination of Example Entity's compliance.

[5] Certain chapters of this audit guide (e.g., Chapter 7, *FHA-Approved Lender Audit Guidance*) specifically require the auditor to include the direct and material compliance requirements tested in this report. Therefore, this report illustrates how the auditor may identify both the major HUD programs and the direct and material compliance requirements tested for each major HUD program in a table format. It is also permissible for auditors to include the major HUD programs and, when required, direct and material compliance requirements tested, within the first paragraph in lieu of inserting a table.

Opinion on Each Major HUD Program

In our opinion, Example Entity complied, in all material respects, with the compliance requirements referred to above that could have a direct and material effect on each of its major HUD programs for the year ended December 31, 201X.

Other Matters

We noted certain matters that we are required to report to management of Example Entity in a separate written communication. These matters are described in our [*identify the name of the written communication*] dated [*insert date of management letter*].[6]

Report on Internal Control over Compliance [7]

Management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the compliance requirements referred to above. In planning and performing our audit of compliance, we considered Example Entity's internal control over compliance with the requirements that could have a direct and material effect on each major HUD program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major HUD program and to test and report on internal control over compliance in accordance with the audit guide, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of Example Entity's internal control over compliance.

A *deficiency in internal control over compliance* exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a compliance requirement of a HUD program on a timely basis. A *material weakness in internal control over compliance* is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a compliance requirement of a HUD program will not be prevented, or detected and corrected, on a timely basis. A *significant deficiency in internal control over compliance* is a deficiency, or a combination of

[6] Certain chapters of this audit guide require the auditor to communicate all nonmaterial noncompliance and certain other matters to management in writing. If the auditor issued or intends to issue such a management letter (or other similar written communication), this report is required to refer to that communication by name. If the auditor has not yet issued such a written communication, but intends to, the auditor may revise the second sentence to indicate that such a communication will be issued. To the extent there are no such matters required to be communicated, this "Other Matters" section would be deleted.

[7] See footnote 1, Example C. If an auditor prefers to issue a separate report on internal control over compliance this section would be omitted from the report. AU-C section 935 includes required elements for separate reporting on internal control over compliance.

deficiencies, in internal control over compliance with a compliance requirement of a HUD program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of the audit guide. Accordingly, this report is not suitable for any other purpose. [8]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

[8] This paragraph has been adapted from AU-C section 905, *Alert That Restricts the Use of the Auditor's Written Communication* (AICPA, *Professional Standards*) to relate to the reporting on internal control over compliance that is required in an audit of compliance in accordance with this audit guide.

Example C-1

Report on Compliance for Each Major HUD Program and Report on Internal Control over Compliance Required by the *Consolidated Audit Guide for Audits of HUD Programs* [9]

(Unmodified Opinion on Compliance; Significant Deficiencies in Internal Control Over Compliance Identified)[10]

Independent Auditor's Report

[*Appropriate Addressee*]

Report on Compliance for Each Major HUD Program [11]

We have audited Example Entity's compliance with the compliance requirements described in the *Consolidated Audit Guide for Audits of HUD Programs* (the audit guide) that could have a direct and material effect[12] on each of Example Entity's major U.S. Department of Housing and Urban Development (HUD) programs for the year ended December 31, 201X. Example Entity's major HUD programs and the related direct and material compliance requirements are as follows: [13]

Name of Major HUD Programs	**Direct and Material Compliance Requirements**
[Insert the name of the major HUD Program]	*[List the direct and material compliance requirements tested.]*
[Insert the name of the major HUD Program]	*[List the direct and material compliance requirements tested.]*

Management's Responsibility

Management is responsible for compliance with the requirements of laws, regulations, contracts, and grants applicable to its HUD programs.

[9] See footnote 1, Example C.

[10] See footnote 2, Example C.

[11] See footnote 3, Example C.

[12] See footnote 4, Example C.

[13] See footnote 5, Example C.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for each of Example Entity's major HUD programs based on our audit of the compliance requirements referred to above. We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and the audit guide. Those standards and the audit guide require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the compliance requirements referred to above that could have a direct and material effect on a major HUD program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

We believe that our audit provides a reasonable basis for our opinion on compliance for each major HUD program. However, our audit does not provide a legal determination of Example Entity's compliance.

Opinion on Each Major HUD Program

In our opinion, Example Entity complied, in all material respects, with the compliance requirements referred to above that could have a direct and material effect on each of its major HUD programs for the year ended December 31, 201X.

Other Matters

We noted certain matters that we are required to report to management of Example Entity in a separate written communication. These matters are described in our [*identify the name of the written communication*] dated [*insert date of management letter*].[14]

Report on Internal Control over Compliance[15]

Management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the compliance requirements referred to above. In planning and performing our audit of compliance, we considered Example Entity's internal control over compliance with the requirements that could have a direct and material effect on each major HUD program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major HUD program and to test and report on internal control over compliance in accordance with the audit guide, but not for the purpose of expressing an opinion on

[14] See footnote 6, Example C.

[15] See footnote 7, Example C.

the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of Example Entity's internal control over compliance.

A *deficiency in internal control over compliance* exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a compliance requirement of a HUD program on a timely basis. A *material weakness in internal control over compliance* is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a compliance requirement of a HUD program will not be prevented, or detected and corrected, on a timely basis. A *significant deficiency in internal control over compliance* is a deficiency, or a combination of deficiencies, in internal control over compliance with a compliance requirement of a HUD program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, we identified certain deficiencies in internal control over compliance, as described in the accompanying [*include the title of the schedule in which the findings are reported (e.g., schedule of findings, questioned costs, and recommendations)*] as items *[list the reference numbers of the related findings, for example, 201X-3, 201X-4, and 201X-5]*, that we consider to be significant deficiencies.

Example Entity's responses to the internal control over compliance findings identified in our audit are described in the accompanying [*include the title of the schedule in which the findings are reported (e.g., schedule of findings, questioned costs, and recommendations)*]. Example Entity's response was not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the response.[16]

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing

[16] Although the auditor does not audit management's response to identified findings, the auditor does have certain responsibilities related to reporting the views of responsible officials under *Government Auditing Standards* and Chapter 2 of this audit guide.

based on the requirements of the audit guide. Accordingly, this report is not suitable for any other purpose. [17]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

[17] See footnote 8, Example C.

Example C-2

Report on Compliance for Each Major HUD Program and Report on Internal Control over Compliance Required by the *Consolidated Audit Guide for Audits of HUD Programs* [18]

(Qualified Opinion on Compliance for One Major HUD Program; Unmodified Opinion on Compliance for the Other Major HUD Program; Material Weaknesses and Significant Deficiencies in Internal Control Over Compliance Identified)[19]

Independent Auditor's Report

[*Appropriate Addressee*]

Report on Compliance for Each Major HUD Program[20]

We have audited Example Entity's compliance with the compliance requirements described in the *Consolidated Audit Guide for Audits of HUD Programs* (the audit guide) that could have a direct and material effect[21] on each of Example Entity's major U.S. Department of Housing and Urban Development (HUD) programs for the year ended December 31, 201X. Example Entity's major HUD programs and the related direct and material compliance requirements are as follows:[22]

Name of Major HUD Programs	**Direct and Material Compliance Requirements**
[Insert the name of the major HUD Program]	*[List the direct and material compliance requirements tested.]*
[Insert the name of the major HUD Program]	*[List the direct and material compliance requirements tested.]*

[18] See footnote 1, Example C.

[19] See footnote 2, Example C.

[20] See footnote 3, Example C.

[21] See footnote 4, Example C.

[22] See footnote 5, Example C.

Management's Responsibility

Management is responsible for compliance with the requirements of laws, regulations, contracts, and grants applicable to its HUD programs.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for each of Example Entity's major HUD programs based on our audit of the compliance requirements referred to above. We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and the audit guide. Those standards and the audit guide require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the compliance requirements referred to above that could have a direct and material effect on a major HUD program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

We believe that our audit provides a reasonable basis for our opinion on compliance for each major HUD program. However, our audit does not provide a legal determination of Example Entity's compliance with those requirements.

Basis for Qualified Opinion on [Identify Major HUD Program] [23]

As described in the accompanying [*include the title of the schedule in which the findings are reported (e.g., schedule of findings, questioned costs, and recommendations)*], Example Entity did not comply with requirements regarding *[identify the major HUD program]* as further described in [*list the reference numbers of the related findings, for example, 201X-1 and 201X-2*]. Compliance with such requirements is necessary, in our opinion, for Example Entity to comply with the requirements applicable to that program.

Qualified Opinion on [Identify Major HUD Program]

In our opinion, except for the noncompliance described in the Basis for Qualified Opinion paragraph, Example Entity complied, in all material respects, with the compliance requirements referred to above that could have a direct and material effect on [*identify the major HUD program*] for the year ended December 31, 201X.

[23] The heading to this section, and the qualified opinion paragraph that follows in the next paragraph, illustrates identifying the specific major HUD programs being referred to in each heading.

Unmodified Opinion on [Identify Major HUD Program][24]

In our opinion, Example Entity complied, in all material respects, with the compliance requirements referred to above that could have a direct and material effect on [*identify the other major HUD program*] for the year ended December 31, 201X.

Other Matters

Example Entity's responses to the noncompliance findings identified in our audit are described in the accompanying [*include the title of the schedule in which the findings are reported (e.g., schedule of findings, questioned costs, and recommendations)*]. Example Entity's response was not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the response.[25]

We noted certain matters that we are required to report to management of Example Entity in a separate written communication. These matters are described in our [*identify the name of the written communication*] dated [*insert date of management letter*].[26]

Report on Internal Control over Compliance[27]

Management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the compliance requirements referred to above. In planning and performing our audit of compliance, we considered Example Entity's internal control over compliance with the requirements that could have a direct and material effect on each major HUD program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major HUD program and to test and report on internal control over compliance in accordance with the audit guide, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of Example Entity's internal control over compliance.

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[24] In this example, there are only two major HUD programs. Therefore, this example illustrates including in the heading the name of the remaining major HUD program with an unmodified opinion. If there are more than two major HUD programs, this heading could be revised as "Unmodified Opinions on Each of the Other Major HUD Programs" and the specific major HUD programs could be identified within the unmodified opinion paragraph.

[25] See footnote 16, Example C-1.

[26] Certain chapters of this audit guide require the auditor to communicate all nonmaterial noncompliance and certain other matters to management in writing. If the auditor issued or intends to issue such a management letter (or other similar written communication), this report is required to refer to that communication by name. If the auditor has not yet issued such a written communication, but intends to, the auditor may revise the second sentence to indicate that such a communication will be issued. To the extent there are no such matters required to be communicated, this paragraph within the "Other Matters" section would be deleted.

[27] See footnote 7, Example C.

Our consideration of internal control over compliance was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as discussed below, we identified certain deficiencies in internal control over compliance that we consider to be material weaknesses and significant deficiencies.

A *deficiency in internal control over compliance* exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a compliance requirement of a HUD program on a timely basis. A *material weakness in internal control over compliance* is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is reasonable possibility that material noncompliance with a compliance requirement of a HUD program will not be prevented, or detected and corrected, on a timely basis. We consider the deficiencies in internal control over compliance described in the accompanying [*include the title of the schedule in which the findings are reported (e.g., schedule of findings, questioned costs, and recommendations)*] as items [*list the reference numbers of the related findings, for example 201X-5 and 201X-6*] to be material weaknesses.

A *significant deficiency in internal control over compliance* is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a HUD program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance. We consider the deficiencies in internal control over compliance described in the accompanying [*include the title of the schedule in which the findings are reported (e.g., schedule of findings, questioned costs, and recommendations)*] as items [*list the reference numbers of the related findings, for example 201X-7 and 201X-8*] to be significant deficiencies.

Example Entity's responses to the internal control over compliance findings identified in our audit are described in the accompanying [*include the title of the schedule in which the findings are reported (e.g., schedule of findings, questioned costs, and recommendations)*]. Example Entity's response was not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the response.[28]

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing

[28] See footnote 16, Example C-1.

based on the requirements of the audit guide. Accordingly, this report is not suitable for any other purpose.[29]

[*Auditor's signature*]

[*Auditor's city and state*]

[*Date of the auditor's report*]

[29] See footnote 8, Example C.

Example D

Schedule of Findings, Questioned Costs,
and Recommendations

Option 1: If the audit resulted in no findings, the schedule should still be included in the audit report package and should include only the following statement:

Our audit disclosed no findings that are required to be reported herein under the HUD Consolidated Audit Guide.

Option 2: If the audit resulted in findings to be reported, the following is the format that is to be used. See paragraph 2-4.D for the content and categorization of findings.

1. Corrective Actions Not Started or in Process.

Finding 201X-1.

Each finding is to be listed and must contain the required information contained in paragraph 2-4.D.4, Content of Finding. The numbering of the findings and recommendations related to each finding is to follow the requirements in paragraphs 2-4.D.4.a and j.

Recommendations:

201X-1-a.

201X-1-b.

Management comments:

2. Corrective Action Completed.

Finding 201X-2.

Each finding is to be listed and contain the required information contained in paragraph 2-4.D.4, Content of Finding. The numbering of the findings and recommendations related to each finding is to follow the requirements in paragraphs 2-4.D.4.a and j.

Recommendations:

201X-2-a.

201X-2-b.

Management comments:

Example E

Schedule of the Status of Prior Audit Findings, Questioned Costs, and Recommendations

The auditee is to list all findings from the prior period audit reporting package in which corrective action was in process or not started. In addition, this schedule is to contain findings that were contained in reports issued by HUD OIG, other Federal agencies, HUD management, or a contract administrator from the beginning of the period covered by the audit to the date of the auditor's fieldwork completion. Only findings that are relevant to the current year's audit should be included.

With respect to items included in the prior period audit reporting package, the auditor is to perform procedures to assess the reasonableness of the schedule and report as a current year finding when the auditor concludes that the schedule materially misrepresents the status of any prior audit finding.

1. The auditee is to identify the prior audited fiscal period of this entity.

Audit Report, dated **[insert date of report]**, for the period ended **[insert date]**, issued by **[insert name of independent auditor]**

If there were no open findings from the prior audit report, so state, and if there were, the following format is to be used:

Finding 201X-1. Nonproject Costs Were Charged to the Project (Questioned Costs $125,000)

Status: The $125,000 has been returned to the project, and the entity's system of distributing costs has been corrected. The entity reviewed all cost accounts up to the time that the system was changed and refunded the project an additional $55,250. The finding was closed by HUD management on July 9, 2011.

Finding 201X-2. The Required Documentation With Regard to Eligibility Was Not Obtained for Tenants Receiving Rent Supplements

Status: The project has not obtained the required documentation from third-party sources, nor has the project reimbursed the appropriate programs. The amount of the rent supplements received for these tenants for the prior audit period was $15,350. The finding remains open.

Finding 201X-3. Separate Security Deposit Bank Accounts Were Not Established for Each of the Five Projects and Interest Earned Was Not Included in the Project's Income and Not Distributed to the Tenant in Accordance with State Law

Status: The owner established the five separate bank accounts but continued to take the interest earned on security deposit investments into the project income account. The owner did not take any action to credit the tenants for the interest earned as required by State law. The interest portion of this finding remains open and is repeated as current finding 201X-2.

2. The auditee should identify findings from audit, attestation, or other studies (source document) performed by HUD, another Federal agency, or a contract administrator during the period described above that directly relate to the subject matter of the current year audit and include them in this section of the schedule of the status of prior audit findings.

Audit Report issued on **[insert date of report]**, by HUD OIG **[or name of report issuer**], titled **[insert title of report]**

Finding 1 -

Status -

OR

There were no reports issued by HUD OIG or other Federal agencies or contract administrators during the period covered by this audit.

3. The auditee is to list any deficiency listed in letters or reports (source documents) issued by HUD management as a result of any reviews of the entity's activity that relates to the audit objectives and during the period described above.

HUD management report was issued on **[insert date of report]**, and is titled **[list title of report]**.

Finding 1 -

Status -

OR

There were no letters or reports issued by HUD management during the period covered by this audit.

Note: The finding or recommendation numbers and the format of those numbers that are to be displayed on this schedule are the ones used in the source documents.

The auditor may rely on management's representation as to reports issued during the audit period. The auditor does not have to independently confirm the completeness of all the reports listed by the auditee with outside sources.

Example F

Corrective Action Plan

The corrective action plan is an important document with which the auditee can demonstrate its willingness to correct the deficient condition noted in the audit findings. This plan will form the basis for HUD to work with the auditee to reach agreement on the actions to be taken to address the audit recommendations and timeframes for implementation.

The auditor should determine whether the auditee agrees or disagrees with the content of the findings, and if there is a disagreement, the auditor should request that the auditee fully explain the points of that disagreement with specific information to support its position. If the information is voluminous, an appendix may be attached to the audit report package.

The auditor should also determine whether the auditee agrees or disagrees with each recommendation. If there is disagreement with the recommended course of action, the auditee should explain the basis for that disagreement and propose an alternative action that would accomplish the same goal.

The following is a recommended format to be followed by the auditee for preparing a corrective action plan:

****

Corrective Action Plan

Name of auditee: _____

HUD auditee identification number: _____

Name of audit firm: _____

Period covered by the audit: _____

CAP prepared by

Name: _____

Position: _____

Telephone number: _____

A. <u>Current Findings on the Schedule of Findings, Questioned Costs, and Recommendations</u>.

1. <u>Finding 201X-1</u>.

a. <u>Comments on the Finding and Each Recommendation</u>.

The auditee is to provide a statement of concurrence or nonconcurrence with each finding. The auditee is also to provide a statement of agreement or disagreement with each recommendation in the finding.

b. <u>Action(s) Taken or Planned on the Finding</u>

The auditee should detail actions taken or planned to correct each finding identified in the report. Appropriate documentation should be submitted for actions taken. For planned actions, the auditee should provide the projected date for completion of all required action. The auditee should provide information on the task(s), subtask(s) and projected completion date(s) for the correction of the deficient condition and repayment of funds if appropriate. The names of the auditee officials or supervisor responsible for completing the proposed task(s) and subtask(s) should also be identified. If the auditee believes a corrective action is not required, a statement describing the reasons should be included.

2. <u>Finding 201X-2 through X</u>.

a. <u>Comments on the Finding and Each Recommendation</u>

b. <u>Action(s) Taken or Planned on Each Finding</u>

B. <u>Status of Corrective Actions on Findings Reported in the Prior Audit Schedule of Findings, Questioned Costs, and Recommendations.</u>

The auditee should comment on the status of corrective actions taken on all prior findings that were reported as open or action not completed on the auditor's prior schedule of findings, questioned costs, and recommendations and remain open. The auditee should also update the planned date(s) for completion of task(s) and subtask(s) and the responsible entity supervisor or official(s) to complete the task(s) or subtask(s). In addition, documentation should be submitted in support of any portions of the action plan that the auditee considers completed.

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. ***Sample Selection.** 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*

[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. <u>Fair Housing and Nondiscrimination.</u>

1. <u>Compliance Requirement</u>. 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. <u>Suggested Audit Procedures.</u>

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. <u>Replacement Reserve.</u>

1. <u>Compliance Requirement</u>. 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. <u>Tenant Security Deposits.</u>

1. <u>Compliance Requirement.</u> Funds collected as a security deposit shall be kept in the name of the project, separate and apart from all other funds of the project in a trust account. The amount of this account shall 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. <u>*Suggested Audit Procedures.</u>

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. <u>Management Functions.</u>

1. <u>Compliance Requirement</u>. 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. <u>Suggested Audit Procedures.</u>

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. <u>Leased Nursing Homes</u>.

1. <u>Compliance Requirements.</u> 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. <u>Suggested Audit Procedures.</u>

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

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. Distribution of Surplus Cash for M2M Projects.

1. **Compliance Requirements.** 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. **Suggested Audit Procedures.**

   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. Special Rules for Cooperatives.

1. **Compliance Requirements.** 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. **Suggested Audit Procedures. ***

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.

Review of Project Income.

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.*

CHAPTER 4. Mortgage Insurance for Hospitals Program

4-1. **Background.** This chapter contains the U.S. Department of Housing and Urban Development (HUD) requirements for conducting the annual financial audits of profit-motivated and limited-distribution entities participating as mortgagors in HUD's Federal Housing Administration (FHA's) Mortgage Insurance for Hospitals Program, under Section 242 of the National Housing Act. Accounting requirements for these entities are in HUD Handbook 4470.2, *Cost Certification Guide for Mortgagors and Contractors of HUD-Insured and Section 202/811 Multifamily Projects*; HUD Handbook 4370.1, *Reviewing Monthly and Annual Reports*; HUD Handbook 4370.2, *Financial Operations and Accounting Procedures for Insured Multifamily Projects;* and *HUD Handbook 4615.1, Mortgage Insurance for Hospitals,* to the extent that these handbooks are applicable to hospitals.

As noted in Chapter 1, Section 1-2, nonprofit entities are subject to the audit requirements in Office of Management and Budget (OMB) Circular A-133. Auditors would normally use OMB's Compliance Supplement to perform the audit and not this audit guide. However, as of the date of this revision to Chapter 4, the Mortgage Insurance for Hospitals Program[1] is not included in the Compliance Supplement. Therefore, the auditor should use the compliance requirements and suggested audit procedures in this audit guide for purposes of building an audit program using the guidance in part 7 of the OMB Compliance Supplement. Auditors auditing nonprofit entities should check the current Compliance Supplement and use the supplement if the program is included.

In fiscal year 2012, HUD redefined the term "mortgagor[2]" in both the loan covenants and the new edition of HUD Handbook 4615.1 as, "*the borrower and its successors and affiliates under the HUD-insured mortgage, to the extent that its assets, liabilities, net assets, revenues, and expenses are encumbered by the mortgage and the security agreement, including without limitation leased equipment for the benefit of the hospital and restricted assets.*" HUD also began attaching a chart showing the mortgagor and excluded affiliates/divisions to the description of the property included in the exhibits to the covenants of each commitment for insurance (See Handbook 4615.1, appendix 9, section 9-3). Throughout this chapter, we are using the revised term of "mortgagor" to refer to both the new term and the previously used term "mortgaged entity."

Understanding the term "mortgagor" and how it may differ from the assets, liabilities, net assets, revenues and expenses presented in consolidated financial statements is

[1] Catalog of Federal Domestic Assistance Number 14.128.

[2] The revised definition of "mortgagor" agrees with the definition of "mortgaged entity" that was used in the rider to the regulatory agreement from 2005 through 2012. The term "mortgaged entity" will not be included in future regulatory agreements.

essential to a compliance audit for Section 242 insured projects. Similarly, it is essential to understand the term "mortgaged entity," which may have been used in loan documents prior to 2013, for a compliance audit of Section 242 insured projects. Auditors should carefully review Handbook 4615.1, appendix 9, section 9-3, to understand the "mortgagor" and "mortgaged entity" terms. Loans insured prior to 2005 are treated in a similar fashion by making a distinction between the project and "other activities."

4-2. **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.

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 4-2 should any of the material referenced below be revised, causing a change to documents' revision number, rather than revising the entire handbook or chapter, since the base handbook number would not change. Also, the auditor should use the references listed in this paragraph when 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 refer to the handbook, including the current revision number.

Document	Title	Source
HUD Handbook 4615.1	Mortgage Insurance for Hospitals	HUD web site
24 CFR, Part 242	Code of Federal Regulations "Mortgage Insurance for Hospitals"	HUD web site
HUD 92466	The executed regulatory agreement between HUD and entity – for-profit[3]	Hospital
Audit and Accounting Guide	Health Care Entities	AICPA
HUD Handbook 4470.2, REV-1	Cost Certification Guide for Mortgagors and Contractors of HUD-Insured and Section 202/811 Multifamily Projects	HUD web site

[3] Including any riders to the regulatory agreement, supplemental agreements, mortgage reserve fund agreement, and depreciation reserve fund agreement, or agreement as to depreciation reserve fund and other conditions. The term "regulatory agreement," when used throughout this chapter, should be understood to include all of the foregoing.

HUD Handbook 4370.1, REV-2	Reviewing Annual and Monthly Financial Reports[4]	HUD web site
HUD Handbook 4370.2 , REV-1	Financial Operations and Accounting Procedures for Insured Multifamily Projects[3]	HUD web site

HUD reference material may be obtained by accessing HUD's Client Information and Policy System (HUDCLIPS) at

http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/handbooks/hsgh

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.

Many of the program requirements are specified in the HUD insured loan documents, including the mortgage note (FHA Form 4167-D), the mortgage[5], the regulatory agreement (HUD-92466-OHF[6]), riders to the regulatory agreement, the mortgage reserve fund agreements and related schedules, the security agreement and any updates to these agreements. Older loans may have a supplementary agreement, an agreement as to depreciation reserve fund and other conditions, or a depreciation reserve fund. All depreciation reserve funds should have been converted to a mortgage reserve fund.

In addition, written correspondence to the hospital that grants permission for modifications or particular transactions often includes additional conditions. These documents must be reviewed and kept in the permanent record file as appropriate. Care must be exercised to avoid confusion of the HUD insured mortgage loan agreements from any agreements associated with a related bond offering that are not a part of the insured loan.

The requirements of the loan documents and subsequent correspondence should be taken into account in the overall audit planning.

4-3. **Reporting Requirements.** The regulatory agreement for the mortgagor requires the owner or management agent to submit audited financial statements, prepared in accordance with the requirements of the Secretary, within 120 days after the end of the fiscal year. Hospital mortgages initially endorsed before 2004 may have a regulatory agreement requiring submission of audited financial statements within 60 days.

[4] If there is a conflict between Handbook 4370.1 or 4370.2 and Handbook 4615.1, Handbook 4615.1 will prevail.
[5] or deed of trust, deed of trust with assignment of rents, or security deed.
[6] HUD-92466-OHF replaced form HUD-92466 in 2013. Hospitals with older loans will have the earlier version.

However, these hospitals were sent a letter notifying them that, as of fiscal years beginning in 2003, the HUD Office of Insured Health Care Facilities (now Office of Hospital Facilities) extended the due date for the receipt of the audited financial statements to 120 days after the end of the fiscal year. The owner must certify the completeness and accuracy of the financial statements. The certifications are to be made in accordance with the requirements of HUD Handbook 4370.2, paragraphs 3-7, as applicable. 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 submission with the Office of Hospital Facilities. The independent auditor must:

A. Issue an independent auditor's report (refer to chapter 2, section 2-6, example A) on the ownership entity's basic financial statements[7]. This report should cover the following items:

- Balance sheet,
- Statement of profit and loss,
- Statement of changes in partner's capital,[8]
- Statement of cash flows, and
- Footnotes to the basic financial statements.

B. Ensure that the independent auditor's report covers all required supplemental information required by HUD. A paragraph may be added to the auditors' report on the basic financial statements, or a full report may be issued separately. The auditor's reporting on this information should be done in accordance with AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*)

[7] If the financial statements include assets, liabilities, equity, revenues, or expenses that are excluded from the project, consolidating supplemental statements are required with appropriate footnote modifications, see Handbook 4615.1, appendix 9(B) (Consolidations and Combined Financial Statements); Handbook 4615.1, appendix 9, section 9-2 (sample reports); and Handbook 4615.1, appendix 9, section 9-3 (mortgagor).

[8] 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.

C. Issue all additional auditor prepared[9] reports described in Chapter 2, including any management letter or other similar written communication as described in Section 2-4.E. All nonmaterial instances of noncompliance disclosed during the audit process must be reported separately in writing to management. Such reporting must be in writing in a management letter or other type of written communication. The form and date of this written communication must be mentioned in the independent auditor's report. The management letter or other written communication should be submitted with the audit report package.

The owner should submit a hard copy of the audit reporting package to the Office of Hospital Facilities at the following address:

Office of Hospital Facilities
Department of Housing and Urban Development
451 7th St. SW, Room 2247
Washington, DC 20410

4-4. Compliance Requirements and Suggested Audit Procedures.

A. Federal Financial Reports.

1. Compliance Requirement. Mortgagors (and in limited cases, operators) 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 mortgagor (operator) and HUD. The individual agreements contain the specific reporting requirements that the mortgagor (operator) must follow. HUD will usually require monthly reports during the construction period or whenever annual financial reviews, on-site reviews, or other information indicates that the project is experiencing financial or management difficulties or the owner or management agent is suspected of noncompliance (HUD Handbook 4370.1, chapter 3 as modified by HUD Handbook 4615.1 and section 26 of the rider to the regulatory agreement). The reporting requirements include full time equivalent staffing ratios and utilization statistics (regulatory agreement Section 26).

While HUD may be aware that the mortgagor is not meeting its reporting obligations, incomplete or late reporting may be indicative of a systemic problem warranting reporting as a finding, thereby bringing the matter to the attention of the board of directors.

[9] All auditee prepared reports described in Chapter 2 are also required to be submitted with the reporting package.

2. **Suggested Audit Procedures.**

   a. Identify all required financial and statistical reports by inquiry of the owner or management agent and review of the regulatory agreement[10] and correspondence with HUD. Request from the mortgagor a copy of its submissions to HUD during the period under audit.

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

   c. Select a sample of financial and statistical 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 supported by project records. Report all material differences between financial reports and project records.

   e. Based on the above, determine whether the mortgagor (operator) complied with HUD's reporting requirements as contained in the HUD regulatory agreement and 24 CFR Part 242.

B. Mortgage Status.

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

2. **Suggested Audit Procedures.**

   a. Obtain a copy of the mortgage note, mortgage, and associated loan amortization schedule to determine the terms and conditions stipulated in those agreements.

   b. Obtain an understanding of the owner or management agent's procedures for assuring prompt payment of the mortgage.

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

      i. Obtaining 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

[10] See footnote 3 for other documents included in the term regulatory agreement.

disbursed) and determining whether monthly payments were made on time and the loan was current at the end of the fiscal year; or

ii. Confirming the outstanding loan balance and annual escrow account activity with the lender or trustee, for accounts held in trust, as of the mortgagor'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 mortgagor is operating under a mortgage modification agreement, workout agreement, forbearance agreement, use agreement, or other agreement, determine whether the owner or management agent is complying with the terms and conditions of the agreement.

C. Mortgage Reserve Fund, Equipment Replacement Reserve Fund, and Special Escrows.

1. Compliance Requirement. Owners are required to establish a mortgage reserve fund to provide HUD with a means to assist the hospital to avoid mortgage defaults and to preserve the value of the mortgaged property and the hospital's business. The mortgage reserve fund replaces a depreciation reserve fund account that may be referred to in the loan documents for older agreements. Disbursements from this fund may be made only after receiving written consent from HUD, or in accordance with the fund schedule.

For-profit hospitals are required to establish an equipment replacement reserve fund and make deposits in accordance with the regulatory agreement and HUD Handbook 4615.1 section 242.14. The reserve for replacement account is usually required to be under the control of the lender. Funds may be drawn out of the equipment replacement reserve for the purchase of fixed or major moveable equipment for the insured project or to make payments on equipment financed by capital leases, loans, or installment purchase contracts. The mortgagor may withdraw funds for the purchase of fixed or major moveable equipment upon submission of appropriate supporting documentation evidencing the purchase of equipment, unless notified by HUD that written permission by HUD is required prior to purchase or use of the funds.

The mortgagor may also be required to establish other special escrow funds via the regulatory agreement, or via another arrangement reflected in a letter. For example, in connection with the sale of mortgaged assets, a release of lien letter may include a requirement to use the proceeds from the sale to establish a special escrow. The purpose and requirements for these funds will be set forth in the loan documents or other agreements. Each fund, its scheduled balance,

required balance[11], and actual balance must be listed in the notes to the financial statements or in the supplemental schedules.

Reserve funds and special escrows are to be invested in (1) interest bearing securities insured by an Agency of the United States Government or in direct obligations of the United States Government, or in obligations for which the principal and interest are guaranteed by the United States Government, or instruments of United States Government agencies such as the Federal Home Loan Bank or the Federal Farm Credit Bank, or (2) mutual funds that invest solely in U. S. Treasury obligations or short term securities that are fully insured or guaranteed by the U. S. Government or its agencies, as specified in the trust agreement and HUD Handbook 4615.1. Interest earned on these funds is required to be maintained in the reserve account, unless HUD has specifically authorized release if certain conditions are met. Interest on those investments is considered project funds and may not be disbursed directly to owners or directly to any individual or entity 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 mortgagor's/management agent's deposit, withdrawal, and maintenance requirements included in the regulatory agreement and any amendments or other written agreements with HUD and determine whether there were any changes to the funding requirement by:

i. Reviewing the records establishing the funds, including any trust agreements, funding schedules, any special releases authorized by HUD, and any modifications.

ii. Make inquiries of the owner or management agent regarding whether any changes have been made to the agreements.

b. Obtain an understanding of the mortgagor's/management agent's procedures for depositing, maintaining, requesting, and disbursing funds from the reserve or escrow account.

c. Determine whether the reserve fund or escrow 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 or management agent reviewed the depository statements to verify that it met HUD requirements as described in HUD Handbook 4615.1 and the trust

[11] The scheduled balance may differ from the required balance because of a special withdrawal request that was granted. When granted, there are often conditions for repayment.

agreement, and that the funds are invested in accordance with HUD requirements.

d. Using confirmation from the trustee, determine whether all required deposits to the reserve fund or escrow were made in compliance with HUD requirements and agreements.

e. Select a sample of withdrawals from the escrow/reserve fund, if any, and related documentation. Determine if withdrawals are in compliance with requirements.

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

g. Determine whether funds were invested and interest was only withdrawn with HUD approval or in accordance with the loan documents or HUD requirements referenced in the compliance requirements noted above.

h. Determine if required "repayments to funds," if any, were made in accordance with requirements.

D. Distributions to Owners or Affiliates.

1. Compliance Requirement. Owners may not make, receive, or retain any distribution of assets or any income of any kind from the project except surplus cash[12] and then only under certain conditions. Similar restrictions apply to distributions to related entities or activities excluded from the mortgagor. Surplus cash distributions can only be made as of and after the end of the fiscal year and completion of the annual audit, with rare exceptions. Surplus cash distributions cannot be made when the owner is in default under any of the terms of the regulatory agreement or under the note or mortgage. The regulatory agreement specifies the requirements to be met prior to any distribution of assets. Distributions may be in the form of cash, assets, the sale of services or assets below market value to an owner or affiliate, the purchase of goods or services at a price above market value, or failure to collect accounts receivables from owners or affiliates in a timely manner. Dealings with a division of the corporation that is not a part of the mortgagor is considered the same as dealing with an affiliate.

[12] Surplus cash is a broad term and includes more than just cash. Surplus cash distributions may be in the form of a distribution of assets, provision of services at a discount, purchasing services at a premium, etc.

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

a. Obtain a copy of the mortgagor's regulatory agreement and any amendments or associated documents to determine the requirements for distributions of assets for activities excluded from the mortgagor, and dealings with affiliates, or the owner, if applicable.

b. Obtain an understanding of the mortgagor's procedures for determining surplus cash and making distributions.

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

d. Make inquiries of 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 agreement.

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

f. Determine whether distributions taken during the audit period exceeded the amounts allowed for that period.

g. Review cash disbursements for evidence of any payments or sales made to the project owners or related parties. Review journal entries for unexplained decreases in accounts payable, notes payable and related interest to project owners or related parties. Determine whether the owner or management agent paid partnership management fees, asset management fees, incentive management fees, non-project costs, or write-offs of related party receivables from funds other than surplus cash or distributions. Determine if sales to, or purchases from affiliates were at arms length or more favorable terms to the mortgagor.

h. Review the deposit or cash receipt records for any deposit, from the project owners or related parties, which would show that incorrect distributions or payments were made and that those funds were redeposited into the project's accounts before the audit.

i. Review a representative sample of inspection reports and owner or management agent 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 it appear that funds were available for distribution to the owners.

E. Equity Skimming.

1. **Compliance Requirement.** Equity skimming is the willful misuse of any part of the revenues, rents, assets, proceeds, income, or other funds derived from a project covered by a mortgage for any purpose other than to meet actual or necessary expenses of the project. Equity skimming deprives a project of needed funds for repairs, maintenance, and improvements, which contributes to the financial and physical deterioration of projects. Forms of equity skimming sometimes seen in hospitals are (1) the use of mortgagor funds for activities that were excluded from the mortgagor or for an affiliate; (2) the use of mortgagor assets to perform services for excluded activities or related parties without receiving appropriate payment for the services rendered; (3) payment for services to affiliates or business units excluded from the mortgagor at rates in excess of permitted amounts or the provision of services to affiliates at rates below market value; or (4) failure to collect amounts owed from affiliates or excluded activities in a timely manner.

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 Chapter 3 Appendix B, to the extent they apply to hospitals.

   a. Obtain representation from management that all distributions to owners from project funds were from surplus cash and were in accordance with HUD requirements.

   b. Make specific inquiries regarding transactions or services between the mortgagor and affiliates and units that are part of the corporation, but have been excluded from the mortgage.

   c. Make inquiries as to how pricing is determined and the mortgagor compensated for intercompany services with units that have been excluded from the mortgage or with affiliates.

   d. Based on steps E(2)(a) through E(2)(c) above, include steps in reviewing cash receipts, cash disbursements, loans, and other areas of the audit as appropriate to determine that the mortgagor is compliant.

F. Cash Receipts.

1. **Compliance Requirement.** All receipts, including cash, check, or electronic payments, and those collected by a management agent, must be deposited into an account in the name of the mortgagor at an institution in which deposits are Federally insured (with the exception of investment brokerage accounts). The

mortgagor or management agent must verify that depositories meet certain conditions[13] where it maintains funds in excess of the Federally insured coverage limit. The depository must be under the control of, and the deposits must be insured by, the Federal Deposit Insurance Corporation, National Credit Union Administration, or other U.S. government insurance corporation. Sources of cash receipts can be from patient revenues, third party receivables, rents, cafeteria sales, parking fees, gift shop, investments, grants, or other income or payments from other Federal agencies.

Most mortgagors will have multiple bank accounts, including a regular operating account, an equipment replacement reserve fund or similarly named reserve for replacement account (held by the mortgagee, see paragraph 4-4.C for audit steps), and a mortgage reserve fund account (held by the mortgagee or a trustee, see paragraph 4-4.C for audit steps), and other accounts for various purposes.

If a corporation for the mortgagor has non-project income or income from activities excluded from the mortgage, it must have a separate account(s) for non-project income. Project funds may not be commingled with non-project funds without written permission from HUD. Otherwise, any funds deposited into the project account are considered a contribution and become project funds, which are only available for non-project or excluded activities purposes in accordance with the regulatory agreement subject to the distribution of assets covenant.

The ***regular operating account*** is a general operating account in the name of the project, which is used for depositing receipts of the project. If a centralized account has been approved, deposits must clearly be traceable to each project. The actual cash position of each project in the centralized account must be easily identifiable at all times.

The accounts of the project serve as additional collateral for the insured loan and, in accordance with the security agreement, the mortgagor has agreed to "comply with all applicable laws and requirements to grant the secured party a valid, perfected first lien." A perfected first lien position is required on all personalty including the accounts of the mortgagor. Many states require a deposit account control agreement (DACA) with the bank to perfect a first lien position on accounts.

[13] See HUD Handbook 4370.2, section 2-6 and 4615.1 (242.17) and Regulatory Agreement paragraph 9. Notwithstanding Handbook 4370.2, commingling of project funds for hospitals is prohibited unless approved by HUD in writing.

Investment/brokerage accounts: Many hospitals have investment accounts to maximize return on investments because of the large sum of dollars retained by the hospital. Prudent investments in diversified interests in accordance with board and typical industry standards are acceptable.

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

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

b. Determine whether the mortgagor or management agent'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.[14]

c. Determine whether the account is exclusively in the name of the project except for approved centralized accounts.

d. Trace a representative sample of receipts to verify that project funds are being deposited into the appropriate accounts. If the hospital has a separate account for non-project activities, verify that deposits to that account are from non-project sources.

e. Determine if a DACA is in place on each account, if required.

f. Select a sample of deposits from the cash receipts ledger or comparable record and perform the following steps:

i. Determine whether the deposits were made in a timely manner (usually within one business day) after receipt of funds and are in the name of the project.

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

iii. Determine that selected deposits recorded in the auditee's records are in agreement with the related bank statements as to amounts and dates.

iv. Determine whether the deposits were posted to the appropriate general ledger accounts.

[14] See footnote 13.

v. Trace selected amounts to any contracts, agreements, or other documentation, and determine whether the amount that was received was properly deposited and posted to the appropriate account.

g. Select a representative sample of remittance advices and trace the amount from the source documents to the individual patient accounts receivable record.

i. Confirm that payments, contractual discounts, and adjustments were properly recorded.

ii. Trace amounts back to related deposits.

h. Owners may be motivated to understate or overstate revenue. Consider the fraud risk factors and the potential for material misstatement of the financial statements related to revenue recognition including valuation of accounts receivable, contractual allowances, and bad debt. The auditor should tailor audit steps and procedures based on the individual risk factors identified and the results of other audit evidence gathered. The following audit steps are designed to disclose such occurrences:

i. Obtain an understanding of the owner or management agent's policies and procedures for providing charity care, collecting patient accounts, estimating contractual adjustments, writing off patient accounts and other accounts receivable.

ii. Review relevant policies with respect to estimates for contractual adjustments, bad debt, charity care, and collectability of accounts receivable by testing against historical records for reasonableness.

iii. Determine whether there has been a change in policy from prior years and review any changes for reasonableness with respect to estimates for contractual adjustments, bad debt, charity care, and collectability of accounts receivable.

iv. Review changes in accounts receivable; bad debt adjustments; charity care; and contractual adjustment estimates, and determine if amounts are reasonable.

v. Determine whether delinquent accounts are sufficiently pursued according to procedures.

vi. Review collectability of accounts with affiliates or units that have been excluded from the mortgagor. Indicators of collectability include

(1) history of promptly paying accounts when due; (2) profitability of creditor; and (3) cash liquidity of creditor.

vii. Select a sample of patient accounts written off to bad debt and charity care. Review supporting documentation to determine if the patient account was written off in accordance with policy and generally accepted accounting principles.

viii. Determine if estimates for contractual adjustments are reasonable and in accordance with policy based on the above.

ix. Determine if investment income, interest income, contributions, grants, and transfers of assets from affiliates have been classified as non-operating revenue in accordance with HUD guidance.

G. Cash Disbursements.

1. Compliance Requirement. All disbursements from the regular operating account or other accounts that are a part of the mortgagor 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 mortgage reserve fund, equipment replacement reserve fund, other special reserve funds, if applicable, 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, if permitted, 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.

HUD does not insure bonds. Payments for services or fees related to bonds are not "reasonable expenses necessary for the operation and maintenance of the project." However, immaterial costs are often incurred and generally permitted. Any payments should be reported as a total amount of incurred bond-related expenses and included in the notes to the financial statements, the auditor's report, or a separate letter from the auditor to HUD.

Payments under an interest rate swap agreement are not "reasonable expenses necessary for the operation and maintenance of the project." Any payments related to such an agreement require advance written permission from HUD.

Hospitals may have affiliate organizations, or may have certain operations that have been excluded from the mortgagor. Such operations may include clinics, a medical office building and associated rents, or some other specifically designated operation. Sometimes the excluded operation is on the main campus

of the hospital and may include a portion of a building and the operations within that portion. Refer to the loan documents for a description of the mortgaged property and operations that make up the mortgagor. Insured hospitals are permitted to provide services to, and purchase services from, related organizations, operating units that are not a part of the mortgagor, or other related parties at fair market value. Transactions with related parties, related organizations, or operating units that are not a part of the mortgagor that are not arms-length, are not permitted unless certain conditions are met. Similar restrictions are placed on transactions that are to the disadvantage of the mortgagor and favorable to a related party, related organization, or operating unit that is not a part of the mortgagor.

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

a. Obtain an understanding of the mortgagor or management agent's procedures for withdrawing funds from the regular operating account or other project accounts.

b. Select a representative sample of disbursements and determine if the disbursements are supported by approved invoices, bills, or other supporting documentation; that the supporting documents are in the name of the mortgagor; and that the costs are reasonable and necessary for the operation of the project. If the supporting documentation is not in the name of the mortgagor, determine if project funds were used only for the portion applicable to the mortgagor.

c. Determine if any of the sampled disbursements were made on behalf of related organizations, related parties, or operations excluded from the mortgagor, or for purposes other than reasonable expenses necessary for the operation and maintenance of the project. If funds were used for non-project purposes, report whether amounts were not repaid from the non-project source within ninety (90) days or such other time period as specifically required by the regulatory agreement. Note: The distribution of assets covenant permits limited transfers if certain conditions are met.

d. Determine whether the sampled disbursements were properly charged to the correct account, including classification as to whether they are a part of the operation of the mortgagor.

e. If any of the sampled disbursements represent withdrawals from the project account through an institution's memorandum or other type of document, determine the reason for that transaction and that it is proper.

f. Audit sampling must be designed to include a separate representative sample of transactions between the mortgagor and related parties, related organizations, and operations excluded from the mortgagor, if any. The following procedures should be performed, at a minimum, on a triennial basis. However, if a reportable event is observed, the procedures should be performed annually until the issue is resolved.

i. Make inquiries of management regarding services provided for related parties, affiliates, related organizations, and operations that are not part of the mortgagor as to how management services and overhead are charged and paid for with revenues of the excluded parties, affiliates, related organizations, and operations.

ii. Obtain documentation from management and verify that goods or services provided to related entities, affiliates, and operations excluded from the mortgagor are at the lower of market value or the fully allocated cost to the mortgagor, in accordance with the regulatory agreement.

iii. Obtain documentation from management and verify that the prices paid for goods or services purchased from related entities, affiliates and operations excluded from the mortgagor are equal to or less than the amounts ordinarily paid for such services, supplies, or materials in the area where the services are rendered or the supplies or materials furnished in accordance with the regulatory agreement.

iv. Determine whether operations that are excluded from the mortgagor were charged for appropriate overhead, utilities, maintenance, payroll, and other related expenses and that the mortgagor was repaid within 90 days or other time period as specifically required by the regulatory agreement.

g. Trace all (typically 12) payments from project funds to the mortgagee and servicer to the insured loan documents and determine whether the mortgagee is billing the mortgagor for items not related to the insured project.

h. Make inquiries of management to determine if project funds are being used to pay for services related to bond financing. If so, determine if the amounts were disclosed to HUD. Make inquiries of the chief finance officer and use other audit procedures, as appropriate, to determine if the mortgagor has entered into an impermissible interest rate swap agreement.

i. For accounts with balances in excess of FDIC-insured limits, determine whether the owner or management agent verified, on a quarterly basis, that

the financial institution's rating was consistent at all times with the minimally acceptable rating established by the Government National Mortgage Association.

H. Unauthorized Change of Ownership/Mergers/Acquisitions, and Liabilities.

1. Compliance Requirements. Owners must not enter into mergers, reorganizations, or consolidations without the written permission of HUD. Owners must 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. Obtain representations from management regarding the above compliance requirements.

b. Review the regulatory agreement and obtain a copy of any letters from HUD regarding change of ownership, mergers, reorganization, acquisitions, consolidation, and additional liabilities.

c. Review the minutes from board meetings for indication of a change in ownership, mergers, reorganization, acquisitions, consolidation, and additional liabilities.

d. Make inquiries of management regarding any change of ownership, mergers, reorganizations, acquisitions, consolidations, or additional liabilities that are significant enough to be included in the notes to the financial statements, and determine if permission was received from HUD for such change if required by the regularity agreement.

e. Make inquiries of management about the existence of any agreements to sell, assign, dispose of, or encumber any of the mortgaged property or assets or beneficial interest[15] in the property.

i. Determine whether HUD has approved the agreement(s) or is in the process of approving the agreement(s) and report any instances of noncompliance.

ii. If an agreement(s) exists, review the agreement(s) to determine if it is in conformity with the approval by HUD.

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

f. Make inquiries of management whether form HUD-2530 "*Previous Participation Certification*" was filed and approved in electronic or paper form for each new principal[16] and report any violations as an audit finding.

g. Review all material changes in assets or liabilities for indications of change of ownership, mergers, reorganizations, acquisitions, consolidations, or additional liabilities. If any such transactions are present, confirm that HUD approval was obtained.

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

I. Unauthorized Loans or Loan Guarantees of Project Funds.

1. Compliance Requirements. Owners must not, without the prior written consent of HUD, assign, transfer, dispose of, or encumber any personal property of the project, including rents, charges, receivables, or other income nor pay out any funds from project accounts or sources (other than from surplus cash) except for reasonable operating expenses and necessary repairs. Note: Loans to physicians or salary guarantees in compliance with not-for-profit industry standards as part of a physician recruitment package are considered part of usual operating expenses.

2. Suggested Audit Procedures.

a. Obtain representations from management regarding the above compliance requirements.

b. Review the regulatory agreement and obtain a copy of any letters from HUD regarding loans or loan guarantees.

c. Review the minutes from board meetings held during the reporting period and up to report date for indications of the issuance of loans or loan guarantees.

d. Make inquiries of management about the existence of any loan guarantees, loans with co-signatures, agreements to assign, transfer, dispose of, or encumber directly or indirectly any of the personal property of the mortgagor, and read any related agreements.

[16] See 24 C.F.R. 200.215 for definition of principal.

e. Review the results of the audit procedures applied to specific accounts or other general procedures to identify the existence of any unauthorized transactions or transactions that are not in compliance with the HUD regulatory agreement.

f. Test non-patient accounts receivable to determine whether receivables are the result of routine operations or whether project funds have been loaned to the management agent; operations that are not a part of the mortgagor, related organizations, employees, the owner, affiliates, or other related parties.

g. Review "due from" accounts for accounts that have not been cleared within 90 days, unless authorized by HUD that could represent inappropriate loans.

h. Based on steps (a) through (g) above, determine if permission was received from HUD, if required for any identified items and that those items were in conformity with any conditions that were included. Note: The regulatory agreement permits loans and transfers if certain conditions are met.

J. Acquisition of Real Property and Personalty.

1. Compliance Requirements. HUD requires a first lien on both realty and personalty of the mortgagor. All equipment of the mortgagor and accounts are part of the collateral for the insured loan. The mortgagor is required to file and maintain the appropriate UCC filings on equipment. The mortgagor is required to notify HUD of any after-acquired real estate and to record a mortgage on any such property if requested by HUD.

2. Suggested Audit Procedures.

a. Obtain representations from management regarding the above compliance requirements.

b. Review all UCC filings and determine whether they are current and have been updated to cover changes in personalty, such as equipment and accounts receivable.

c. Examine the assets ledger or similar record for additions of real property and determine whether HUD was notified.

d. Obtain representations from management and hospital counsel, or determine by a review of the hospital records, that a mortgage in favor of the mortgagee was recorded on the property in accordance with the requirements of the regulatory agreement.

K. Budget.

1. **Compliance Requirement**. Hospitals are required to submit a budget for the new fiscal year within thirty (30) days of the start of the new fiscal year.

2. **Suggested Audit Procedures.**

   a. Review board minutes to determine when the budget was approved by the board

   b. Inspect records for evidence of submission of the budget to HUD within 30 days of the start of the hospital's fiscal year, as required in the regulatory agreement.

L. Financial Monitoring by the Board.

1. **Compliance Requirement**. The regulatory agreement for most mortgagors requires the governing board of the hospital to review the financial statements of the mortgagor not less frequently than twice a year, including, but not limited to, the fiscal year audited financial statements, any board-certified financial statements, and the six-month interim financial statements. Under certain conditions, the board must submit a written report or develop a business plan or notify HUD based on the financial results and criteria in the covenants.

2. **Suggested Audit Procedures.** Review the regulatory agreement, rider to the regulatory agreement, and other loan documents to determine whether the financial monitoring requirement applies. If the auditor is unsure of the requirement, contact the Office of Hospital Facilities at HUD or the assigned account executive for the hospital. If the financial monitoring requirement applies:

   a. Review board minutes for evidence that the entity complied with the financial statement review and submitted to HUD the required written report.

   b. Determine if the mortgagor was required to develop a business plan or notify HUD as required by the covenant.

   c. Review documentation that the hospital notified HUD and completed the business plan, or consultant's report, and that any required updates have been submitted in accordance with the regulatory agreement.

M. Additional Indebtedness.

1. **Compliance Requirement**. Owners must not, without the prior written permission of the Secretary, encumber any of the mortgaged property, encumber the personal property of the project, or permit the encumbrance of the property. See the regulatory agreement for specific requirements. Many hospitals have entered into a rider to the regulatory agreement or a supplemental agreement that permits the mortgagor to incur a limited amount of additional indebtedness if certain conditions are met.

2. **Suggested Audit Procedures**.

   a. Obtain representations from management regarding the above compliance requirement.

   b. Review the rider to the regulatory agreement or any supplemental agreements for the specific conditions for entering into any additional indebtedness.

   b. Review any correspondence from HUD granting permission for additional indebtedness and any requirements imposed.

   c. Review minutes from board meetings and the books and records for evidence of additional indebtedness, including lease agreements.

   d. Make inquiries of management, including the chief finance officer, regarding any loan guarantees or assurances, made by the mortgagor on behalf of affiliates or non-project operations for loans, leases, or other encumbrances on project assets.

   e. Review hospital documents for compliance with the covenants regarding additional indebtedness.

   f. Review loan documents and leases for the required "successor clause" as specified in the regulatory agreement.

   g. Determine that the hospital has complied with reporting requirements, as specified in the regulatory agreement, for entering into additional indebtedness. Note: As part of the reporting requirement, and in accordance with the capital budget for the year, a hospital may document compliance for a "grouping of planned purchases" at one time.

   h. Verify the accuracy of the mortgagor’s calculations to determine eligibility to incur additional indebtedness without prior HUD approval.

i. Determine if any outstanding line of credit was paid down in accordance with the regulatory agreement.

N. Minimum Account Presentation.

1. Compliance Requirement. The books and records of the mortgagor must be kept in accordance with the requirements of the Secretary. Refer to the AICPA Audit and Accounting Guide: Health Care Entities, using the natural classification of accounts for general presentation. While the mortgagor may show additional detail, certain specific accounts are required by HUD. See Handbook 4615.1, appendix 9 for financial statement presentation requirements.

Certain accounts are only required for Tier I hospitals. Tier I hospitals will have a letter designating it as a Tier I hospital, and the rider to the regulatory agreement will have special Tier I conditions.

Income from operations that are not a part of the mortgagor but deposited in the mortgagor's account are to be classified as non-operating income to the extent that the revenue is not directly associated with a related expense[17]. Income from investments and contributions must be classified as non-operating income. Depreciation and interest expense are to be included in income from operations.

2. Suggested Audit Procedures.

a. Review the financial statements for the presence of the required accounts.

b. Review the financial statements, related notes, and supplementary information for inclusion and correct classification of supplementary information.

c. See HUD Handbook 4615.1 appendix 9 for required account groupings and definitions.

[17] Example 1: Hospital ABC receives a grant or contribution for the purpose of providing special diabetes educational clinics in the community. The hospital would not normally provide these clinics except for the special funding. As a result of the funding, the hospital provides the clinics and incurs additional expense related to the contribution. In this instance, the contribution or grant income would be classified as Other Operating Revenue.

Example 2: Hospital ABC receives a contribution that is classified as temporarily restricted net assets. Time passes and the funds are used to cover what would otherwise be classified as normal ongoing operations, charity care, or for the purchase of equipment. In this case, the contribution would be classified as Non-Operating Revenue.

O. Ratios.

1. **Compliance Requirement**. Certain ratios, defined in the regulatory agreement, are required to be supplied to HUD. The ratios must be calculated based on the balances of the accounts that are a part of the mortgagor only, unless separate instructions have been provided by HUD. Management should prepare the ratios and may provide the ratios in a separate letter to HUD, or the ratios may be provided as a part of the audited financial statements by including them in a supplementary schedule. In either case, the mortgagor shall engage the auditor to report on the ratios in accordance with AICPA AU-C section 725, *Supplementary Information in Relation to the Financial Statements as a Whole*.

2. **Suggested Audit Procedures.**

   a. Review the regulatory agreement for the required ratios.

   b. Recalculate the required calculations made by management based on the mortgagor accounts and verify the accuracy to two decimal places.

P. Cost Certification and Final Endorsement.

1. **Compliance Requirements.**

   The mortgagor agrees to complete the construction project by the date specified in the building loan agreement (BLA). Generally, this is two months prior to the commencement of loan amortization.

   The mortgagor agrees to construct the project in accordance with all applicable ordinances and statutes and in accordance with the requirements of all regulatory authorities. The BLA also requires the mortgagor to obtain evidence that all work requiring inspection by municipal or other governmental authorities having jurisdiction has been inspected and approved by these authorities, and that all requisite certificates of occupancy and approvals have been issued.

   The mortgagor agrees to execute and deliver to the lender a security agreement and financing statement, or other similar instrument, covering all property of any kind whatsoever purchased with mortgage proceeds in the BLA. This occurs at final endorsement.

   Both the mortgagor and the contractor or construction manager agree to deliver a cost certification to HUD within the time period fixed in the BLA for completion of the project or any extension approved in writing by HUD as part of the Agreement and Certification (form HUD-3305).

2. **Suggested Audit Procedures.**

   a. Determine if all outstanding FHA insured notes have been through the final endorsement process. If final endorsement has occurred for all outstanding notes, no further steps are necessary. If final endorsement has not occurred for any HUD insured note, proceed with steps 2(b) through 2(g).

   b. Review the BLA and the "Agreement and Certification" to determine when the project is to be completed and if cost certification is required. These two documents are in the initial loan closing documents.

   c. Determine if HUD has granted an extension to the completion date specified in the BLA.

   d. Determine if HUD has granted an extension for final endorsement.

   e. Determine if cost certification has occurred for the fiscal year that coincides with the date in the BLA plus any extensions.

   f. Determine if final endorsement has occurred for the fiscal year that coincides with the date in the BLA plus any extensions.

   g. Report as a finding, any failure to cost-certify and final endorse the insured note within six months of the completion date plus any extensions granted by HUD.

Q. Other Conditions.

1. **Compliance Requirements.**

   The loan documents including the regulatory agreement, rider to the regulatory agreement, security agreement, BLA and subsequent correspondence may include other compliance requirements. Additionally, riders to the regulatory agreement for all loans after fiscal year 2005 have a requirement to identify any changes in accounting policy and the effect of such changes on the balance sheet and on the income statement.

2. **Suggested Audit Procedures.**

   a. Review all loan documents for the HUD insured loan and list any additional compliance requirements (with special attention to the regulatory agreement and any riders thereto) that could have a direct and material effect on the FHA Mortgage Insurance for Hospitals Program.

b. The auditor should design the audit to determine whether the mortgagor is in compliance with the additional conditions.

c. Review the notes to the financial statements and determine if the effects of any changes in accounting policy and the related effect on the balance sheet or on the income statement has been explained.

4-5. Audit Finding Reporting.

Reporting of material instances of noncompliance with any HUD requirement or regulation, deficiencies in internal control, instances of fraud or illegal acts, or contract violations that were disclosed during the audit process is covered in Chapters 1 and 2 of this audit guide. All nonmaterial instances of noncompliance disclosed during the audit process must be reported, in writing, to management (See Section 4-3.C). 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.

4-6. Technical Assistance.

The Office of Hospital Facilities 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, 877-458-4342.

CHAPTER 5. DEVELOPMENT COST CERTIFICATION AUDIT GUIDANCE

5-1 **Program Objective.** Multifamily projects are an integral part of the U.S. Department of Housing and Urban Development's (HUD) housing programs, which have the objectives of providing decent, safe, affordable, and sanitary housing for low- and moderate-income families. *The loans for the multifamily projects are insured through the multifamily project loan program. *HUD- Federal Housing Administration (FHA) insures lenders against losses on mortgages providing the financing for the construction or rehabilitation of multifamily rental projects. For the insured loan program, the project is ordinarily HUD's only source for loss recovery in the event of a foreclosure. Therefore, it is essential that collateral value be commensurate with the insurance risk.

This handbook chapter is intended for use by for-profit mortgagors to provide audit guidance for the audit of development cost certifications. However, this chapter can also be used to provide audit guidance to not-for-profit mortgagors for their audits of development cost certifications as provided for under OMB Circular A-133, paragraph 235(a), program-specific audit guide available.

5-2 **Program Procedures.** *The cost certification is the basis for HUD's determination of the project's actual development cost and/or the maximum insurable mortgage, which is necessary before the project may proceed to final formal endorsement, a critical factor to multifamily projects. The effective date for the determination of actual costs is usually the date the HUD inspector signs the final HUD representative's trip report (Form HUD-95379), provided that the trip report is subsequently endorsed by the construction manager. Construction must be completed, except for acceptable items of delayed completion (Multifamily Accelerated Processing Guide (MAP Guide), chapter 14, section 14.7). The HUD field office manager has the option to set an earlier date to halt the unnecessary accumulation of certain costs. A reasonable time is set for submission of the cost certification, which must be in the HUD field office 30 days before final endorsement/closing. Typically, the cost certification is prepared and submitted within 60 to 90 days after the cost cutoff date. The cost certification is submitted in hard-copy format to the HUD field office. The cost certification **is not submitted electronically** to HUD's Real Estate Assessment Center (REAC).

The owner's first operating audit will cover the period beginning on the day after the cost certification cutoff through the owner's fiscal year end. All operating audits must be prepared in accordance with chapter 3, HUD Multifamily Housing Programs, of this guide and must be submitted to REAC electronically via the Financial Assessment Subsystem (FASS) within 90 days of the owner's fiscal year end.*

On occasion, the owner may be responsible for submitting financial statements with reporting periods of less than 12 months (referred to as a stub period). If that reporting period is less than 90 days, upon request, HUD may approve the deferment of the owner's reporting of the stub period and add that period to the next full year financial statements (Submission and Review Requirements & REMS Critical Data Fields for Annual Financial Statements, attachment 2, paragraph C).

HUD expects completed certifications, fully documented and in the prescribed format, to be submitted by the mortgagor. If an identity of interest exists between the mortgagor and the contractor or if a cost plus type construction contract was used, the contractor is also required to submit a cost certification. Similarly, if an identity of interest exists between a subcontractor, materials supplier, or equipment lessor, a cost certification must be submitted. Additional support for any cost items questioned by HUD is expected within 15 days of the request. Extended delays in the cost certification process, which postpone final endorsement, can cause substantial harm to the project's viability and eventual success.

5-3 **Reference Material.** *One of the primary sources of guidance for cost certifications is the MAP Guide. In particular, chapter 14 contains the most current guidance issued by HUD regarding the cost certification process. The following is the reference material that was in effect at the time this handbook chapter was issued. It is the auditor's responsibility to use the appropriate reference material that was in effect during the period covered by the audit.

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 5-3 rather than revising the references in the entire handbook/chapter. Also, the auditor should ensure that the updated reference is used for performing the audit. If reference to the handbook is needed in the audit report, the auditor should ensure that the entire updated reference, including the revision number, is used.*

Document	Title
HUD Handbook 4571.5	Supportive Housing for Elderly, Conditional Commitment - Final Closing
*HUD Handbook 4571.4	Supportive Housing for Persons with Disabilities, Conditional Commitment - Final Closing*
HUD Handbook 4571.1, REV-2	Section 202 Direct Loan Program for Housing for the Elderly and/or Handicapped

Document	Title
HUD Handbook 4470.2, REV-1	Cost Certification Guide for Mortgagors and Contractors of HUD-Insured and Section 202/811 Multifamily Projects
HUD Handbook 4470.1, REV-2	Mortgage Credit Analysis for Project Mortgage Insurance, Section 207
HUD Handbook 4450.1, REV-1	Cost Estimation for Project Mortgage Insurance
*HUD Handbook 4435.1, REV-1	Project Construction and Servicing Before Final Closing*
*Notice H 96-102	Redesigned Section 202 Supportive Housing for the Elderly and Section 811 Supportive Housing for Persons with Disabilities Programs - Firm Commitment*
*Mortgagee Letter 04-41	Multifamily Accelerated Processing Guide Revised March 15, 2002 (1)*
*Document does not have a HUD number or transmittal reference	Submission and Review Requirements & REMS Critical Data Fields for Annual Financial Statements (2)*

*

(1) = This document is not a numbered document under the HUD unified issuance system and can be obtained by using the following link:

http://www.hud.gov/offices/hsg/mfh/map/mapguide/mapguide.cfm

(2) = This document is not a numbered document under the HUD unified issuance system and can be obtained by using the following link:

http://www.hud.gov/offices/reac/products/PDFs/finl_memo_2004_1a.pdf

If the program participant does not have this reference material, it may be obtained by accessing HUD's Client Information and Policy System (HUDCLIPS) at the following Web site:

http://www.hudclips.org/cgi/index.cgi

*

*or may be ordered from HUD's Direct Distribution System by telephone at (800) 767-7468; in a letter addressed to HUD, Customer Service Center, Room B-100, 451 Seventh Street, SW, Washington, DC 20410; or by fax at (202) 708-2313.

5-4 Reporting Requirements.

Regulations at 24 CFR [*Code of Federal Regulations*] 200.95, 200.96, 200.97, and 891.545 require mortgagors/borrowers to submit certificates of actual cost before final endorsement of the insured loans or disbursement of loan proceeds or capital advances for the project. Mortgagors and contractors are required to determine costs in accordance with Mortgage Credit Analysis for Project Mortgage Insurance, HUD Handbook 4470.1; Cost Certification Guide for Mortgagors and Contractors of HUD-Insured Multifamily Projects, HUD Handbook 4470.2; Chapter 5, Supportive Housing for Persons with Disabilities, Conditional Commitment - Final Closing, HUD Handbook 4571.4; Chapter 5, Supportive Housing for Elderly – Conditional Commitment Final Closing, HUD Handbook 4571.5; Section VI of HUD Notice H 96-102; and chapter 14 of the MAP Guide. The MAP Guide, as well as HUD Handbook 4470.2, contains the requirement for who among the mortgagor, general contractor, subcontractors, and suppliers must provide cost certifications, guidance on eligible costs, necessary financial statements which must accompany the certificate of actual cost, and details concerning the mortgagor's Form HUD-92330 and contractor's Form HUD-92330-A.

Mortgagors and contractors must prepare certification of actual cost and submit the required financial statements. The mortgagor's certificate of actual cost (Form HUD-92330) shall be submitted after the cost certification cutoff date. It is submitted upon completion of the physical improvements to the satisfaction of HUD and before endorsement. The certificate shall show the actual cost to the mortgagor after deduction of any kickbacks, rebates, trade discounts, or other similar payments to the mortgagor or officers, stockholders, or partners. Those documents must be prepared in conformity with the basis of accounting and reporting procedures prescribed by HUD, which is a comprehensive basis of accounting other than generally accepted accounting principles. The owner must sign and date Form HUD-92330, and the contractor must sign and date Form HUD-92330-A, in the areas provided on the forms, by no later than the date of the audit opinion.

A. Mortgagor Submission Requirements. Mortgagors must certify for all projects except 207/223(f) refinances in which the insured value is 80 percent or less of value. They are to submit the mortgagor's cost certification (Form HUD-92330) supported by an accountant's opinion, an audited balance sheet of the mortgage entity as of the cutoff date, and an audited operating statement if occupancy*

*occurred before the cost certification cutoff date. An audit report with the certification by an independent certified public accountant or an independent public accountant must accompany the mortgagor's certification of actual cost, the audited balance sheet and operating statement of the mortgagor, and the contractor's certificate of actual cost (Form HUD-92330A). The period covered by the operating statement is from the beginning of marketing and rent-up activities to the cutoff date. Costs reported on Form HUD-92330 support certain entries on the required financial statements. If there were more than three months between the cost cutoff date and the start of amortization, the mortgagor must submit a supplemental operating statement.

The certificate of actual cost, auditor's reports, and required financial statements are to be submitted to the applicable HUD field office.

The auditor must conduct the audit under both the auditing standards generally accepted in the United States of America and the generally accepted government auditing standards (GAGAS) issued by the comptroller general of the United States (MAP Guide chapter 14, section 14.11, paragraph 6 and chapter 2 of this guide). Illustrative reporting information on the cost certification is provided in paragraph 5-7 of this chapter.

B. Contractor Submission Requirements: Contractors must certify when

(1) The contractor has an identity of interest with the mortgagor and/or

(2) The contractor used the Construction Contract Cost Plus, Form HUD-92442-A.

A subcontractor at any tier, equipment lessor, material supplier, and manufacturer of industrialized housing must certify when

(3) The total of all subcontracts, purchases, and leases is more than .5 percent of the mortgage and

(4) An identity of interest exists or comes into being between such subcontractor, equipment lessor, material supplier, or manufacturer of industrialized housing and either the mortgagor or the contractor if the contractor must certify.

The contractor is to submit a certificate of actual cost (Form HUD-92330A), supported by an accountant's opinion, to the mortgagor. A certification by an independent certified public accountant or an independent public accountant must*

accompany the contractor's certification of actual cost. The auditor must use GAGAS in auditing the cost certification. No other financial statements or reports of the contractor are required to be submitted. The contractor should submit the reporting package to the mortgagor for inclusion in the mortgagor's submission to the appropriate HUD field office.

5-5 Compliance Requirements and Audit Area.

A. Federal Financial Reports.

1. **Compliance Requirement.** Projects with a HUD - insured mortgage or receiving HUD direct loans or capital advances 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 entity and HUD. The individual agreements contain the specific reporting requirements that the entity is to follow.

2. **Suggested Audit Procedures.**

   a. Identify all required financial reports by inquiry of the owner/manager.

   b. Obtain an understanding of the auditee's procedures for preparing and reviewing the financial reports.

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

   d. For the sample, trace significant data to supporting documentation; i.e., worksheets, ledgers, etc. Report all material differences between financial reports and project records.

   e. Review adjustments made to the general ledger accounts affecting HUD-assisted activity and evaluate for propriety.

B. Accounting System.

1. **Compliance Requirement.** Mortgagors and contractors involved in projects that are to receive HUD-insured loans and capital advances have agreed to maintain adequate records for the purpose of determining the eligible costs associated with the projects (HUD Handbook 4470.2, chapter 3).

2. **Suggested Audit Procedures.**

   a. Obtain an understanding of the mortgagor's and contractor's accounting system for identifying actual costs associated with a given project. Test the system to determine whether it identifies the costs to be reported on the Form HUD-92330 on an individual project basis.

   b. Review Form HUD-92330 for completeness and support by the accounting records.

   c. Trace significant data from Form HUD-92330 to supporting documentation; i.e., worksheets, ledgers, etc. Report all material differences between the amounts reported on the Form HUD-92330 and the supporting documents.

C. Cutoff Timing and Eligibility of Costs.

1. **Compliance Requirement.** As a general rule, only the costs which have been or will be paid in cash within 45 days after the date of final endorsement or closing or which are escrowed with the mortgagee are eligible for inclusion on the mortgagor's or contractor's certificates of actual cost.

   For projects with insured mortgages, the mortgagor determines the cost cutoff date for the actual cost of the interest, taxes, insurance, and mortgage insurance premium as well as soft costs and special escrow items. This date may, at the earliest, be the same date as the final completion date and, at the latest, be a date 60 days after the final completion date or, at the mortgagor's option, any date in between. The date chosen as the cutoff date and the date to which the operating statement and balance sheet are computed must be the same. *The mortgagor, general contractor, and mortgagee will be notified in writing of the final completion date (MAP Guide chapter 14, section 14.7).*

   The final completion date is the date on which the HUD inspector signs the final HUD Representative's Trip Report, Form HUD-95379, showing substantial completion. The field construction manager must properly endorse this form.

   HUD notifies the mortgagor/borrower, the general contractor, and the mortgagee of the date of completion in writing. This date becomes the basis for establishing the cutoff date for insured projects, direct loan projects, and capital advance projects (HUD Handbook 4470.2, chapter 1, *and MAP Guide, chapter 14)*.

Eligible costs are those costs of the project construction and certain fees paid in cash or such costs that will be paid in cash within 45 days of final endorsement. HUD Handbooks 4470.1; 4450.1; and 4470.2, chapter 2, contain information on allowable costs to be reported on Form HUD-92330 and the ways in which costs are to be adjusted for items considered to be a recovery of costs.

2. Suggested Audit Procedures.

a. Review the trip report, Form HUD-95379, or similar notification to determine the final completion date.

b. Based on the completion date, the mortgagor/borrower determines the project's cutoff date for time-sensitive expenses, such as interest, taxes, insurance, mortgage, and property insurance premiums, as well as soft costs and special escrow items. Review these costs/charges to determine that none were incurred after the cutoff date *and that the costs are proper charges to the project.*

c. Review the other amounts claimed on Form HUD-92330 to determine that the claims represent those expenses paid in cash or expected to be paid in cash within 45 days after final closing on behalf of the project. All amounts claimed should be net of any adjustments or recoveries of costs.

D. Identity of Interest.

1. Compliance Requirement. HUD Handbooks 4430.1; 4470.1; 4470.2, chapter 3; and MAP Guide, chapter 14, Section 14.15, describe several situations, which constitute an identity of interest involving a mortgagor, a contractor, a subcontractor, or a materials supplier. When an identity of interest exists, the contractor must also submit a certificate of actual cost, or the party involved in the identity of interest is required to submit additional documentation as required by HUD Handbook 4470.2, chapter 3. The contractor is also required to submit a certificate of actual cost if a cost plus construction contract was used.

2. Suggested Audit Procedures.

a. Review mortgagor and project records such as contracts and vendor invoices to determine whether an identity of interest exists among any of the parties involved in the project, from mortgagors to contractors, suppliers, and equipment lessors. *Inquire to determine whether an identity-of-interest relationship exists.*

b. When an identity of interest exists, determine that the additional reporting requirements of HUD Handbook 4470.2 and MAP Guide, chapter 14, have been met.

*

5-6 Audit Finding Reporting.

All material instances of noncompliance with any HUD requirement or regulation, deficiencies in internal control, 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, deficiencies in internal control, fraud or illegal acts, or contract violations disclosed during the audit process may be reported separately to management. Such reporting must be in writing in a management letter or other type of written auditor communication and must be mentioned in the independent auditor's report, including the date of the management letter or other written communication. Noncompliance's, deficiencies, or instances of violations that were corrected during the audit process, after the fiscal year under audit, or disclosed as a part of the audit process before the end of the fiscal year under audit and/or before the issuance of the audit report must be included in the report as resolved findings or in a management letter or other types of written auditor communication, depending on their materiality.

A. Content of Finding.

Findings are to be presented in accordance with the standards and requirements of the "Yellow Book." A finding should be supported by sufficient, competent, and relevant evidence; be presented in a manner to promote adequate understanding of the matters reported; and provide convincing but fair presentations in proper perspective.

Please refer to chapter 2 for the information that is to be included in a finding.

B. Corrective Action in Process.

Many times when auditees are presented with draft findings, they will start to take action to correct the deficient condition. When this action is underway and the auditor has completed his/her fieldwork, the auditee can include the action completed and the action remaining to be taken in the auditee's comments and in the corrective action plan. Regardless of whether the auditee is in the process of correcting the finding, the auditor is to include the finding in the report with all required elements.*

C. *Corrective Action Completed.

Many times when auditees are presented with draft findings, they will start to take action and complete that action, correcting the deficient condition before the completion of the fieldwork. When this occurs, the finding is still to be included in the audit report with all required elements. The action taken/completed should be included in the auditee's comment section and should be validated by the auditor. The recommendation section should follow the auditee's comment section, and the auditor should state whether he/she validated the action or not. In addition, the auditor could include any additional recommendations he/she believes necessary based on their validation of that action.

If costs are involved and if those costs have been repaid, the auditor should validate that the auditee made the necessary adjustments to its books-of-account. The auditor's certified statements should contain all necessary adjustments to the reported amounts, with appropriate notes, so that the certified costs of the project are accurately stated. Comments should also be included in the report in the "action taken" section of the finding. *

5-7 **Illustrative Reporting.** *These samples are for the ***Sample Company,*** which is a partnership. The wording is to be changed based on the type of ownership of the property.*

Report of Independent Certified Public Accountants

To the Partners
Sample Company

We have audited the mortgagor's certificate of actual costs (Form HUD-92330), through [insert cutoff date, for example, April 30, 2010]; pertaining to the development of the ***Sample Company***, Project No. [Insert project number]. We have also audited the [insert names of statements included in the report (financial statement)] as of [insert the cutoff date, for example, April 30, 2010], and the results of project operations for the period from [insert date, for example, August 28, 2008, which is the date of commencement of marketing and rent-up activities, etc.] through [insert the cutoff date, for example, April 30, 2010]. The Form HUD-92330 and the financial statements are the responsibility of the ***Sample Company's*** management. Our responsibility is to express an opinion on the Form HUD-92330 and on the financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the government auditing standards issued by the comptroller general of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Form HUD-92330 and the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the Form HUD-92330 and in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in note [insert the note number], the certificate of actual cost (Form HUD-92330) and the project's financial statements were prepared in conformity with the basis of accounting and reporting practices prescribed by the U.S. Department of Housing and Urban Development (HUD), which is a comprehensive basis of

accounting other than generally accepted accounting principles. Further, the accompanying financial statements represent the financial statements of the project.

In our opinion, the mortgagor's certificate of actual costs (Form HUD-92330) and the financial statements referred to above present fairly, in all material respects, the actual costs of the ***Sample Company***, through [insert cutoff date, for example, April 30, 2010]; the assets, liabilities, and project equity as of [insert cutoff date, for example, April 30, 2010]; and the results of project operations for the period from [insert date, for example August 28, 2008, which is the date of commencement of marketing and rent-up activities, etc.] through [insert cutoff date, for example, April 30, 2010], on the basis of accounting described in note [insert the note number].

In accordance with government auditing standards,, we have also issued our report dated [*date of report*] on our consideration of the ***Sample Company's*** internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with government auditing standards and should be considered in assessing the results of our audit.

This report is intended solely for the information and use of the board of directors and management of the ***Sample Company*** and HUD and is not intended to be and should not be used by anyone else other than these specified parties.

Certified Public Accountant Signature

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Date

Sample Company
Project No. XXX-XXXXX

Notes to Financial Statements

Summary of Significant Accounting Policies

Basis of Presentation

The financial statements have been prepared in conformity with the accounting and reporting standards prescribed by the U.S. Department of Housing and Urban Development (HUD) in the Audit Guide for Auditing Development Costs of HUD-Insured Multifamily Projects. These standards differ in some respects from generally accepted accounting principles, and the financial statements reflect the following additional HUD accounting and reporting principles:

a. Costs are to be exclusive of kickbacks, rebates, or trade discounts.

b. Financing charges are limited to the lesser of amounts actually paid or amounts approved by HUD on the mortgagee's certificate. For this project, the financing charges are the amounts [insert comment that applies - actually paid or approved by HUD].

c. The (insert actual name of statement; i.e., statement of rental operations) reflects the rental activity and operating expenses of the project beginning [insert date of commencement of marketing and rent-up activities, etc., for example, August 28, 2008]. The statement does not include depreciation and amortization expenses and certain other expenses, which are not incidental to the rental operation of the project.

d. Project equity represents the difference between the funds received by the project from ***Sample Company*** and the costs incurred to develop the project, plus the income from the project. More detailed information on the determination of equity is contained in the MAP Guide, chapters 7, 12, and 14. Further, partners' (members') (nonproject) obligations are classified as project equity. Partners' (members') equity is not intended to reflect the actual equity of the partnership because it may include partnership obligations and adjustments for the as-is value of land. The financial statements are not intended to represent those of the partnership.

Sample Company
Project No. XXX-XXXXX

Notes to Financial Statements

Summary of Significant Accounting Policies

Organization

Sample Company is a limited partnership organized under the laws of the state of [Insert name of State], for the purpose of developing and operating a 203-unit project located in [location of project]. The partnership will operate under the provisions of Section 221(d) (4) of the National Housing Act, with mortgage insurance provided by the Federal Housing Administration (FHA) of the U.S. Department of Housing and Urban Development.

The responsibility for management of the affairs of the partnership and the ongoing management of the ***Sample Company*** is vested with the general partners. Compensation for such services is as determined in the management agreement between the partners.

*

5-8 Technical Assistance Needed.

The chief, Technical Support Division, Office of Multifamily Housing Development, 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, 202-708-0614, extension 2559.*

CHAPTER 6. Ginnie Mae Issuers of Mortgage-Backed Securities Audit Guidance

6-1. **Program Objective.** The Government National Mortgage Association, also known as Ginnie Mae, is a wholly owned government corporation. Created by Congress in 1968, Ginnie Mae's mission is to support expanded affordable housing in America by providing an efficient, government-guaranteed secondary market vehicle linking the global capital markets with the Federal housing market. It does this by facilitating secondary market activities for packaged residential mortgages. Through its well-known Mortgage-Backed Securities (MBS) and Multiclass Securities programs, Ginnie Mae creates a vehicle for channeling funds from the securities markets into the mortgage market and helps to increase the supply of credit available for housing.

6-2. **Program Procedures.** The parties involved in the MBS program are Ginnie Mae, the securities issuer, the securities dealer, the investor, a custodian of mortgage documents, a mortgage servicer (often the issuer), and a transfer agent. Once approved by Ginnie Mae, the issuer of the securities is responsible for acquiring eligible mortgages, creating a pool of mortgages to be held by a custodian, issuing the securities backed by a pool of mortgages, arranging for the marketing of the securities, servicing the mortgages in the pool, administering the securities outstanding, and making the full and timely payment of all amounts due to the investors. The issuer is responsible for using its resources to cover shortfalls in amounts due to investors that result from mortgage delinquencies or foreclosures.

For each pool or loan package of mortgages and the accompanying issue of securities, there can be only one issuer. While the issuer is responsible for servicing the pool or loan package of mortgages, the servicing may be carried out on behalf of the issuer by another servicer (a subservicer), which must also be a Ginnie Mae-approved issuer. The issuer is responsible and fully liable for the satisfactory performance of any work performed by a subservicer. All activities of any subservicer must be covered by a contractual agreement between the issuer and the subservicer and approved by Ginnie Mae. The issuer may not delegate or transfer to others its obligations to (1) withdraw funds from a principal and interest (P&I) custodial account for any purpose, (2) sign any accounting reports and certifications to Ginnie Mae, and (3) withdraw mortgage documents from the document custodian. In addition to obligations described above, Ginnie Mae MBS program issuers may not delegate or transfer to others the following obligations: (1) signing checks to Ginnie Mae, (2) signing remittance advice to security holders, (3) funding guaranty fees due Ginnie Mae, and (4) maintaining the register for security holders.

6-3. **Reference Material.** Throughout this chapter, reference is made to various reference materials using the base reference material number without the revision number (for example, REV-1, REV-6, etc.). This will enable periodic updates to section 6-3 rather than revising the references in the entire guide or chapter. Also, the auditor should ensure that the updated reference is used for performing the audit. If reference to the guide is needed in the audit report, the auditor should ensure that the entire updated reference, including the revision number, is used.

Ginnie Mae program regulations are contained in 24 CFR (Code of Federal Regulations) Parts 300 through 395. The U.S. Department of Housing and Urban Development's (HUD) guidance for Ginnie Mae is 5500.3, REV-1, Government National Mortgage Association MBS Guide. The issuer should have a copy of or access to the guide. The MBS Guide is available on the Internet at **www.ginniemae.gov**.

6-4. **Reporting Requirements.** Ginnie Mae issuers of mortgage-backed securities are required to submit the following financial statements, reports, and supplemental information annually:

Description	Reference in Handbook 2000.4
Reports	
Financial statements and opinion	Chapter 2, section 2-1
Internal controls	Chapter 2, section 2-1
Compliance with specific requirements	Chapter 2, section 2-1
Supplemental information	
Adjusted net worth calculation for issuer	Chapter 6, attachment B
Capital requirement calculation for issuer	Chapter 6, attachment C
Liquid asset requirement calculation for issuer	Chapter 6, attachment D
Adjusted net worth calculation for issuer's parent (if appropriate)	Chapter 6, attachment E
Capital requirement calculation for issuer's parent (if appropriate)	Chapter 6, attachment F
Liquid asset requirement calculation for issuer's parent (if appropriate)	Chapter 6, attachment G
Insurance requirement	Chapter 6, attachment H
Report of independent auditors on consolidating balance sheet and statement of income	Chapter 6, attachment I
Required transmittal or checklist	Chapter 6, attachment J
Corrective action plan (if appropriate)	Chapter 1, section 1-9

Nonprofit organizations that elect to submit audited financial statements in accordance with Office of Management and Budget Circular A-133 must also independently submit evidence of meeting Ginnie Mae's fidelity bond and errors and omissions insurance requirements and adjusted net worth requirements. The issuer's chief financial officer or executive officer must certify to the accuracy of the unaudited insurance and net worth schedules.

Issuers that did not have outstanding Ginnie Mae securities or commitment authority to issue new securities at any time during the fiscal year under audit do not have to submit an internal controls report, a report on compliance with specific requirements, and supplemental information. However, they must still submit evidence of meeting Ginnie Mae's fidelity bond and errors and omissions insurance requirements, adjusted net worth

requirements, and capital and liquidity requirements. The issuer's chief financial officer, president, or chief executive officer must certify to the accuracy of the unaudited insurance and net worth schedules.

A. <u>Audited Financial Statements.</u> Issuers are required to submit audited annual financial statements, which include a balance sheet, statement of operations, cash flow statements, notes to financial statements, and supplemental schedules, as stipulated in chapter 2 of this guide. The financial documents are to be submitted to Ginnie Mae's review agent using the checklist presented in attachment J (Annual Submission of Financial Documents) to this chapter. If for any reason an issuer needs to restate or revise a prior year's financial statements, the amended audited financial statements must be submitted to Ginnie Mae's review agent using the checklist presented in attachment J to this chapter.

B. <u>Other Reports.</u> In addition to the financial statements, all issuers not specifically exempted in section 6-4 must submit a report on internal controls and a report on compliance with specific requirements. A sample report on consideration of internal controls and a report of compliance with specific requirements are included in chapter 2.

The computation of the issuer's and issuer parent's adjusted net worth and computations of issuers' insurance requirements are to be reported on supplemental schedules to the basic financial statements. The computation of the issuer's and issuer parent's adjusted net worth is designed to eliminate those assets considered unacceptable by Ginnie Mae. **Note that the adjusted net worth computation and calculations for capital and liquidity requirements for the issuer's parent are required only when the issuer's parent presents a consolidated financial statement, along with consolidating schedules that reflect the financial condition of the issuer, and the issuer makes up less than 40 percent of the parent's equity.** Similarly, the required reporting formats for presenting these analyses are provided in attachments B, C, and D for the issuer and attachments E, F, and G for the issuer's parent. The required reporting format for presenting the analysis of the issuer's insurance is presented in attachment H.

Ginnie Mae requires submission of audited financial statements exclusively of the issuer. However, Ginnie Mae will accept alternative financial statements (that is, not exclusively of the issuer) if certain conditions are met as stated below:

1. For issuers that make up 40 percent or more of the equity of their parent (the 40 percent threshold may be collectively met by related-party issuers that have entered into a cross-default agreement with Ginnie Mae), Ginnie Mae will accept consolidated financial statements of the issuer's parent, provided that the consolidating schedules, which distinguish the balance sheet and operating statement of the Ginnie Mae issuer, are included with the parent's audit. The consolidating schedules must be subjected to the auditing procedures applied to the consolidated statement of the parent.

2. For an issuer with equity that is less than 40 percent of the equity of its parent, Ginnie Mae will accept consolidated financial statements of the issuer's parent, provided that the conditions in item 1 above are met and the issuer's parent enters into a corporate guarantee agreement with Ginnie Mae to guarantee the performance of the issuer. The parent must meet the terms and conditions of the agreement for the issuer to remain in good standing with Ginnie Mae.

Further, the issuer is required to submit with its parent's consolidated audited financial statements an adjusted net worth calculation on the parent. The parent's net worth, after adjustments for unacceptable assets, is required to be at least 110 percent (120 percent for issuers approved to issue manufactured housing or multifamily pools) of the required net worth of the issuer. That organization's auditor, in accordance with this audit guide, must audit the parent's audited financial statement and adjusted net worth calculations. The parent must also demonstrate in its adjusted net worth calculation that it meets the 110 percent (120 percent for issuers approved to issue manufactured housing or multifamily pools) requirement noted above.

The required format for presenting the "presentation of adjusted net worth calculation for issuer's parent" is provided in attachment E of this chapter.

3. For issuers that are Federal- or State-regulated depository institutions, such as those under the supervision of the Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Ginnie Mae will accept audited financial statements of the issuer's parent, so long as the issuer makes up 40 percent or more of the parent's equity and there is no more than one bank holding company covered in the audit. In such instances and in addition to the audited financial statement of the issuer's parent, the issuer must submit its unaudited regulatory report (call report).

Although Ginnie Mae may accept alternative audited financial statements, all other required reports (internal controls, compliance with specific requirements, adjusted net worth calculation, capital, liquidity, and insurance requirements) must be prepared by a certified public accounting firm that is an independent auditor exclusively for the issuer.

A sample auditor's report on the consolidating balance sheet and operating statement is included as attachment I to this chapter.

C. <u>Submission of Reports.</u> The issuer must submit the audited financial statements in accordance with section 6-4, regardless of whether the issuer had securities or commitment authority outstanding. Reports must be submitted within 90 calendar days of the end of the issuer's fiscal year to Ginnie Mae's review agent. If an issuer needs to restate or revise a ***prior*** year's financial statements, the amended audited financial statements must be submitted to Ginnie Mae's review agent within 15 business days of

their issuance by an auditor. Instructions for submitting electronically can be found in appendix VI-20 of the Ginnie Mae MBS Guide.

D. Single Auditor Approach. In many instances, it may be to the advantage of the custodian, the issuer, or both to hire a certified public accounting firm (auditor) to conduct a review of the mortgage documents that are held by a particular custodian, which has responsibility for several issuers' documents, rather than having each issuer require that a different auditor review that part of the custodial documents pertaining to each issuer's pools. The single auditor approach may also resolve practical problems associated with travel when the issuer, custodian, and auditor are not located near each other, thus reducing the cost of compliance while ensuring necessary audit coverage.

To determine whether the single auditor approach is practical in a given situation, the auditor and the issuer should contact the custodian(s) holding the issuer's pool and loan documents to determine the extent of the custodian's activities with other issuers. Arrangements may then be made regarding the most effective approach to conducting the review of custodial documents. Under the single auditor approach, the custodian will arrange with an auditor to review documents relating to each of the respective issuer's pools. The auditor for each issuer's pools will then prepare separate reports.

The single auditor approach and the reviews of custodial documents by the issuer's auditor are both acceptable methods under the Custodial Review section of the audit guide.

6-5. Compliance Requirements and Suggested Audit Procedures.

A. Federal Financial Reports.

1. **Compliance Requirement.** Issuers participating in HUD-assisted activities 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 entity and HUD. The individual agreements contain the specific reporting requirements that the entity is to follow.

2. **Suggested Audit Procedures.**

   a. Identify all required financial reports by inquiry of the issuer.

   b. Obtain an understanding of the auditee's procedures for preparing and reviewing the financial reports.

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

d. For the sample, trace significant data to supporting documentation (for example, worksheets, ledgers, etc.) Report all material differences between financial reports and issuer records.

e. Review significant adjustments made to the general ledger accounts affecting HUD-assisted activity and evaluate for propriety.

B. Eligibility To Issue Mortgage-Backed Securities.

1. Compliance Requirement. To be approved and maintain eligibility to issue Ginnie Mae-guaranteed mortgage-backed securities and act as administrator of such securities, an applicant must meet and maintain the following requirements:

a. Be a Federal Housing Administration (FHA)-approved lender in good standing. A State or local government instrumentality that is an FHA-approved lender is eligible. Lenders previously approved by FHA solely as loan correspondents (known as third-party originators) are not eligible to be Ginnie Mae issuers.

b. Maintain its Federal National Mortgage Association (Fannie Mae), or Federal Home Loan Mortgage Corporation (Freddie Mac) approval, whichever it has, or both if it has both. Loss of either approval may cause the issuer to become ineligible to issue and service Ginnie Mae mortgage-backed securities.

c. Conduct, as a principal element of its business operation, the origination or servicing of mortgage loans.

d. Conduct its business operations in accordance with accepted sound mortgage lending and servicing practices, ethics, and standards and have the experience, management capability, and access to adequate facilities necessary to assure Ginnie Mae of its ability to issue and service mortgage-backed securities. Except in instances in which the issuer can demonstrate that an alternative arrangement constitutes a sound business practice, the issuer must have at least three full-time officers and one additional employee, each with sufficient experience in the origination and servicing of mortgages of the type to be pooled to ensure effective pool management on a long-term basis. The officer in charge of day-to-day operations must be a full-time employee of the issuer firm only, and the issuer's offices must be self-contained and separate from those of any other entity.

e. Maintain policies that prohibit any discrimination against a borrower based on race, religion, color, sex, national origin, age, familial status, or disability. The issuer must comply with any applicable rules, regulations, and orders of general applicability issued under Title VI of the Civil Rights Act of 1964; Executive Order 11063, Equal Opportunity in Housing, issued November 20, 1962; Title VII of the Civil Rights Act of 1968 as amended; Section 504 of the Rehabilitation Act of 1973; other applicable civil rights laws and regulations

and applicable FHA rules and regulations. In addition, this section incorporates by reference section 202 of Executive Order 11246, Equal Employment Opportunity, issued September 24, 1965, as amended. The issuer is required to comply with the implementing rules and regulations of the U.S. Department of Labor (41 CFR 60-1) and HUD (24 CFR Part 130).

f. Have and maintain fidelity bond coverage and a mortgage servicing errors and omissions policy that contains the required elements according to section 2-7(B) of the MBS Guide and is in an amount that is based on the issuer's remaining principal balance of its total loan servicing portfolio[1] in accordance with the MBS Guide, chapters 2 and 3, both of which name Ginnie Mae as loss payee.

g. Maintain net worth, capital, and liquidity values based on an audited financial statement prepared in accordance with generally accepted accounting principles in assets acceptable to Ginnie Mae, as outlined in section 6-5, paragraph G.2; section 6-5, paragraph H.1; and section 6-5, paragraph I.2, of this chapter, respectively.

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

a. Determine that the issuer meets stated eligibility requirements covered in section 6-5, paragraph B, above.

b. Test whether the issuer has in place and follows an established policy that prohibits discrimination in housing and lending as communicated in chapters 2 and 3 of the MBS Guide as well as section 1-9 of this guide.

c. Recompute the issuer's required fidelity bond and mortgage servicing errors and omissions coverage policy at the end of the fiscal year in accordance with chapters 2 and 6 of the MBS Guide. Verify that (1) the policy contains the required elements according to section 2-7(B) of the MBS Guide, (2) the required levels of insurance were maintained throughout the year with testing of the adequacy of insurance at least once per quarter, and (3) the fidelity bond and errors and omissions policies are written by an insurance carrier that maintains an A.M. Best rating of B+ or better in the Best Insurance Reports and is specifically licensed or authorized by law to transact business within the State or territory where the named insured has its corporate headquarters. Lloyd's of London, although not rated, is an accepted insurer.

An issuer's minimum insurance coverage must comply with the following, based on the issuer's total loan servicing portfolio:

[1] The total loan servicing portfolio should include all single-family housing, multifamily housing, and manufactured housing loans. It does not need to include servicing on car loans, credit card loans, or any loan type that Ginnie Mae does not allow in the program.

(1) For issuers with a total loan servicing portfolio of $100 million or less, $300,000.

(2) For issuers with a total loan servicing portfolio of more than $100 million and up to $500 million, $300,000 plus 0.15 percent of the amount of total servicing in excess of $100 million.

(3) For issuers with a total loan servicing portfolio of more than $500 million and up to $1 billion, $900,000 plus 0.125 percent of the amount of total servicing in excess of $500 million.

(4) For issuers with a total loan servicing portfolio of more than $1 billion, $1,525,000 plus 0.1 percent of total servicing in excess of $1 billion.

The maximum required loan servicing errors and omission insurance coverage requirement is $20 million. The maximum fidelity bond coverage is not limited. The required reporting format for the "presentation of insurance requirement" is provided in attachment H of this chapter.

d. Determine whether the issuer is an affiliate (parent, subsidiary, or related party) of any other Ginnie Mae issuer(s). All affiliated Ginnie Mae issuers should be identified in the auditor's verification of insurance. If an affiliate(s) is covered by the same insurance policy, the loan servicing portfolio of each issuer must be added together to calculate the combined total loan servicing portfolio. The amount of this combined servicing portfolio should be used to determine the minimum required insurance coverage.

e. Compare the issuer's adjusted net worth (net worth reported in the audited financial statements as adjusted for any unacceptable Ginnie Mae assets) to the minimum required net worth as discussed in section 6-5, paragraph G.2, of this chapter.

C. Review of Custodial Documents.

1. Compliance Requirements. Documents relating to the pooled mortgages are required to be held on Ginnie Mae's behalf for the life of the pool by a custodial institution. It is the issuer's responsibility to arrange for such an institution to hold the documents. The custodial relationship must be evidenced by the execution of a "master custodial agreement" with the custodian, certifying on the reverse side of the schedule of pooled mortgages that it has examined and has in its possession all required documents. A custodial institution is permitted to function as a custodian to more than one issuer. An issuer may use more than one custodian. Pools issued on or after February 1, 1979, must have a single custodian.

A custodial institution must meet the eligibility requirements specified in chapter 13 of the Ginnie Mae MBS Guide. The eligibility requirements for custodians are also stated in chapter 2 of the MBS Guide, appendix V-1, Document Custody Manual.

The auditor must follow the procedures in section 6-5, paragraph C.2, below. All document custodians with Ginnie Mae portfolios must have an onsite review at least once every 3 years.

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

a. Determine whether an issuer uses more than one custodial institution. If more than one custodian is used, at least one custodial institution must be reviewed each year, and all custodial institutions must be reviewed within a 3-year cycle. Determine that the custodial institution meets the following eligibility requirements:

(1) Is a federally regulated financial institution in good standing with its primary regulator and not in receivership, conservatorship, liquidation, or any other management oversight by its primary regulator unless operating under an approved management plan. If the document custodian is a government-sponsored enterprise (GSE)-approved document custodian, it must be in good standing with the GSE(s). The auditor must determine whether the issuer has ever been the subject of an adverse action by a GSE.

(2) Maintains a secure, 2-hour fire-resistant storage facility standard with adequate access controls.

(3) Uses knowledgeable employees in its custodial function to handle mortgage documents and perform custodial functions.

(4) Maintains for review annual financial statements audited by an independent certified public accountant for itself or its parent.

(5) Maintains the minimum insurance requirements of its primary regulator and maintains coverage to indemnify against losses involving Ginnie Mae pools and loan documents custody.

(6) Maintains updated written procedures within its operation in addition to the Document Custodian Manual.

(7) Satisfies eligibility requirements and other requirements as directed by Ginnie Mae.

(8) Is part of a trust department that is physically separate from the service area and operations of the issuer if the custodian maintains issuer records on its own behalf or on behalf of its parent (self-custodian). The affiliated and

self-custodian must also have obtained prior approval to exercise fiduciary powers from its primary regulator. Such fiduciary powers must include ordinary trust services, such as personal trust services, personal representative services (executor), guardianship, custodian services, or investment advisory services offered to the public, and not be limited to maintaining custody of valuable documents for Ginnie Mae issuers. The trust service function must be subject to periodic review or inspection by its primary regulator.

(9) If it is an affiliated custodian that does not meet all of the requirements in section 6-5, paragraph C.2.a.(8), above or if the custodial documents are not held in the trust department, provides evidence that there is a vertical independence between the issuer and the custodial or warehouse institution.

(10) Maintains a written disaster recovery plan that covers restoration of the facilities, physical recovery of the files, and backup and recovery of information from electronic tracking systems.

(11) Tests whether the document custodian has in place a quality control plan for document review standards.

b. Verify that the custodial institution maintains or performs the following inventory accounting requirements:

(1) Maintains an issuer master file, which contains the issuer custodial register, any blanket legal opinions, a copy of the issuer's corporate resolution for a name change, and any other applicable issuer-level documents.

(2) Maintains an issuer custodial register, which includes a list of pools in custody (must provide pool identification numbers), the actual or due dates for final certification and recertification, and a count of the total number of pools in custody.

(3) Maintains a pool master file for each pool in custody, which contains a copy of the master custodial agreement, schedule of pooled mortgages, form HUD-11711B (Certification and Agreement), form HUD-11711A (Release of Security Interest) if applicable, original blanket interim assignment(s) (a copy of which is included in each individual loan file to which the blanket interim assignment applies), copies of opinion(s) from qualified outside legal counsel (originals maintained in the issuer master file), original pool-level waiver letters from Ginnie Mae, and all forms HUD-11708 (Request for Release of Documents) for liquidated release codes.

(4) Has performed an annual physical inventory of all pools held for the issuer, which will include, at a minimum, a reconciliation of the pool numbers on the issuer custodial register to a current issuer-provided pool listing and verification that the pool numbers on the issuer custodial register agree with the pool master files in custody.

(5) Maintains a nonliquidation release inventory or file of all forms HUD-11708 submitted on or after July 1, 1992, on the basis of the nonliquidation release code 6. If a file is maintained, copies of the forms HUD-11708 must be kept in chronological order by document release date. If an inventory is maintained, it must contain the pool number, FHA-U.S. Department of Veterans Affairs (VA)-U.S. Department of Agriculture Rural Development (RD)-Office of Public and Indian Housing (PIH) case number or loan number, and the document release date.

If any documents have been released for more than 90 days (nonliquation reason code 6), the custodian is required to notify the issuer of the overdue documents every 90 days. If the document is outstanding after 180 days, Ginnie Mae must be notified by the document custodian. The notification must be in writing and documented in the inventory or file.

c. If more than one custodial institution is used, identify which pools are at which custodial institution to select a sample of pooled mortgages for that institution. If the issuer uses only one custodial institution, obtain a list of the pools. Select a representative sample of Ginnie Mae pools for review. For pools selected, determine whether the pools include

(1) An executed original form HUD-11711B (Certification) signed by an officer of the issuer, whose signature appears on the issuer's form HUD-11702, covering the mortgages that are being reviewed and that were closed after March 31, 1979, stating that

(a) Release(s) of security interest (form HUD-11711A) delivered by the issuer to the custodian comprise(s) all evidence of any security agreements affecting all mortgages in this pool. Upon the delivery of securities, only Ginnie Mae will have an ownership interest in and access to the pooled mortgages, or

(b) Other than the unrecorded assignment to Ginnie Mae, there are and will be no security agreements affecting any mortgages in this pool.

(2) If noted on the form HUD-11711B that a form HUD-11711A is required, an original form HUD-11711A (Release of Security Interest) must be executed by all secured institution(s), relating to any mortgages included in the mortgage pool that are being reviewed and that were closed after March 31, 1979. The form should state:

The lending (or other financing) institution named below agrees to relinquish any and all right, title, or interest it may have in mortgages to be placed in this Ginnie Mae mortgage-backed securities pool or loan package (pooled mortgages) no later than the date and time of delivery of the securities by Ginnie Mae or its agent. In the case of

home equity conversion mortgage loans, "pooled mortgages" must include the mortgages, participations related to such mortgages, and any amounts related to such mortgages that do not constitute participation interests.

d. Obtain a copy of the original schedule of pooled mortgages (form HUD-11706)[2] from the document custodian for each of the pools selected. The purpose of the schedule of pooled mortgages is to provide a means to identify and control mortgages placed into the pool, which secures the obligations issued. Accordingly, select a sample of pooled mortgages from the schedule of pooled mortgages.

e. Review the custodial files of the sampled mortgages for the following documents and compare the information shown on these documents to the information on the schedule of pooled mortgages. Reconcile and report on any differences. Procedures for the custodian document review are contained in paragraph 13-4 and appendix V-1 of Ginnie Mae's MBS Guide.

(1) The original note or other evidence of indebtedness endorsed in blank and without recourse.

(2) For multifamily and manufactured housing pools only, an assignment to Ginnie Mae of the mortgage or other security instrument in recordable form but not recorded. The assignments to Ginnie Mae can be in blanket form. The blanket assignments must apply to mortgages in the same pool and same recording jurisdiction. If the pool was issued after March 31, 1979, and if the mortgage was originated by a lender other than the issuer, there also must be a recorded assignment if State law requires recordation to make the assignment valid against all lien holders from the originating lender to any intervening interest holder and from such holder to any further holders of mortgage ownership. These interim assignments must be either originals or certified copies of the originals and if required by State law to assure validity, be either recorded or certified by the issuer to have been transmitted for recordation.

f. Within 12 months of the issuance of the securities, transfer of issuer responsibility, or change of custodial responsibility, the files must contain the following documents. Report any missing documentation as a finding.

(1) Original evidence of guaranty for PIH loans or evidence of the custodian's verification of insurance or guaranty for the FHA, VA, and RD loans if the loans were originated before January 1, 2003. If the loan is a VA vendee

[2] For programs other than the single-family MBS program, the form numbers before January 1, 1996, was
- Project loans: form HUD-11721, and
- Manufactured home loans: form HUD-11725.

loan or contract, there will be a portfolio loan statement of settlement form from VA rather than a loan guarantee certificate.

(2) Original recorded mortgages (or other security instruments) signed by the borrower securing repayment of the indebtedness. (Note: Compare the borrower's name as it appears on the schedule of pooled mortgages with that which appears on the recorded mortgage to ensure identity). Copies of the recorded mortgage are acceptable if the copies clearly show the document recording information.

(3) Evidence that a mortgage title insurance policy has been obtained or other evidence of title acceptability to FHA, VA, RD, or PIH (not required in cases involving the conveyance of HUD Secretary-owned property if an exception has been authorized by Ginnie Mae or on VA vendee loans or contracts). Copies of lender title insurance policies are acceptable.

(4) A complete chain of original recorded interim assignments. These are not required if the mortgage is retained by the original lender. Copies of the recorded interim assignments are acceptable if the copies clearly show the document recording information.

(5) Verification that the custodian has completed the final certification on the back of the schedule of pooled mortgages.

g. Within 12 months of a transfer of issuer responsibility, the following documents must be in the custodial file, and the custodian is required to have completed recertification of the approved pools.

(1) An updated endorsement on the promissory notes.

(2) A recorded assignment of the mortgage to the current issuer.

(3) All documents required in section 6-5, paragraphs C.2.d and C.2.e, above.

h. Within 12 months of a transfer of custodial responsibility, all documents required in section 6-5, paragraphs C.2.d and C.2.e, above must be in the custodial file. The custodian is required to have a completed recertification of the appropriate pools within 12 months. Report any pool(s) for which the final certification or recertification is past due and has not been completed.

If an issuer has entered into a representations and warranties agreement with Ginnie Mae, the documents referenced above that must be in the custodian file are subject to chapter 13 and appendix V-1 of the Ginnie Mae MBS Guide 5500.3, REV-1.

i. Determine that documents and loan files released from custodial files are evidenced by a request for release of documents (form HUD-11708). For the sampled mortgages,

(1) Determine whether the custodian is in possession of a form HUD-11708 for documents and files removed from the custodian's care.

(2) Prepare a list of missing documents and loan files not supported by a form HUD-11708. This listing should be reviewed with the custodian and also with the issuer. Any items not reconciled should be reported as a finding.

j. Select paid-in-full or foreclosed-upon mortgages listed on form HUD-11708 on a test basis. Verify that these mortgage documents are no longer with the custodian. The custodian should note this removal on its inventory control record (the schedule of pooled mortgages).

Any discrepancies should be noted on an exceptions listing, noting the pool number, the borrower, and the defect, and reported as a finding. This listing should be reviewed with the custodian, and errors should be corrected by the custodian. The custodian should furnish this listing to the appropriate issuers, and the auditor should then review with the issuer the reasons for any missing or deficient documents.

Missing documents for mortgages that are still current according to the issuer's records could be an indication that the issuer has received mortgage payoffs and not passed payments through to securities holders.

D. Issuer's Administration of Pooled Mortgage.

1. Compliance Requirement. Administration of the pool of mortgages and of payments to securities holders is the responsibility of the issuer. Servicing of pooled mortgages must be carried out in accordance with generally accepted practices in the mortgage lending industry. Contractual requirements with respect to pool administration are contained in the guaranty agreement executed by the issuer and Ginnie Mae for each pool. The servicing system must be capable of producing, at any time for any mortgage, an accounting, which identifies the Ginnie Mae pool number for each listed mortgage and for each monthly due date, the amount of each collection, disbursement, advance, or adjustment. It should also indicate the latest outstanding balances of principal, deposits, advances, and unapplied payments. In no instance may the issuer or subservicer remove a loan from a pool, reduce a loan balance, or remove funds from any pool custodial account without prior written approval by Ginnie Mae.

The issuer may incur losses for pooled loans that are not fully insured, such as coinsured multifamily loans, manufactured housing loans, and VA guaranteed loans. For each of these loan types, should a foreclosure take place, the issuer may

not be fully reimbursed through the claims process. Any shortfall in collections must be paid to the securities holder out of the issuer's own funds. These shortfalls have been particularly large in the VA program. Special attention should be given to issuers with a concentration of VA loans in declining market areas.

In the VA program, should a default occur, VA will determine the cost effectiveness of bidding at the foreclosure sale. VA will not bid if it believes its losses will exceed the guarantee amount. As a result, this "no bid" scenario may be costly to the issuer, as it must pay off the security holder for the outstanding mortgage balance.

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

a. Test whether the issuer meets Ginnie Mae's requirement for separate custodial bank accounts for P&I collections (non-interest-bearing) and tax and insurance escrow funds (option of interest bearing) applicable to pooled mortgages with the P&I accounts held in institutions meeting Ginnie Mae's rating requirements in section 16-8 of the MBS Guide. Test the custodial account titles for compliance with requirements established by Ginnie Mae letter agreements, forms HUD-11709 and 11720. If a P&I disbursement clearing account is used, verify that it is used only for payments to Ginnie Mae securities holders. (Note: These accounts may contain funds for more than one pool, provided that the issuer maintains separate accounting records for each pool).

b. Review monthly collections of mortgage P&I, as well as collections of claims on defaulted and liquidated mortgages, to determine that funds have been deposited into the appropriate custodial account(s) in accordance with section 16-9(A) of the MBS Guide as appropriate.

c. Test whether the issuer is making proper payments of interest, principal, and unscheduled principal to certificated securities holders so that those payments are received no later than the 15th of the month. Test whether partial prepayments, prepayments in full, assignments, and foreclosures are passed through to the securities holders in the regular monthly payment following the month of receipt. Test that all such recoveries are recorded on MBS report controls, the pool collateral is removed from the custodian's possession, and the transaction is supported by documentation.

d. Test whether disbursements from P&I custodial bank accounts are authorized under the guaranty agreement.

e. Review a representative sample of payments to securities holders to determine that such payments were made to those shown in the securities holders register for the pools being tested.

f. Compare mortgages listed in the issuer's monthly reconciliation of liquidation(s) to those identified on form HUD-11708 held by the custodian as having been withdrawn from the pool to ensure proper pass-through of proceeds to securities holders.

g. Test whether the issuer is using its own resources to

(1) Make advances to the pool accounts to cover shortfalls in collections from borrowers. (Note: Limited exceptions to this requirement are included in the Ginnie Mae MBS Guide.) Special attention should be given to the issuer's calculation and use of excess funds, particularly for internal reserve pools.

(2) Cover principal amounts not recovered in claim settlements or which are due in connection with defective loans. (Issuers are required to "buy out" uninsured or otherwise defective loans from the pools in accordance with instructions in the MBS Guide, using the issuer's own funds. Such buyouts may only occur once the issuer has received prior approval by Ginnie Mae).

h. Obtain an understanding of the issuer's controls to project the need for and availability of funds. These controls should allow the issuer to make required advances to securities holders as required under section 6.02(a) of the guaranty agreement.

i. Test whether the issuer incurred losses for pooled loans not fully insured, such as coinsured multifamily loans, manufactured housing loans, and VA guaranteed loans. Determine that the issuer has disclosed a contingent liability in its financial statements.

j. Test whether the issuer has a system to follow up on and obtain the required documents to enable the custodian to make its final certification in a timely manner. Ginnie Mae must receive the final certification, covering documents listed on the reverse side of the schedule of pooled mortgages, within the timeframes identified in the MBS Guide.

k. If the issuer has acquired pools from another issuer or if the issuer has transferred pools from one document custodian to another, test whether these pools have received new final certifications (recertification) within the timeframes outlined in the Ginnie Mae MBS Guide.

l. Test whether the issuer has established a complete securities holders' register in accordance with Ginnie Mae instructions and has updated the register before paying holders each month. The register should include a record of all certificate transfers for the life of the pool.

m. Test whether the issuer is servicing delinquent mortgages and managing foreclosures and assignments in accordance with the applicable requirements of VA, FHA, RD, PIH, and the Ginnie Mae Guide.

n. Test whether undelivered payments are deposited into the P&I custodial account and whether checks that remain outstanding in excess of 6 months of the payment date are made payable to Ginnie Mae and sent to Ginnie Mae's central paying and transfer agent pending a claim from the security owner. Undelivered payments should not be used as excess funds or used by the issuer to fund pool shortfalls.

o. Test whether any transfer of the P&I or taxes and insurance custodial accounts, change of document custodian, change of mortgage servicer, or transfer of issuer responsibility was accomplished after written approval from Ginnie Mae was obtained.

E. Review of Monthly Accounting Reports and Quarterly Submissions.

1. Compliance Requirement. Ginnie Mae issuers of mortgage-backed securities are required to submit the following reports periodically throughout the year:

a. Form: HUD-11710D, Issuer's Monthly Summary Report.

Issuers reporting: all Ginnie Mae issuers of record.
Frequency of reporting: monthly.
Deadline for submission: on or before the fourth business day of the month following the month covered in the report.

b. Trial balance (pool and loan level) information.

Issuers reporting: all Ginnie Mae issuers of record.
Frequency of reporting: monthly.
Deadline for submission: on or before the second business day, with all critical pool and loan-level exceptions to Ginnie Mae's Reporting and Feedback System (RFS) designated as errors (E) or critical (C) corrected no later than the fourth business day. RFS exceptions that are designated high (H), medium (M), and low (L) should be corrected by the 10th business day. All other corrections to the monthly report of pool and loan data must be submitted no later than the 10th business day.

This information must also be retained by the issuer in hardcopy or electronic format with the ability to reproduce hardcopy reports for data included in the RFS pool and loan records upon request by Ginnie Mae or its agents.

Additional or alternative reports are required in connection with pools other than those for single-family-level payment loans, as explained in the chapters and appendixes for the other programs.

These reports, along with supporting documents, must be sent to Ginnie Mae with sufficient lead time and via a method that ensures delivery no later than the second business day of each month. Instructions for the preparation and submission of the forms are found in appendix VI-19 of the MBS Guide.

Monthly reports submitted to Ginnie Mae on each pool and remaining principal balance (RPB) data must be submitted electronically via the Ginnie*NET* system or computer-to-computer option. RPB corrections must be submitted via Ginnie*NET* only. Data submitted are equivalent to the RPB data required on the physical form HUD-11710D (Issuer's Monthly Summary Report). Effective October 1, 2015, the requirement for monthly RPB reporting through Ginnie*NET* was eliminated through All Participant Memorandum (APM) 15-15.

c. Monthly reports must be submitted to Ginnie Mae on all of the loans in their portfolio. All issuers must report loan-level detail every month. The loan-level data should report trial balance information for all nonliquidated loans as part of the cutoff date for the month.

d. Quarterly unaudited reports on their financial condition must be submitted to Ginnie Mae by issuers that are not federally regulated. Reports must be submitted electronically, using form HUD-11750, Mortgage Bankers' Financial Reporting Form, no later than 30 days after the end of the calendar quarter or 60 days after the end of the calendar year. Issuers may access this shared form at www.mbfrf.org. Federally regulated financial institutions (banks, savings and loans, and credit unions) are not required to submit this report.

2. Suggested Audit Procedures.

a. To obtain an understanding of the issuer's procedures for collecting and entering all data relating to mortgage collections and securities payments on the RFS pool record, use reconciliations and tests located within the Ginnie Mae MBS Investor Reporting Manual, formerly known as the Accounting Manual, to identify whether entries are made in accordance with Ginnie Mae requirements.

b. Trace and reconcile the issuer's internal servicing records to the issuer's monthly reconciliation report of liquidations.

c. Compare the securities balance reported electronically via RFS to the remaining pool balance reported to Ginnie Mae or its agent in accordance with Ginnie Mae MBS requirements. Effective October 1, 2015, this reconciliation is no longer required, as the requirement to report RPB in Ginnie*NET* was eliminated in APM 15-15.

d. Test whether each loan removed from the pool was reported on the RFS monthly liquidation reconciliation report. This report is equivalent to the liquidation schedule (form HUD-11710E). Also, test that the unpaid loan balances passed through to securities holders and reported in the liquidation schedule agree with the issuer's records.

e. Compare the amount of checks sent to certified securities holders for the month to the amount reported to Ginnie Mae.

f. Compare the custodial account balances as reported to Ginnie Mae to the actual balances (after reconciliation) of the disbursement clearing and custodial bank accounts as shown by the bank statements.

g. On pools selected for review, reconcile the total unpaid principal balance of the pooled mortgages (mortgage collateral) to the unpaid principal balance of the securities outstanding, as follows:

(1) Month end pool principal balance

(2) (Plus) prepaid installment principal

(3) (Minus) delinquent installment principal

(4) (Minus) concurrent date (CD) pools only: scheduled principal

(5) (Plus) CD pools only: last liquidation principal installment

(6) (Minus) CD pools only: additional principal adjustment or fixed installment control change for graduated payment mortgage pools

(7) (Equals) security principal balance difference (over-short).

Differences may arise in the reconciliation between the pooled loan balance and the outstanding securities balance due to additional principal payments or rounding. Such differences should not exceed $1 for each loan in the pool up to a maximum of $50 per pool for over-under collateralizations. Any greater difference must be funded to the pool in the current report. At least once a year, adjustments to the securities holder payments must be made to fully correct for any difference. Reconcile and report on any difference.

h. For pools randomly selected for review, test the expected P&I custodial account balances at cutoff. This test (outlined in section 1.D of the Ginnie Mae Investor Reporting Manual) identifies a minimum dollar amount expected in the P&I account for any particular pool as of a given cutoff date. This test verifies the accuracy of the P&I balance reported to Ginnie Mae and will only yield

accurate results when the mortgage and securities balances reconcile in step 7 above.

The test assumes that all collections are paid out by the pass-through of funds to securities holders or taken as issuer servicing fees. The test formula is different between internal reserve and CD pools. However, in either case, indicate the amount of P&I funds that should be held in the account at the cutoff date.

i. Obtain an understanding of the issuer's procedures and test whether the issuer meets the delivery requirement by the second business day of each month for pool and loan-level reporting.

j. Test that loan-level information is being reported monthly to Ginnie Mae.

k. For all issuers that are not federally regulated financial institutions, test that quarterly financial information (form HUD-11750) is being submitted electronically through the Mortgage Bankers' Financial Reporting Form Web-based system.

F. Securities Marketing and Trading Practices.

1. Compliance Requirement. Ginnie Mae has established securities marketing and trading requirements, which are intended to ensure that issuers fulfill their securities marketing and trade activities in a manner consistent with prudent business practices and their own and others' financial capacity. There are three components to these requirements: (1) a suitability rule, (2) prudent business practice rules, and (3) minimum forward delivery contract requirements related to so-called mark-to-market deposit requirements. There are also record-keeping and reporting requirements. All approved issuers must implement these procedures, whether or not securities or commitments are outstanding. The applicable requirements are found in the MBS Guide, specifically in appendix IV-1.

2. Suggested Audit Procedures.

a. Obtain an understanding of the written procedures established by the issuer to determine the financial integrity of dealers, brokers, and investors, including an explanation of standards for and steps taken in determining the financial capacity of dealers, brokers, or investors to complete transactions.

b. Test whether the issuer is following established procedures to determine the financial capacity of dealers, brokers, and investors to complete a transaction and to determine the business reputation of the dealers, brokers, and investors.

c. Obtain copies of the resolution executed by the issuer's board of directors designating key persons responsible for overall supervision of issuer activities relating to the marketing and trading of securities.

d. Obtain an understanding of the procedures established by the issuer to maintain a record of all commitments entered into to deliver or acquire securities.

e. Test whether the issuer's records of such commitments include the following:

(1) Date of the transaction (trade date).

(2) Type of securities.

(3) Nature of the transaction: purchase, sale, optional or mandatory delivery, repurchase, or other credit arrangement.

(4) Settlement date.

(5) Dollar amount of securities.

(6) Interest rate on the securities.

(7) "Price" of the securities.

(8) Name of the firm and individual with whom the transaction was executed.

(9) Current market price (value) of the contract.

f. For "regulated transactions" (see note 1 at step h), test whether the issuer's records include the following:

(1) A copy of the delayed delivery contract required by the Ginnie Mae MBS Guide.

(2) The name of the financial institution with which collateral is or will be deposited.

(3) Records of mark-to-market computations, including market value, amounts of deposits by issuer and by counterparty, and the type of collateral deposited.

(4) If the collateral used is a letter of credit, a copy of the letter of credit.

g. Review the issuer's statement showing the computation of the issuer's "net position" as referenced in appendix IV-1 of the Ginnie Mae MBS Guide. Compare this information to the issuer's accounting records and prove the mathematical accuracy of the net position. The statement should identify amounts of loans and securities closed and held for sale, plus those expected to be acquired, less commitments the issuer has available for disposing of loans

and securities. It also should include any positions involving repurchase, reverse repurchase, or other credit transactions.

h. Determine the potential impact on an issuer's net worth of any identified forward or future commitment contract entered into by the issuer to purchase or sell securities. If there are material potential effects on the issuer's net worth, determine whether they are disclosed in the appropriate footnotes to the financial statements. **Note 1:** "Regulated transaction" means the purchase or sale of securities by an issuer under a delayed delivery contract, except that the term does not include

(1) A sale of securities when (1) the issuer holds a valid, outstanding commitment to guarantee mortgage-backed securities (which is not applied in connection with another transaction) issued by Ginnie Mae in an amount at least equal to the face amount of the securities sold and (2) the settlement date under the contract is no later than the last day of the calendar month in which the 150th calendar day after the contract's trade date falls.

(2) A sale of securities guaranteed by Ginnie Mae and based on construction loans (construction loan securities) or project loans (project loan securities).

(3) A sale or purchase of securities under a contract, which does not obligate the issuer to sell or purchase securities; that is, a standby commitment on which the issuer has the option to perform.

(4) A purchase (or sale) of mortgage participation certificates directly from (or to) Freddie Mac.

G. Adjusted Net Worth.

1. Computation. The reporting of the "adjusted net worth calculation" is required for all Ginnie Mae issuers, even if there are no securities or commitments outstanding at fiscal yearend. The required format for the adjusted net worth calculation is provided in attachments B and E of this chapter.

Unacceptable assets are defined in attachment A of this chapter and should be itemized by asset type in the required format for presentation of adjusted net worth calculation for the issuer (attachment B). Do not combine the unacceptable assets into one line entitled "Unacceptable Assets." In certain circumstances and at its sole discretion, Ginnie Mae may accept a corporate guaranty as consideration for reclassifying certain assets that are treated as unacceptable under the HUD Consolidated Audit Guide. In addition, if evidence exists indicating the existence of related-party receivables or any unacceptable asset, which have not been deducted by the auditor, Ginnie Mae will deduct the amount from the issuer's adjusted net worth.

An issuer's adjusted net worth will be calculated by subtracting the total amount of unacceptable assets from the net worth as stated on the auditor's audited balance sheet. Excess (deficit) net worth is computed as the difference between adjusted net worth and required net worth.

When the Ginnie Mae issuer is a subsidiary, the adjusted net worth computation must use the assets and liabilities of the Ginnie Mae issuer exclusively. Failure of the issuer to respond satisfactorily and in a timely manner to requests made by Ginnie Mae or its agent for additional information could result in disallowance of questionable assets and suspension or termination of issuer status.

2. **Required Net Worth.** Required net worth will be calculated as of the end of the issuer's fiscal year as follows:

   a. For issuers approved to securitize MBS pools backed by single-family-level payment, graduated payment, growing equity, buydown, serial note, or adjustable rate mortgages, the minimum base net worth requirement is $2.5 million plus 0.35 percent of the total single-family effective outstanding obligations. The total single-family effective outstanding obligation is the sum of (1) all single-family securities outstanding, (2) available commitment authority to issue new single-family pools, and (3) total single-family pools funded.[3]

   b. For issuers approved to securitize MBS pools backed by manufactured home loans, the minimum base net worth is $10 million plus 10 percent of the issuer's total effective manufactured home outstanding obligations. The total effective MH outstanding obligation is the sum of (1) all manufactured home securities outstanding, (2) available commitment authority to issue new manufactured home pools, and (3) total manufactured home pools funded.

   c. For issuers approved to securitize MBS pools backed by multifamily construction or permanent loans, the minimum base net worth is $1 million plus 1 percent of the issuer's total effective multifamily outstanding obligations in excess of $25 million up to $175 million plus 0.2 percent of the total effective multifamily outstanding obligations in excess of $175 million. The total effective multifamily outstanding obligation is the sum of (1) all multifamily securities outstanding, (2) available commitment authority to issue new multifamily pools, and (3) unexpended multifamily construction draws.[4]

[3] Total single-family pools funded are the pools that have been logged and are in the review process and in which the commitment line balance has been reduced.
[4] The unexpended multifamily construction draws are the net amount between construction loan commitment authority reserved and total construction loan draws made.

d. For issuers approved to participate in the home equity conversion mortgage MBS (HMBS) program, the minimum base net worth is $5 million plus 1 percent of the total effective HMBS outstanding obligations. The total effective HMBS outstanding obligation is the sum of (1) all HMBS securities outstanding, (2) available commitment authority to issue new HMBS pools, and (3) total HMBS pools funded.

e. Issuers approved to participate in more than one program type (single family, multifamily, manufactured home, or HMBS) are required to meet and maintain a minimum adjusted net worth equal to or greater than the sum of the minimum net worth program types in which the issuer is approved to participate.

H. Institutionwide Capital Requirements.

1. Computation. All Ginnie Mae issuers (except for issuers that are approved exclusively to issue MBS pools backed by manufactured home loans) must meet the following net capital requirements, without regard to securitization type and even if there are no securities or commitments outstanding at fiscal yearend. When the Ginnie Mae issuer is a subsidiary, the capital computation must use the assets and liabilities of the Ginnie Mae issuer exclusively. This requirement provides assurance that issuers will have sufficient capital to offset financial risk on an institutionwide basis.

a. Banks, thrifts, bank holding companies, and savings and loan holding companies must meet the following requirements:

(1) Tier 1 capital-total assets ratio of 5 percent or greater.

(2) Tier 1 capital-risk-based assets of 6 percent or greater.

(3) Total capital-risk-based assets ratio of 10 percent or greater.

The above requirements are not applicable to credit unions.

b. Entities that are not covered by the above requirements in subparagraph “a” must maintain a total adjusted net worth as defined by Ginnie Mae and presented by issuers as part of their annual financial reporting obligations-total assets ratio of 6 percent or greater.

I. Liquid Asset Requirement.

1. Computation. All Ginnie Mae issuers are required to meet the liquid asset requirements below without regard to securitization type and even if there are no securities or commitments outstanding at fiscal yearend. When the Ginnie Mae issuer is a subsidiary, the liquid asset computation must use the assets and required net worth of the Ginnie Mae issuer exclusively. The liquid asset requirement

ensures that funds are available should there be the need for cash to fund loan buyouts or pay for potential indemnification requests from insuring agencies.

a. Multifamily and HMBS Issuers
Issuers approved to securitize multifamily or HMBS pools are required to have liquid assets of at least 20 percent of their net worth requirement as defined in section 6-5, paragraph G.2, of this guide.

b. Single-Family Issuers
Issuers approved to securitize single-family MBS pools are required to have and maintain liquid assets equal to the greater of $1 million or .10 percent of the issuer's outstanding single-family mortgage-backed securities.

c. Manufactured Housing Issuers
Issuers approved to securitize pools backed by manufactured home loans are not required to meet a separate liquidity requirement.

Issuers approved to participate in more than one program type (single family, multifamily, manufactured home, or HMBS) are required to meet and maintain minimum liquid assets equal to or greater than the sum of the minimum liquid assets requirements for all program types in which the issuer is approved to participate.

2. <u>Acceptable Liquid Assets.</u> Liquid assets are cash and cash equivalents as defined under Financial Accounting Standards Board Statement No. 95.

6-6. <u>Audit Finding Reporting.</u> All material instances of noncompliance with any HUD requirement or regulation, deficiencies in internal control, 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, deficiencies in internal control, fraud or illegal acts, or contract violations disclosed during the audit process may be reported separately to management. Such reporting must be in writing in a management letter or other type of written auditor communication and must be mentioned in the independent auditor's report, including the date of the management letter or other written communication. Noncompliance, deficiencies, or instances of violations that were corrected during the audit process or after the fiscal year under audit or disclosed as a part of the audit process before the end of the fiscal year under audit and before the issuance of the audit report must be included in the report as resolved findings or in a management letter, depending on their materiality.

A. <u>Content of Finding</u>. Findings are to be presented in accordance with the standards and requirements of generally accepted government auditing standards. A finding should be supported by sufficient, competent, and relevant evidence; be presented in a manner to promote adequate understanding of the matters reported; and provide convincing but fair presentations in proper perspective. Please refer to chapter 2 for the information that is to be included in a finding.

B. Corrective Action in Process. Many times when auditees are presented with draft findings, they will start to take action to correct the deficient condition. When this action is underway and the auditor has completed his or her fieldwork, the auditee can include the action completed and the action remaining to be taken in the auditee's comments and in the corrective action plan. Regardless of whether the auditee is in the process of correcting the finding, the auditor is to include the finding in the report with all required elements.

C. Corrective Action Completed. Many times when auditees are presented with draft findings, they will start to take action and complete that action, correcting the deficient condition before the completion of the fieldwork. When this occurs, the finding is still to be included in the audit report with all required elements. The action taken or completed should be included in the auditee's comment section and should be validated by the auditor. The recommendation section should follow the auditee's comment section, and the auditor should state whether he or she validated the action. In addition, the auditor could include any additional recommendations he or she believes to be necessary based on the validation of that action.

6-7. Technical Assistance Needed. Ginnie Mae contractors will receive, review, and act on audit reports conducted using this chapter. It is important that the report meet Ginnie Mae's requirements and expectations. For this reason, questions on audits performed using this chapter should be referred to Ginnie Mae's Office of Mortgage-Backed Securities at (202) 708-1535.

Attachment A

Unacceptable Assets for Computation of Adjusted Net Worth

1. Any asset or portion thereof pledged to secure obligations of another entity or any person. Supervised institutions that provide financial services to incorporated communities are sometimes required by State law to pledge their assets for the benefit of the community. These pledged assets are acceptable for supervised institutions only.

2. An asset due from an officer or stockholder of the lender or from a related entity, except for

a. A construction loan receivable secured by a first mortgage from a related entity.

b. A mortgage loan receivable established in the normal course of business in an arm's-length transaction and secured by a first mortgage on the related property.

c. A receivable from a related party when the affected parties have executed a cross-default agreement[5] or corporate guarantee agreement[6] with Ginnie Mae.

3. An investment in a related entity in which any officer or stockholder of the lender has a personal interest[7] unrelated to that person's position as an officer or stockholder of the lender.

4. That portion of an investment in a joint venture, subsidiary, affiliate, or other related entity, which is greater than equity as adjusted. "Equity as adjusted" means the book value of the related entity reduced by the amount of unacceptable assets carried by the related entity.

5. Any intangible asset, including but not limited to goodwill, covenants not to compete, franchise fees, organization costs, software, value placed on insurance renewals, and value placed on property management contract renewals.

6. The value of any servicing contract not determined in accordance with Statement of Financial Accounting Standards (SFAS) No. 65, "Accounting for Certain Mortgage Banking Activities," and SFAS No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," or their revisions.

[5] A cross-default agreement is an agreement between related affiliated Ginnie Mae issuers, which provides for the default of all affiliated issuers in the event of a default by any one of them.
[6] A corporate guaranty agreement is an agreement in which the issuer's parent guarantees the performance of the issuer.
[7] "Personal interest," as used here, indicates a relationship between the lender and a person or entity in which that specified person (for example, spouse, parent, grandparent, child, brother, sister, aunt, uncle, or in-law) has a financial interest or is employed in a management position by the lender.

7. Any asset not readily marketable and for which appraised values are very subjective. Examples include but are not limited to antiques, artwork, and gemstones.

8. That portion of any marketable security (listed or unlisted) in excess of the lower of cost or market.

9. Any amount in excess of the lower of cost or market value of mortgages in foreclosure, construction loans, or property acquired through foreclosure.

10. Any asset that is principally used[8] for the personal enjoyment or benefit of an officer, director, or stockholder and not for normal business purposes. This includes motor vehicles and personal residences.

11. "Other assets" unless the financial statements are accompanied by a schedule prepared by the auditor or a schedule prepared by the issuer-lender and signed by an officer of the issuer-lender.

12. That portion of contributed property, not otherwise excluded, in excess of the value as of the date of contribution determined by an independent appraisal.

Unacceptable Assets for Computation of Liquid Asset Requirement

Cash and cash equivalents, the use of which in whole or in part is restricted for specific purposes under contractual agreements. Such assets are not deemed to be immediately available to the issuer.

[8] "Principally used" means that any other use of the property must be solely incidental.

Attachment B

Required Format for Presentation of
Adjusted Net Worth
Calculation for Issuer

A. Adjusted net worth calculation:

Stockholder's equity per statement of financial condition at end of reporting period $ _____

Less:

Itemized unacceptable assets[9]

1. $ _____
2. $ _____
3. $ _____

Total unacceptable assets $ _____

Adjusted net worth $ _____

B. Required net worth calculation:

Unpaid principal balance (UPB) of securities outstanding

	UPB in $	#of pools
Single family	$_____	_____
Multifamily	$_____	_____
HMBS	$_____	_____
MH	$_____	_____

Total UPB $ _____

Plus:

Outstanding balance of available commitment authority and pools funded

Single family	$_____
Multifamily[10]	$_____
HMBS	$_____
MH	$_____

Total $ _____

Total outstanding portfolio, commitment authority, and pools funded $ _____

[9] Unacceptable assets are listed in attachment A.
[10] Unexpended multifamily construction draws must be included here.

Required net worth $ _____

C. <u>Excess (deficit) net worth</u>:
(Adjusted net worth – required net worth)[11] $ _____

[11] In the event that adjusted net worth does not meet the Ginnie Mae requirement, the auditor may include comments from representatives of the issuer of corrective measures contemplated.

Attachment C

Required Format for Presentation of
Capital Requirement
Calculation for Issuer

A. Capital requirement for depository institutions:[12]

Tier 1 capital	$ _____
Total capital	$ _____
Risk-based assets	$ _____
Total assets	$ _____

Tier 1 capital-total assets	_____%
Tier 1 capital-risk-based assets	_____%
Total capital-risk-based assets	_____%

		Meets requirement? (*yes-no*)
5% of tier 1 capital-total assets	$ _____	_____
6% of tier 1 capital-risk-based assets	$ _____	_____
10% of total capital-risk-based assets	$ _____	_____

B. Capital requirement for nondepository institutions:[13]

Total adjusted net worth	$ _____
Total assets	$ _____

		Meets requirement? (*yes-no*)
Total adjusted net worth-total assets	_____%	_____

[12] Depository institutions include banks, thrifts, bank holding companies, and savings and loan holding companies. This does not include credit unions.
[13] Nondepository institutions include entities that are not covered by footnote 10 above.

Attachment D

Required Format for Presentation of Liquid Asset Requirement Calculation for Issuer

A. Liquid asset calculation:

Required net worth (attachment B, section B) $ _____

Acceptable liquid assets[14]

1. $ _____
2. $ _____
3. $ _____
4. $ _____
5. $ _____
6. $ _____

Total liquid assets $ _____

B. Required liquid asset:

Single-family issuer liquidity requirement		**Meets requirement?**
(Greater of $1,000,000 or .10% of outstanding single-family securities)	$ _____	(*yes-no*) _____

All other issuer types liquidity requirement[15]		**Meets requirement?**
(Total liquid assets-required net worth)	_____%	(*yes-no*) _____

Multiple program participation[16]

Liquid assets	Required	Actual	
Single family	$_____	$_____	
Multifamily	$_____	$_____	**Meets**
HMBS	$_____	$_____	**requirement**
MH	$_____	$_____	(*yes-no)*
Total	$_____	$_____	_____

[14] Acceptable liquid assets are defined in section 6-5, paragraph I.2.

[15] In the event that the total liquid assets do not meet the Ginnie Mae requirement, the auditor may include comments from the issuer of corrective measures made or contemplated.

[16] Issuers participating in multiple programs must meet and maintain minimum liquid assets equal to or greater than the sum of the minimum liquid asset requirements for all program types in which the issuer is approved to participate.

Attachment E

Required Format for Presentation of Adjusted Net Worth Calculation for Issuer's Parent

A. Adjusted net worth calculation:

Stockholder's equity per statement of financial condition at end of reporting period		$ _____
Less:		
Itemized unacceptable assets[17]		
1.	$ _____	
2.	$ _____	
3.	$ _____	
Total unacceptable assets		$ _____
Adjusted net worth		$ _____

B. Comparison of net worth calculation:

Issuer's required net worth (taken from issuer's adjusted net worth calculation)	$ _____
(multiply issuer's required net worth by 110% for issuers with single-family status only; otherwise multiply by 120%)	$ _____
Parent's required net worth	$ _____

C. Excess (deficit): **$ _____**

[17] Unacceptable assets are defined in attachment A.

Attachment F

Required Format for Presentation of
Capital Requirement
Calculation for Issuer's Parent

A. Capital requirement for depository institutions:[18]

Tier 1 capital	$ _____
Total capital	$ _____
Risk-based assets	$ _____
Total assets	$ _____
Tier 1 capital-total assets	_____%
Tier 1 capital-risk-based assets	_____%
Total capital-risk-based assets	_____%

		Meets requirement? (*yes-no*)
5% of tier 1 capital-total assets	$ _____	_____
6% of tier 1 capital-risk-based assets	$ _____	_____
10% of total capital-risk-based assets	$ _____	_____

B. Capital requirement for nondepository institutions:[19]

Total adjusted net worth	$ _____
Total assets	$ _____

		Meets requirement? (*yes-no*)
Total adjusted net worth-total assets	_____%	_____

[18] Depository institutions include banks, thrifts, bank holding companies, and savings and loan holding companies. This does not include credit unions.
[19] Nondepository institutions include entities that are not covered by footnote 15 above.

Attachment G

Required Format for Presentation of
Liquid Asset Requirement
Calculation for Issuer's Parent

A. Liquid asset calculation:

Required net worth (attachment E, section B) $ _____

Acceptable liquid assets[20]
1. $ _____
2. $ _____
3. $ _____
4. $ _____
5. $ _____
6. $ _____

Total liquid assets $ _____

B. Required liquid asset:

Single-family issuer liquid asset requirement (Greater of $1,000,000 or .10% of outstanding single-family securities)		**Meets requirement?** (*yes-no*)
	$ _____	_____

All other issuer types liquid asset requirement		**Meets requirement?** (*yes-no*)
(Total liquid assets-net worth)[21]	_____%	_____

Cumulative liquid asset requirement **(**Issuer participates in more than one program type)		**Meets requirement?** (*yes-no)*
	$_____	_____

[20] Acceptable liquid assets are defined in section 6-5, paragraph I.2.
[21] In the event that the total liquid assets do not meet the Ginnie Mae requirement, the auditor may include any comments from the issuer of corrective measures made or contemplated.

Attachment H

Required Format
for Presentation of
Insurance Requirement

A. Identification of affiliated[22] Ginnie Mae issuers:

Affiliated Ginnie Mae issuers:_____
(Issuer name and Ginnie Mae issuer identification number)

Affiliated issuers
on same insurance policies: _____
(Issuer name and Ginnie Mae issuer identification number)

B. Required insurance calculation:

Servicing portfolio:

Ginnie Mae	$ _____
Fannie Mae	$ _____
Freddie Mac	$ _____
Conventional (other)	$ _____
Remaining principal balance of total servicing portfolio	$ _____
Required fidelity bond coverage	$ _____
Required mortgage servicing errors and omissions coverage	$ _____

C. Verification of insurance coverage:

Fidelity bond coverage at end of reporting period	$ _____
Mortgage servicing errors and omissions coverage at end of reporting period	$ _____

D. Excess (deficit) insurance coverage:

Fidelity bond coverage	$ _____
Required mortgage servicing errors and omissions coverage	$ _____

E. Policies contain the required elements[23]

Fidelity bond coverage	Yes-No
Mortgage servicing errors and omissions coverage	Yes-No

[22] Definition of an affiliate: An affiliate is a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an issuer.
[23] The required elements are found in section 2-7(B) of the MBS Guide.

Attachment I

Report of Independent Auditors on Consolidating Balance Sheet and Statement of Income

Board of Directors
[ABC Financial Corporation]

We have audited, in accordance with the auditing standards generally accepted in the United States of America; Government Auditing Standards, issued by the Comptroller General of the United States; and the Consolidated Audit Guide of HUD Programs, issued **[insert date of guide or applicable updated chapters]** by the U.S. Department of Housing and Urban Development (HUD), Office of the Inspector General, the consolidated financial statements of **[Insert name of auditee; for example, ABC Financial Corporation and subsidiaries]** as of **[insert ending date; for example, December 31, 1991]** and have issued our unqualified opinion thereon, dated **[insert date; for example, January 24, 1992]** included on page **[insert page number]** of **[identify report]**. Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The following consolidating balance sheet and statement of income and cash flows on pages **[insert page numbers]**, respectively, are presented for purposes of additional analysis and are not a required part of the consolidated financial statements of **[ABC Financial Corporation and subsidiaries]**. Such information has been subjected to the auditing procedures applied in our audit of the consolidated financial statements and in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

This report is intended for the information of the audit committee, management, and the Government National Mortgage Association. However, this report is a matter of public record, and its distribution is not limited.

[Firm signature]

[Date]

Attachment J

Annual Submission of Financial Documents

The following information is being sent to maintain eligibility in the HUD Mortgage-Backed Securities (MBS) program.

A. Issuer name: _____
B. Ginnie Mae issuer number:_____
C. Auditor's contact person & telephone number: _____
D. All Ginnie Mae waivers: Yes_____ No_____ Effective date or N/A_____
(if available please provide a copy)
E. Please list all affiliates' names, addresses, and Ginnie Mae issuer numbers[24]

Place a checkmark by item(s) submitted[25]

1. ___Annual audited financial statement for period ended Date ____/____/_____

Auditor's report on

2. ___Consolidating balance sheet-statement of income (expense & income reported separately)
3. ___Internal controls
4. ___Compliance with specific requirements

Auditor's presentation on

5. ___Insurance coverage schedule
6. ___Adjusted net worth schedule for issuer
7. ___Adjusted net worth schedule for parent (if applicable)
8. ___Capital requirement schedule[25]
9. ___Parent's capital requirement schedule (if applicable)
10. ___Liquid asset requirement schedule[25]
11. ___Parent's liquid asset requirement schedule (if applicable)
12. ___Other reports submitted (please list)
_____
13. ___Current insurance certificate and endorsement of Ginnie Mae as loss payee
_____Fidelity bond _____ Lender's errors & omissions
_____Attestation of insurance compliance
14. ___Corrective action plan
15. ___Schedule of "other assets"[26]
16. ___Schedule of "breakdown of depreciation and amortization expenses by asset class"

Issuer's point(s) of contact regarding the items being sent:

Name: _____
Telephone: _____
Email: _____
Item(s) #:_____

Name: _____
Telephone: _____
Email: _____
Item(s) #:_____

[24] An affiliate is defined for these purposes as an organization that is related to the issuer through some type of control or ownership as defined by generally accepted accounting principles.
[25] Only submit the items that apply. Manufactured housing issuers do not submit items 8 to 11. Inactive issuers do not submit items 3 and 4. Please contact your Ginnie Mae account executive if you have any questions.
[26] Optional schedules beneficial in properly recording the net of unacceptable assets during the financial review process

For requirements, report, and supplementary schedule templates, reference HUD Audit Guide chapters 2 and 6: http://www.hudoig.gov/reports-publications/audit-guides/consolidated-audit-guides

Signature: _____ Date: _____

Type or print name: _____

Title: _____

CHAPTER 7. FHA-APPROVED LENDERS AUDIT GUIDANCE

7-1 **Program Objective.** The U.S. Department of Housing and Urban Development (HUD) insures loans and mortgages made by private and governmental, financial, and mortgage lending institutions to finance the purchase, refinance, or construction of single-family homes and multifamily projects. HUD approves such institutions for participation in the Federal Housing Administration (FHA) insurance programs for Title I property improvement and manufactured housing loans and for Title II single-family and multifamily mortgages. After initial approval, institutions are required to recertify annually to maintain their FHA-approved status.

As defined in 24 CFR (Code of Federal Regulations) Part 202, a "lender" or "Title I lender" is a financial institution that (a) holds a valid Title I contract of insurance and is approved by the HUD Secretary or (b) is under suspension or held a Title I contract that has been terminated but remains responsible for servicing or selling Title I loans that it holds and is authorized to file insurance claims on such loans. A "mortgagee" or "Title II mortgagee" is a mortgage lender that is approved to participate in the Title II programs.

As it revises its various requirements, FHA is adopting a common industry practice of using the terms "lender" and "borrower" for all of its programs and discontinuing the use of the terms "mortgagee" and "mortgagor." Throughout this guide, we use the terms "lender" and "borrower" to include "mortgagee" and "mortgagor," respectively. Auditors must be aware that existing guidance and Federal regulations may continue to use both sets of terminology. For the Home Equity Conversion Mortgage (HECM) program, the definition of borrower does not include successors or assigns as it does in forward mortgages.

7-2 **Lender Approval Types.** HUD has four types of lenders that are approved for participation. (Refer to 24 CFR 202.6 through 202.10.)

A. Supervised Lenders. Supervised lenders are financial institutions that are members of the Federal Reserve System (FRS) or institutions with accounts insured by the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), or the National Credit Union Administration (NCUA). Supervised lenders may originate, underwrite, purchase, hold, service, or sell FHA-insured loans.

1. **Small Supervised Lenders**. Small supervised lenders are members of FRS or regulated by FDIC, OCC, or NCUA, the consolidated assets of which do not meet the threshold required by those agencies for submitting audited financial statements (delineated at 12 CFR 363.1(a), 562.4(b)(2), and 715.4(c)).

2. **Large Supervised Lenders.** Large supervised lenders are those lenders that are members of FRS or regulated by FDIC, OCC, or NCUA, the consolidated assets

of which are equal to or greater than the prevailing threshold required by those agencies for submitting audited financial statements (delineated at 12 CFR 363.1(a), 562.4(b)(2), and 715.4(c)).

B. Nonsupervised Lenders. Nonsupervised lenders are lending institutions that have as their principal activity the lending or investing of funds in real estate mortgages, consumer installment notes, or similar advances of credit or the purchase of consumer installment contracts and are not approved as supervised, as described in paragraph A above, or as government lenders, as described in paragraph D below. A nonsupervised lender may originate, purchase, hold, service, or sell all types of FHA-insured loans, including multifamily loans.

C. Investing Lenders. Investing lenders may purchase, hold, or sell FHA-insured loans but may not originate FHA-insured loans in their own name or submit applications for the insurance of mortgages. An investing lender may not service FHA-insured loans without prior approval of the HUD Secretary. Investing lenders are generally required to provide only audited financial statements and a computation of adjusted net worth. Those investing lenders that are authorized to service FHA-insured mortgages are also required to submit a report on internal controls and a report on compliance.

D. Governmental Lenders. Government lenders are Federal, State, or municipal governmental agencies; a Federal Reserve bank; a Federal home loan bank; the Federal Home Loan Mortgage Corporation (Freddie Mac); or the Federal National Mortgage Association (Fannie Mae). A government lender may originate, purchase, service, or sell FHA-insured loans, including multifamily loans. No financial reporting is required.

Lenders with Title I authority are approved to process or service loans for property improvements and the purchase of manufactured housing. Lenders with Title II authority are approved to process or service loans for single-family homes and multifamily projects. A lender may be approved for both Title I and Title II programs.

These institutions are approved on the basis of their financial capacity, experience, facilities, and other criteria as specified in HUD Handbook 4000.1, Mortgagee Approval Handbook; HUD Handbook 4700.2, Title I Lender Approval Handbook; and subsequent mortgagee letters and Title I letters.

7-3 Audit and Reporting Requirements. The following chart is a summary of the financial reporting requirements for supervised and nonsupervised lenders. A more detailed explanation of the financial reporting requirements is also provided below.

Scenario	Level of financial statements	Audited consolidating schedules	Financial data templates, including net worth schedule	Net worth schedule (audited)
Supervised lenders				
Stand-alone bank	Bank	N/A	Bank	Bank
Bank ≥ 40% of consolidated entity; no guarantee by parent	Consolidated	Not required	Consolidated	Bank
Bank <40% of consolidated entity; guarantee by parent	Consolidated	Not required	Consolidated	Bank
Bank <40% of consolidated entity; no guarantee by parent	Consolidated	Required	Bank	Bank
Multiple banks, each <40% of consolidated entity; no guarantee by parent	Consolidated	Required	Each bank	Each bank
Nonsupervised lenders				
Stand-alone lender	Lender	Lender	Lender	Lender
Lender in a parent-subsidiary structure	Lender	Required	Lender	Lender

Except for governmental and small supervised lenders (a small supervised lender must submit a copy of its unaudited regulatory report, signed by a corporate officer, that aligns with its fiscal yearend), all FHA-approved lenders are required to have an annual audit in accordance with this guide **regardless of the number of loans originated or serviced**. All required audits are to be submitted within 90 days of the close of the lender's fiscal year. Audits must be performed in accordance with the most currently effective Government Accountability Office generally accepted government auditing standards (Generally Accepted Government Auditing Standards (GAGAS), also referred to as the "Yellow Book"), auditing standards generally accepted in the United States of America (GAAS) as issued by the American Institute of Certified Public Accountants (AICPA),[1] and this guide.

If the supervised or nonsupervised lender is also a Government National Mortgage Association (Ginnie Mae)-approved issuer and wants to have the same audited financial

[1] The Public Company Accounting Oversight Board (PCAOB) has established professional standards that apply to financial audits of publicly traded companies with a reporting obligation under the Securities Exchange Act of 1934. As noted in the "Yellow Book," auditors may elect to use the PCAOB standards in conjunction with GAGAS.

statements satisfy both FHA and Ginnie Mae, the financials will also have to be prepared in accordance with Ginnie Mae's requirements. (See chapter 6 of this guide.)

Unqualified opinions in the audit report on the financial statements and compliance are acceptable for recertification. If either opinion is qualified, HUD will determine, on a case-by-case basis, whether a report with a qualification is acceptable for recertification purposes. In addition to the detailed description of the reason for the qualification in the audit report, an appropriate finding may need to be included by the auditor in the schedule of findings and recommendations. When findings are reported, a corrective action plan prepared by the lender must accompany the audit findings. For additional information on the required audit reports and suggested wording, please refer to chapter 2 of this guide, which contains examples.

In some instances, a HUD-approved lender may enter into arrangements in which the responsibility for performing certain required procedures transfers to another HUD-approved entity. A common example is when a lender originates a loan and later sells the loan and the related servicing to another HUD-approved entity. In these situations, the lender must comply with any required activities for the period during which it is legally obligated to perform those services, and the independent auditor would report on the lender's compliance during that period. After the transfer of responsibility to another party, the independent auditor for the entity acquiring those responsibilities would report on that party's compliance with HUD requirements.

A. <u>General Audit Requirements.</u> The audit reporting package must include

1. <u>Audit of the Financial Statements and Supplementary Information</u>.

a. The basic financial statements prepared in accordance with generally accepted accounting principles (GAAP) and the independent auditor's report prepared in accordance with GAAS and GAGAS.

b. The independent auditor's report must cover the lender's computation of its adjusted net worth, the hardcopy of the electronic submission, and if applicable, consolidating schedules. The auditor's reporting on this information must be done in accordance with GAAS relating to "Supplementary Information in Relation to the Financial Statements as a Whole."

2. <u>Internal Control Report.</u>

The internal control reports, which do not include the expression of the independent auditor's opinion, must include

a. An independent auditor's report on internal control over financial reporting based on an audit of financial statements. If the lender engages the auditor to provide an opinion on internal control over financial reporting, as required either by FDIC or under the standards of the Public Company Accounting Oversight Board, such reporting may be submitted for this requirement.

b. An independent auditor's report on internal control over compliance with HUD-assisted programs. This report may be combined with the independent auditor's report on internal control over financial reporting.

Alternatively, auditors may issue combined reports on (1) internal control over financial reporting and compliance based on the audit of the financial statements under GAGAS and (2) compliance and internal control over compliance with major HUD programs.

3. <u>Compliance Report.</u>

The compliance report relating to major HUD programs must include

a. A listing of compliance areas tested.

b. An independent auditor's opinion on compliance with specific program requirements that could have a direct and material effect on each major HUD-assisted program.[2]

4. <u>Schedule of Findings and Questioned Costs.</u> This is required for all material instances of noncompliance, significant deficiencies, and material weaknesses in internal control identified by the auditor (including those cases in which corrective action was taken by the lender on the finding after the end of the fiscal year). Refer to section 7-9 of this chapter for information on reporting findings. A management letter reporting all immaterial instances of noncompliance must accompany the compliance report.

5. <u>Corrective Action Plan.</u> This is prepared by the lender, using the lender's letterhead, and describes the corrective action taken or planned in response to the findings identified by the auditor. The plan must also include comments on the corrective action taken on prior findings resulting from relevant HUD, Office of Inspector General, audits and HUD program reviews.

[2] A major program is defined as an individual assistance program or a group of programs in a category of Federal financial expenditures, which is equal to or exceeds the amount shown in the threshold table in chapter 1 of this guide during the applicable year or a project that has an outstanding HUD-insured or HUD-guaranteed loan balance, which is equal to or exceeds the amount shown in the table as of the reporting date.

B. Reporting Requirements for Lenders in Parent-Subsidiary Structures

1. **Nonsupervised Lenders.** For nonsupervised lenders, HUD will accept the audits of the consolidated financial statements of the parent if they include consolidating schedules that distinguish the balance sheets and operating statements of each FHA-approved subsidiary and the computation of adjusted net worth of each FHA-approved subsidiary. Such information must be subjected to audit procedures in accordance with GAAS relating to "Supplementary Information in Relation to the Financial Statements as a Whole."

2. **Large Supervised Lenders.** Supervised lenders in parent-subsidiary structures are permitted to submit the audited consolidated financial statements of a parent company without audited or unaudited consolidating schedules if one of the following conditions is met:

   a. The FHA-approved subsidiary owns at least 40 percent of the assets on the consolidated balance sheet, or

   b. The FHA-approved subsidiary provides FHA with an executed copy of a corporate guaranty agreement between it and the parent company in which the parent company guarantees the ongoing net worth and liquidity compliance of the FHA-approved subsidiary. At the time of the revision of this chapter, FHA was finalizing a standardized agreement (see attachment E) and will require lenders to use this agreement or obtain prior approval to use a different agreement.

   A supervised FHA-approved lender electing to submit audited consolidated financial statements under one of the above-mentioned conditions must submit its fourth quarter call report as an attachment to its electronic submission. Additionally, the reports on internal control and compliance at the FHA-approved subsidiary's level must be included as an attachment to the FHA-approved lender's electronic submission.

3. **Investing Lender.** Investing lenders in parent-subsidiary structures are permitted to submit the audited consolidated financial status of the parent as allowed in paragraphs B.1 and B.2 above.

   Investing lenders are required to submit audited financial statements and an audited computation of adjusted net worth. Investing lenders that have been approved to service FHA loans must also submit reports on internal control and compliance.

C. Reporting Requirements for Small Supervised Lenders. Small supervised lenders are not required to submit audited financial statements to FHA or an audited

computation of adjusted net worth. Such lenders must submit a copy of their unaudited regulatory report (report of condition and income, also known as the "call report" and submitted on the Federal Financial Institutions Examination Council forms 031 and 041, or a consolidated or fourth quarter NCUA call report, submitted on NCUA Form 5300 or 5310), signed by an officer, that aligns with their fiscal yearend.

7-4 **Electronic Submission of Audited Financial Statements and Compliance Data.** All FHA-approved lenders are required to electronically submit their financial and compliance data to the Lender Approval and Recertification Division through the Lender's Electronic Assessment Portal (LEAP) within 90 days of the close of the end of their fiscal year. The submission must be based on the signed issued paper copy of the audit of the lender's financial statements, supplemental information, and the signed independent auditor's report containing the auditor's opinion. A copy of the issued signed hardcopy of the financial statements, supplemental information, and the signed independent auditor's report(s) must be submitted electronically.

Lenders that are approved by both FHA and Ginnie Mae must complete the electronic submission of their financial and compliance data through FHA's electronic system and submit their audited financial statements to Ginnie Mae in accordance with the Ginnie Mae Mortgage-Backed Securities Guide.

A. **Auditor Involvement in the Electronic Submission Process.** The responsibility for the electronic submission of the lender's financial and compliance data rests with the lender; however, the auditor is required to perform a separate, agreed-upon procedures engagement to determine whether the financial data entered into HUD's electronic system by the lender are accurate and reconcile with the data on the lender's hardcopy audited financial statements that are contained in the issued signed audit report. In general, the auditor must compare the electronic data transmitted to HUD to the hardcopy of the basic financial statements, supplemental information, footnotes, the signed independent auditor's reports, the computation of adjusted net worth, and financial data templates. This procedure must be performed under the current AICPA Statements on Standards for Attestation Engagements for Agreed Upon Procedures Engagements.

B. **Extension Requests.** The lender may request an extension of its recertification package due date. Extension requests must be submitted through LEAP at least 45 days before the lender's recertification package due date.

C. **Operating Loss Reporting.** Approved lenders must submit either audited or unaudited financial statements to HUD within 30 days of the end of each fiscal quarter in which the lender experiences an operating loss of 20 percent or greater of its adjusted net worth and must continue to make submissions until the lender

demonstrates an operating profit for two consecutive quarters or until the next annual recertification by FHA, whichever is the longer period (24 CFR 202.5(m)(1)). The submission must be submitted as a "notice of material event" in LEAP.

7-5 Compliance Requirements and Suggested Audit Procedures Applicable to Lenders With Both Title I and Title II Authorities.

A. Quality Control Plan.

1. **Compliance Requirement.** The adoption and implementation of a quality control plan is a required element of a lender's application for approval to participate in FHA programs. FHA-approved lenders are required to

   a. Originate and service HUD-insured mortgages in accordance with accepted practices of prudent lending and comply with all relevant HUD rules and regulations.

   b. Adopt and implement a quality control program that fully complies with the requirements of section V of HUD Handbook 4000.1, FHA Single Family Housing Policy, and, as applicable, the additional multifamily quality control requirements outlined in the Multifamily Accelerated Processing (MAP) Guide, 4430.G. The lender must maintain and update its quality control program as needed to ensure that it fully complies with all applicable FHA requirements at all times.

   c. If they use third-party originators (TPO), ensure that the direct endorsement lender has a quality control plan that requires the review of loans that are originated by the TPO.

   d. Review all loans that are originated or underwritten by their company or originated by a sponsored TPO that go into default within the first six payments (referred to as early payment default).

   e. Review a sampling of rejected applications. (See suggested audit procedure below in 7-5.D.2.d.)

   f. Immediately report to HUD, via Neighborhood Watch, fraud or material violations of FHA requirements that, based on the auditor's judgment, represent a significant risk to the FHA insurance fund (section V-A, HUD Handbook 4000.1).

2. **Implementation.** FHA-approved lenders must implement a quality control plan consistent with their needs and the above-referenced guidance to assist corporate management in determining whether their personnel are following HUD

requirements and corporate policies and procedures. Lenders must ensure the following:

a. Quality control reviews are performed on a regular and timely basis. Depending on a lender's production volume, origination reviews may be performed weekly, monthly, or quarterly. The review of a specific mortgage must be completed within 90 days of closing.

b. Reviews of different aspects of servicing will vary in frequency; however, delinquent servicing and loss mitigation activities must be reviewed monthly. Timing and frequency of quality control reviews are addressed in the Origination and Servicing sections of HUD Handbook 4000.1.

c. The quality control function must be independent of the origination and servicing functions.

The quality control procedures may be conducted by the entity itself internally, personnel not involved in any aspect of loan origination or servicing, or an external reviewer.

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

a. Obtain a copy of the lender's quality control plan and compare it to the general and specific requirements contained in section V-A of HUD Handbook 4000.1 or chapter 6 of HUD Handbook 4700.2 as applicable.

b. Determine whether the lender has a procedure in place to disseminate quality control policies and procedures to all employees involved in loan origination and servicing.

c. Determine whether the lender has guidelines to revise its procedures in a timely manner to accurately reflect changes in HUD requirements, that personnel are informed of the changes, and that employees are held accountable for performance failures and errors.

d. Determine whether the lender has procedures for reviewing and monitoring its sponsored third-party originators. At a minimum, these procedures must include the requirements outlined in "Basic Requirements for Quality Control of Single Family Production" in section V-A of HUD Handbook 4000.1

e. Determine whether the quality control plan requires that all mortgage change records be reviewed for accuracy of sale, transfer of loans, and terminations of insurance.

(1) For cases involving the transfer of legal rights to service FHA-insured loans,

(a) The transferee is required to report the "change of legal rights to service" to HUD.

(b) The transferor is required to verify that the "change of legal rights to service" has been reported and that all of the details contained in the report are accurate.

(2) For cases involving the holder's sale of loans,

(a) The holder (seller) is required to report the "sale of loans" to HUD within 15 calendar days, and

(b) The buyer is required to confirm that the "sale of loans" has been reported and that all of the details contained in the report are accurate.

f. Determine whether the lender has a procedure for expanding the scope of quality control reviews as required by section V-A of HUD Handbook 4000.1 when fraudulent activity or patterns of deficiencies are identified.

g. Inquire into whether the lender relies on an internal or external quality control review of its origination, underwriting, and servicing functions.

(1) If the lender relies on an internal review,

(a) Verify that the quality control system is separate and apart from the loan processing and underwriting process and is carried out by knowledgeable personnel not involved in loan processing and underwriting.

i. Check the employee or contractor listing or organization chart and loan production report provided by the lender to ensure that the personnel are not involved in the day-to-day processes that they are reviewing and

ii. Interview the personnel identified as the quality control reviewers. Inquire about their roles and responsibilities, how loans are selected, what occurs during a review, steps taken when fraud is suspected, to whom they report, how deficiencies are resolved, and what they are to do when they note any other type of irregularity during their quality control reviews of the loan files.

(b) Determine whether the lender provided the staff access to current guidelines relating to the operations it is responsible to review. It is not necessary to maintain these guidelines in hardcopy format if they are accessible in an electronic format.

(2) If the lender relies on an outside review firm,

(a) Determine whether the lender ensured that the outside firm met HUD's requirements. (Refer to HUD Handbook 4000.1, section V-A, or HUD Handbook 4700.2, chapter 6.)

(b) Determine whether the agreement with the outside firm is in writing, states the roles and responsibilities of each party, and is available for review by HUD staff.

h. Determine whether the sample sizes of FHA loans to review used throughout the year were determined in accordance with the criteria specified in section V-A of HUD Handbook 4000.1. This includes a random sample of insured loans being serviced by the lender or its agent.

i. Determine whether the lender is in compliance with the timeliness and frequency requirements in section V-A of Handbook 4000.1.

j. Determine whether any branch offices received an onsite review as required by section V-A of HUD Handbook 4000.1 or chapter 6 of HUD Handbook 4700.2.

k. Determine whether the quality control plan includes coverage for any sponsored third-party originators and authorized agents of the lender.

l. Determine whether the sponsor's quality control program provides for the sponsor to review the loans originated and sold by each of its sponsored TPOs. If it does,

(1) Determine whether the sponsor determined an appropriate percentage of loans to be reviewed. (Refer to section V-A of Handbook 4000.1.)

(2) Determine whether the sponsor retained the documents and methodologies used in making that determination and the results of the review.

(3) Review the documentation for compliance with HUD requirements and determine whether the findings were reported and followed up on in accordance with the lender's policies and procedures.

m. In addition to the loans selected by the lender for routine quality control reviews, lenders must select early payment defaults (EPD) for review monthly. EPDs selected must be reviewed within 60 days from the end of the month in which the loan was selected. Determine whether the early payment default review report and followup, including review findings and any actions taken along with procedural information as specified in section V-A of HUD Handbook 4000.1, are retained for 2 years.

n. Review the supporting documentation of the most recent review to determine whether all of the required general and specific elements included in section V-A of HUD Handbook 4000.1 or chapter 6 of HUD Handbook 4700.2 were included in the quality control review. The quality control plan must provide for the written reverification of the borrower's employment, deposits, gift letter, or other sources of funds.

o. Obtain a written copy of the latest quality control review report and determine whether senior management officials also received a copy that included any deficiencies identified during the review.

p. Determine whether management is monitoring its default and claims rate in accordance with FHA's Credit Watch program. Copies of Neighborhood Watch reports may be obtained to determine whether the client is using such reports to meet the monitoring requirement.

q. Determine whether the lender reported any findings of fraud or material misrepresentation to FHA upon the lender's confirmation of the deficiency, using the lender reporting feature in Neighborhood Watch, and determine any other material findings that were documented in the quality control review report, the lender is unable to mitigate, or were reported within 90 days after the completion of the initial findings report.

r. Determine whether senior management officials promptly initiated corrective action for all deficiencies noted in the quality control review report.

s. Determine whether the files showed the actions taken by senior management to correct the deficiencies.

t. Determine whether the files contain evidence that the appropriate employees were notified of the deficiencies and provided instructions to correct the deficiencies and prevent recurrence.

B. Sponsor Responsibility for Third-Party Originators.

1. **Compliance Requirement.** HUD does not monitor sponsored TPOs for the purpose of the origination of loans submitted for FHA insurance. FHA-approved lenders are responsible for performing quality control reviews of their sponsored TPOs. Such reviews include but are not limited to performing a review of loans originated and sold to the lender by each of its sponsored TPOs (Handbook 4000.1). The lender must determine the appropriate sample amount of each sponsored TPO's loans to review based on volume, past experience, and other factors specified in section V-A of HUD Handbook 4000.1.

2. **Suggested Audit Procedures.**

   a. Determine whether the sponsoring lender has issued an annual written communication to each TPO under its sponsorship indicating its intent to assume the responsibility of ensuring the TPO's compliance.

   b. Test the documentation supporting the reviews and the reports of the TPOs and determine the accuracy and reliability of the reviews and reports.

C. Branch Office Operations.

1. **Compliance Requirement.** A lender may maintain one or more branch offices for the origination of loans and submission of applications for mortgage insurance. A lender may originate or service FHA-insured loans from branches that meet FHA requirements (section V-A of HUD Handbook 4000.1 or HUD Handbook 4700.2). Each branch office where a lender's FHA origination personnel are assigned must be registered with FHA, and its facilities must meet State originating requirements. It must also meet FHA's staffing and manager requirements in section I-A of HUD Handbook 4000.1 or HUD Handbook 4700.2.

   The direct lending branch office is a branch that will be used for the sole purpose of direct lending. Its facilities must meet State originating requirements. It must also meet FHA's staffing and operating requirements in HUD Handbook 4000.1.

2. **Suggested Audit Procedures.**

   a. Determine whether all branches that manage a lender's FHA origination personnel are registered with HUD by reviewing the appropriate form or screen printout from LEAP.

   b. Through inquiry or physical observation, determine whether the branches are true branches and are not subsidiaries, independent contractors, agents of the

lender, or separate entities. A lender with a separate tax identification number is required to have approval in its own right. A branch must have at least one employee including a branch manager. The branch manager may manage more than one branch except in the case of a direct lending branch, which must have its own manager. Branch office expenses must be paid by the lender.

c. Review the lender's payroll records for indications of any branch office personnel, except the receptionist, who are not employed exclusively by the lender at any given time. Inquire of personnel to determine whether branch employees conduct only the business affairs of the lender during normal business hours.

d. Determine whether the branch office facilities meet State mortgage lending licensing requirements.

e. Review company records for evidence that:

(1) The present branch office managers are corporate officers or employees authorized to bind the corporation in matters involving loan origination and servicing and whether the branch office manager of each direct lending branch office manages only that one branch.

(2) Branch compensation and contractual relationships comply with the requirements in section I-A of HUD handbook 4000.1.

D. Loan Origination.

1. Compliance Requirement. HUD requires lenders to originate loans in accordance with HUD requirements. They must obtain and verify information with at least the same care that would be exercised in originating a loan in which the mortgage would be entirely dependent on the property as security to protect their investment.

Information on the lender's copy of form HUD-92900-A, "HUD/VA Addendum to Uniform Residential Loan Application," must be supported by documents in the lender's files (HUD Handbook 4000.1).

Lenders may not require, as a condition of providing an insured loan, the principal amount of the loan to exceed a minimum amount established by the lender (24 CFR 203.18(d)).

Regulations at 24 CFR 202.12 prohibit lenders from originating insured mortgages if it is the customary practice of the lender to engage in "tiered pricing"

of its loans (for discount points, origination fee, and other such fees) of more than 2 percent in an area (metropolitan statistical area or county in rural areas). The regulation further requires HUD to ensure that any variations in mortgage charge rates be based only on the actual variations in costs to the lender to make the loan. The 2 percent limitation on variation in "mortgage charge rates" must be applied to all Section 203 mortgages by loan type.

For Title I loans, HUD expects that the lender will exercise prudence and diligence in determining whether the borrower is solvent and an acceptable credit risk with a reasonable ability to make payments on the loan obligation. All documentation supporting this determination of credit worthiness must be retained in the loan file (24 CFR 201.22).

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

a. Obtain an understanding of the lender's procedures for processing loan applications. Determine whether the lender's procedures provide for the applicant's credit report, employment verification, and verification of deposits to be sent directly to the lender and not passed through any interested third party (for example, a real estate agent).

b. Obtain a sample of files for Title II loans originated during the audit period to perform the following tests. These files must include loans originated at the lender's branch offices and by its sponsored TPOs as well as its central office.

(1) Review loan file documentation for evidence that the loan applicant had an opportunity for a face-to-face interview. If the loan applicant opted not to have a face-to-face interview, determine whether the lender asked sufficient questions to elicit a complete picture of the borrower's (i) financial situation, (ii) source of funds for the transaction, and (iii) intended use of the property. Verification of all of this information, as well as the identity of the loan applicant, must be documented in the loan file. In addition, determine whether a home equity conversion mortgage (HECM) loan applicant completed the required counseling.

(2) Review all files in the sample to determine whether any forms have been signed by the lender but not completed by the applicant.

(3) Determine whether all employment and income data are supported by a verification of employment or other sources, especially for self-employed applicants and applicants with nonemployment income. Review loan file documentation for evidence that the lender reconciled any conflicting information before submitting the application package to the appropriate

HUD Homeownership Center for endorsement or insuring the loan under the lender insurance procedure.

(4) Determine whether the applicant's cash assets, source of funds, and liabilities are supported by documentation, such as verifications of deposit, gift letters, credit reports, etc.

c. Obtain a sample of files for Title 1 loans originated during the audit period to be examined for the documentation required by the regulations. The sample must include loans originated at the lender's branch offices as well as the home office.

(1) Determine whether the lender obtained a separate dated credit application on the HUD-approved form from the borrower, any comaker, or cosigner and verified the validity of the borrower's Social Security number in accordance with Title I Letter TI-414.

(2) Determine whether all income and employment data are supported by written verification or other documentation, especially for self-employed applicants and those with nonemployment income.

(3) Determine whether the lender obtained a complete and current consumer credit report on the borrower, any comaker, or cosigner and checked on any credit inquiries reported within the previous 90 days.

(4) Determine whether the lender obtained written verification of the borrower's payment status on any senior mortgages or deeds of trust on the property to be improved.

(5) For each person on the credit application, determine whether the lender checked HUD's Credit Alert Interactive Reporting System to verify whether the borrower is in default or a claim has been paid on behalf of the borrower on any federally insured or guaranteed loan and whether the lender recorded the borrower's "credit alert response code" on the application for each person listed.

(6) When the principal balance of the loan exceeds $5,000 and the initial payment exceeds 5 percent of the loan amount, determine whether the lender obtained written verification of the source of these funds through verifications of deposit, bank statements, gift letters, or other methods or evidence.

(7) Review the loan file documentation for evidence that the lender conducted a face-to-face or telephone interview with the borrower before making a final determination of the borrower's credit worthiness.

(8) For dealer loans with a credit application, review the file documentation to determine whether a telephone interview occurred before the loan disbursement. Lenders are required to conduct a telephone interview before disbursing the loan in addition to the credit underwriting telephone interview.

d. Obtain a sample of files for rejected loans during the audit period and perform the following review:

(1) Determine whether individual reviews were conducted for all sampled rejected applications that were denied due to a statistical category or score (for example, credit score, debt-to-income ratio). Determine whether the score accurately reflected the financial status (for example, loan and rent payments, current housing payments) of the applicant. A rejection must not be influenced by statistical categories or geographic location.

(2) Determine whether the rejections were made based on established criteria and the reasons for the rejections were provided to the applicant. Determine whether procedures for accepting and processing the loans were followed.

E. Loan Servicing.

1. Compliance Requirement. Lenders that service FHA-insured loans are permitted to collect certain fees from the borrowers in accordance with HUD rules (HUD Handbook 4330.1, chapter 4). Sponsored TPOs are not allowed to service loans.

Lenders that service insured HECMs with adjustable rate mortgages are responsible for adjusting those rates in accordance with the annual and lifetime caps as established by HUD Handbook 4000.1.

Loan servicing procedures are to be followed consistently and must not vary. The lender must have an organized means of periodically identifying the payment status of delinquent loans to enable personnel to initiate and follow up on collection activities and must document its records to reflect its collection activities regarding delinquent loans. The lender must accept partial payments under an executed modification agreement or an acceptable repayment plan. (Refer to 24 CFR 201.41 for details.) A modification agreement may be used to increase or reduce payments but not to increase the term or the interest rate to

ensure that the delinquent or defaulted loan is brought current before or by the end of the loan term. A modification agreement may also be used to effect a reduction in the interest rate and payment for current loans (24 CFR 201.18).

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

a. Obtain an understanding of the lender's procedures for servicing loans.

b. Select a sample of delinquent and defaulted loans, including loans in foreclosure, for testing the lender's loan servicing procedures.

c. Review the loan file documentation for evidence that the lender documents its records to reflect its servicing on delinquent and defaulted mortgages.

(1) Determine whether the lender maintains individual servicing records documenting collection (loan servicing) activities.

(2) Review the servicing records to determine whether they contain information on collection contacts attempted and completed.

d. Review selected loan file documents for evidence that the lender communicates with the borrower or makes a reasonable effort to do so to determine the cause of default.

(1) Review the individual loan servicing records for recorded collection contacts of more than one type (such as telephone, letter, face-to-face interview, etc.) if one type of contact effort is unsuccessful.

(2) Review the individual loan servicing records for borrower explanations of defaults and documented attempts by loan servicing personnel to contact the borrowers.

(3) Based on the review of the individual loan servicing records, when the cause of delinquency appears to be temporary (such as illness or unemployment), test whether the lender offers reasonable repayment plans.

e. Review selected receipts for evidence that the lender accepts partial or late payments offered by borrowers.

(1) Review the lender's procedures for the handling of partial payments. Obtain a representation letter from the lender concerning such procedures.

(2) Review the servicing records for the recording of partial payments accepted, held in a pending file, or rejected. (Note: The decision to reject a late or partial payment must be a decision based on the individual circumstances.)

(3) Review the payment records of selected borrowers to determine whether

(a) The amount of the late charge, if any, was computed correctly.

(b) The late charge was assessed after 15 days of delinquency or the 17th day of the month.

f. Determine whether the lender has implemented steps to comply with the provisions of HUD's loss mitigation program. Servicing lenders must use the following six tools to mitigate losses to the insurance fund: special forbearance, mortgage modification, partial claim, FHA home modification, preforeclosure sale, and deed in lieu of foreclosure. HUD requires that all loss mitigation tools be considered, and the servicing lender is required to document its loss mitigation efforts. Review selected servicing and claim files for evidence that such relief measures were considered. (Refer to section III-A of Handbook 4000.1.)

g. Determine whether the lender sends notices to advise the borrower about HUD's foreclosure relief program once it has decided to foreclose. Review the loan files selected for evidence that such letters were sent before the initiation of foreclosure proceedings.

h. Compare charges assessed to borrowers for servicing activities to allowable amounts. (Refer to 24 CFR 203.552, 24 CFR 203.25, and section III-A of HUD Handbook 4000.1.) For the loans selected,

(1) Review charges to borrowers for checks returned due to insufficient funds.

(2) Review charges to borrowers for attorney's fees and determine whether

(a) The charges were for services performed by someone other than salaried members of the lender's staff and

(b) The charges were made only in those cases in which the lender decided to foreclose and referred the loan to an attorney for initiation of foreclosure proceedings.

i. Obtain an understanding of the lender's procedures for paying insurance premiums to HUD. Determine whether the lender made the insurance premium payments via FHA Connection or through central processing unit batch transmissions and that its practices comply with HUD regulations. Review a representative sample of insurance claims submitted to HUD. Recalculate the net claim amount on the Single Family Application for Insurance Benefits (form HUD-27011) and compare the claim amount information to the accounting records. Test the amounts included in the claim for preservation and protection expenses to determine whether they are supported by documentation.

j. Select a sample of adjustable rate HECMs and determine whether the lender is exceeding the limitations of the 2 percent annual and 5 percent lifetime caps. This applies only to annually adjusted HECMs in accordance with 24 CFR 206.21(b)(1).

k. Select a sample of HECMs and determine whether the disbursements have been made in accordance with the mortgage note.

F. Federal Financial and Activity Reports.

1. Compliance Requirement. Lenders participating in HUD-assisted Title I and Title II programs are required to ensure that financial status, single-family default monitoring, and reports required under the Home Mortgage Disclosure Act (HMDA) contain reliable data and are presented in accordance with the terms of applicable agreements between the entity and HUD. The individual agreements, handbooks, and mortgagee letters contain the specific reporting requirements that the lender is to follow. Refer to HMDA reporting requirements at: http://www.ffiec.gov/hmda/guide.htm.

In addition to the specific reporting requirements referenced above, lenders originating Title I loans are required to submit annual HMDA reports by March 1 of each year under Title I Letter TI-479. All lenders with Title I authority are required to report any noncompliance by borrowers, contractors, or other parties related to a Title I-insured loan under Title I Letter TI-447.

2. Suggested Audit Procedures.

a. Obtain a list from management of the HUD programs participated in during the reporting period, along with all related guidance and reference materials addressing reporting requirements for each program listed.

b. Obtain an understanding of the lender's procedures for preparing and reviewing the required reports.

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

d. Select a sample of activity reports and determine whether the reports selected are prepared in accordance with HUD requirements and are filed in a timely manner.

e. For the sample, trace significant data to supporting documentation, such as worksheets, ledgers, etc. Report all material differences between selected reports and lender records.

f. Review adjustments made to the general ledger accounts having a material effect on the HUD program activity and evaluate the propriety of those adjustments.

G. Lender Annual Recertification, Adjusted Net Worth, Liquidity, and Licensing.

To help strengthen FHA's oversight of approved lenders and better manage program risks, Section 203 of the Helping Families Save Their Homes Act of 2009 (Public Law 111-22) provides limitations on those eligible to participate in FHA programs. This Act directs that lenders not be and not have any officer, partner, director, principal, manager, supervisor, loan processor, loan underwriter, or loan originator of the applicant lender who is currently (1) suspended; (2) debarred; (3) under a limited denial of participation; (4) under indictment for or has been convicted of an offense that reflects adversely upon the applicant's integrity, competence, or fitness to meet the responsibilities of an approved lender; (5) subject to unresolved findings contained in HUD or other governmental audit, investigation, or review; (6) engaged in business practices that do not conform to generally accepted practices of prudent lenders or that demonstrate irresponsibility; (7) convicted of or who has pled guilty to a felony related to participation in the real estate or mortgage loan industry; or (8) in violation of any other requirement as established by the HUD Secretary. The timeframes associated with criminal activity and clarification of the term "unresolved findings" is further outlined in Handbook 4000.1, section I-A.

1. Compliance Requirements. All lenders must maintain both fidelity bond and errors and omissions insurance of at least $300,000 each. HUD does not require that it be the beneficiary of such coverage. A fidelity bond that is generally acceptable to the secondary market agencies, such as Ginnie Mae, Fannie Mae, or Freddie Mac, will meet FHA's requirement. An applicant must provide evidence of such coverage.

In compliance with Handbook 4000.1, FHA-approved lenders must complete the online annual certification (formerly known as the yearly verification report)

before electronically submitting the annual renewal fee and audited financial statements. The annual recertification process must be completed within 90 days of the lender's fiscal yearend. There are three steps to FHA's annual recertification process; namely, (1) the completion of the online annual certification, (2) electronic payment of the annual renewal fee, and (3) electronic submission of acceptable audited financial statements and other required documents that have been received as acceptable by HUD. The following net worth requirements are for all approved supervised and nonsupervised lenders and all approved investing lenders with FHA approval (24 CFR 202.5(n)).

- **Existing non-small-business-approved lenders**. An applicant for FHA-approved lender that exceeds the size standards for its industry classification as established by the Small Business Administration (SBA) at 13 CFR 121.201, sector 52 (Finance and Insurance), subsector 522 (Credit Intermediation and Related Activities), must have a net worth of not less than $1 million, of which no less than 20 percent must be liquid assets consisting of cash or its equivalent acceptable[3] to the HUD Secretary.

- **Existing small-business-approved lenders**. An approved lender that meets the SBA size standards for its industry classification must have a net worth of not less than $500,000, of which no less than 20 percent must be liquid assets consisting of cash or its equivalent acceptable to the HUD Secretary. The net worth requirements for small business lenders remain applicable as long as the lender continues to meet the SBA size standard for small business. If a small business lender no longer meets the SBA size standard of a small business, as evidenced by the audited financial statements provided to HUD 90 days after the end of a fiscal year, the lender must meet the net worth requirements for a non-small-business lender by the last day of the fiscal year in which the audited financial statements were submitted.

In addition, the following net worth requirements are for new applicants for FHA approval to participate in FHA single-family and multifamily programs, for all approved supervised and nonsupervised lenders, and for all FHA-approved investing lenders:

- **Single-family lenders**. Regardless of size, each applicant and each approved lender, for participation solely under the FHA single-family programs, must have a net worth of not less than $1 million, plus an additional net worth of 1

[3] Cash and cash equivalents constitute liquid assets. Cash includes cash on hand, checking accounts, savings accounts, and certificates of deposit. Cash equivalents are readily marketable investments; for example, securities readily convertible into cash. To be considered a liquid asset, the cash or cash equivalent must not be restricted or otherwise reserved for any purpose other than the payment of a current liability. FHA does not consider a line of credit or loans or mortgages held for resale by the lender to be liquid assets.

percent of the total volume in excess of $25 million in FHA single-family insured mortgages originated, underwritten, purchased, or serviced during the prior fiscal year, up to a maximum required net worth of $2.5 million. No less than 20 percent of the applicant's or approved lender's required net worth must be liquid assets consisting of cash or its equivalent acceptable to the HUD Secretary.

- **Multifamily lenders**. Regardless of size, each applicant for approval and each approved lender for participation solely under the FHA multifamily programs must have a minimum net worth of not less than $1 million. For those multifamily approved lenders that also engage in mortgage servicing, an additional net worth of 1 percent of the total volume in excess of $25 million in FHA multifamily mortgages originated, purchased, or serviced during the prior fiscal year, up to a maximum required net worth of $2.5 million, is required. For multifamily approved lenders that do not perform mortgage servicing, an additional net worth of one half of 1 percent of the total volume in excess of $25 million in FHA multifamily mortgages originated during the prior fiscal year, up to a maximum required net worth of $2.5 million, is required. No less than 20 percent of the applicant's or approved lender's required net worth must be liquid assets consisting of cash or its equivalent acceptable to the HUD Secretary.

An FHA computation of adjusted net worth is required for all lenders, even if there were no loans originated or serviced during the audit period. The required amount, which must be maintained throughout the year, varies by program participant type and approval date. When the lender is a parent or a subsidiary of a parent, the adjusted net worth computation must focus on the assets and equities of the individual FHA-approved entity.

Included in this chapter are examples of adjusted net worth computation schedules, which are shown in attachments A and B.

The following are unacceptable assets and are not to be used in the computation of adjusted net worth:

a. Any asset or portion thereof pledged to secure obligations of another entity or any person. Supervised institutions that provide financial services to incorporated communities are sometimes required by State law to pledge their assets for the benefit of the community or to the government regulator. These pledged assets are acceptable for supervised institutions only.

b. An asset due from an officer or stockholder of the lender or from a related entity, except for

(1) A construction loan receivable, secured by a first mortgage, from a related entity.

(2) A mortgage loan receivable established in the normal course of business in an arm's length transaction and secured by a first mortgage on the related property.

(3) A receivable from a related party when the affected parties have executed a cross-default agreement[4] or corporate guarantee agreement[5] with Ginnie Mae.

(4) A receivable from an officer or stockholders of a publicly traded supervised institution that owns less than 5 percent of the shares outstanding or issued.

c. An investment in a related entity in which any officer or stockholder of the lender has a personal interest[6] unrelated to that person's position as an officer or stockholder of the lender.

d. Any intangible asset, including but not limited to goodwill, covenants not to compete, franchise fees, organization costs, value placed on insurance renewals, and value placed on property management contract renewals aside from mortgage servicing rights referenced below.

e. The value of any servicing contract not determined in accordance with Financial Accounting Standards Board Accounting Standards Codification 860-50 – Transfers and Servicing – Servicing Assets and Liabilities or its revisions.

f. Any asset unrelated to the lending business and not readily marketable and for which appraised values are highly subjective. Examples include but are not limited to antiques, artwork, and gemstones.

g. That portion of any marketable security (listed or unlisted) in excess of the lower of cost or market, except for shares of Fannie Mae stock required to be

[4] A cross-default agreement is an agreement between related, affiliated Ginnie Mae issuers, which provides for the default of all affiliated issuers in the event of a default by any one of them.

[5] A corporate guarantee agreement is an agreement in which the issuer's parent guarantees the performance of the issuer.

[6] "Personal interest" as used here indicates a relationship between the lender and a person or entity in which that specified person (for example, spouse, parent, grandparent, child, brother, sister, aunt, uncle, or in-law) has a financial interest in or is employed in a management position by the lender.

held under a servicing agreement, which must be carried at cost, including unrealized gains on "available for sale" securities.

h. Any amount in excess of the lower of cost or market value of mortgages in foreclosure, construction loans, or property acquired through foreclosure.

i. Any asset, which is principally used[7] for the personal enjoyment or benefit of an officer, director, or stockholder and not for normal business purposes. This includes motor vehicles and personal residences.

j. "Other assets" unless the financial statements are accompanied by a schedule covered by the audit opinion or a schedule prepared by the issuer or lender and signed by an officer of the issuer or lender.

k. That portion of contributed property, not otherwise excluded, in excess of the value as of the date of contribution, determined by an independent appraisal. If property is contributed but the related mortgage or debt is not also transferred to the company, the value of the contributed property must be reduced by that obligation.

Mortgage lenders are required to file their annual licensing requirements with the National Mortgage Licensing System (NMLS). The lender must also file a quarterly call report on loan information that also includes selected financial data. The detail required depends on the size of the lender. The link to the NMLS Web site can be found below.

http://mortgage.nationwidelicensingsystem.org/Pages/default.aspx

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

a. As of the financial statement date and additional representative points of time during the audit period, test whether the lender meets the required levels for adjusted net worth, liquidity, fidelity bond coverage, and errors and omissions bond according to HUD Handbook 4000.1. If the lender does not meet the requirement, report the deficiency in the report on compliance and in a written audit finding. Determine whether there are internal control deficiencies related to the noncompliance that must be reported in the report on internal controls and in a written audit finding.

b. Ensure that the lender has filed the annual certification, paid the annual renewal fee, and submitted audited financial statements for the prior year.

[7] "Principally used" means that any other use of the property must be solely incidental.

c. Determine the lender's compliance in reporting any quarterly net operating loss, calculated based on GAAP, in excess of 20 percent of net worth. (Refer to HUD Handbook 4000.1.)

d. Determine the lender's compliance with the liquidity requirements as outlined above. (Refer to HUD Handbook 4000.1.)

e. Review the lender's filings with NMLS to ensure that the required filings were made. Review the yearend filing to ensure that the financial data filed agree with the audited financial statement data.

7-6 Compliance Requirements and Suggested Audit Procedures Applicable to Lenders With Title I Authority.

A. Loan Disbursement.

1. Compliance Requirement. The lender has certain responsibilities to be carried out in connection with the disbursement of loan proceeds (24 CFR 201.26 and 201.40). These responsibilities vary widely, depending upon whether the loan is a property improvement or manufactured home loan and whether the disbursement is made directly to the borrower or to a dealer. The disbursement of loan proceeds must be adequately documented in the lender's file. When dealer loans are involved, the lender must also maintain separate dealer files, which reflect compliance with HUD's requirements concerning the dealer's approval and supervision (24 CFR 201.27).

2. Suggested Audit Procedures.

a. Review the lender's procedures for determining borrower eligibility and evaluating whether the loan proceeds are being used for eligible purposes (24 CFR 201.20 or 201.21 as appropriate). Also, review the lender's procedures for documenting that the property improvements have been completed or the manufactured home has been satisfactorily delivered and installed (24 CFR 201.26(a) or (b) as appropriate).

b. Select a representative sample of property improvement loan files and determine whether each file contains the following:

(1) The note, security instrument if any, credit application, completion certificate, and notice of HUD's role in the loan transaction required by 24 CFR 201.26(b)(7) for manufactured home loans and 24 CFR 201.26(a)(8) for property improvement loans.

(2) A contract or contract proposal between the borrower and a dealer or contractor or a detailed written description of the work with a materials list and estimated costs if the borrower is carrying out the work without a dealer or contractor.

(3) Evidence of an onsite inspection to determine that the improvements were completed if the loan is for $7,500 or more.

c. Select a representative sample of manufactured home loan files. Review the files to determine whether each file contains the following documents:

(1) The note, security instrument, credit application, purchase contract, manufacturer's invoice, itemized statements of other costs, and fees or charges.

(2) Evidence of the borrower's initial payment, a placement certificate signed by the borrower and dealer, and the notice of HUD's role in the loan transaction required by 24 CFR 201.26(b).

d. For each file reviewed under A.2.c above, determine whether the lender has documented a site-of-placement inspection within 60 days after disbursement of the loan proceeds.

e. When the lender approves dealer loans, determine whether

(1) The lender supervised and monitored each dealer and visited the dealer periodically.

(2) Each dealer's approval is documented on a HUD-approved form, signed and dated by both parties.

(3) Each dealer's file contains the dealer's current financial statement, including a determination that the dealer met the minimum adjusted net worth requirements of 24 CFR 201.27(a)(1) and credit reports on the dealership and its owners, principals, and officers.

(4) The file contains documentation of the lender's experience with the dealer's Title I loans, including information on borrower defaults and borrowers' complaints and evidence of the resolution of those complaints.

B. <u>Eligible Fees and Charges.</u>

1. <u>Compliance Requirement</u>. Title I Letters TI-440 and TI-440-S list all fees and charges allowed in the program.

2. **Suggested Audit Procedures.** Obtain the lender's general ledger, cash journal, canceled checks, and supporting invoices for at least 2 months of the audit period and, based on review of a representative sample, determine whether

   a. The fees and charges were within the allowable amounts contained in Title I Letters TI-440 and TI-440-S and report amounts paid in excess of the allowable amounts.

   b. Disbursements are supported by invoices and were for eligible amounts in return for goods or services provided in connection with a Title I loan. Review and report on any differences.

   c. Referral fees are being paid. During the review of loan origination and loan settlement documents, the auditor must be alert for any fees or other types of payments that show evidence of being referral fees. If the auditor notes any such referral fees, they must be reported as a finding.

   d. Points and closing costs are accurate.

7-7 Compliance Requirements and Suggested Audit Procedures Applicable to Lenders With Title II Authority.

A. Loan Settlement.

1. **Compliance Requirement.** The loan origination fee must normally compensate the lender for the required loan settlement services. As a result of regulatory changes to 24 CFR 203.27, FHA no longer limits the origination fee to 1 percent of the mortgage amount for its standard mortgage insurance programs. HUD has specified the types and amount of additional charges and fees that the lender may collect from the borrower. Additionally, the lender is responsible for promptly submitting upfront mortgage insurance premiums to HUD following loan settlement, disbursing the funds, and completing the transaction in accordance with the closing documents without undue delay.

2. **Suggested Audit Procedures.**

   a. Obtain an understanding of the lender's procedures for settling and completing loan transactions.

   b. Select a representative sample of HUD loans for testing from those settled during the audit period.

      (1) Examine the signed closing disclosure. Prove the mathematical accuracy of the closing disclosure. Compare amounts listed on the closing

disclosure to other authentic loan documents, including the good faith estimate.

(2) Review the fees and charges collected from the borrowers as shown on loan settlement statements.

(a) Determine whether they are equal to the lender's actual out-of-pocket costs for the related service or the maximum charge allowed by HUD, whichever is lower. (Refer to 24 CFR 203.27, 24 CFR 203.26, and section III of HUD Handbook 4000.1.)

(b) Determine whether all such fees were disclosed in the loan estimate.

(3) Review the points and closing costs to determine whether those costs were the costs that the borrower agreed to.

(4) Review computations and supporting data for amounts collected to establish escrow accounts for taxes and hazard insurance. Determine whether the amounts charged are in accordance with the supporting data. Report any differences.

(5) Review computations and supporting data for interest collected from the borrower at loan closing. Reconcile and report on any differences.

(6) Compare the amount of the insured mortgage to the acquisition costs to determine whether the borrower made the required minimum investment. The form HUD-92900-A contains the acquisition cost of the property. The closing disclosure contains the amount of the insured mortgage.

(7) Examine the canceled check or other supporting documentation for evidence that the lender submitted the mortgage insurance premium to HUD in accordance with HUD policy at the time of closing. Determine whether payment reached HUD's depository within 10 calendar days of closing (Handbook 4000.1).

(8) Compare the purchase contract and the closing disclosure for agreement as to sales price, earnest money deposit, and any seller concessions.

B. <u>Escrow Accounts.</u>

1. <u>Compliance Requirement.</u> HUD requires that lenders establish escrow accounts and borrowers make monthly payments to these accounts to ensure that funds will be available to pay taxes and insurance premiums. Each month, the lender must collect from the borrower an amount that the lender estimates will be

sufficient to enable it to accumulate funds to pay all escrow obligations before delinquency; that is, (a) mortgage insurance premiums; (b) taxes, special assessments, and ground rents if any; (c) hazard insurance premiums if any; and (d) flood insurance premiums when required. The lender must analyze the escrow account at least annually to determine whether projected escrow balances will be sufficient to fund escrow disbursements. Any projected escrow shortage must be collected by either (a) lump-sum payment or (b) allocating the shortage over a 12-month period. The mortgage instrument provides the authority for the lender to accumulate sufficient escrow funds with which to pay the borrower's tax and insurance bills before the bills become delinquent (HUD Handbook 4000.1, section 2).

Lenders may not use borrower escrow funds for any purpose other than that for which they were received, and lenders may not report escrows as their own assets. If a lender reports its escrow funds on its balance sheet, such funds must be fully offset by a corresponding liability and must be segregated on the balance sheet.

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

a. Obtain an understanding of the policies and procedures for reconciling escrow accounts.

b. Determine whether escrows are reported on the balance sheet. If so, determine whether the proper liability account is established and reported and the accounts are segregated as required.

c. Obtain trial balances of individual escrow accounts and reconcile or review the reconciliation of the total with the lender's control account and the related bank account. Select a sample and test to determine whether the lender used escrow funds to pay late charges, assumption fees, or any other expense that are not allowable expenses as specified above.

d. For selected mortgages, obtain the most recent escrow analysis and note whether it was prepared not more than 1 year previously and whether monthly deposits appear adequate to provide for payments of taxes, insurance, etc., by review of actual payments or other evidence of amounts due (for example, tax assessment notices or prospective rate adjustment notices from insurance companies). Also, determine whether the most recent real estate tax bills for each account were paid. If not paid within the discount period, inquire as to reasons for the delay and test to determine whether the borrower retained the benefit of the discount and any late charges assessed were borne by the lender at its expense. Determine whether the borrower was furnished a statement of

interest paid during the preceding calendar year within 60 days after the end of that calendar year.

e. On accounts selected for review, inspect supporting documents for escrow disbursements, such as receipts, invoices, tax bills, and canceled checks. Determine whether the funds were used only for the intended purpose and the proper amount was disbursed.

f. Determine whether escrow funds have been deposited into accounts fully insured by FDIC or NCUA and whether the lender covered any overdrafts on selected accounts by advancing its own funds to custodial accounts so that FDIC or NCUA insurance protection was not impaired. HUD regulations neither require nor forbid escrow accounts to bear interest. However, in those cases in which accounts are interest bearing, determine whether interest earned, net of any bank account fees, is passed on to the borrower.

g. Determine whether the lender advises the borrower of the amount of any surplus escrow funds in accordance with HUD requirements.

h. Review the policies and procedures that the lender has established to ensure that bills payable from the escrow fund or the information needed to pay such bills is obtained in advance of the due date.

i. For any bills paid late by the lender, determine whether any late charges or penalties assessed are paid out of the lender's funds and not the borrower's funds.

j. Determine whether the lender requires the borrower to purchase hazard insurance coverage from the lender or from a specific company.

k. Review selected loan payoffs for evidence that the lender returns to the borrower the amounts held in escrow for taxes and hazard insurance within 30 days of receipt by the lender of payoff funds.

l. Determine whether the lender has notified HUD within 15 calendar days of the sale or transfer of an FHA-insured loan to another FHA-approved lender under Handbook 4000.1.

C. Kickbacks.

1. Compliance Requirement. The Real Estate Settlement Procedures Act prohibits lenders from paying any fee, kickback, compensation, or thing of value, including a fee representing all or part of the lender's origination fee, to any person or entity

other than for services actually performed or to any person or entity for referral of the loan or as a finder's fee (HUD Handbook 4000.1, section I-A).

2. Suggested Audit Procedures.

a. Obtain the general ledger; the cash journal; and a representative sample of canceled checks, check vouchers, and supporting invoices for at least 2 months of the audit period and determine whether

(1) Disbursements are supported by an invoice and were not for an unreasonable amount in return for goods or services actually performed. Reconcile and report on any differences.

(2) Any funds were advanced to real estate agents, real estate brokers, mortgage brokers, or packagers as an advance of anticipated commissions on sales to be financed with an FHA-insured mortgage.

b. Determine whether any no-interest loans or loans at less than prevailing rates were made to a real estate broker, real estate agent, mortgage broker, packager, builder, or any other party from whom, based on available evidence, the lender accepts proposals involving FHA-insured mortgages.

c. From a sample of payments, determine whether any payment was made for a gratuity or for a gift valued above items that are customarily distributed in the normal course of advertising or public relations or as a general promotion device to any person or entity involved in FHA-insured mortgage transactions of the lender.

d. From a sample of payments, determine whether any fees or compensation was paid that is prohibited by the Real Estate Settlement Procedures Act.

e. During the review of loan origination and loan settlement documents, the auditor must be alert for any fees or other types of payments that may represent kickbacks. If the auditor notes any kickbacks or indications of kickbacks, these must be reported in an audit finding.

7-8 Multifamily Insured Loans Reporting Requirement - Loan Fees for Multifamily Mortgages

A. Compliance Requirement. Lenders participating in FHA multifamily programs are now required by chapter 11.5 of the MAP Guide to report total loan fees earned that exceed 5 percent of the insured loan amount on each FHA-insured loan of more than $2 million endorsed during the lender's fiscal year period covered in its audited financial statements.

Loan fees include

1. Origination and placement fees as permitted by the Multifamily Accelerated Processing Guide,

2. **Plus** trade profit, trade premium, or marketing gain earned on the sale of the Ginnie Mae security at a value above par, even if the security sale is delayed until after endorsement,

3. **Minus** loan fees applied by the lender to its legal expenses incurred in connection with loan closing.

Loan fees must be reported on a separate schedule included as supplemental information with the lender's annual audited financial statements submitted to HUD. (See example format below.) For each loan in which the lender earned total loan fees of more than 5 percent, the schedule must list (1) the FHA loan number, (2) the loan amount at initial or final endorsement, and (3) the amount of total loan fees earned above 5 percent, both in dollar amount and as a percentage of the FHA-insured loan amount.

Schedule of loan fees for multifamily lenders

FHA loan number	Dollar amount of endorsed loan	Loan fees earned that exceed 5% of insured loan amount	
		Percentage of insured loan amount	Amount in dollars

Lenders are not required to separately report on total loan fees that do not exceed 5 percent.

If, on a single loan endorsement, the trade profit, trade premium, or marketing gain earned on the sale of the Ginnie Mae security is received by the lender during a fiscal year reporting period that is after the period in which the origination and placement fees were received and if the total of the fees earned requires reporting under Mortgagee Letter 2011-05, the lender must disclose the total loan fees it earned that are above 5 percent of the loan amount on the schedule filed during the next fiscal year.

Handbook 4000.1 also states that that lenders' annual audited financial statements are not subject to Freedom of Information Act requests.

B. Suggested Audit Procedures.

1. Review insured loans of more than $2 million that closed during the reporting period and determine whether the total loan fees earned exceeded 5 percent of the loan amount.

2. Review the report and determine whether all of the fees earned that exceeded 5 percent of the loan amount were listed in the report.

3. Determine whether the report included all of the required information and whether that information was accurate based on information in the loan file.

4. Determine whether (1) any trade profit, trade premium, or marketing gain fees earned on the sale of the Ginnie Mae security were received by the lender during a fiscal year reporting period that was after the period in which the origination and placement fees were received, (2) the total of the fees earned requires reporting under Handbook 4000.1, and (3) the lender disclosed the total loan fees it earned that were above 5 percent on the schedule filed during the next fiscal year.

7-9 Audit Finding Reporting.

All material instances of noncompliance with any HUD requirement or regulation, significant deficiencies and material weaknesses in internal controls, 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, deficiencies in internal control, instances of fraud or illegal acts, or contract violations relating to HUD programs disclosed during the audit process may be reported to management in a separate communication outside of the audit report. Such reporting must be in writing in a management letter or other type of written auditor communication and must be mentioned in the independent auditor's report, including the date of the management letter or other written communication. The management letter or other communication must accompany the electronic submission. Noncompliance, deficiencies, or instances of violations, which were corrected during the audit process or after the fiscal year under audit or disclosed as a part of the audit process before the end of the fiscal year under audit and before the issuance of the audit report, must be included in the report as resolved findings or in a management letter, depending on their materiality, regardless of whether they were found to be material or immaterial FHA compliance issues.

A. Content of Finding.

Findings are to be presented in accordance with the standards and requirements of the Government Auditing Standards, "Yellow Book." A finding must be supported by sufficient, competent, and relevant evidence; be presented in a manner to promote adequate understanding of the matters reported; and provide convincing but fair presentations in proper perspective. Each finding is to be accompanied by a corrective action plan prepared by the lender.

Please refer to chapter 2 for the information that is to be included in a finding.

B. Corrective Action in Process.

Many times when lenders are presented with draft findings, they will start to take action to correct the deficient condition. When this action is underway and the auditor has completed his or her fieldwork, the lender may include the action completed and the action remaining to be taken in the lender's comments and in the corrective action plan. Regardless of whether the lender is in the process of correcting the finding, the auditor is to include the finding in the report with all required elements.

C. Corrective Action Completed.

Many times when the lender is presented with draft findings, it will start to take action and complete that action, correcting the deficient condition before the completion of the fieldwork. When this action occurs, the finding is still to be included in the audit report with all required elements. The action taken or completed must be included in the lender's comment section and must be validated by the auditor. The recommendation section must follow the lender's comment section, and the auditor must indicate whether any of the information is inconsistent with or in conflict with the report's findings. In addition, the auditor could include any additional recommendations he or she believes are necessary based on the testing of that action.

7-10 Reference Material. The following is the reference material that was in effect at the time this handbook chapter was issued. It is the auditors' responsibility to use the appropriate reference material that was in effect during the period covered by their audit.

Throughout this chapter, except in this paragraph, reference is made to handbooks using only the base handbook number without the revision number (that is, REV-1, REV-6, etc.). In this section only, we are citing the revision numbers that were current on the date of publication since it was those documents we used in establishing the requirements of this audit guide. Also, the auditor must ensure that the updated references or the reference materials that were in effect during the period of the audit are used for performing the audits. Auditors must make any needed modifications or updates to the

material used to perform their audits. If reference to the handbook is needed in the audit report findings or in any other part of their audit report, auditors must ensure that the entire updated reference (including the revision number) is used.

The information collection requirements contained in this handbook have been approved by the Office of Management and Budget (OMB) under the Paperwork Reduction Act of 1995 (44 U.S.C. (United States Code) 3501-3520) and assigned the following OMB approval numbers: 2502-0328, 2502-0551, and 2502-0005.

Document	Title
24 CFR Part 5	General HUD Program Requirements: Waivers
24 CFR Part 201	Title I Property Improvement and Manufactured Home Loans
24 CFR Part 202	Approval of Lending Institutions and Mortgagees
Mortgagee letters	Various
Forms	Various
HUD Handbook 4000.1	FHA Single Family Housing Policy Handbook[8]
HUD Handbook 4145.1	Architectural Processing and Inspections for Home Mortgage Insurance
HUD Handbook 4155.2	Lender's Guide to the Single Family Mortgage Insurance Process
HUD Handbook 4235.1, REV-1	Home Equity Conversion Mortgages
HUD Handbook 4240.2, REV	The Graduated Payment Mortgage Program
HUD Handbook 4330.1, REV-5	Administration of Insured Home Mortgages
HUD Handbook 4330.4, REV-1	FHA Single Family Insurance Claims
HUD Handbook 4350.4	Insured Multifamily Mortgagee Servicing and Field Office

[8] Handbook 4000.1 only applies to single family lenders with the exception of section I.A.1 – I.A.9, which also applies to multifamily lenders.

Document	Title
HUD Handbook 4700.2	Title I Lender Approval Handbook
LEAP User Manual	LEAP User Manual

If the program participant does not have this reference material, it may be obtained by accessing HUD's Client Information and Policy System at http://www.hud.gov/offices/adm/hudclips/index.cfm, or it may be ordered from HUD's Direct Distribution System by telephone at (800) 767-7468; in a letter addressed to HUD, Customer Service Center, Room B-100, 451 Seventh Street, SW, Washington, DC 20410; or by fax at (202) 708-2313.

7-11 Technical Assistance.

On behalf of the HUD Secretary, the Lender Approval and Recertification Division determines the acceptability of all audited financial statements submitted by FHA-approved lenders. Therefore, it is important that such submissions meet the requirements delineated in this chapter and HUD Handbook 4000.1, REV-2. If a program participant has questions related to HUD's audited financial statements' requirements, the participant may contact the helpline at 1-800-CALL-FHA (1-800-225-5342) or submit an email to answers@hud.gov.

Attachment A

FHA Lenders With Title I Authority - Adjusted Net Worth Computation*

Stockholders; equity (net worth) Per balance sheet	$_____	(a)
Less unacceptable assets	$_____	(b)
Adjusted net worth for HUD purposes (c) = (a)-(b)	$_____	(c)
Less minimum net worth required	$1,000,000	(d)
Adjusted net worth above or below minimum net worth required *(e) = (c)-(d)*	$_____	(e)

*FHA loan activity is not required.

Attachment B

FHA Lenders With Title II Authority - Adjusted Net Worth Computation

Stockholders; equity (net worth) Per balance sheet	$_____	(a)
Less unacceptable assets	$_____	(b)
Adjusted net worth for HUD purposes *(c) = (a)-(b)*	$_____	(c)
Less minimum net worth required	$1,000,000	(d)
Adjusted net worth above or (below) minimum net worth required *(e) = (c)-(d)*	$_____	(e)

Attachment C

Title II Single Family Program Lenders' Adjusted Net Worth Computation

FHA servicing portfolio* at (end of fiscal year under audit) _____ (a)
*HUD FHA-insured single-family mortgages only. Include HECMs at maximum claim amount.

FHA originations – FHA-insured Title II loan originations during the fiscal year _____ (b)

FHA purchases – FHA-insured Title II third-party originator purchases during the fiscal year _____ (c)

Total FHA loan activity [(d) = (a)+(b)+(c)] _____ (d)

FHA-insured Title II loan originations retained at the fiscal yearend _____ (e)

FHA-insured Title II third-party originator purchases retained at the end of fiscal year _____ (f)

Adjustments [(g) = (e)+(f)] _____ (g)

Total adjusted FHA loan activity [(h) = (d)-(g)] _____ (h)

Net worth required $1,000,000 (i)
If (h) ≤ $25 million, skip lines (j) and (k) and insert (i) on line (o).

Additional net worth required _____ (j)
If (h) > $25,000,000, then (j) = (h)-(25,000,000)*(1%).

Total net worth [(k) = (i)+(j)] _____ (k)
If line (k) < $2,500,000, insert line (k) on line (o).
If line (k) > $2,500,000, insert $2,500,000 on line (o).

Stockholders' equity (net worth) per balance sheet _____ (l)

Less unacceptable assets _____ (m)

Adjusted net worth [(n) = (l)-(m)] _____ (n)

Minimum net worth required _____ (o)

Adjusted net worth above or below required minimum amount [(p) = (n) – (o)] _____ (p)

Attachment D

Title II Multifamily Program Servicers - Adjusted Net Worth Computation

FHA servicing portfolio* at (end of fiscal year under audit) _____ (a)
*HUD FHA-insured single-family mortgages only. Include HECMs at maximum claim amount.

FHA originations – FHA-insured Title II loan originations during the fiscal year _____ (b)

FHA purchases – FHA-insured Title II third-party originator purchases during the fiscal year _____ (c)

Total FHA loan activity [(d) = (a)+(b)+(c)] _____ (d)

FHA-insured Title II loan originations retained at the fiscal yearend _____ (e)

FHA-insured Title II third-party originator purchases retained at the end of fiscal year _____ (f)

Adjustments [(g) = (e)+(f)] _____ (g)

Total adjusted FHA loan activity [(h) = (d)-(g)] _____ (h)

Net worth required $1,000,000 (i)
If (h) ≤ $25 million, skip lines (j) and (k) and insert (i) on line (o).

Additional net worth required _____ (j)
If (h) > $25,000,000, then (j) = (h)-(25,000,000)*(0.5%).

Total net worth [(k) = (i)+(j)] _____ (k)
If line (k) < $2,500,000, insert line (k) on line (o).
If line (k) > $2,500,000, insert $2,500,000 on line (o).

Stockholders' equity (net worth) per balance sheet _____ (l)

Less unacceptable assets _____ (m)

Adjusted net worth [(n) = (l)-(m)] _____ (n)

Minimum net worth required _____ (o)

Adjusted net worth above (below) required minimum amount [(p) = (n) – (o)] _____(p)

Attachment E

ILLUSTRATIVE CORPORATE GUARANTY AGREEMENT

U.S. Department of Housing and Urban Development
Federal Housing Administration

Whereas, _____("Parent") is the parent company of _____(the "Subsidiary"), an institution with FHA lender identification number _____; and

Whereas, the Subsidiary is currently a Lender in good standing and approved by the Federal Housing Administration ("FHA") to participate in FHA programs; and

Whereas, the Subsidiary accounts for less than forty percent (40%) of the Parent's assets; and

Whereas, as a condition precedent to FHA allowing the Subsidiary to continue to participate in FHA programs, FHA requires that the Parent promises the performance by it of actions necessary for the Subsidiary to meet the obligations required to maintain approval for participation in FHA programs ("Corporate Guaranty");

Now, therefore, in consideration of FHA allowing the Subsidiary to continue to participate in FHA programs, and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parent agrees as follows:

1. Guaranty. The Parent hereby irrevocably promises to FHA the prompt and unconditional performance of any actions necessary for the Subsidiary to meet the obligations required to maintain approval for participation in FHA programs ("Approval Obligations") in accordance with the requirements of 24 CFR Part 202 et seq. and the FHA Title II Mortgagee Approval Handbook 4000.1, as amended, modified, or supplemented from time to time (the "Handbook"). The obligations of the Subsidiary include but are not limited to the obligation of FHA-approved participants to meet ongoing net worth and liquidity requirements.

   In the event that FHA determines that the Subsidiary has failed to meet or maintain Approval Obligations, the Parent shall be liable for any sanctions, fees, debts, or damages so ordered by FHA relating to such failure. Except to the extent that actions taken by FHA against the Subsidiary cause the promises made by Parent with respect to the Subsidiary to be satisfied, in the event FHA terminates the Subsidiary's approval to participate in FHA programs, the Parent hereby agrees to reimburse FHA for any and all actual and direct losses, damages, costs and expenses (including, without limitation, reasonable attorney's fees) resulting from the nonperformance or

nonfulfillment of the Subsidiary of FHA program requirements and all legal and other expenses of or for the collection of payments due to the Subsidiary.

In the event that any payment to FHA in respect of the obligations promised by the Parent pursuant to this Corporate Guaranty is rescinded or must otherwise be returned for any reason whatsoever, the Parent shall remain liable with respect of such obligations as if such payment had not been made. During the term of this Corporate Guaranty, the Parent shall not be discharged or released hereunder by reason of the discharge or release of the Subsidiary from its obligations under the Handbook and related agreements for any reason, including surrender by the Subsidiary of its FHA lender approval; a discharge in bankruptcy, receivership, or other proceeding; a stay or other enforcement restriction; or any other reduction, modification, impairment, or limitation of the liability of the Subsidiary. FHA shall not be obligated to file any claim relating to the obligations promised by the Parent pursuant to this Corporate Guaranty in the event that the Subsidiary becomes subject to a bankruptcy or reorganization or similar proceeding, and the failure of FHA to so file shall not affect the Parent's obligations hereunder.

2. Make Well Agreement. If Subsidiary fails to meet ongoing net worth and liquidity requirements set forth in the regulations at 24 CFR part 202 and the Handbook, the Parent shall make or cause to be made cash payments to Subsidiary in such amount as is required to meet such requirements. Parent shall make the cash payments required by this Section not later than thirty (30) Business Days following the date on which Subsidiary's net worth and liquidity amounts fall below HUD's minimum requirements.

3. Independent Obligation. The obligation of the Parent under this Corporate Guaranty shall be, in each instance, absolute, irrevocable, and unconditional and independent of the obligations of the Subsidiary. Parent may not assign its rights or delegate its obligations under this Corporate Guaranty without FHA's prior written consent. FHA may proceed directly against the Parent to enforce its rights under this Corporate Guaranty without proceeding against or joining the Subsidiary. The Parent hereby waives any rights it may have to compel FHA to proceed first against the Subsidiary. Neither the exercise of any remedies against the Subsidiary nor the sale, enforcement, or realization of any of the servicing rights shall (except to the extent that such actions cause the obligations guaranteed by the Parent to be satisfied) in any way affect the Parent's obligations hereunder, even though any rights which the Parent may have against such Subsidiary or others may be extinguished, diminished, or otherwise affected by such action.

4. No Waiver; Cumulative Rights. FHA may grant any extension of time or indulgence to the Subsidiary for the payment of any sums due or take any note or other obligation or any security for the payment of any sum or sums due or to become due without notice to the Parent and without thereby in any releasing or affecting the liability of the Parent

under this Corporate Guaranty. No failure on the part of FHA to exercise and no delay in exercising any right, remedy, or power hereunder shall operate as a waiver thereof, nor shall any single or partial exercise by FHA of any right, remedy, or power hereunder preclude any other or future exercise of any right, remedy, or power. Each and every right, remedy, and power hereby granted to FHA or allowed it by law or other agreement shall be cumulative and not exclusive of any other and may be exercised by FHA at any time or from time to time.

5. Cost of Enforcement. The Parent agrees to indemnify FHA for all out-of-pocket third-party costs and expenses, including but not limited to reasonable attorneys' fees incurred or paid by FHA in enforcing this Corporate Guaranty, whether or not litigation is commenced, if the Parent defaults in any payment owing by it hereunder.

6. Governing Law and Consent to Jurisdiction. This Corporate Guaranty shall be governed by and construed in accordance with the Federal law of the United States of America. To the extent that Federal law does not apply, the laws of the State of New York shall apply. The Parent agrees that the United States of America District Court for the District of Columbia shall have exclusive jurisdiction to hear and determine any claims or disputes pertaining directly or indirectly to this Corporate Guaranty or to any matter arising here from or related hereto. The Parent hereby expressly submits and consents in advance to such jurisdiction and venue in any action or proceeding either commenced by FHA or brought against the Parent in such court.

7. No Oral Change. This Corporate Guaranty may not be changed or amended except by a writing signed by the party against whom enforcement of such change or amendment is sought, and no obligation of the Parent shall be released or waived except by a writing signed by FHA.

8. Parent's Representations and Warranties. The Parent hereby represents and warrants to FHA as follows:

   a. The Parent is duly organized, validly existing, and in good standing under the laws of the jurisdiction of its organization and has all requisite power and capacity to enter into this Corporate Guaranty and to perform its obligations hereunder. The Parent's execution and delivery of this Corporate Guaranty and any related agreements or instruments and the consummation of the transactions contemplated hereby has been duly authorized by all requisite action, and no further action or approval is required in order to constitute this Corporate Guaranty as a binding and enforceable obligation of the Parent;

   b. The Parent's execution and delivery of this Corporate Guaranty does not violate any provision of law or regulation or any order or any court or other agency or instrumentality or government (including but not limited to a supervisory agreement, memorandum of understanding, cease and desist order, capital directive,

supervisory directive, or consent decree);

c. The execution, delivery, and performance of this Corporate Guaranty and any related agreements or instruments by the Parent, its compliance with the terms hereof and thereof, and consummation of the transactions contemplated hereby and thereby will not violate, conflict with, result in any material breach of, constitute a material default under, be prohibited by, or require any additional approval under its by-laws or any instrument or agreement to which it is a party or by which it is bound;

d. All consents, licenses, clearances, authorizations and approvals of, and registrations and declarations with any governmental authority or regulatory body necessary for the due execution, delivery, and performance of this Corporate Guaranty have been obtained and remain in full force and effect, and all conditions thereof have been duly complied with, and no other action by and no notice to or filing with any governmental authority or regulatory body is required in connection with the execution, delivery, or performance of this Corporate Guaranty; and

e. This Corporate Guaranty constitutes a legal, valid, and binding obligation of the Parent enforceable against the Parent in accordance with its terms, subject to bankruptcy, insolvency, reorganization, moratorium, and other laws of general applicability relating to or affecting creditors' rights and to general equity principles.

9. Termination. This Corporate Guaranty shall be terminated if and when the Subsidiary has relinquished its FHA lender approval, has transferred its FHA mortgages to an approved FHA lender with FHA's consent, and has satisfied all outstanding obligations to FHA. This Corporate Guaranty shall not terminate, and this section shall in no way limit FHA's rights in the event FHA is entitled to proceed against the Parent under Section 1 above.

10. Notices. All notices or demands on the Parent shall be deemed effective when received, shall be in writing, and shall be delivered by hand or by registered mail or by facsimile transmission promptly confirmed by registered mail, addressed to the Parent at:

Parent Address:

Parent Fax #:

or to such other address or fax number as the Parent shall have notified FHA in a written notice delivered to FHA in accordance with the related Guaranty Agreements.

In witness whereof, the undersigned has caused this Corporate Guaranty to be executed by a duly authorized officer and its corporate seal to be affixed and attested by its Secretary in accordance with express authority of its Board of Directors.

Dated:

Attest: By:

(Secretary) (Authorized Officer)

(Seal)

Appendix A

Attribute Sampling

This appendix applies to all chapters in this audit guide.

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 1-7C of chapter 1, 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.

A. Determining the Sample Size.

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

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

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

3. **Expected Exception Rate.** No exceptions should be accepted.

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

B. **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, 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.

C. **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) 5 items when the population being tested contains between 20 and 49 items, and
(4) Fewer than 5 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.

D. **Testing and Evaluating Results.** The sample sizes in the table above are based on an expectation of no exceptions. If the testing performed discovers no exceptions, the auditor has achieved a high degree of confidence that the attribute/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 1-7C and chapter 2 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 include or is a compliance violation that must be included in the report. If it is determined that an exception is not material enough to report and is not a compliance issue that must 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.

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

F. **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)