Oregon
Housing and Community Services

Audit Guide for Bond Program Risk Share and Elderly/Disabled and ARRA Program TCAP and 1602 Exchange

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January 15, 2016

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AUDIT GUIDE

1. Background and General Information

Purpose of the Audit Guide

This Audit Guide ("Audit Guide") sets forth the guidelines to be followed by independent Certified Public Accountants (CPA) in conducting and presenting audits of the financial statements for projects whose mortgage loan is financed by the Department with general obligation and revenue bonds.

This Audit Guide is intended primarily for use by independent CPA's, as defined by the American Institute of Certified Public Accountants (AICPA) standard, in auditing the annual financial statements of a borrower whose project construction has been completed and cost certified.

This Audit Guide is not intended to be a complete manual of procedures, nor is it intended to supplant the auditor's judgment of audit work required. Suggested audit procedures contained herein may 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 achieved.

Bond Regulations and Loan Documents

The borrower has agreed to conditions that apply to a Bond Financed Project which is monitored by the Department for compliance with various controls and regulation of certain aspects of the project's operations. These may include, but are not limited to, limits on rental rates, rates of return, eligibility of tenants and fiscal management. Many of these requirements are contained in the Department's Loan Documents.

Management Agents

Many borrowers contract with professional management agents to operate their project and produce the financial statements the CPA audits. The management agreement between the borrower and management agent must conform to the pertinent requirements of the Loan Documents (including, but not limited to, the Department's Regulatory as to Management Agreement).

2. Definitions

The following definitions are provided to assist the CPA with terms commonly used in the Loan Documents, by the Department and to define abbreviated references as used in this Audit Guide. The definitions are provided alphabetically and not in an order of importance.

ARRA Funded Projects: The Department funded projects through programs created by the American Recovery and Reinvestment Act of 2009 ("ARRA"); Tax Credit Assistance Program ("TCAP") and the 1602 Program.

Bond Financed Projects: The Department issues general obligation and revenue bonds to provide permanent Mortgage financing for the construction or rehabilitation of multi-unit projects, structures or facilities. There are two bond financing programs that are subject to this Audit Guide:

- Risk Sharing Loan Program
- Elderly and Disabled Loan Program

The bond indenture requires that the Department certify to its bondholders that annual audit reports are received from each borrower and reviewed by Department staff as assurance of the continued economic feasibility of the projects financed by the bonds.

Distribution: A distribution is any withdrawal of cash or other assets of the project other than for Mortgage payments or for the payment of necessary and reasonable expenses to the operation and maintenance of the project. A distribution shall only be made from Surplus Cash and is subject to the specific limitations outlined in the Loan Documents and prior approval from the Department.

Fiscal Year End (FYE): A fiscal year is the period that an entity uses for accounting purposes and preparing financial statements. The fiscal year may or may not be the same as a calendar year.

An audit is required at the first fiscal year end (FYE) even if a twelve-month period has not elapsed. The FYE may be March 31, June 30, September 30, or December 31.

Loan Documents: The Department's Loan Documents, include by reference all documents relating to the funding of the loan, which may include, but are not limited to:

- Promissory Note (or Trust Deed Note);
- Trust Deed (or Deed of Trust);
- Assignment of Rents;
- Loan Agreement;
- Regulatory Agreement;
- Regulatory as to Management Agreement;
- Uniform Commercial Code (UCC) documents;
- Side Letter;
- Consent to Transfer (loan assumption document);
- Operating Agreement (if applicable); and
- Modification, forbearance and workout agreements (if applicable).

The Loan Agreement and/or Regulatory Agreement are two of the primary loan instruments through which the Department controls the borrower's operation of the project.

Necessary and Reasonable Expenses: The CPA will have to make judgments as to the propriety of project disbursements. The Department considers the following to be distributions of project income, not expenses necessary and reasonable to the operations of the project:

- Legal expenses incurred in the sale of Entity interests;
- The fee for preparation of a partner's, shareholder's, corporation's or individual's federal, state or local income tax returns;
- Partnership Fees
- Payment for advice to an owner on the tax consequences of foreclosure;
- Withdrawals of project funds to reimburse owners for prior advances;
- Capital expenditures; and
- Project acquisition costs.

Owner Advances (Cash deposit to the Project's Operating Account): On occasion, it is necessary for an owner to provide additional cash to the project's Operating Account to meet the financial obligations of the project and to maintain the financial viability of the project. Options for providing for owner advances are:

1. Additional paid-in capital can be shown in net worth or owner's equity. This can only be repaid from Surplus Cash which distribution has been authorized by the Department.
2. As an unsecured interest bearing loan to the Project with interest and principal which can only be repaid from Surplus Cash which distribution has been authorized by the Department
3. In the case of a partnership, a loan to the partnership, non-interest bearing or interest bearing, is not to be a liability to the project but, upon the authorization to distribute surplus cash, can be repaid through the partnership distribution.

Note: Once owner/partner advances are paid in and deposited to project operating funds, the funds cannot be repaid without specific written authorization from the Department.

<u>Payroll Expenses:</u> Payroll expenses are to be distributed to various categories: Administration, Kitchen, Housekeeping, etc. Payroll taxes, worker's compensation insurance, and employee benefits should be allocated to the respective payroll categories.

<u>Related Party Transactions:</u> Related Party Transactions involve transactions with parties known to be related to the entity such as parent-subsidiary or investor-investee. Determine and report all related party transactions regardless of nature or amount.

<u>Surplus Cash (See Appendix 2 for specific computation):</u> Any operating cash remaining on hand after the payment of:

- All sums due or are currently required to be paid under the terms of the Department's Mortgage or Promissory Note.
- All amounts required to be deposited in the reserve fund for replacements as defined by the Loan Documents.
- All obligations of the project other than the Mortgage, unless funds for payment have been set aside or deferment of payment has been approved by the Department.

And after the segregation and recording of:

- An amount equal to the aggregate of all special or restricted funds to be maintained by the project. This includes any deficiency in the tax and/or insurance escrows.
- All tenant security deposits held including interest for projects for which the initial application request was submitted to HUD on or after February 29, 1980.
- All accounts payable and accrued items payable including accrued interest on the Mortgage.

In addition to cash, two types of accounts receivable may be used in the calculation:

- Housing assistance rental receivables outstanding as of FYE that have since been collected;
- Approved Replacement Reserve Account requests as of FYE.

<u>Transfers of Interest in Ownership:</u> The Loan Documents and Oregon Administrative Rule (OAR) requires prior written approval from the Department for certain types of transfers of ownership of bond financed projects. A transfer may also require payment of a fee to the Department.

Note: For Risk Sharing— HUD prior approval of the transfer is also required.

In general, any change in an individual's ownership (i.e., John Smith or Susan Smith), or a cumulative 25% change in the ownership entity (i.e., general partner or limited partner) requires prior written approval from the Department. Some examples requiring approval are: (1) transfer to a "Trust" or for estate planning purposes; (2) inheritance; (3) divorce; (4) stock buy-out; (5) transfer to additional parties (i.e., transferring from a husband and wife to themselves, plus their adult children); or (6) transfer from a limited partnership to a limited liability company (but maintaining same partners). If the Questionnaire identifies a transfer that may not have been approved, assumption of the mortgage (and HAP contract, if applicable) may still be required.

For further clarification about transfer of ownership, refer to the following OARs:

- OAR 813-012-0150 for Risk Sharing Program
- OAR 813-030-0061 for Disabled Housing Program
- OAR 813-030-0066 for Elderly Housing Program

3. Audit Requirements

Audit Objectives

The primary purpose of the audit is to report on the financial statements of the project's operations. The CPA must also report on internal control and any deviations from compliance with the Loan Documents. The Department is interested in the financial solvency of the project, its ability to meet debt service requirements, keeping the property free of any unauthorized liens or transfer of ownership, and avoiding Mortgage default. The objectives of the Audit are to determine:

- Financial Status: Whether the financial statements present fairly the financial position of the project and the results of its operations in conformity with generally accepted accounting principles.
- Compliance: Whether operating practices and controls comply with certain specific Department requirements as outlined in the Loan Documents, this Audit Guide and the Questionnaire. *Deficiencies and/or deviations must be corrected prior to the release of surplus cash* and must be specifically addressed in the Auditor's Report on Compliance and Internal Controls.

Audit Scope

The audit must be sufficiently comprehensive in scope to permit the expression of an opinion on the financial statements and supplemental data in the Audit Report. If deemed necessary, the auditor may review the tenant files. If either a qualified or adverse opinion is expressed or if an opinion is disclaimed, the Department requires an explanation. As used in these instructions, the term "expression of opinion" includes:

- an unqualified opinion;
- a qualified opinion;
- a disclaimer of opinion; or
- an adverse opinion.
- The CPA is also required to:
- Review, evaluate and comment on the adequacy of the accounting records and procedures and the system of internal controls; and
- Indicate, if disclosed by the audit, the borrower's failure to adhere to the certain specific provisions of their corporate charter, the Loan Documents, or to Department regulations and procedures applicable to the borrower's operation.

Audit Standards

The Audit must be performed in accordance with the following standards:

- Generally accepted auditing standards established by the American Institute of CPA's ("AICPA");
- Government Auditing Standards issued by the Comptroller General of the United States; and
- Audit requirements as set forth in this Audit Guide.
- The CPA's working papers are expected to conform to the guidelines prescribed in the AICPA, Statements of Auditing Standards (SAS) ("Standards").
- Nonprofit institutions that own individual properties receiving HUD Section 8 Housing Assistance Payments will be required to complete project-specific audits because each project is deemed to be a separate entity. Audits of nonprofit institutions will also be subject to Office of Management and Budget (OMB) Circular A-133 "Audits of States, Local Governments, and Non-Profit Organizations."

For questions of compliance with audit standards, please contact the State Board of Accountancy.

Annual Audit Required

The Loan Documents require mandatory submission to the Department of a complete audit of the annual financial reports for the project. The Audit must be:

- Submitted to the Department within 90 days after the FYE;
- Prepared in accordance with the American Institute of Certified Public Accountants (AICPA) Standards;
- Prepared in accordance with Generally Accepted Accounting Principles (GAAP);
- Prepared in accordance with the requirements of the Department;
- Certified to be accurate by the borrower or an officer of the borrower; and
- Examined and reported on by an independent CPA. (The CPA must meet the standards of independence established by the AICPA.)

Neither the auditor nor project owner need to submit the audit report to HUD, either electronically or directly.

Engagement Letter

The Department encourages the borrower to obtain an engagement letter from an independent CPA to perform the Audit in compliance with this Audit Guide. The engagement letter does not need to be sent to the Department.

The arrangements for audit between the CPA and the borrower must allow Department staff to examine the auditor's working papers supporting the Audit.

The engagement letter shall specifically direct the auditor to perform the audit in accordance with the provisions of the Loan Documents, the Audit Guide, and all procedures, rules and regulations, statutes and requirements referred to therein.

Important Note: According to AICPA Ethics Interpretation 501-3 "Failure to follow standards and/or procedures or other requirements in governmental audits", a CPA who accepts an engagement and undertakes an obligation to follow Government Auditing Standards, (Yellow Book) issued by the Comptroller General of the United States, guides, procedures, statutes, rules and regulations, in addition to generally accepted auditing standards, is obligated to follow such requirements. Failure to do so is an act discreditable to the profession, and a violation of Rule 501.

Document Review

In addition to the Audit Standards, the CPA may find the following documents necessary in the conduct of the audit and should obtain them from the borrower's files prior to starting the Audit.

- Department Loan Documents, plus any modifications, forbearance and workout agreements;
- Management Agreement between the owner and management agent (in addition to the Department's Management Agreement);
- Entity Documents, (including all amendments) if applicable;
- Prior FYE Audit;
- Sample of all approved tenant Lease Agreements used in the project;
- Project Lease Agreement, if applicable (i.e., when project is leased to another entity or there is a ground lease.);
- Any notice of default;
- Secondary mortgage loan documents including modification, forbearance, and workout agreements;
- Written approval from the Department (and HUD, if applicable) for new secondary financing;
- Any contracts for services and supplies executed on behalf of the project, where material;
- Written statement from the borrower of any changes in the owners/partnership during the year as covered by the Department rules on the sale or partial sale of a project which explain that any change in ownership

by a sole proprietor or general partner which introduces a new party to this class of ownership shall constitute a sale in whole or part;

- Written approval from the Department (and HUD, if applicable) for transfer of ownership. Note: A recorded assumption agreement in which the Department is a party, meets this requirement;
- All correspondence related to release of surplus cash, audit questions and financial requirements to make repairs or improvements;

Tenant Eligibility

The Department's Loan Documents contain specific eligibility requirements that may be based on income, family composition, and similar criteria. The criteria are contained in the Regulatory Agreement, and for the most part, on the tenant eligibility forms maintained at the project.

Audit Compliance Requirement Questionnaire

Appendix 1 of this Audit Guide is an Audit Compliance Requirement Questionnaire (the "Questionnaire) which is provided to assist the CPA in the audit of compliance matters which are of particular interest to the Department. While the Questionnaire may reveal conditions of internal control, it is not to take the place of internal control testing documentation the auditor employs in the standard conduct of the audit in accordance with AICPA standards. The questionnaire has been designed so that "No" answers indicate an adverse condition which must be described in the Auditor's Report if they have a material effect. The CPA should also cite other conditions which constitute weaknesses as disclosed by the Questionnaire and/or the process of conducting the audit.

The Questionnaire must be made a permanent part of the CPA's working papers which may be subject to review by the Department. If any adverse conditions are found, a copy of the Questionnaire must be provided to the Department as part of the Auditor's Report.

APPENDIX 1 - Audit Compliance Requirement Questionnaire

This Questionnaire is to be completed and retained in the Auditor's file.
All adverse conditions must be reported in the Auditor's Report.

Answers to these questions should be based upon a review of procedures and/or an actual test of transactions. "No" answers are indicative of an adverse condition which must be described in the audit report unless the borrower has written permission from the Department to deviate from the regular Mortgage requirements. The work performed by the CPA is to be done on a test basis. All questions must be answered whether or not material.

EXAMINATION ITEM		Yes, No or N/A (not applicable)	Were "No" Answers - corrected by Date of Audit report?
1	Mortgage Status		
a.	Are payments on the Mortgage current?		
b.	Were property taxes paid in full in November?		
c.	Was property insurance paid in full when due?		
d.	Were escrow deposits held by Loan Servicer at FYE, if continued at monthly assessment, as determined by Loan Servicer, be sufficient to pay the insurance premium one month before premium is due, also will sufficient funds be available on October 15th to pay full property taxes and assessments when due next November 15th?		
e.	Has any deficiency in escrow deposits been deducted from the surplus cash calculation?		
f.	Were deposits to the Replacement Reserve Account current, including interest paid in?		
g.	Were all distributions from the Replacement Reserve Account authorized by the Department?		
h.	Has all interest earned by the Replacement Reserve Account been retained in the Replacement Reserve Account? (Note: All projects for which the initial application request was submitted to HUD on or after 2-29-80 must comply.)		
i.	Is the balance shown for replacement reserves in the Balance Statement confirmed by the Loan Servicer?		
j.	If "other financing" agreements have been executed, did the Department approve these?		

EXAMINATION ITEM		Yes, No or N/A (not applicable)	Were "No" Answers - corrected by Date of Audit report?
2	Books and Records		
a.	The books, contract, records, documents and other papers relating to the property, the project and its operation are to be maintained in reasonable condition for proper audit as prescribed by the Department in written directions to specific projects as may be agreed to from time to time. Was there an adequate audit trail?		
b.	Does the borrower make frequent posting (at least monthly) to the ledger accounts?		
3	Cash Activities		
a.	Are all cash receipts deposited in the name of the project in a bank whose deposits are federally insured by FDIC?		
b.	Are security deposits kept separate and apart form all other funds of the project in an interest bearing account?		
c.	Does the borrower keep sufficient funds in the security deposit account to equal or exceed the aggregate of all outstanding obligations to the depositors?		
d.	Have all refunds of security deposits included interest earnings for the period of that deposit? (Note: All projects with A-HAPs signed by HUD on or after 2/29/80 must comply.)		
e.	Did cash disbursements exclude payments for:		
	i. Legal expenses incurred in the sale of Entity interests?		
	ii. The fee for the preparation of a partner's, shareholder's, corporation's, or individual's federal, state or local income tax returns?		
	iii. Advice to an owner on tax consequences of foreclosure?		
	iv. Reimbursement to the owners or affiliates while the Mortgage is in default, under modification, forbearance, or provisional workout arrangements for prior advances, capital expenditures and/or project acquisition costs? (Not applicable if owner has prior written approval from the Department.)		

	EXAMINATION ITEM	Yes, No or N/A (not applicable)	Were "No" Answers - corrected by Date of Audit report?
f.	Were distributions made to or on behalf of the owners limited to those authorized by the Loan Documents or in accordance with prior written approval of the Department while the project was in a "surplus cash" position? - *Note: (1) Projects operating under a modification or forbearance agreement are not in a "surplus cash " position; and (2) the use of rental proceeds to pay for costs included in the borrower's cost certification are unauthorized distributions of project income.*		
g.	Does the borrower have a formal collection policy?		
h.	Is the collection policy enforced?		
i.	Were all accounts or notes receivable from tenants less than 30 days old?		
j.	Do tenant accounts receivables consist exclusively of amounts due from other than employees unless authorized by the Department?		
k.	Have "write-offs" of tenants' accounts been less than 1% of gross rent?		
l.	Are other than tenants' accounts receivable composed exclusively of amounts due from unrelated persons or firms?		
m.	Were there indications that payments for services, supplies, or materials were comparable to amounts normally paid for such services?		
4	Management Agreement		
a.	Has the Management Agreement been approved by the Department?		
b.	Was compensation to the management agent limited to the amounts prescribed in the Management Agreement?		
5	Rents and Occupancy		
a.	Were individual units charged rents in accordance with the Department approved rental schedule?		
b.	Were rentals or leases to tenants made for periods of at lease 30 days or more?		
6	Expenses		
a.	Are expenses reasonable and necessary?		
7	Capital Items		
a.	Were Capital Items (as defined by the Loan Documents) purchased with Department approval as required by the Loan Documents?		

	EXAMINATION ITEM	Yes, No or N/A (not applicable)	Were "No" Answers - corrected by Date of Audit report?
	Future Liabilities		
a.	Does the project, if qualified for property tax abatement or any other special tax assessment, show the future liability in the notes to financial statements including a calculation of what the current tax would have been if paid?		
b.	Does the project indicate in the notes to Financial Statements when a future liability will become effective?		
9	Financial Stability		
a.	Does the project show the ability to meet its financial obligations as a going concern?		
10	Insurance Coverage - The maximum deductible for any loss, for all-risk property insurance is $2,500 for projects with 10 or less units, and $10,000 for projects with more than 10 units. The Department must approve any exceptions in writing.		
a.	Is the project covered against loss of rents as required by the Department?		
b.	What is the actual deductible amount as shown for the insurance policy now in effect?		
c.	If the effective deductible amount is in excess of the allowable amount, has the Department approved the excess?		
d.	If the effective deductible amount is in excess of the allowable amount, has the project set-up a special fund for this?		
e	If there is a special fund, has it been assigned to the Department?		
f.	If "no" to number (d.) above, or if deductible amount is insufficient, has the excess been deducted in the calculation of surplus cash?		
11	Ownership		
a.	Has the ownership of the project remained the same, since last year? - Note: A change in ownership includes, but is not limited to: an entity name change, transfers to trusts, death of an owner, divorce of an owner, merger, sale of stock, adding or removing a member of the entity, and any deeded change of interest or modification of entity documents such as partnership agreements. Refer to Audit Guide "Transfer of Interest in Ownership (Definitions) for more information.		

b.	Has the ownership of the project kept current with the Oregon Secretary of State, Corporation Commission?		
EXAMINATION ITEM		Yes, No or N/A (not applicable)	Were “No” Answers - corrected by Date of Audit report?
12	Surplus Cash Limitations		
a.	Were any deferred maintenance and repair items deducted when calculating surplus cash?		
13	Release of Surplus Cash		
a.	Were distributions of surplus cash made following the receipt of authorization from the Department?		
14	New Liens or Encumbrances		
a.	Was the condition of title unchanged except as approved in writing by the Department? (If approved, provide date of Department approval.) Date approved:		
15	Completion of Audit in Timely Manner		
a.	Was the audit completed within the submission requirements of the loan program (60 days from the FYE for Elderly/Disabled or 90 days from the FYE for Risk Sharing), as otherwise allowed by the Loan Documents, or as extended in writing by the Department?		

APPENDIX 2 – Surplus Cash Calculation

PROJECT NAME: ______________________

PERIOD COVERED: From: ______ To: ______

CASH:

1	Cash (on hand & in unrestricted accounts)		
2	Resident Security deposits		
3	Rent Receivable (for period covered that was not collected by month-end, but has since been collected)		
4	Other (describe)		
	(a) TOTAL CASH		$0.00

CURRENT OBLIGATIONS:

5	Accrued mortgage interest payable (from date of last payment through the end of the month-usually 15 days)		
6	Accounts Payable		
7	Accrued expenses due (excluding OHCS loan)		
8	Short term notes due within 30 days		
9	Prepaid rents		
10	Resident security deposit liability		
11	Mortgage Tax & Insurance Reserve deficiency		
12	Delinquent mortgage principal payments		
13	Delinquent deposits to Reserve for Replacements		
14	Other (describe)		
	(b) TOTAL CURRENT OBLIGATIONS		$0.00

SURPLUS CASH (line a less line b) $0.00

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Prepared by: Authorized Signer for Project:

Date: ______________________________

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Surplus cash as calculated above (or amended) is hereby authorized for distribution.

OREGON HOUSING AND COMMUNITY SERVICES

By:______________________________ Date:____________________