



OFFICE OF MULTIFAMILY HOUSING ASSISTANCE RESTRUCTURING

U. S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

The Portals Building  
1280 Maryland Avenue, SW, Suite 4000  
Washington, DC 20024

February 23, 2004

Owner  
Address  
Address  
Address

***Subject: Mark to Market Full Restructure Financial Reporting and Compliance***

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

As you may be aware, OMHAR routinely reviews property operations and financial reporting because of the importance of cash flow and surplus cash to the payments on HUD-held subordinate debt. During the course of this review questions have come up, or we have noted financial reporting presentations that indicate a need to discuss some of the changes resulting from the restructured mortgage and new mortgage, notes, regulatory agreements and riders. These questions and answers address questions arising from the new regulatory and debt structure and should be helpful as you prepare to file your Annual Financial Statement in the coming months.

***1. Q: If a post-M2M property has negative Surplus Cash at the end of its fiscal year, what happens?***

There are several impacts. No Incentive Performance Fee (IPF) is earned, accrued, or paid to the Owner for the year just ended. No payment is due under the Mortgage Restructuring Note (MRN) or Contingent Repayment Note (CRN) for that year. Finally, it is possible that the property may not meet the preconditions for continued payment of Capital Recovery Payments (CRPs).

***2. Q: What are the preconditions for CRPs and IPFs to be earned and paid?***

The following paraphrases the Regulatory Agreement Rider; see the Rider for the exact wording: (a) all project expenses have been paid; (b) all required payments have been made on the Mortgage Restructuring Note and on any 1<sup>st</sup> mortgage; (c) the most recent REAC physical inspection score is 60 or above; (d) there are no outstanding HUD audit or management findings; and (e) the owner is not in default under any of the key governing documents such as the Regulatory Agreement. As noted elsewhere, in addition to these general performance and compliance criteria, IPF is earned and paid only from positive Surplus cash.

***3. Q: Say that the M2M closing occurs on October 10<sup>th</sup>. Is the owner eligible to receive a Capital Recovery Payment (CRP) on November 1?***

No. The first CRP that the owner may receive (provided all preconditions for payment have been satisfied) would be the December 1 CRP. No CRP is allowed for the partial month in which the M2M closing occurs.

**4. Q: If the CRP is not payable, due to lack of sufficient cash or failure to meet performance criteria, how is it treated from an accounting standpoint?**

Accrued and unpaid CRPs should be listed as obligations on the Surplus Cash calculation; there is no surplus cash until those have been covered.

**5. Q: For the year in which the M2M closing occurs, how is the Incentive Performance Fee (IPF) calculated?**

The IPF is calculated based on the Effective Gross Income for the period beginning the day after the M2M closing and continuing through year-end. Owners who claim an IPF for the partial year in which the M2M closing occurs must include a computation of partial year Effective Gross Income (EGI) in the notes to the audited financial statements.

**6. Q. How is EGI calculated?**

Effective Gross Income is:

- Gross Potential Rents (FASS account 5100T Total Rent Revenue, but excluding FASS accounts 5180 Flexible Subsidy Revenue and FASS account 5191 Excess Rents);
- Minus Vacancy and Bad Debt (FASS account 5200T Total Vacancies plus FASS account 6370 Bad Debt)
- Plus Other Income (FASS account 5900T Total Other Revenue, but excluding FASS account 5945 Interest Reduction Payments Revenue).

Note: FASS account 5400T Total Financial Revenue is not included in EGI because these line items were not included in the M2M underwriting and because (for the most part) this represents interest income on the Reserve for Replacements that is not available for operations.

**7. Q. If an IPF is earned for the year, how should it be reflected in the annual financial statements?**

Do not reflect the IPF as an obligation on the Surplus Cash schedule; instead, the IPF is calculated on the Surplus Cash schedule (FASS S1300-203). The IPF should be shown as an expense on the Profit and Loss Statement (FASS 7115) and as an accrued liability on the balance sheet (FASS 2190 Miscellaneous Current Liabilities).

**8. Q. How does the owner document the distribution of Surplus Cash after M2M?**

The actual payment of Capital Recovery Payments, payment of Incentive Performance Fees, and/or payments on the Mortgage Restructuring Note / Contingent Repayment Note must be reflected in the Statement of Changes in Financial Condition in the audited financial statements for the year in which payment was made. In addition:

- Any CRPs that were due but not paid as of year-end (for example, because the REAC physical inspection score was too low) must be reflected as liabilities on the balance sheet.
- Any IPF that was earned for the year (to be paid to the Owner in cash after completion of the audited financial statements) must be reflected as an expense on the Profit and Loss Statement.

- The proposed distribution of positive year-end Surplus Cash must be reflected on Part B of the Surplus Cash Schedule in the audited financial statements.

OMHAR recommends that accountants include in the audited financial statements an explanation of how any IPF was calculated, and an explanation of how any Mortgage Restructuring Note / Contingent Repayment Note payment was calculated.

**9. Q: *How are Mortgage Restructuring Note payments calculated?***

Start with audited positive Surplus Cash. Subtract any IPF that was earned for the year just ended. Any remaining positive Surplus Cash is divided between the Mortgage Restructuring Note and the owner according to a percentage determined by the PAE, approved by OMHAR, and documented in the Mortgage Restructuring Note (and subject to all other applicable HUD requirements). If no IPF is payable for the year, all positive Surplus Cash is split between the MRN and the owner. By statute, the percentage due on the Mortgage Restructuring Note cannot be less than 75%.

**10. Q. *Will HUD read footnotes and explanations regarding post-M2M accounting treatments?***

HUD and its servicer find supplemental information very valuable in understanding the accounting treatments. Such information may forestall questions and accountants are encouraged to make use of the opportunity to provide explanations.

On an entity basis, the new OMHAR Regulatory Agreement, Notes and Riders cause very few changes to property accounting. The changes made, however, are important to owners and HUD because they implement new incentives and provide for payment on subordinated debt created in the M2M process. It is important that all parties understand how to properly implement and account for these incentives and obligations. This guidance is offered as a resource in that regard.

Sincerely,

Charles H. Williams  
OMHAR Director