

# REAC Session

What's Still Important to HUD



# Today's Menu

- HUD's Role in Housing
- Project Operating Environment
- HUD Regulatory Agreement
- DEC Referral Flags
- REAC Perspective on Compliance

# HUD as Insurer

- HUD functions as an insurance company and a hands-on underwriter of the insurance commitment for mortgage loans funded by commercial lenders, under Sec 221, 223, and 236.
- HUD is directly involved in the underwriting of multifamily housing for low and moderate income families, elderly and disabled families, and a broad array of housing for older Americans, including nursing homes, and intermediate care facilities, funded under Sec 232.



# HUD as Lender



- HUD is the funding source for the capital advance programs, i.e. Sec 202 & 811.
- Older Sec 202 direct loan programs, often with Sec. 8 subsidy
- These multifamily direct loan and capital advance programs are also part of today's discussion.

# HUD as Subsidizer

- Section 8 is the dominant rental assistance program for federally assisted multifamily housing
  - Sec 8 New Construction
  - Sec 8 Substantial Rehabilitation
  - Sec 202 Capital Advance (PRAC)
  - Sec 811 Capital Advance (PRAC)

# HUD as Insurer or Lender

- HUD as Insurer or Lender desires to protect its interest in the Project (bricks & mortar) and Project Assets (cash & reserves)
- HUD seeks to protect the project and its assets thru the Regulatory Agreement signed with the Owner

# HUD as Partner (and Risk Assumer)

- The Regulatory Agreement restricts Owner's actions and requires compliance with its provisions
- The Agreement forms the basis for compliance requirements in the HUD audit guide
- HUD approval is required for most Owner actions involving the Project and Project assets

# HUD's Role in Housing

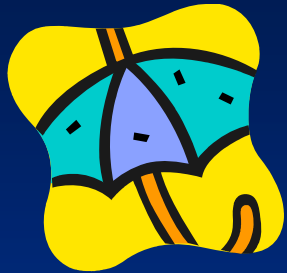
- Insured Loans
- Sec 221 (d)(3)
- Sec 221 (d)(4)
- Sec 236
- Sec 232
- Sec 223(f)
- Direct Loans
- Sec 202
- Sec 811
- Capital Advances
- Sec 8 Tenant Subsidy
- PRAC Subsidy

# Project Operating Environment: Key Concepts

- Owning Entity vs. Project
- Relationship between Owner & Agent?
- Services provided by Agent?
- Entity Cash vs. Project Operating Cash
- As the Insurer/Lender of the loan, HUD wishes to protect the bricks & mortar as well as project assets, both cash & non-cash.

# Project Operating Environment

## HUD Regulatory Agreement



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Entity

G.P.

Management Agent

Project

Agent

\$\$

Operating \$  
Security Dep.  
R4R  
Res. Rec.

-Landscaping  
-Decorating  
-Supplies



# Hierarchy of HUD Requirements

- Regulatory Agreement
- Use Agreement
- Subsidy Contract
- HUD Program Handbooks
- Housing Notices
- Mortgagee Letters

# HUD's Regulatory Agreement

- There are several types of agreements and at least six are listed on HUDClips
- Regulatory Agreement from 2002
- Reg Agreement for Capital Advance programs
- Reg Agreement for Leased Nursing Home
- And there are Riders to Reg. Agreements
- Don't forget the Section 8 contract provisions either, noting the addition AFS requirement
- These form the basis of the HUD Audit Guide

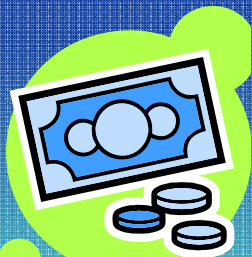
# Protecting the Project (DEC Referral Flags)

- Mortgage Status
- Reserve for Replacement
- Unauthorized Change in Project Ownership
- Disposal of Project Assets



# Protecting Project Assets (DEC Referral Flags)

- Distribution of Project Assets
- Loans from Project funds
- Underfunded Security Deposits
- Commingling of funds



# Departmental Enforcement Center

- It was created at the same time as the REAC
- The DEC focuses on assuring the highest standards of ethics, management and accountability in the resolution of HUD's troubled properties
- Their primary goal is to bring owners to full compliance so that there is no compromise in the quality of America's housing
- In instances where owners fail to bring properties up to standard, and where physical and financial deficiencies persist, the DEC can take appropriate enforcement action
  - administrative sanctions
  - civil money penalties
  - suspension and/or debarment
  - referral to the Department of Justice for civil action

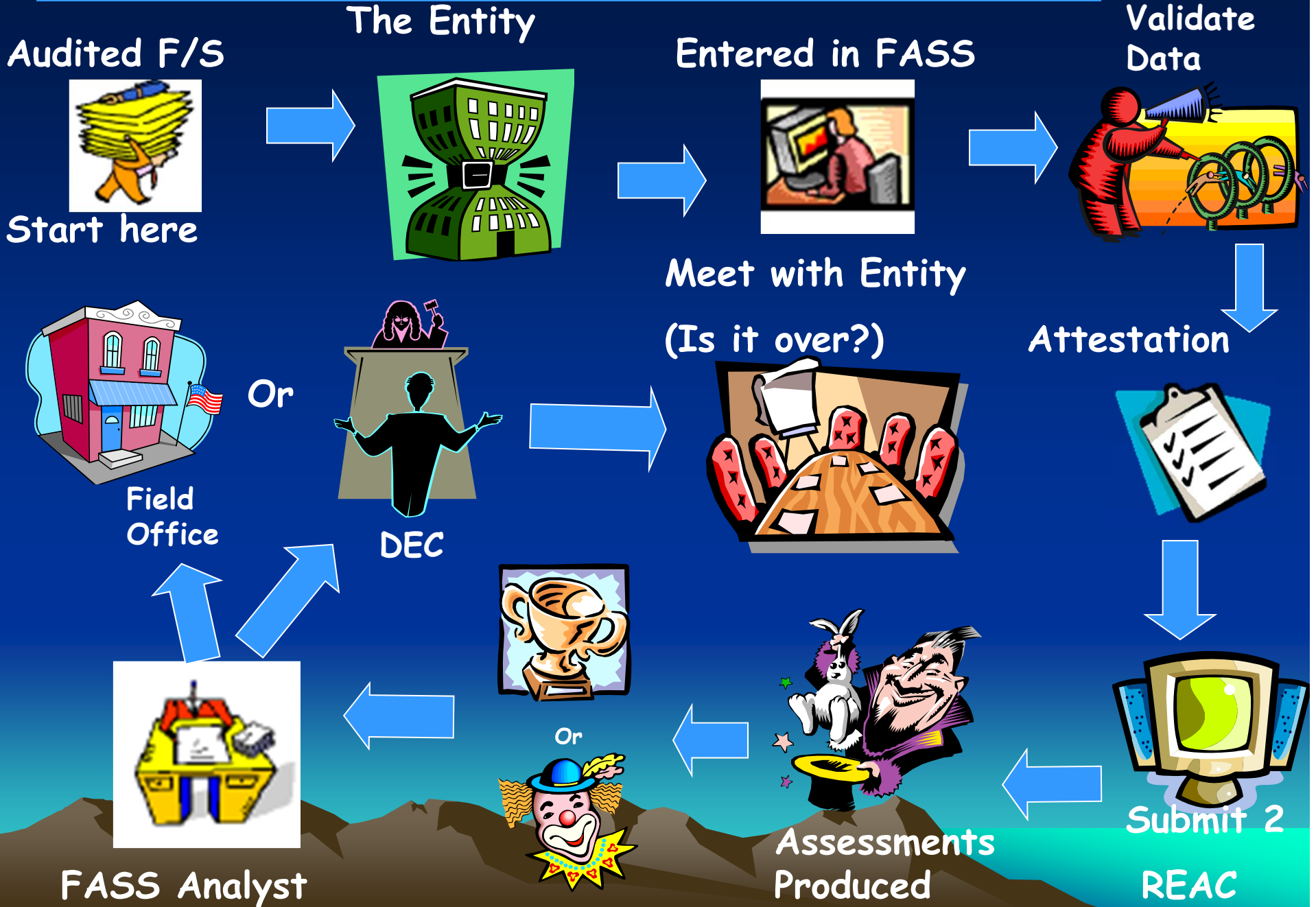
# Materiality

- As part of the planning process, auditors should consider materiality, among other matters, in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures

# Materiality

- Materiality is established and applied based on the governmental audit requirement
- Consider quantitative factors and qualitative factors and the risk to HUD in select areas, e.g., UAD, UAL, R4R
- Option: consider the DEC referral areas as material
- Option: consider the areas where OIG has identified equity skimming as material

# REAC Financial Assessment Process



# Most Popular Compliance Flags

1. Unauthorized Distributions
2. Unauthorized Loans
3. 'Other' Auditor Findings - Code Z
4. Failure to make R4R Deposits
5. Acquisition of Liabilities
6. Failure to make Res. Rec. Deposits
7. Underfunded Security Deposits

# Computation of Surplus Cash

- Surplus cash is a HUD concept and calculation
- It is based on balance sheet information
- Surplus Cash equals “Total Cash” less “Total Current Obligations”
- Why it’s done
- Is it required of all projects?

# Computing Project Cash

- What's Included
  - Operating Cash
  - Short Term Investments
  - Tenant Security Deposits
  - A/R-HUD
  - A/R-Medicare/Medicaid
  - Approved but not received R4R reimbursements
  - Other HUD backed receivables
- Do Not Include
  - Entity/Construction Cash Accounts
  - Tenant Accounts Receivable
  - Accounts/Notes Receivable from Related Parties
  - Insurance Receivables
  - Escrow Deposits

# Computing Current Obligations

- Accrued Mortgage Interest Payable
- Delinquent Mortgage Principal Payments
- Delinquent Deposits to R4R
- Delinquent Escrow Deposits
- Project Accounts Payable due within 30 days
- Accrued Expenses due within 30 days
- Prepaid Revenue
- Tenant Security Deposits
- Delinquent Residual Receipts Deposits
- PY Delinquent R4R Deposits

# Surplus Cash

- For Profit Motivated Projects: equals the amount available for distribution in the next fiscal period
- For Nonprofit Projects: equals the amount due to the Residual Receipts Account
- For Limited Dividend Projects: Part B of the Computation should be completed to determine distributions and residual receipts deposits

# Unauthorized Distributions

Per the Regulatory Agreement:

- *‘Owners shall not without the prior written approval of the Secretary: Make, or receive and retain, any distribution of assets or any income of any kind of the project except surplus cash and except on the following conditions:’*

# More on HUD's Perspective

- Any withdrawal or taking of cash for purposes other than the payment of reasonable & necessary expenses is a distribution (per HB 4370.2)
- For REAC, this results in referral to either a HUD Field Office or the Enforcement Center and maybe to QASS as well

# OK to Take a Distribution When

- There is Surplus Cash available from the prior accounting period.
- Construction has been completed.
- All cost certification submissions are complete.
- Project is in good repair & condition.

# Not OK to Take Cash

- When there's No Surplus Cash
- From borrowed funds
- Prior to completion of Project
- When the Project is in default
- While the Project is under a forbearance agreement

# HUD Considers these as UAD

- Unauthorized
  - Distribution of any Project Assets
  - Loans from Project Funds
  - Acquisition of Liabilities
  - Management Fees
  - Withdrawals from Residual Receipts
- Remember the Operating Environment

# Always a UAD Finding...

- If these are paid from the project operating account:
  - Any Distributions
  - Entity Expenses (e.g. legal fees, asset management fees, syndication fees, general partner fees)
  - Loan Payments on Notes whose terms restrict payments to Surplus Cash

# Case Study on UAD

- What does the 2001 CSC show?
- What does the 2002 Cash Flow show?
- What do the 2002 Notes show about the General Partner?

# Another Frequent Finding: Unauthorized Loans

- Definition: An unauthorized distribution that appears on the balance sheet as a receivable.
- Results in referral to either a HUD Field Office or the Enforcement Center and maybe to QASS as well

# HUD Takes an Extra Look at:

- Overpayments of management fees & distributions
- Advances of project cash
- Loans to employees or owners
- Loans to other projects or businesses.

# Unauthorized Loans

- What is the purpose of the receivable?
- OK if it's from a
  - Reserve Release
  - Insurance Settlement
  - Grant Award
  - Lawsuit Settlement
  - Vendor Overpayment
- REAC tries to determine the reason from the Notes. Occasionally, they can.

# Unauthorized Loans

- Receivables that are not OK
  - Due from Related Parties
  - Due from Other Projects or Businesses
  - Due from the Management Company
  - Due from Partners/Owners (unless it's from syndication or equity contribution)

# Case Study on UAL

- Court Apartments 2/31/03
- Ignore the auditor finding
- The unauthorized loan flag was caused by several receivable and other asset accounts
- Determine who owes the money and where it should be referred

# Replacement Reserve

- Investment of Reserve in interest bearing account is of renewed interest to HUD, including disposition of interest
- See HB 4350.1, Chapter 4 on programs requiring investment with interest
- Any changes to HUD required monthly amount?
- Sampling required for R4R repair disbursements. Sampling unit?
- How the REAC system does its assessment

# Replacement Reserve (HB 4350.1, Ch 4)

- HUD requires interest earned to remain in the account for the following programs:
  - Sec 236
  - Sec 221 d3 BMIR
  - Sec 221 d3 Rent Supplement or Sec 8
  - Sec 223 f
  - Any insured project with an Operating Loss Loan
  - NC & SR Projects with HAPs executed after 1979 & 1980, respectively.

# More R4R Guidance

- HUD does not establishing specific liquidity requirements for the Reserve Fund for Replacements.
- The mortgagor, not the mortgagee, is responsible for deciding the liquidity requirements of funds held in the Reserve Fund.
- The mortgagor should maintain some portion of its reserves in the form of very liquid assets such as passbook savings accounts.

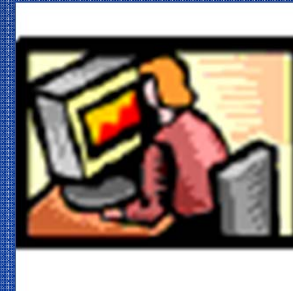
# Case Study on Mortgage & R4R

- Is the Reserve for Replacement flag valid?
- Is Failure to Make Mortgage Payments Valid?
- What else do you see?
- No evidence of a HUD-approved workout agreement

# How to Reach REAC



- *REAC Web Site:*  
[www.hud.gov/offices/reac](http://www.hud.gov/offices/reac)

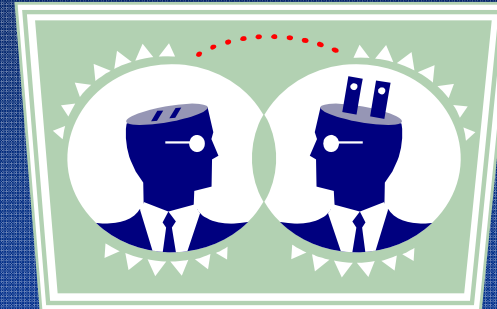


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