
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 Program¹ 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 "mortgagor²" 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/hsg

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 mortgage⁵, the regulatory agreement (HUD-92466-OHF⁶), 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 statements⁷. 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.

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- C. Issue all additional auditor prepared⁹ 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 agreement¹⁰ 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 balance¹¹, 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. Suggested Audit Procedures.

- 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 cash¹² and then only under certain conditions. Similar restrictions apply to distributions to related entities or activities excluded from the mortgage. 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 mortgage 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. Suggested Audit Procedures.

- 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 conditions¹³ 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. Suggested Audit Procedures.

- 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.

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- 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. Suggested Audit Procedures.

- 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.

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- 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 interest¹⁵ 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.

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- f. Make inquiries of management whether form HUD-2530 “*Previous Participation Certification*” was filed and approved in electronic or paper form for each new principal¹⁶ 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.

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- 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 expense¹⁷. 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.