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## CHAPTER 4. HUD Multifamily Hospital Program

- 4-1. Background.** This chapter contains the U.S. Department of Housing and Urban Development's (HUD) requirements for conducting annual financial audits of entities participating in the profit-motivated and limited-distribution HUD multifamily hospital program.

Separately, practitioners with nonprofit clients who participate in Federal Housing Administration (FHA)/HUD programs covered by the Single Audit Act should conduct financial audits in accordance with Office of Management and Budget (OMB) Circular A-133 and the associated compliance supplement.

- 4-2. Reporting Requirements.** The regulatory agreement incident to the insured mortgage **requires the annual submission of audited financial statements, prepared in accordance** with the requirements of the Secretary, within 90 days after the end of the fiscal year. In addition to the basic financial statements of the housing project, the auditor is required to submit a report on the consideration of internal controls and a report on compliance with specific requirements as well as supplemental data reports. These statements must be certified to be accurate by the mortgagor when the project is owned by an individual. They should be certified by two general partners when the project is owned by a partnership or by two officers when owned by a corporation. When circumstances prohibit the ideal number of partners' or officers' certifying signatures, explanatory information should be provided with the audit report. These statements must also be certified to by the chief executive officer of the management agent when applicable. The report shall include the employer identification number assigned by the Internal Revenue Service. This number must be entered below the partner or corporate signatures. The report should include the following basic financial statements plus supplemental data prepared in accordance with Real Estate Assessment Center (REAC) instructions.

The auditors' role is to conduct and report the results of their audits in accordance with generally accepted auditing standards (GAAS) and generally accepted government auditing standards (GAGAS). It is the owner's responsibility to file an accurate electronic submission with HUD's REAC. In that regard, the independent auditor shall

- A.** Issue an independent auditor's report (refer to chapter 2, example A) on the ownership entity's basic financial statements. This report should cover the following items:
- Balance sheet,
  - Statement of income,

- Statement of changes in partner's capital,<sup>1</sup>
  - Statement of cash flows, and
  - Footnotes to the basic financial statements including descriptions of accounting policies.
- B. Issue an independent auditors' report (refer to chapter 2, example A) on the supplemental information. This report may be added to the auditor's report on the basic financial statements or may appear separately in the auditor-submitted document.<sup>2</sup>
- C. Issue the additional reports described in chapter 2.

#### 4-3. **Compliance Requirements and Audit Areas.**

##### A. **Federal Financial Reports.**

1. **Compliance Requirement.** Projects participating in HUD-assisted activities are required to ensure that financial status reports contain reliable financial data and are presented in accordance with the terms of applicable agreements between the entity and HUD. The individual agreements contain the specific reporting requirements that the entity is to follow.
2. **Suggested Audit Procedures.**
  - a. Identify all required financial reports by inquiry of the owner/manager.
  - b. Obtain an understanding of the auditee's procedures for preparing and reviewing the financial reports.
  - c. Select a sample of financial reports, other than those that are included in the audited financial statements, and determine that the reports selected are prepared in accordance with HUD instructions.
  - d. For the sample, trace significant data to supporting documentation, i.e., worksheets, ledgers, etc. Report all material differences between financial reports and project records.
  - e. Review significant adjustments made to the general ledger accounts affecting HUD-assisted activity and evaluate for propriety.

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<sup>1</sup> Or similarly titled report based on the type of participating ownership entity. For example, if a limited liability company owns the property, a "statement of changes in members' equity" should be opined upon.

<sup>2</sup> Refer to *AICPA Professional Standards, Volume 1, U.S. Auditing Standards*, AU §551.06 e.

- f. For a Section 236 interest reduction payment subsidy project, obtain a sample of the monthly reports of excess income for the period under audit and test the accuracy. Reconcile any differences. Report any delinquent unremitted excess income of the project as of the end of the period under audit as a finding. Determine whether the owner has approval to retain excess income. If the owner is under a repayment plan for delinquent excess income, determine compliance with the plan.

**B. Fair Housing and Nondiscrimination.**

1. **Compliance Requirement.** Management and owners are prohibited from discriminatory practices in accepting applications, renting units, and designating units or sections of a project for renting to prohibited bases of the Fair Housing Act and according to the regulatory agreement.
2. **Suggested Audit Procedures.**
  - a. Obtain a copy of the owner's approved affirmative fair housing marketing plan if applicable to the project.
  - b. Inquire of the owner/manager as to policies and procedures relating to marketing of the units; processing, approving, and rejecting applications, including determining that applicants are processed and selected in appropriate order; and providing reasonable accommodation to applicants and tenants with disabilities in accordance with the requirements of applicable federal civil rights laws.
  - c. Test whether procedures were placed in operation as established by management through inquiry and examination of documentary evidence.
  - d. Review a sample of correspondence files for applications rejected, including documented reasons for valid rejections, or tenants evicted and legal invoices for any evidence of litigation or potential litigation related to discriminatory rental practices.
  - e. Determine that the HUD-approved equal housing opportunity logo, slogan, or statement is displayed in marketing materials.

**C. Mortgage Status.**

1. **Compliance Requirement.** Owners shall promptly make all payments due under the note and mortgage (regulatory agreement).
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**2. Suggested Audit Procedures.**

- a. Read the mortgage note, mortgage (or deed of trust), and associated loan amortization schedule to determine the terms and conditions of those agreements. Obtain an understanding of the owner's procedures for assuring prompt payment of the mortgage
- b. Obtain or prepare a schedule of the client's mortgage and escrow payments and withdrawals for the reporting period. The schedule should include the amount, by escrow item, and date each item was paid or disbursed.
- c. Verify that the monthly mortgage and escrow payments were made.
- d. Confirm the outstanding loan balance and annual escrow account activity with the loan servicer as of the client's fiscal year end. Determine whether payments on the notes are current at the reporting entity's fiscal year end. (Note: The auditor should use alternative procedures to satisfy this requirement if the auditor considers the confirmation process unreliable or impractical.)
- e. If the project is operating under an agreement (mortgage modification agreement, workout agreement, forbearance agreement, use agreement, etc.), test whether the owner is complying with the terms and conditions.

**D. Replacement Reserve.**

- 1. **Compliance Requirement.** Owners of profit-motivated and limited-distribution properties shall establish a reserve for replacement account and make deposits in accordance with HUD requirements. Disbursements from such fund may be made only after receiving written consent from HUD (source: HUD regulatory agreement).

**2. Suggested Audit Procedures.**

- a. Obtain an understanding of the project owner's procedures, including the regulatory agreement (and any amendments or other written agreements with HUD) for establishment and maintenance of the fund and for making approved disbursements from the reserve fund.
- b. Determine that the reserve fund has been established in a federally insured depository approved by the mortgagee and that interest was

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retained in the account and test whether the conditions were met for the funds not federally insured for the period.

- c. Using the schedule prepared for the mortgage status compliance requirement, verify the reserve for replacement account activity for the reporting period for compliance with the client's regulatory agreement.
- d. Verify that deposits were made into the replacement reserve.
- e. Trace disbursements from the reserve for replacement account to the associated HUD approval form and canceled invoices. Trace to the client's general ledger, monthly (or annual) mortgage statement(s), and the schedule prepared above. Determine whether sampled disbursements were authorized by HUD and used for the purpose authorized by HUD.
- f. Confirm the account balance and annual reserve for replacement account activity with the loan servicer as of the client's fiscal year end. (Note: The auditor should use alternative procedures to satisfy this requirement if the auditor considers the confirmation process unreliable or impractical.)

**E. Residual Receipts.**

- 1. **Compliance Requirement.** Owners of limited-distribution properties shall establish a residual receipts account and make deposits into the account in accordance with HUD requirements. Disbursements from such fund may be made only after receiving written consent from HUD (source: HUD regulatory agreement).
- 2. **Suggested Audit Procedures.**
  - a. Read the client's regulatory agreement (and any amendments) to determine the client's requirements for making deposits into the residual receipts fund. Normally, program participants are required to deposit "surplus cash" into the account within 60 days after the end of each fiscal year.
  - b. Determine that the prior year's amount required to be deposited to the residual receipts fund was calculated correctly and deposited within 60 days of the close of the fiscal year.
  - c. Using the schedule prepared for the mortgage status compliance requirement, verify the residual receipts account activity for the reporting

period for compliance with the client's regulatory agreement.

- d. Verify that deposits were made into the residual receipts account.
- e. Trace disbursements from the residual receipts account to the associated HUD approval form and canceled invoices. Trace to the client's general ledger, monthly (or annual) mortgage statement(s), and the schedule prepared above. Determine whether disbursements were authorized by HUD and used for the purpose intended.
- f. Confirm the account balance and annual residual receipts account activity with the loan servicer as of the client's fiscal year end. (Note: The auditor should use alternative procedures to satisfy this requirement if the auditor considers the confirmation process unreliable or impractical.
- g. Test whether established procedures for deposit of cash receipts into a federally insured bank are being followed through inquiry and examination of documentary evidence.

**F. Distributions to Owners.**

- 1. **Compliance Requirement.** Owners of profit-motivated and limited-distribution properties are not allowed to make or receive and retain any distribution of assets or any income of any kind of the project except surplus cash. Surplus cash distributions can only be made as of and after the end of a semiannual or annual fiscal period. Surplus cash distribution 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 allowable distribution for limited-distribution owners is further restricted to a percentage of the owner's initial equity investment as described in the regulatory agreement or subsequent HUD-approved agreements.
- 2. **Suggested Audit Procedures.**
  - a. Read the client's regulatory agreement (and any amendments or associated documents) to determine the client's requirements for receiving distributions.
  - b. Inquire of management about the existence of any notices of default under any of the terms of the regulatory agreement and read any notices.
  - c. Inquire of management about the payment of distributions during the reporting period. Conduct follow-up or corroboration of management's

responses as considered necessary.

- d. Read the minutes of partner meetings held during the reporting period for evidence of any discussions about distributions.
- e. Scan cash disbursements for evidence of payments made to the project owners. Trace payments and determine whether they are allowable under the terms of the regulatory agreement.
- f. If applicable, determine that surplus cash computations were prepared in accordance with HUD criteria.

**G. Tenant Application, Eligibility, and Recertification.**

- 1. **Compliance Requirement.** Owners who participate in HUD's rent subsidy programs are responsible for accepting applications, correctly calculating the tenant's contribution toward rent and utilities, and correctly calculating any subsidy. They are also responsible for determining initial tenant eligibility, annual recertification of tenant eligibility, and rectifying improper or inaccurate tenant information.
- 2. **Suggested Audit Procedures.**
  - a. Compare the client's procedures for accepting applications, determining initial eligibility, total tenant payment, and reexamination of eligibility with the provisions in HUD Handbook 4350.3.
  - b. Review a sample of tenant files to determine that applications are complete and signed by the applicant, that tenants met the eligibility requirements pertaining to their subsidized unit for annual income and family composition, that the tenant payment was calculated correctly, and that the family income was reexamined on an annual basis. Include in the sample some of the oldest and some of the most recently admitted tenants.
  - c. Review a sample of tenant files for evidence of whether the owner noted any improper or inaccurate information while determining tenant eligibility or during tenant recertification. If so, determine that the owner followed the guidance in HUD Handbook 4350.3 pertaining to overpayment of a subsidy and follow up on suspected fraud.
  - d. Review a sample of tenant files to determine that the tenant file contains the following documents:

- (1) Application;
  - (2) Required verifications of Social Security numbers, disability status, waiting list preferences, income, and allowances for adjusted income;
  - (3) Lease/lease addendums in the form as required by HUD;
  - (4) Certification and recertification forms (Form HUD-50059);
  - (5) Move-in and move-out inspections; and
  - (6) Computation of tenant's contribution toward rent and utilities and the subsidized portion of the tenant's monthly rent
- e. Test Section 8 rents to ensure that those rents do not exceed the fair market rents.
  - f. Compare the amount claimed according to the housing assistance payment billing to the supporting documentation in the tenant files.
  - g. Verify the mathematical accuracy of the billing, including the accuracy of the total number of units on the bill.

#### **H. Management Functions.**

1. **Compliance Requirement.** The owner is responsible for performing management functions or contracting with a management agent to provide project management. The owner or the owner's agent must be approved by HUD to manage a project and must certify that it will follow HUD's project management regulations.
2. **Suggested Audit Procedures.**
  - a. Determine that the owner's designated management agent has obtained a fidelity bond in an amount at least equal to two months potential collections. When an agent has multiple projects, the coverage must be at least equal to two months of the highest potential collections. All principals of the management entity and all persons who participate directly or indirectly in the management and maintenance of the project and its assets, accounts, and records must be covered.

- b.** Test work orders and complaints for timely follow-up and compliance with management's procedures.
- c.** Test management's procedures for ensuring that units meet applicable housing quality standards.
- d.** Inquire whether management has conducted routine unit and general property inspections and if findings were identified, whether corrective action was taken (HUD Form 9834, part A.4).
- e.** Inquire of management about any fees charged to the project for property management services. Also inquire about whether there has been a change in the project's property management agent. Conduct follow-up or corroboration of management's responses as considered necessary.
- f.** Read a copy of the owner's latest HUD-approved management certification (form HUD-9839a, b, or c, as appropriate). Determine whether HUD has approved the current management agent.
- g.** Review the management certification to determine whether the owner has disclosed the existence of an identity of interest (item 12).
- h.** Review the management entity profile for disclosure of identity-of-interest companies.
- i.** Review the maintenance contracts and vendor invoices for identity-of-interest relationships with the owner/agent and agent/service contractor.
- j.** Test a sample of payments, including those made to identity-of-interest relationship for services, supplies, etc., to determine that the amounts do not exceed the amounts ordinarily paid for such services and supplies.
- k.** Obtain from client or prepare a schedule analyzing the fees charged to the project for management services. Trace the amounts on the schedule to the client's general ledger.
- l.** Compare the schedule created above to form HUD-9839. Determine whether the management fees charged exceed the HUD-approved amount.
- m.** Determine that there is comprehensive general liability coverage on an industry standard form, in an amount required by the project's mortgage, and that HUD is named as an additional payee in the event of loss.

**I. Unauthorized Change of Ownership/Acquisition of Liabilities.**

- 1. Compliance Requirements.** Owners of profit-motivated and limited-distribution properties shall not, without the prior written consent of HUD, convey, transfer, or encumber any of the mortgaged property or permit the conveyance, transfer, or encumbrance of such property (source: HUD regulatory agreement).
- 2. Suggested Audit Procedures.**
  - a. Inquire of management about the existence of any agreements to sell or encumber any of the mortgaged property and read any agreements.
  - b. Confirm all material debt agreements listed on the client's balance sheet. Review confirmations to determine whether a change of ownership has occurred or whether any of the mortgaged property was encumbered without HUD approval.
  - c. Review the results of the audit procedures applied to specific accounts or other general procedures to identify the existence of any unauthorized conveyance, transfer, or encumbrance of any of the mortgaged property.
  - d. Read the minutes of partner meetings held during the reporting period for evidence of any unauthorized conveyance, transfer, or encumbrance of any of the mortgaged property.

**J. Unauthorized Loans of Project Funds.**

- 1. Compliance Requirements.** Owners of profit-motivated and limited-distribution properties shall not, without the prior written consent of HUD, assign, transfer, dispose of, or encumber any personal property of the project, including rents, or pay out any funds except from surplus cash, except for reasonable operating expenses and necessary repairs (source: HUD regulatory agreement).
- 2. Suggested Audit Procedures.**
  - a. Inquire of management about the existence of any agreements to assign, transfer, dispose of, or encumber any of the personal property of the project, including rents, and read any agreements.
  - b. Review the results of the audit procedures applied to specific accounts or

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other general procedures to identify the existence of any unauthorized transactions.

- c. Read the minutes of partner meetings held during the reporting period. Highlight discussions of any unauthorized agreements to assign, transfer, dispose of, or encumber any of the personal property of the project.

**K. Unauthorized Transfer of Beneficial Interest.**

1. **Compliance Requirements.** Owners of profit-motivated and limited-distribution properties shall not, without the prior written consent of HUD, convey, assign, or transfer any beneficial interest in any trust holding title to the property or the interest of any general partner in a partnership owning the property or any right to manage or receive the rents and profits from the mortgaged property (source: HUD regulatory agreement).
2. **Suggested Audit Procedures.**
  - a. Inquire of management about the existence of any agreements to convey, assign, or transfer any beneficial interest.<sup>3</sup>
  - b. Review the results of the audit procedures applied to specific accounts or other general procedures to identify the existence of any unauthorized conveyance, assignment, or transfer of any beneficial interest of any of the owners.
  - c. Read the minutes of partner meetings held during the reporting period for evidence of discussions of any unauthorized conveyance, assignment, or transfer of any beneficial interest of any of the owners.

**L. Electronic Submission Verification.**

1. **Compliance Requirements.** Owners of profit-motivated and limited-distribution properties are required to submit electronically to HUD audited financial information in accordance with GAAP and HUD requirements (source: HUD regulatory agreement and 24 CFR [Code of Federal Regulations] Part 5, Subpart H).
2. **Suggested Audit Procedure.** Compare the client's Financial Assessment Subsystem submission from the last reporting period to the annual financial

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<sup>3</sup> Beneficial interest is generally the right to profits from an estate or property without owning the estate or property.

report prepared for the same period. Identify any material misstatements or omission from the data electronically submitted to HUD's REAC.

**M. Excess Income.**

**1. Compliance Requirements.** Owners of limited-distribution properties with mortgages insured under Section 236 of the National Housing Act must obtain prior authorization from HUD before retaining excess income and use excess income only for HUD-authorized purposes.

**2. Suggested Audit Procedures.**

**a.** Inquire of management about the existence of a letter of permission or denial from HUD with respect to excess income. If the owner has received a letter from HUD permitting or denying the retention of excess income, obtain and read a copy of that correspondence from the property's management.

**b.** Select a sample of the HUD forms HUD-93104, Monthly Report of Excess Income, filed by the client, covering the period under audit. Determine whether the reports selected were prepared in accordance with HUD instructions.

**c.** For the sample, determine whether the client retained excess income or remitted the amount collected to HUD in accordance with HUD instructions. Trace amounts retained back to the client's supporting records.

**d.** If excess income was retained by the client, determine whether

(1) HUD approved if the amount was retained.

(2) The amount retained was used for authorized purposes as enumerated in housing notices.

**4-4. \*Audit Finding Reporting.**

All 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 must be reported as findings in the audit report. All nonmaterial instances of noncompliance disclosed during the audit process may be reported separately to management. Such reporting must be in writing in a management

letter or other type of written communication, and form and date of written communication must be mentioned in the independent auditor's report. Noncompliance, deficiencies, or violations that were\* \*corrected before the issuance of the audit report must be included in the report as resolved findings or in a management letter or other written communication depending on their materiality.

- A. **Content of Finding.** Findings are to be presented in accordance with the standards and requirements of GAGAS. Refer to chapter 2 for further information on the information that is to be included in a finding.
  - B. **Corrective Action Not Started or in Process.** When the project's management is in the process of correcting a finding at the time of report issuance, the auditee can include a description of the action completed and the action remaining to be taken in the auditee's response to the finding, stated in the auditee's comment section of the finding and in the corrective action plan.
  - C. **Corrective Action Completed.** When the project's management has corrected a finding, the action taken should be included in the auditee's response to the finding, stated in the auditee's comment section of the finding and in the corrective action\* \*plan, and should be validated by the auditor. The auditor's recommendation in the finding should state the results of the auditor's validation testing. In addition, the auditor could include any additional recommendations that he/she believes are necessary based on the auditor's testing of that action.
- 4-5. **Technical Assistance Needed.** The Office of Insured Health Care 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, 202-708-0599 or 877-458-4342.\*