

Baldwin Retirement Apartment Complex, Inc. (BRAC)

Guiding documents for Accounting, Financial management, and Reporting

Pages 2-59

USDA-RD Asset Management Handbook HB-2-3560

Included here is Chapter 4: Financial Management

Full handbook available here:

<https://www.rd.usda.gov/files/hb-2-3560.pdf>

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BRAC Management Plan (Contract between USDA and BRAC)

Included here is Section X: Plans for Accounting, Record Keeping, and Meeting USDA Rural Development Reporting Requirements

Full Plan available on request

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BRAC Internal office procedures and board review

CHAPTER 4: FINANCIAL MANAGEMENT

4.1 INTRODUCTION

Successful projects require sound financial management procedures to track funds, prepare realistic budgets, manage project funds effectively, and report financial progress. This chapter covers the borrower's financial management responsibilities and provides guidance to Loan Servicers on monitoring a borrower's financial management performance.

The chapter is divided into five sections:

Section 1: Project Accounting System describes program requirements and Agency monitoring responsibilities for the project accounting system.

Section 2: Project Accounts discusses the contribution, use, and monitoring of project accounts.

Section 3: Reserve Accounts outlines the requirements for and monitoring of reserve accounts.

Section 4: Project Budgets explains project proposed budget requirements and the budget approval process.

Section 5: Reporting and Financial Examination describes project actual reporting and financial examinations and Agency review of these reports.

SECTION 1: PROJECT ACCOUNTING SYSTEM

4.2 OVERVIEW OF ACCOUNTING SYSTEM REQUIREMENTS [7 CFR 3560.302]

Borrowers must establish accounting systems that support safe and sound project financial management. The accounting system must allow borrowers to maintain records in a manner suitable for an audit; track the use of funds, report accurate operational results to the Agency, and otherwise comply with the terms of their loan agreement. The following requirements apply to the borrower's accounting system:

- Agency approval. The accounting system must be approved by the Agency as part of the management plan (as discussed in Chapter 3). The borrower must notify the Agency of any changes in the method or system of accounting through a revision to the project management plan.

- **Method of accounting.** The borrower is required to use the accrual method of accounting throughout the year for bookkeeping and budget preparations. Annual reporting must be convertible to the standards identified in §3560.308.
- **When the accrual method of accounting is used,** the accrual-to-cash adjustment must equal the difference between Beginning Cash Balance and Ending Cash Balance to ensure these balances match their respective Balance Sheet figures. The sole purpose of this adjustment is to reconcile a company's internal ledger, kept on an accrual basis, to the IRS forms which are on a cash basis.
- **Recordkeeping.** Borrowers must retain all financial records and supporting material for at least 3 years after the issuance of annual financial reports and financial statements or until the next Agency monitoring visit whichever is longer. These records must be maintained in a manner that can be audited by the Agency or a third party. Records may need to be retained longer for IRS retention rules or Tax Credit Guidelines. Borrower accounts and records will be made available in a location with reasonable access for review at the request of the Agency.

If an account is a problem case or an investigation or audit is in process, do not destroy material until the problem is resolved or the investigation audit is closed.

- **Account requirements.** The following general requirements apply to the borrower's accounts:
 - ◇ Accounts must be held in domestic institutions;
 - ◇ Accounts must be insured by an agency of the Federal Government, backed by collateral approved by the bank, or held in securities meeting the requirements of 7 CFR part 3560, subpart G;
 - ◇ Funds maintained in an institution may not exceed the limit established for Federal deposit insurance. If funds at any one institution exceed the amount covered by Federal deposit insurance, borrowers must obtain a collateral pledge from the institution to cover all funds, or must move funds to an institution that will insure funds; and
 - ◇ Borrowers must maintain at least one demand deposit or checking account so that funds are always readily available to pay necessary operating expenses.
- **Use of funds.** Funds other than those in the security deposit/membership fee or patron capital accounts serve as security for the Agency grant or loan and must be held in trust by the borrower until used.
 - ◇ In no case may project funds be pledged as collateral for non-project debts;

- ◇ Funds must be used only for authorized purposes as described in 7 CFR part 3560, subpart G and in the project loan agreement or resolution; and
- ◇ Priority Order of planned and actual project expenditures are discussed in 7 CFR, part 3560, subpart G.
- **Separate accountability.** The accounting system must establish separate accountability for different projects. Funds for housing projects managed by the same management company must not be co-mingled.

The borrower may combine funds from different projects owned by the same borrower with the same tax identification number or Social Security Number in the same bank account, as long as the accounting system segregates and tracks each project's funds separately. A statement issued by a Certified Public Accountant (CPA) stating that the accounting system is structured to meet the principle of separate accountability will be provided. If funds for different projects are combined, the management plan must document how revenue and expenses that are not clearly associated with a particular project are prorated across projects. For example, the plan must document how costs for a computer system that serves several projects are allocated across the projects. The accounting system must track these prorated costs.

4.3 OVERVIEW OF ACCOUNTS

The borrowers must establish and maintain the accounts required by their loan agreement or resolution. At a minimum, these include the following accounts:

- General operating account;
- Tax and insurance account (amounts escrowed may be part of the general operating account but tracked separately);
- Reserve account;
- Tenant security deposit account
- Membership fee account (if applicable); and
- For cooperative projects, a patron capital account.

Each account serves a different purpose, as described in Section 2 and the project loan agreement or resolution.

SECTION 2: PROJECT ACCOUNTS

4.4 GENERAL OPERATING ACCOUNT

The borrower must establish a general operating account to handle all revenues and expenses associated with project operations. Authorized expenses payable from this account include expenses that are directly attributable to project operations and are necessary to carry out successful project operations. Attachment 4-C addresses eligible and ineligible operating expenses.

A. Initial Operating Capital and Other Advances [7 CFR 3560.304].

The period between initial occupancy and full rent-up in a project can be risky because rental income may not be sufficient to cover all operating costs, make payments on the Agency loan, and make required contributions to the reserve fund. To assist projects through this phase, the Agency requires the establishment of a fund for Initial Operating Capital by the borrower for each project. Approval of subsequent loans, transfer of ownership or other servicing actions may require additional deposits to the Operating Account and will be described in the loan, transfer or servicing approval.

This Initial Operating Capital is to be used for initial operating expenses, such as advertising, insurance, fidelity coverage, and initial lease-up expenses. The funds may also be used to meet project obligations, such as debt payments and reserve deposits, until cash flow is sufficient to fund these accounts. In addition to these regular operating expenses, there are some special expenses associated with this period, such as purchasing furniture or equipment for public spaces or advertising and marketing. Borrowers are to provide the Agency with a list of proposed uses for Initial Operating Capital during loan origination.

Other Advances include any advances made by the borrower, borrower entity, or designee to cover ordinary project operating expenses.

- **Funding of Initial Operating Capital**

All borrowers must provide Initial Operating Capital equal to at least 2 percent of the total development costs to support initial operation of the project. Borrowers must put this amount down at the loan closing or construction start, whichever comes first. The Agency may loan the required 2 percent to not-for-profit borrowers. (For details on this process, see Chapter 5 of HB-1-3560.)

- **Accounting for Initial Operating Capital**

When the project accounts are established, Initial Operating Capital is blended with other revenue and used for operating expenses. The borrower may leave an amount of money equal to the initial capitalization of the fund in the operating

account. This money should not be treated as surplus funds in the operating account nor should it be transferred to reserves. Its presence in the operating account should not be used as justification for the Loan Servicer to deny a rent increase.

- **Duration of Initial Occupancy**

The initial occupancy phase lasts until the project has attained a stable occupancy rate and the operating budget can reliably be supported by rental income.

Projects vary as to when they achieve this stability; the Agency anticipates it occurs sometime between the end of the second and seventh year of occupancy. When project stability is reached before the end of the seventh year, a for-profit borrower whose cash contribution created the Initial Operating Capital may request that the contribution be repaid.

- **Repayment**

- ◊ **Agency Policy**

The borrower may, with the consent of the Agency, withdraw its original contribution to the Initial Operating Capital in multiple annual installments or a single installment after the second year of the housing project operations and prior to the seventh full year of project operation, provided the borrower can satisfy Agency criteria for approving repayment. Repayment can only be made once the project has been operating for 2 years, and the project's operations and finances have stabilized. Repayment may be requested in one to five annual installments, until the borrower's contribution to Initial Operating Capital has been fully repaid and prior to the close of year seven. The borrower must be able to demonstrate that the project is financially stable, that repayment will not require a rent increase, and that the project is in compliance with Agency requirements. The financial condition of the project may preclude full repayment of Initial Operating Capital.

- ◊ **Borrower Submissions**

The borrower may submit a request for repayment of Initial Operating Capital when the annual financial report is submitted. The borrower's request is submitted in writing and addressed to the Servicing Office.

The submission should specify the amount of the repayment the borrower is requesting in the current year and, if applicable, the borrower's plan for withdrawing the balance of the repayment in ensuing years. The submission includes documentation demonstrating how the project meets Agency criteria for repayment:

- **Occupancy.** The occupancy rate for the project over the most recent 12 months has averaged at least 90 percent.

- **Contributions to Reserves.** Contributions to reserves are on schedule, less any authorized withdrawals.
- **Sufficient Income.** The project's financial position is stable. All accounts payables are less than 30 days old. When the amount of the repayment is subtracted from the general operating account, the ending cash balance still includes an amount equal to 20 percent of projected annual operating costs and required escrows for taxes and insurance.
- **Impact on Rents:**
 - Repayment is acceptable if no rent increases are projected in the year the repayment is made.
 - A rent increase will not affect repayment if rents are increasing to cover increases in costs, such as wages, taxes, or insurance.
 - Repayment is denied if it creates a shortfall in operating income that must be made up by a rent increase and/or funded by the owner.
- **Physical Maintenance.** There are no outstanding deficiencies in management's physical maintenance of the housing project in accordance with 7 CFR 3560.354.
- **Compliance.** There are no outstanding compliance violations, and the project is not under a workout agreement.

◇ **Agency Processing**

Agency staff will examine the submission for eligibility, completeness, and compliance with the criteria the Agency has established that a project must meet for a repayment to be made. If staff finds that the project can support the repayment, the repayment amount will be calculated.

▪ **Amount of Repayment**

The borrower may receive a lump sum amount equal to the original contribution of Initial Operating Capital, or smaller amounts in installments if the operating budget cannot support repayment in a single lump sum amount (see Example below).

Example – Initial Operating Capital			
	Case One	Case Two	Case Three
Year-end cash balance	\$57,000	\$40,000	\$27,000
20% O&M requirement plus taxes & insur.	<u>27,000</u>	<u>27,000</u>	<u>27,000</u>
Surplus	<u>30,000</u>	<u>13,000</u>	<u>0</u>
Initial Operating Capital	30,000	30,000	<u>30,000</u>
Repayment Amount	30,000	13,000	0
Initial Operating Capital unpaid balance	0	17,000	30,000
▪ The borrower in Case One can be repaid in a single installment. ▪ The borrower in Case Two will require 3 installments assuming little change in the project's financial condition. ▪ The borrower in Case Three could not receive any repayment this year.			

▪ The Decision Process

- The Servicing Office has 60 calendar days to review the annual financial statement, including any request for repayment of Initial Operating Capital.
- The Servicing Office may decide to:
 - Permit repayment in the amount requested by the borrower;
 - Permit repayments, but in an amount less than that requested by the borrower; or
 - Deny repayment because the project does not meet the criteria for repayment.
- The decision of the Servicing Office is provided to the borrower in a letter. In addition to the amount of any authorized repayment or the reasons for denying repayment, the letter states the amount of any remaining unpaid balance of the original contribution to Initial Operating Capital. If repayment is denied appeal rights will be sent.
- The Servicing Office updates Multi-Family Integrated System (MFIS) Tracked accounts and Servicing efforts to show the amount of the authorized repayment and the unpaid balance of Initial Operating Capital.

- **Other Borrower Advances**

Prior written approval by the Loan Servicer is required for any advances made by the borrower, borrower entity, or designee to cover ordinary project operating expenses. Such advances may be authorized when justified by unusual short-term conditions. When conditions are not short term in nature, a servicing plan may be developed, and advances may be approved if justified by the following:

- A review of the documented circumstances and the project operating budget before any funds are advanced. The financial position of the project must not be jeopardized.
- Funds are not immediately available from any of the following sources:
 - Reserve funds;
 - Initial operating capital; or
 - An imminent rent increase.

The borrower may charge or be paid interest on the loan using project income; however, interest must be reasonable. The proposed loan may be denied if Agency financing can be provided to resolve the problem in a more cost-effective manner.

No lien in connection with the loan will be filed against the property securing the Agency's loan or against project income. The advance may be shown as an unsecured project liability on financial statements prepared for year-end reports until such time as it is authorized to be repaid.

- **Repayment of Advanced Loan Funds**

The repayment of the advance may be permitted by the Loan Servicer, provided the terms and conditions were mutually agreed to by the borrower and the Agency at the time of the advance, and the financial position of the project will not be jeopardized. Repayment should only be permitted on the advance when the Agency debt is current, and the reserve requirements are being maintained in accordance with Section 3 of this chapter.

B. Return on Investment/Return to Owner [7 CFR 3560.305]

The borrower's Return on Investment (ROI) is the annual amount of profit an owner operating on a limited or full-profit basis may receive from a project, as established in the loan agreement. When a property has a transfer of ownership,

ROI is referred to as a Return to Owner (RTO) and is based upon the transfer underwriting analysis and approval conditions. The amount is calculated as a percentage of the owner's investment in the project.

The borrower may take the earned ROI/RTO (Return) before withdrawing the original contribution to Initial Operating Capital. A full or partial Return may be taken in a given year. If only a partial is taken, the remainder may be taken the following year if allowed. The borrower may receive a Return in accordance with the terms of its loan agreement, and if the following conditions exist:

1. The borrower may take the Return budgeted and approved after the project's fiscal year ends if there is a positive net cash flow (see line 30 on *Form RD 3560-7, Multiple Family Housing Project Budget/Utility Allowance*), and the balance of the reserve account is equal to or greater than required deposits minus authorized withdrawals.

When determining positive net cash flow, the Agency will consider such items as accounts payable and reserve withdrawals to cover operating expenses. For example, the borrower may not circumvent the order for funding accounts by using reserve funds or creating an accounts payable for budgeted operating expenses to make it appear as though the budget has a positive cash flow at year end. If the annual financial reports indicate that the borrower should not have taken a Return, the Agency will require the borrower to repay the unauthorized Return to the project.

2. If the project's operations show a negative cash flow (see *Form RD 3560-7*, line 30) as in the Example, Case 1 below, the Agency may authorize the borrower to take the Return only after the Agency has reviewed the project's annual financial report and determines:

- ◇ There is surplus cash in either the general operating account or the reserve account and;
- ◇ The housing project has sufficient funds to address identified capital or operational needs. Needs of the property may be identified by inspections and/or capital needs proposed.

The Agency considers surplus cash to be the portion of the ending cash balance on *Form RD 3560-7* that after all payables, exceeds 20 percent of projected annual operating and maintenance expenses, the taxes and insurance escrow, and initial operating capital, if applicable. To determine surplus cash, refer to Attachment 4-D, *PROPOSED BUDGET AND YEAR END ANALYSIS PROCESS*.

An earned, but unpaid Return for the previous year may only be requested if, at the end of a project's current fiscal year, surplus project funds are more than sufficient to pay Return for the year just ended. The borrower may request that the additional surplus project funds be used to pay any portion of the prior year's Return that could not be paid previously. See Example Payment of Return, Case

3. The borrower will indicate the year the Return being withdrawn represents on Form RD 3560-7, Part I, line 23 under "Comments".
4. The borrower may request the Return from the reserve account if the conditions set out in the loan agreement are met and the account balance is greater than the required deposits minus authorized withdrawals. After the disbursement the reserve account actual balance must be equal to or greater than the required balance. The disbursement does not reduce the required balance.

C. Surplus Funds [7 CFR 3560.306]

If the general operating account has surplus funds at the end of the housing project's fiscal year, the Agency will require the borrower to use the surplus funds to address capital needs, make a deposit into the housing project's reserve account, reduce the debt service on the borrower's loan, or reduce rents in the following year.

Example- Payment of Return

Consider a project that has been operational for 8 years, has a \$1,000 Return specified in the loan agreement, and needs \$10,000 cash to cover 20 percent of annual operating and maintenance expenses, and taxes and insurance escrow.

Case 1: If the project had a negative cash flow after payment of operating and maintenance expenses, reserves, and debt service expenses during the fiscal year (FY) 20X7 but had \$20,000 available in the general operating account, the Agency would approve a Return from funds available at the end of FY 20X7. In this example, "FY 20X7 RTO" would be noted in the comments section of *Form 3560-7*. This Return would be taken immediately after the end of the fiscal year, preferably January 20X8.

After the \$1,000 RTO was paid, if all or a portion of the previous year (20X6) RTO is unpaid - it may be paid from the remaining surplus cash. Any remaining previous years unpaid RTO will then be written off.

Case 2: If the project had a negative cash flow during FY 20X7 but had only \$5,000 available in the general operating account, the Agency would not approve a Return from funds available at the end of FY 20X7. This FY 20X7 RTO could be requested the following year if there is surplus cash to cover it, the 20X8 RTO is paid first and it does not cause a rent increase. The Return would be taken immediately after the end of the fiscal year, preferably January 20X9.

Case 3: Consider the same project as described above. During FY 20X7, the borrower believed that there would not be adequate cash to pay taxes at year end, so the borrower requested \$2,000 from the reserve account for operating purposes; however, the project ended the year with \$3,000 positive cash flow. In this case, the borrower can take the \$1,000 without Agency permission, as they used a reserve withdrawal request to cover operating expenses. However, if the net cash amount was less than \$2,000, the borrower can only take Return from surplus cash.

	Case One	Case Two	Case Three
<i>Form RD 3560-7</i>			
Part I Line 30	\$ (2,000)	\$ (2,000)	\$ 3,000
<i>Form RD 3560-7</i>			
Part I Line 33	\$ 20,000	\$ 5,000	
Tax & Ins escrow	\$ (5,000)	\$ (5,000)	
Accounts Payable	\$ (2,500)	\$ (2,500)	
Cash Available	\$ 12,500	\$ 0	
Cash Required (20% proposed O&M - Tax & Insurance)	\$(10,000)	\$(10,000)	
Surplus Cash	\$ 2,500	\$ 0	

4.5 TAX AND INSURANCE ACCOUNT

The borrower must deposit money on a monthly basis to pay required taxes and insurance. Generally, these funds can be kept in the general operating account as long as they are tracked separately from other general operating funds to ensure that funds are available to pay taxes and insurance. In some cases, however, the Agency may require a separate account for taxes and insurance to ensure the availability of these funds. See Chapter 3 for a discussion of insurance requirements and taxes. Also, see Attachment 4-D Budget and Year End Analysis for evaluation of escrow amounts.

4.6 RESERVE ACCOUNT

The reserve account is used primarily to pay for large planned expenses for maintenance and improvements of capital items. It is funded through contributions from project operating funds. The reserves are not to be used as an alternative operating budget. The project's reserves must be held in an account with a current executed Depository Agreement that requires the Agency's approval on all withdrawals. The administration of project reserves is covered in detail in Section 3 of this chapter.

4.7 SECURITY DEPOSIT OR MEMBERSHIP FEE ACCOUNT

The security deposit or membership fee account holds funds provided by residents as security deposits and membership fees. See Chapter 7 for a full discussion of security deposits and membership fees.

- **Uses of Funds.** Funds deposited in the security deposit/membership fee account must be used for purposes outlined in the management plan:
 - ◇ The borrower may only use security deposits to cover costs of fixing damage to units beyond ordinary wear and tear by the tenant who provided the deposit. The funds must be returned to the tenant if not used in accordance with the State Law. If the borrower cannot locate the tenant to return the deposit, these funds must be deposited in the general operating account or handled in accordance with applicable state laws. In cooperatives, the return of membership fees depends upon the legal instruments governing the project.
 - ◇ Funds retained by the borrower as a result of a lease or occupancy violation must be transferred to the general operating account and treated as project income.
 - ◇ **Interest.** The interest on security deposit/membership fee accounts is handled in accordance with state law. If no state law governs the use of interest, it must be deposited in the general operating account, at least annually, and used for general operating expenses. In no case may interest accrue to the benefit of the borrower or management agent.

4.8 PATRON CAPITAL ACCOUNT

In cooperative projects, borrowers must establish a patron capital account to hold surplus operating funds in trust for cooperative shareholders.

- Any funds in excess of 3 months of average operating expenses remaining in the general operating account at the end of the fiscal year must be deposited in the patron capital account. This account must be interest bearing and must be administered according to state laws governing patronage capital.
- Each shareholder of the cooperative association must be assigned an equal portion of the funds in this account. These funds are held in trust for the shareholders of the association until they terminate their membership in the cooperative. Shareholders may receive their portion of the funds only if they have paid all association charges and costs due the cooperative association.

SECTION 3: RESERVE ACCOUNT [7 CFR 3560.306]

4.9 PURPOSE OF RESERVES

The Agency has a financial interest in a project over the life of its loan. During this period, which can be as long as 50 years, major replacements and capital expenditures will have to be made to the building, such as replacing the roof, rewiring, replacing windows, doing major exterior work, or adding new kitchen and bathroom fixtures. The reserve account is primarily used to meet the major capital expense needs of a project. If these expenditures are not made, the property loses value, becomes less attractive to tenants, and begins to deteriorate. The Agency's financial interest in the project is then at risk.

Adequate replacement reserves are a critical component of a successful project. The reserves are not to be used as an alternative operating budget. Rents should reflect and cover the reasonable and customary costs of annual operating expenses of the property in the market. Annual reserve deposit for projects with Agency approved Capital Needs Assessments (CNA) will be adjusted as authorized in the loan, transfer or servicing approval.

4.10 RESERVE ACCOUNT REQUIREMENTS

The reserve account is a required account subject to the requirements set out in this paragraph. The borrower will initiate deposits in this project account, starting in the same month the first loan payment is due the Agency. As projects age, the required reserve account level may be adjusted to meet anticipated life-cycle needs, such as equipment and facility replacement costs, by amending the loan agreement/resolution. Refer to Attachment 4-B for guidance on the amendment. Requirements for the reserve account include the following:

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- All Rural Rental Housing, Rural Cooperative Housing, and Farm Labor Housing borrowers are required to establish and maintain a reserve account. This requirement excludes On-Farm Labor Housing borrowers with fewer than 12 units.
- Reserve accounts must be deposited in interest-bearing accounts or securities with rates greater than or equal to savings or checking accounts.
- Reserve funds are required to be placed in a supervised account or have an Agency accepted Depository Agreement approved by the Agency, executed after October 1, 2018. With the updated Depository Agreement, the Agency is no longer required to countersign approved withdrawals from reserve accounts as provided by 7 CFR 3560.306(e)(2) and 7 CFR 1902.4(a)(1).
- Agency approval must be obtained prior to the withdrawal of any reserve account funds per 7 CFR 3560.306 and MFH Handbook (HB)-2-3560 Chapter 4, Section 3. If the Agency finds any unauthorized Reserve account usage, the Agency will take the appropriate servicing actions.
- Any amount in the reserve account that exceeds the total sum specified in the loan agreement or resolution may be transferred to the general operating account for authorized purposes only when it is agreed, between the borrower and the Agency, to be in excess of the requirement and there is a specific need for the excess funds. However, the Loan Servicer may direct the excess sum to be retained in the reserve account or applied as an extra payment on the loan.
- Section 515 properties leveraged with 538 Guarantee Rural Rental Housing (GRRH) program funding are not subject to countersignature requirements. Direct Section 515 loan borrowers, exempted from the counter-signature requirements, must comply with the Section 538 GRRH program regulatory requirements. In all cases, the Section 538 lender must get prior written approval from the Agency before reserve account funds involving a direct MFH loan project can be disbursed to the borrower.

4.11 RESERVE INSTALLMENTS

Required reserve installments will be transferred to the reserve account at least at the rate stipulated by the borrower's loan agreement or resolution, starting with the date the first loan payment is due to the Agency. Transfers of funds to the reserve account will continue until the account reaches the total amount specified in the loan agreement or resolution. Transfers will be resumed the period following withdrawals that decrease the reserve account balance below its fully funded level until it is restored to the specified total minimum sum.

The Agency may approve a change in the borrower/projects reserve account funding level based on the findings of an approved Capital Needs Assessment (CNA). The approval to increase reserve account funding levels will take into consideration the housing project's approved budget and ability to support increased reserve account deposits without causing basic rents to exceed conventional rents for comparable units in the area. If the borrower requests an increase in the project's annual reserve account deposits, the borrower must have

a capital needs assessment prepared and submitted to the Agency to reflect the project's anticipated needs for replacement of capital equipment and systems. The cost for preparation of a CNA will be approved by the Agency as an eligible project expense for existing owners, provided that the cost of the assessment is reasonable and meets Agency requirements. (Note: CNA's required by transferees for ownership changes are not eligible for payment from the reserve account unless the transferee is also a non-profit entity and no additional third party is providing funds for acquisition or rehab.)

The Agency may approve a borrower's request to increase the fully funded level of the reserve account to ensure sufficient funds are available to address the capital requirements of a Transition Plan.

The following definitions are displayed on the MFIS Tracked Accounts page, and are used to further explain the reserve account:

- **Required Balance.** The amount that the reserve account is required to contain as of the date displayed. This amount is calculated by adding deposits as required by the loan agreement/resolution and subtracting authorized withdrawals.
- **Fully Funded.** The amount set in the borrower's loan agreement/resolution for funds to be set aside during the life of the project.
- **Annual Deposit.** The amount of funds that must be deposited annually to the reserve account according to the borrower's loan agreement/resolution.
- **Account Balance.** The account balance as of the date displayed. This would correspond to the reserve section actual balance on financial reports.
- **Account Status.** This shows whether the reserve account is current or delinquent according to the required balance less the account balance.

4.12 RESERVE ACCOUNT PRINCIPLES

Reserve account funds are governed by the following principles:

A. Investment Vehicles and Institutions

Reserve account funds not immediately needed to pay for expenses or authorized purposes may be held as set out in this paragraph. Reserve account funds may be held in the form of:

- ◇ A checking, savings, negotiable order of withdrawal, or similar account at a federally-insured domestic institution, such as a bank, savings and loan, or credit union.

- ◇ Readily marketable obligations of the U.S. Treasury Department (e.g., U.S. Treasury bonds, U.S. Savings bonds, zero coupon bonds, etc.) at a federally-insured domestic institution or at an insured domestic institution authorized to sell securities.
- ◇ An account established at an insured domestic institution authorized to sell securities, provided that the accounts meet the remaining conditions set out in this paragraph and are not used in a speculative manner. The account may be a tax-exempt account or a taxable account, and the institution may or may not charge brokerage fees.

B. Limitations on Investments in Securities

Any securities must be:

- ◇ Backed by the U.S. Government or an Agency of the U.S. Government;
- ◇ Triple A-rated Government National Mortgage Association (GNMA)-collateralized tax-exempt bonds; or
- ◇ Triple A-rated pre-refunded bonds.
Pre-refunded bonds are bonds that originally may have been issued as general obligation or revenue bonds but are now secured, until the call date or maturity, by an escrow fund consisting entirely of direct Government obligations that are sufficient for paying the bondholders.

C. Reporting Actual Costs of Securities

To ensure that required amounts have been paid into the reserve account, the actual costs of securities (which in many cases may not be the face value) must be shown on the project books. In addition, details of these transactions should be disclosed in footnotes to financial information provided to the Agency.

1. Security Sales

When the Agency approves withdrawals from the reserve account and the funds are invested in securities, borrowers must, to the extent that securities are available, assure that securities are sold in an amount that results in proceeds sufficient to cover the disbursement.

2. *Forecasting Security Sales*

Since the sale or redemption of any securities may result in cash proceeds of less than the amount invested, borrowers should take steps to minimize the risk of loss from converting securities to cash. Needed reserve account withdrawals should be planned in advance to permit Agency approval of anticipated needs such that security sales can be arranged to be sold in favorable market conditions. When sales of securities take place, the proceeds will normally be held in a reserve fund at a domestic bank, savings and loan, credit union, or similar institution insured by an Agency of the Federal Government until such time as withdrawals are actually needed for the purposes authorized. Should unusual circumstances require the sale of securities in unfavorable market conditions, the borrower will not be required to reimburse the project for any losses incurred.

3. *Knowledge Required of Securities Investors*

Those investing in securities must be knowledgeable of common industry practices prior to investing in securities. Knowledge of the various fees that may be associated with the purchase and sale of securities and the maintenance of security accounts must be considered when making security investments. Examples of these fees are front-end loads of fees, back-end loads of fees, and maintenance fees. These fees may be paid using general operating account or reserve account funds. However, the Agency must give its prior consent before reserve account funds may be used.

4. *Financial Advisor Limitations*

Project proceeds may not be permitted to be used to pay for the services of a financial advisor to assist in the selection of securities for investment, since the securities permitted are relatively limited and must meet the requirements set out in this chapter. However, normal brokerage fees may be paid to secure and sell securities. It is recognized that financial advice may also be provided as part of the normal brokerage fee.

4.13 USE OF THE RESERVE ACCOUNT

A. *Planned Use of Reserve Funds*

The borrower will request approval for use of the reserve funds using *Form RD 3560-12, Request for Authorization to Withdraw Reserve Funds*, before funds are needed if items were not included on the approved capital budget. The borrower will request withdrawal from the reserve fund using Form RD 3560-12. Annual budgets are to include realistic routine income and expense levels to avoid the need to use reserve funds for routine expenses (operating shortfalls) not

caused by emergencies or very unusual servicing situations. The Agency expects borrowers to anticipate and plan for major capital expenditures at least annually, including a careful review of any approved CNA. Loan Servicers will monitor planned capital needs and expenditures to determine if revisions will be necessary and document the file accordingly.

The borrower is required to submit an annual capital expenditure budget as part of the annual budget submission. The budget should include plans to catch up with any maintenance expenses deferred from previous years, correct any deficiencies identified during Agency site visits, complete capital repairs and replacements scheduled in the project's approved CNA, and/or make necessary modifications to remove physical barriers as identified in a Transition Plan. A cost analysis provides data on projected useful life of materials, common replacement and repair schedules. Independent resources of information such as insurance actuary tables, FANNIE MAE Physical Needs Assessment Guidance to the Property Evaluator or Agency documentation should be consulted for common costs and repair/replacements schedules.

When a reserve account and contributions to the reserve account have been sized in accordance with a fully acceptable capital needs assessment, the reserve account funds are to be used to fund capital items as described in the plan. Since under a capital needs assessment, funding of the reserve is designed to match the timing and amount of needs, following the plan should limit the amount of funds required from operating sources to pay for capital needs.

B. Authorized Uses/Eligible Expenditures

Items usually considered as eligible for draws from the reserve account include capital items such as, but not limited to, the following:

- Making improvements to the housing project without creating new living units, or to retrofit units to make them accessible to the physically handicapped. This is not meant to limit the use of reserve account funds to meet handicapped accessibility needs required to make reasonable accommodations for persons with a disability who apply for housing.
- To address the capital requirements identified by the borrower's Transition Plan and other servicing tools. Loan funds may also be used for this purpose.
- Making permanent improvements to the housing project, such as installing an energy-conserving heat pump.
- For other purposes desired by the borrower, which in the judgment of the Agency will promote the loan purposes; strengthen the security of the loan; or facilitate, improve, or maintain the project and the payment of the loan without jeopardizing the loan or impairing the adequacy of the security.

- Facilitating payment of fees associated with the buying or selling of securities or maintaining a securities account.
- Meet loan obligations of the project in the event the amount available for debt service is not sufficient for the payments.
- Meet an emergency shortfall in operating expenses when the emergency is beyond the control of the borrower and threatens life, or the safety or the physical security of the project. Examples include an extreme weather disaster or reductions in rental income caused by changes in the rental market that affect other housing projects in the market as well. In cases of weather disasters, the project insurance coverage will be reviewed to determine if funding from insurance will be available for repairs. Suitable justification as to why the general operating account is insufficient is required.
- With Agency approval, borrowers operating on a for-profit or a limited-profit basis may make an annual withdrawal from the reserve account equal to no more than 25 percent of the interest earned on the reserve account during the prior year. The borrower will use *Form RD 3560-12* to request the withdrawal and must provide documentation of the prior year interest earned. For example, in the report submitted for the period January 1, 20X9 through December 31, 20X9, the owner is entitled to 25 percent of the interest earned during calendar year 20X9. The borrower is not entitled to interest earnings from prior years.
- Other items considered eligible for draws from the reserve account include capital items listed in Attachment 4-A, Capital Expenditures.

C. Unanticipated Uses of Reserves

The Agency recognizes that not all capital expenditures can be predicted a year in advance. Sometimes a major piece of equipment will break down unexpectedly or a severe storm will create damage. Borrowers must seek Agency approval for the unforeseen use of reserves. In emergency situations when the borrower can demonstrate an imminent and serious threat to the health, safety, or physical security of the project, the borrower may request the Agency to post-approve the use of reserves. The Agency will only approve emergency withdrawals if the reserves are used for eligible expenses. If post-approval is requested, the bidding requirements, as described below, still apply. If the bid is obtained post-approval and is less than the expense, the difference will be reimbursed to the account by the borrower. Unforeseen circumstances may alter the approved CNA schedule adversely and require further review and modification to meet the reserve deposit schedule in the borrower's loan agreement /resolution. Loan Servicers will

review any loan, transfer or servicing conditions that may be impacted and develop a plan to reflect any modified schedule of findings or repairs.

D. Withdrawal Approval Process

- The borrower must submit a written request, on *Form RD 3560-12*, “Request for Authorization to Withdraw Reserve Funds”, to the Agency to withdraw reserve funds, even if the Agency has reviewed and approved the capital expenditures in its review of the annual capital budget.
- The Loan Servicer will take prompt action on a request for reserve withdrawal, normally within 5 working days of receipt of the request, and provide written authorization to the borrower, on *Form RD 3560-12*, for any authorized withdrawal of funds before the borrower actually withdraws any funds.
- When the Depository Agreement has been updated to allow, upon receipt of authorization to use reserve funds, the borrower may use electronic transfer of reserve funds. It is acceptable for the approved withdrawal to be run through the general operating account.
- Borrowers will notify the Loan Servicer of work completed within 5 days so that needed inspections may occur.
- Borrowers will submit a final invoice that describes the specific service and banking transaction if the amount is different than initially approved or was a preapproved capital budget item.
- Borrowers must maintain records documenting all expenses that were paid by withdrawals from the reserve account.

1. Bid Requirements

Expenditures of \$5,000 or less do not require bids, even if it is an identity-of-interest (IOI) entity.

The expenditure of reserve funds for a project (all work included in one contract) estimated to cost *more than* \$5,000 will require a minimum of two bids. When there is an IOI between the borrower or property manager and a bidder a minimum of three bids must be submitted. The entity with the IOI must submit its bid directly to the Servicing Office prior to requesting bids

from other firms. Once the bids are received the borrower will submit the request using Form RD 3560-12 to the servicing office with all bids attached. An explanation of why the borrower was unable to obtain two non-IOI bids must be provided when appropriate

2. Projects Involving Moderate Levels of Construction

If construction does not involve substantial changes to structures or replacement of major systems, e.g. electrical, plumbing, heating, or cooling, the housing project is considered to involve moderate levels of construction. Examples include exterior repainting, roof repair, parking lot repaving, and repairs to plumbing or electrical systems.

When the borrower requests access to reserves for a moderate construction activity, the Agency first reviews the project documents for acceptance, and then reviews a payment request.

In addition to the items for bids specified above, the borrower must provide the following:

- Project planning documents that describe the work to be performed;
- Copies of written bids; and
- A copy of the contract/proposal.

After the project has been completed, the borrower notifies the Loan Servicer with actual invoice/cost. The Loan Servicer will perform an inspection of the work done to assure it has been completed in accordance with the contract/agreement or statement of work if applicable.

3. Project Involving Large Levels of Construction

A project with large levels of construction involves substantial changes to the structure, replacement of major systems, and/or expenditures estimated in excess of \$100,000. Such activities are subject to the design requirements of

Exhibit K of RD Instructions 1924-A and 1924-C. In addition to the items for bids specified above, the borrower must provide:

- Project planning documents, including specifications and drawings as necessary to fully describe the work;
- Copies of written bids;
- A rationale for awarding the contract; and
- A copy of the construction contract.

The required planning documents may be prepared by any individual or firm meeting the qualification requirements of the local building jurisdiction.

After the planning documents and construction contract have been accepted by the Agency, the borrower may request an initial draw to pay for materials or make a down payment to the contractor. The request for an initial draw should be accompanied by an invoice and a check made out to the contractor or vendor, to be cosigned by the Agency. The Agency may approve such a request provided the amount of the initial draw does not exceed a reasonable percentage of the value of the construction contract. Refer to RD instruction 1924-A.

The Agency will inspect the project before approving the work and again at construction completion before approving the final payment.

- The purpose of the initial inspection is to establish that the proposed work is needed and is an appropriate response to existing conditions.
- The purpose of the final inspection is to establish that the work was performed as described in the Agency-accepted documents.

The Agency may conduct additional inspections as necessary.

The borrower should be required to hire an independent third-party inspector to verify that the work complies with all applicable requirements. To verify that all major systems are adequate, State-licensed inspectors must certify that the dwelling has been inspected and meets Agency standards. When a State does not have licensed inspectors, a qualified, independent, third-party inspector may provide these certifications.

SECTION 4: PROJECT BUDGETS

4.14 BUDGET REQUIREMENTS [7 CFR 3560.205 and 3560.303]

A. General Information

Project budgets are planning documents that provide a picture of a project's financial operations for the coming year. They reflect:

- Expected revenues and expenses;
- Plans for maintenance, capital improvements, and reserve account activity;
- Return on the owner's investment, or a Non-Profit Asset Management Fee;
- Establish rents; and
- Reasonable and customary costs to cover turnover costs and maintenance which should be in line with comparable properties in the market.

For projects with 8 units or more, all borrowers will be required to submit project budgets through the Management Agent Interactive Network (MINC). The Agency may make an exception to this requirement if the borrower submits documentation that the costs associated with electronic submission of project budgets would pose a financial hardship to the project. Borrowers must submit annual project budgets to the Agency for approval. Budgets must meet the following requirements:

- Budgets must be reasonable and realistic. Revenues, vacancies and expenses must be consistent with past project budgets, historical actuals and comparable projects. Any differences must be due to legitimate operating needs of the project.
- Project expenses will include only expenses necessary to maintain successful projects. An example of an unnecessary expense is owner or manager entertainment expenses. Project expenses cannot be used for unearned personal benefit or gain, or for reimbursement of false or inaccurate expenses.
- The priority order of project expenditures must be:
 - Senior Position lien holder, if any;
 - Operating and maintenance expenses, including taxes and insurance;
 - Debt service to the Agency;
 - Reserve account deposits;

- Other authorized expenses; and
- Return on the owner's investment or Non-Profit Asset Management Fee.

B. Sections of the Project Budget (*Form RD 3560-7*)

The *Form RD 3560-7* is used to plan and report the financial activity of a multiple family housing project as required by Agency regulations. Refer to the Forms Manual Insert (FMI) for this form and for a detailed explanation of each line item on the budget. The form is divided in 6 parts as described below:

1. *Part I - Cash Flow Statement*

For budgeting purposes, the cash flow statement projects whether the property will generate enough revenues for all cash needs for the budget period. The proposed budget ending balance must be a positive cash balance and not cause an unwarranted rent increase, nor should it exceed the total of: (1) approximately 20 percent of Total O&M Expenses (Part I, line 16); (2) the amount held for taxes and insurance; (3) any initial operating capital during the first 7 years or until it is withdrawn, whichever comes first. Accrual method accounting will be considered with the annual financial reports and is discussed in Section 5 of this chapter.

- The borrower must not include expenses for purposes unrelated to the housing project or for fines, penalties, and legal fees in the event the borrower has been found guilty of violating laws such as civil rights, evictions, and building codes.
- The borrower is responsible for submitting project budgets that address the project's physical accessibility needs. The Loan Servicer may approve the cost of providing accessible rental housing as an authorized use of project funds.
- The borrower must not include organizational expenses among project expenses. These items are covered by the management fee. (For a list of the bundle of services covered in the management fee, see Chapter 3, Attachment 3-D, and 7 CFR 3560.102.)

A vacancy and contingency allowance is calculated from the previous 3 years' historical vacancy rate of the property, and should not exceed the caps as identified below. If the historical vacancy rate is greater than established caps, the vacancy and contingency allowance is capped at the following levels:

- ◇ For projects with 15 or fewer units, the vacancy and contingency allowance is capped at 15 percent.

- ◇ For projects with more than 15 units, the vacancy and contingency allowance is capped at 10 percent.
- ◇ When historical vacancy rates exceed the caps, a budget may be approved with the historical rates only after a feasible workout plan has been submitted and approved.
- A Non-Profit Asset Management Fee may be requested by non-profits and cooperatives. Non-profit owners are entitled up to \$7,500 per project for certain organizational expenses, such as Errors and Omissions insurance and actual expenses prorated by the number of Rural Development units. Expense reimbursement may not be duplicated on multiple properties. Evidence of expenses is necessary to support the budgeted amount. Examples of acceptable documentation for this expense would be:
 - ◇ A copy of the Errors and Omissions Insurance policy that reflects who is covered and the cost;
 - ◇ Documentation of hours, number of meetings, and the hourly wage rate used for Board of Director's review.
 - ◇ The oversight functions include:
 - Board of Director's review and approval of proposed budgets, including proposed repairs, outlays, and accruals;
 - Review of capital expenditures;
 - Approval of annual financial reports and considerations of any management comments noted; and
 - Long-term asset management reviews.

Any investor asset management fee, investor service fee, or similar fee may be paid solely from the annual Return to Owner and may not be paid from project operating funds. This is not the same as the Non-Profit Asset Management Fee.

Part II - Operating and Maintenance Expense Schedule

- Operating and Maintenance Expenses entered in this section are broken down as indicated on the appropriate lines according to the following categories:
- Operating and Maintenance include items such as maintenance payroll, painting, snow removal, and grounds. Borrowers should include expected unit turnover expenses, based on the properties historic turnover rate, in

the operating budget. Turnover expenses, such as the replacement of a refrigerator, scheduled unit carpet cleaning, curtain or flooring cleaning or replacement, painting, etc. should be treated as a normal operating occurrence and do not represent a reserve account need. If the unit sustains damages beyond reasonable wear and tear, then an exception may be warranted, as the costs may be abnormal. This is not the typical situation. If an item is budgeted in the annual operating budget as an operating expense, the item must be paid for out of the operating budget, unless it is a circumstance beyond the borrower's control.

- Utilities include only utilities paid by the project. Utilities paid by the tenant are not included on this form. Administrative expenses are project expenses only and do not include expenses that a management firm incurs. The management fee and the services performed for the fee are defined in the 7CFR 3560.102 (i)(1) , Management Certification and or Management Agreement. The Management Plan establishes the systems and procedures that will be employed on site to ensure that project operations comply with Agency requirements.
- Taxes and Insurance expenses include all project insurance and real estate taxes, or any special assessments or other taxes allowed.

2. *Part III - Account Budgeting/Status*

This section of the budget reflects the projected reserve account. The balances of the other accounts are not completed for budgeting purposes, only when actuals are received.

The Loan Servicer must review the reserve account levels and contributions to ensure that they are consistent with the loan agreement. The review focuses on four items:

- ◇ **Beginning balance.** The Loan Servicer should review the beginning balance of the reserve account to ensure accuracy.
- ◇ **Transfers to reserves.** The Loan Servicer should examine the budget to ensure that the appropriate dollar amount, as specified in the loan agreement/loan resolution, is budgeted for deposit in the reserve account.
- ◇ **Transfers from reserves.** Any transfers from the reserve account that are included in the budget should be described in the budget narrative and justified by the capital plan.
- ◇ **Ending balance.** The ending reserve account balance is calculated by taking the beginning balance, adding the transfers to the reserve account, and subtracting the transfers from the reserve account.

If the Loan Servicer finds that the reserve account level is not where it is supposed to be, that the budget does not show correct contributions to reserves, or that transfers from reserves are not adequately documented, then the borrower must submit corrected budget documents.

3. *Part IV - Rent Schedule and Utility Allowance*

The rent schedule documents the rent and utility allowance structure, and establishes the Rental Income entered in *Form RD 3560-7*, Part I, Line 1.

- ◇ The Basic Rent is the level required to cover all uses of cash and the repayment of the Rural Development loan at the interest credit reduced payment.
- ◇ The Note Rate rent is the level required to cover all uses of cash and the repayment of the Rural Development loan at the unsubsidized or promissory note rate.

When tenants pay some or all of their utility costs themselves, borrowers must establish a utility allowance to determine the amount tenants pay toward rent. The utility allowance is deducted from the total shelter cost calculated for the tenant, and the difference is paid by the tenant as rent. If the tenant is entitled to a utility reimbursement, management companies may issue a joint check payable to the tenant and utility company, if they choose.

4. *Part V- Annual Capital Budget*

The capital budget portion of *Form RD 3560-7*, Part V provides information on plans for capital improvements. It lists all the capital items in the project and provides space for the borrower to indicate their condition, address transition plan items and any needed improvements. The Annual Capital Budget allows capital items to either be expensed from operations or capitalized from the reserve.

The borrower identifies major maintenance, replacement and accessibility needs during the annual budget cycle and develops a schedule for making withdrawals from the reserve account to pay for their cost. These plans are incorporated by the borrower into the annual capital expenditure budget and may also be reflected in the operating budget if the work is to be paid for out of operating income. Attachment 4-A offers guidance for budgeting capital items. The objective is to help ensure the borrower properly manages reserve account resources and establishes budgets to address the project's capital needs.

If the Loan Servicer finds the operating and capital budgets inadequate to keep the project in compliance with Agency standards for physical conditions [7 CFR 3560.103], the Loan Servicer must request the borrower to modify the annual capital plan. The Loan Servicer may also request modifications if it is found that the borrower has proposed expenditures to be paid from reserves that should be charged to the operating account.

5. *Part VI - Narrative, Signatures, Dates and Comments*

This section of the form will be used to complete the borrower's Budget Narrative, Signatures, Dates and Comments.

Budget Narrative:

The budget narrative provides a description of the budget and highlights important elements to aid Loan Servicers in their review of the budget.

The budget narrative must be completed, or the budget will be considered incomplete and returned for correction.

◇ Items to Be Covered in a Budget Narrative:

The following information should be included in the budget narrative.

- A brief description of the project and its status. The description should address key indicators of project status.
- A statement of project compliance. Indicate any outstanding monitoring findings and the progress in addressing the problems.
- An explanation of projected capital expenditures and reserve withdrawals for the upcoming year and capital needs for the next three years.
- A description of the project's overall financial status and important factors contributing to the changes. (Vacancy, workout plan status, debt deferrals, servicing efforts.) If the analysis reveals that the subtotal for any operating expense category (maintenance and operating costs, utilities, administration, or taxes and insurance) exceeds the tolerance threshold, the borrower will provide adequate documentation that the expenses for this category are reasonable and necessary. For example:

Costs are comparable to the costs for similar properties in the conventional market. In this example, the borrower might show that insurance costs for the same coverage at a conventional project are comparable to the costs for the project shown in the budget.

- The factors contributing to the cost increases are beyond the borrower's control and the borrower is actively implementing cost-containment measures. For example, the project is subject to utility rate or tax increases.
- The cost increase is needed to cover actions to address identified physical deficiencies that are not due to negligence by the borrower or the management agent. Physical deficiencies that are due to negligence by the borrower or the management agent are not acceptable reasons for a rent increase.

- ***Signatures:***

The budget form requires signatures of the borrower. If the budget has been submitted electronically, a signed copy is not required to be submitted to the Agency. Agency approval may be by letter submitted electronically or by signing and returning form RD 3560-7.

- ***Comments:***

Borrowers are encouraged to submit additional information detailing sources and uses of cash required. Detailed breakouts should relate to specific line subtotals or total entry as listed on the form. Comments are encouraged to better explain the contents of the submitted budget. Use the comment area if additional disclosures or analyses are necessary. Rural Development Servicing Officials should document additional relevant information, or record issues or concerns noted during review.

C. Borrower Submission Requirements

The borrower should ensure that the project budget meets all the following:

- ***Complete Budget***

The Budget is considered complete when the borrower has submitted the information listed in Exhibit 4-1.

- ***Changes in Rents***

It may be necessary for the borrower to request Agency approval to effect a rent change as operating costs and/or revenues in a project fluctuate. Exhibit 4-3 shows the timeline for borrower submission and Agency review of rent change requests.

All borrowers, including those using the Department of Housing and Urban Development (HUD) project-based Section 8 contract assistance, must obtain prior Agency approval for a rent increase. Changes in rental rates will apply to all units in a project. Rent change requests for multi-family housing projects with no HUD subsidy are typically submitted and reviewed at the same time the borrower submits an annual budget for approval. Rent changes in HUD project-based Section 8 projects resulting from rent increases by HUD must also be reviewed and are not to be automatically approved. As with any Section 515 project, only the amount of rent necessary to cover project expenses must be approved.

- ***Annual Utility Allowance Reviews***

The borrower should review utility allowances on an annual basis to determine whether any changes need to be made. The borrower should indicate changes or no changes to utility rates in the budget narrative. Setting Utility Allowances:

The utility allowance is based on expected costs for utilities. Once established, the borrower must review the utility allowance annually. This is done in conjunction with the annual budget process. The borrower must submit documentation along with *Form RD 3560-7* to the Field Office using the following procedures:

1. A 12-month average will be used for the calculation.
2. Borrowers must establish utility allowances for each size and type of rental unit in the housing project based on utility costs.
3. Borrowers will request a change to the existing utility allowance if the proposed change is 10 percent or more.
4. A summary of the calculations must be submitted to the Servicing Official along with the *Form RD 3560-7*.
5. The borrower must obtain the following documentation describing the utility allowances and keep in the project files:
 - **Rate Changes:** Documentation of the rate changes may include actual billing information or documentation from utility companies;
 - **Usage:** Documentation of a 12-month sampling of tenant utility usage from the utility company. A sampling will be dependent on the size of the project and will include every size of unit. If tenant utility information is unavailable from the utility company or only provided at cost, utility billings received by tenants are acceptable.

- **No Changes:** Documentation of no change in utility rates has occurred during the period being reviewed. A public release from the utility provider indicating no change in rates has occurred during the period reviewed is acceptable. The borrower should indicate no changes to utility rates in the budget narrative.

- ***Tenant Notification and Comments***

At the same time the borrower submits the initial Notice to the Agency that it intends to submit a rent or utility allowance change request, the borrower will send or deliver notices to each tenant in the project notifying them of the rent change request that will be submitted to the Agency with their annual budget. *Handbook Letter 203(3560)* provides an example of such a Notice. The borrower must also post this Notice in a common area frequented by the tenants, such as the laundry room or near the mailboxes.

The Notice must inform the tenants that they have 20 calendar days to provide their comments to the Agency. If during this time the Agency receives any tenant comments, these must be immediately forwarded to the borrower with the identity of the tenant protected. This can be done by either paraphrasing the comments for the borrower or by removing any identifying information from the correspondence received from the tenant before forwarding it on to the borrower. The Agency will respond to the tenant that their comments will be considered in the review of the budget. Upon conclusion of the 20-day comment period, the Agency must notify the borrower of approval or denial within 10 days.

Exhibit 4-1 Information required for a complete Budget Submission reflects information the borrower is required to submit on the annual budget for the project.

Exhibit 4-1**Information Required for Budget Submission to be Complete**

1. *Form RD 3560-7* must be used to reflect the project's financial needs for the year and thereby rental charge requirements. A new operating budget for the fiscal year must include:
 - Proposed budget at proposed rents
 - Operating and Maintenance Expense Schedule
 - Rent Schedule and Utility Allowance
 - Annual Capital budget
 - Narrative explaining
 - Project statusProject compliance
 - Rent and utility allowance change justification
 - Projected capital expenditures and reserve withdrawals
 - Outstanding findings
 - Servicing effort status (Work out plan / other debt)
 - Project financial accountability and concerns
 - Account status (T&I, GOA, Reserve)
 - Any unique situations
2. *Utility allowance review.* Required documentation for utility costs as described earlier in this Chapter and Chapter 7.
3. *HB Letter 203(3560)* Notice to Tenants (Members) Of Proposed Rent (Occupancy Change) And Utility Allowance Change (if applicable).
4. *Other information.* Any other information the borrower believes is necessary to justify the proposed rent and/or utility allowance change request.

- **Documentation**

The borrower must fully document any rent and utility allowance change request. Requests for a rental charge change must be based on a realistic projected budget for the interim year or the ensuing full year. The borrower must provide to the Agency the information identified in Exhibit 4-1 with the rent or utility allowance change request.

The narrative attached to the budget form must clearly explain the necessity for the change request, and the Loan Servicer must analyze the supporting documentation to the budget *Form RD 3560-7*, to see if it supports the request. For example, if the rent increase is due to increased taxes, then the Loan Servicer should look for copies of tax increase notices in the budget documentation. If the rent increase is due to an increase in general operating expenses, the Loan Servicer must review those expenses for reasonableness.

- ***Late Budget Submissions***

The schedule provided for budget reviews relies on timely submission of budget documents by the borrower. If the borrower is tardy in submitting required documents, the Agency cannot ensure that all deadlines will be met. Therefore, if a borrower submits the budget late, Agency deadlines no longer apply, and the borrower is not eligible for “automatic approval” of the budget (as discussed in Paragraph 4.14 D of this chapter). If no budget is approved by the end of the project’s fiscal year, the borrower must operate under the previously approved budget (referred to as a Carry-Over budget) until the Agency reviews and approves the new budget.

- ***Carry-Over Budgets***

If a budget for the new fiscal year is not entered in MFIS before the first day of the fiscal year, a Carry-Over budget is automatically built from the prior year budget on the first day of the project’s fiscal year by MFIS. This is necessary as the borrower has not presented an acceptable budget in time to be effective on the first day of the project’s fiscal year and is, therefore, operating under the current existing budget, which would then become the Carry-Over budget.

When an acceptable budget is received, after the beginning of the fiscal year, a Mid-Year Budget will need to be completed.

- ***Mid-Year Budgets***

A Mid-Year Budget is a budget that has an effective date other than the first day of the project’s fiscal year. This type of budget should be used if there is a change in rents or utilities on the project after the current budget has been approved. It should include operating income and expenses that would be expected for the next 12 months after the effective date of the budget.

MFIS will prorate the budget correctly for analysis. The Mid-Year Budget will need to be added to MFIS with the new effective date. This process would also be used for transfers to establish the first budget.

A Mid-Year Budget may also be needed if the regular annual budget was not submitted and approved prior to the first day of the project's fiscal year and a Carry-Over budget went into effect.

Exhibit 4-2 Timeline Example for Carry-Over and Mid-Year Budgets provides an example of the timelines for Carry-Over and Mid-Year budgets and updates in MFIS.

Exhibit 4-2 Timeline Example for Carry-Over and Mid-Year Budgets		
1.	No budget was received by 1-1-XXXX	MFIS creates a Carry-Over budget using a 1-1-XXXX approved date.
2.	Budget received 2-10-XX with rent change effective 6-1-XX	Create new budget in MFIS (Mid-Year budget) with effective date of 6-1-XXXX

Exhibit 4-3 Schedule for Budget Submission and Review provides the timeframes for project budget submission and its review by Loan Servicers.

Exhibit 4-3
Schedule for Budget Submission and Review

Budgets Without Rent Change

60 calendar days prior to end of the project's fiscal year <i>November 1*</i>	Borrower submits all necessary budget documents to Agency. Within 30 calendar days of transmitted, the Agency must take action by approval or denial of the budget or contact the Borrower to request additional information or clarification.
30 calendar days prior to end of fiscal year <i>December 1</i>	Agency approves or denies the budget.** - If the budget was unacceptable, the borrower may submit additional information to address deficiencies within 10 calendar days. - Agency makes final approval or denial of budget within 20 calendar days of receipt of this additional information.
End of fiscal year <i>December 31</i>	Final approval or denial of the budget. If budget is denied, the current year's budget remains in effect.

Budgets With Rent Change

90 calendar days prior to end of fiscal year <i>October 1*</i>	Borrower notifies tenants of requested rent change (<i>Handbook Letter 203(3560)</i>) and submits all necessary budget documents to Agency. - Tenants have 20 calendar day comment period to provide comments to Agency. - Within 30 calendar days of transmitted, the Agency must take action by approval or denial of the budget or contact the Borrower to request additional information or clarification. If no action is taken and the rent increase is \$25 or less, it may be considered automatically approved.
60 calendar days prior to end of fiscal year <i>November 1</i>	Agency provides notice to the borrower of budget approval or denial.** - If the budget was unacceptable, the borrower may submit additional information to address deficiencies within 10 calendar days. - Agency has 20 calendar days to review the additional information.
30 calendar days prior to end of fiscal year <i>December 1</i>	Agency gives final approval or denial of the budget. - If the budget is approved, tenants must have at least 30-calendar days' notice (<i>Handbook Letter 204(3560)</i>) or notification required by local law before the rent increase takes effect. If notices given to tenants at the outset stated the correct amount of the effective increase, then the 30-calendar day notice has been given. - If the rent increase is denied, the borrower may submit a revised budget at previously approved rents with expenditures acceptable to the Agency. In the absence of such a revised budget, the current year's budget remains in effect. - Tenants will receive Handbook letter 204 (3560) notifying of RD approval or denial of the rent change
Beginning of project's fiscal year <i>January 1</i>	New budget and rent increase take effect.

* The dates provided are for a sample project with a fiscal year that begins January 1. For projects with different fiscal years, adjust accordingly.

** If the borrower submitted the budget on time and has not been notified by the Agency of any deficiencies by this time, the budget is considered approved unless it is not eligible for automatic approval.

D. Agency Review Requirements

Loan Servicers must take the steps shown in Exhibit 4-4, Steps in the Budget Review and Approval Process, when reviewing and approving budgets.

Exhibit 4-4	
Steps in the Budget Review and Approval Process	
•	Follow procedure for receipt of budgets;
•	Prioritize budgets for review;
•	Review outstanding monitoring findings;
•	Review the budget for reasonableness;
•	Review the rent change, if requested; and
•	Approve or deny the budget.
•	Update MFIS

Budgets for projects that receive HUD project-based Section 8 assistance need to be reviewed with the same rigor as other projects. However, there are certain procedures that differ. These procedures are discussed later in the chapter.

1. *Receiving the Budget*

Standard procedures for budget receipt will help Loan Servicers track the progress of budgets through the approval process and meet approval deadlines. Further, intake procedures should help prioritize the review of budgets so that those with the highest priority (e.g., those with rent changes) receive the attention they need in a timely manner.

The following steps are taken upon receipt of budget submissions:

- When hard copies of the budget are submitted, the documents should be date stamped, entered into MFIS (complete transmitted date and input the financial details), and forwarded to the appropriate Servicing Official for review.
- When budgets are transmitted through MINC, the Loan Servicer will find the budget under Industry Interface in MFIS. If the budget transmission is accepted, the system will complete the transmitted date for this item. The following items are needed for the budget to be accepted by the MFIS system:
 - ◊ Effective day must be 1st of the month.
 - ◊ Effective day must be within fiscal year range.
 - ◊ The budget cannot be in approved status.

- ◇ The type of units identified in the rent schedule submitted must match the units identified in MFIS and must support all project units.
- ◇ Budget line items identified as 'Other' must contain a supporting detailed comment.
- Within 30 calendar days of transmitted, the Agency must take action by approval or denial of the budget or contact the Borrower to request additional information or clarification. Refer to Exhibit 4-1 for complete budget requirements.
- If the budget submission is complete, the Loan Servicer will input the receive date in MFIS and the budget review should continue as described in the following sections. If the budget is incomplete, the Loan Servicer must take the steps described below.
- Incomplete Budgets
 - If any items are missing or are of such poor quality that there is insufficient information to begin an assessment of the budget, the budget is considered incomplete.
 - If the budget submission is incomplete, the Loan Servicer must contact the borrower in writing, stating that the budget is incomplete, and discuss the deficiencies.
 - ◇ If the borrower submits the information within 10 days, the budget is considered to be on time, and the review can still be completed prior to the end of the fiscal year. The budget is eligible for automatic approval, as described later in this chapter.
 - ◇ If the borrower does not submit the requested information within a 10-day time period from the Agency's contact, the Agency cannot guarantee approval of the budget before the beginning of the new fiscal year. In these cases, the borrower must continue operations under the previous year's budget until a budget is approved. The borrower is not eligible for automatic approval as described in Paragraph 4.14 D, and the budget will be returned unapproved.
 - ◇ A Notice should be sent to the borrower when it is determined the budget is past the deadlines set by the Agency.

Agency Review Time

The total Agency review time for a budget from submission to initial approval or denial is 30 calendar days for budgets with or without rent increases.

If the initial budget is denied, this schedule allows for a second review of the budget and approval (if appropriate) before the start of the fiscal year. However, the Agency must take final action on all budgets within 60 calendar days of receipt of the borrower's budget.

2. Prioritizing Budgets for Review

After budgets have been received and determined to be complete, the Loan Servicer should prioritize budgets for review. Prioritizing the budgets helps to ensure that the budgets that require the most thorough review receive the attention they need. Budgets with the highest priority for review include budgets for projects with:

- Requests for rent increases above \$25/month;
- Vacancy rates above the allowable threshold; and
- Past monitoring findings.

While Loan Servicers should place the highest priority on reviewing these budgets, they should plan their time to allow for sufficient review of all budgets.

3. Reviewing Outstanding Monitoring Findings

Having determined that the budget submission is complete, the Loan Servicer must check the project for outstanding monitoring findings and assess whether the borrower's budget reflects adequate efforts to address these findings.

- If the outstanding monitoring issues have been adequately addressed in the budget, the Loan Servicer should proceed with the review for reasonableness.
- If project compliance issues have not been addressed, the budget documents should be returned to the borrower for revision.

4. *Review the Budget for Reasonableness*

If all outstanding compliance issues have been addressed, the Loan Servicer must review the budget for reasonableness using the steps outlined in Attachment 4-D Budget and Year End Analysis, to make a determination. These review items are automated in the MFIS budget analysis process. Attachment 4-D shows the items included in the analysis and how they are calculated

- Review Form RD 3560-7 to verify that all appropriate line items are completed. Perform a quick assessment to ensure that they appear to be completed properly.
- Complete the budget analysis which is required prior to entering an “Approved” date in the Supervisory Activity of MFIS. The analysis will reflect areas of observations and review items which will require comments. Just because an item is brought out as an observation or review does not necessarily mean the budget cannot be approved.
 - ◇ Observations are the results of a test performed that may be of importance to the loan servicer.
 - ◇ Review items are the results of a test performed that require comments as documentation of the review.
 - ◇ Ratio analyses are reflected in the Budget Analysis in MFIS and are an effective tool for financial analysis. They prescribe various measures of actual operating performance. The Loan Servicer should become familiar with these percentages as a comparative analysis and consider utilizing the Hyperion MFH Budget Line Item Comparative Cost data report for their Region in their analysis. The ratios ran in the MFIS Analysis Review are described in Attachment 4-D.
 - ◇ Norms are also reviewed on the Budget Analysis. The Norms are based on Regional Groupings of “like” properties. This gives the Servicer an analysis of how the property is performing compared to other “like” properties. The norm definitions are described in Attachment 4-D.
- Determine whether the ending cash balance exceeds the permissible limit. If it does, the surplus must be contributed to reserves to address capital needs, be deposited in the project’s reserve account, or applied to the loan balance to reduce the debt service on the borrower’s loan. Based on the surplus, the Agency may require a rent decrease.

- Verify that the capital budget is complete. Capital improvements including implementing a borrower's transition plan, and Capital Needs Assessment (CNA) should be included as part of the capital budget portion of Form RD 3560-7 when applicable. Compliance-related costs include reasonable fees and costs for preparing self-evaluations and transition plans.

- Annual Capital Expenditure Budget

The Loan Servicer uses the budget cycle to assess the borrower's annual capital expenditure budget compared with available information about the types of capital improvements needed to maintain the project's physical condition. Independent sources of information such as insurance actuary tables, FANNIE MAE Physical Needs Assessment Guidance to the Property Evaluator or Agency documentation should be consulted for common costs and repair/replacements schedules.

The Loan Servicer reviews the operating and annual capital budgets, and compares them with previous budgets, site visit reports, physical inspections, capital needs assessments, and audit reports. When doing so, the Loan Servicer should consider the following questions:

- ◇ Are expenditures sufficient to maintain the project according to the Agency's performance standards and the requirements of the project management plan?
- ◇ Were any essential items of maintenance deferred during the past year, which should be financed from the upcoming operating or capital budget?
- ◇ Are there any uncorrected defects noted in site visit reports that should be financed from the upcoming operating or capital budget?
- ◇ Has a CNA of the property been prepared? Does the budget match the prepared CNA?
- ◇ Is the amount budgeted for maintenance and replacement reserve expenditures sufficient to address immediate capital needs?
- ◇ If capital needs information is available from a prepared CNA, are replacement reserve contributions and funding levels sufficient to address anticipated capital needs over the next 5 years? Does the CNA need to be updated?

5. *Review the of Rent Change Requests*

When the borrower submits a budget with a rent or utility allowance change request, the Agency must respond to the borrower within 30 calendar days of submission. If the Agency does not contact the borrower, the borrower may assume that any rent change request of \$25 per month or less has been automatically approved.

Even if the Loan Servicer has determined that the budget is reasonable based on the tests outlined in Attachment 4-D, the rent increase must still be reviewed to confirm that the rent/utility allowance change will not adversely affect the marketability of the units and create a vacancy problem. If a review of the rent increase shows that the rent increase will adversely affect the marketability of units, the full rent increase cannot be approved. The borrower should seek a reduced rent increase and, if appropriate, request a servicing action that will enable the project to achieve a positive cash flow at lower rents. The Agency will not consider rent increases based solely on guaranteeing that the borrower will receive a Return at the end of the project's fiscal year.

a. Circumstances in which the Agency Will Not Approve a Rent Increase

The Loan Servicer must not approve a rent increase under the following circumstances:

- The borrower is able but unwilling to comply with program requirements. Such a borrower has ignored repeated requests from the Loan Servicer to take servicing actions by a specified deadline.
- If the borrower is in default of the Agency loan agreement and does not have an Agency-approved workout plan or is not in compliance with an Agency-approved workout plan.
- There are sufficient project funds under the existing rents to meet project operating expenses, and the borrower is not able to justify the higher rents. Such a condition is established when the project budget shows that income meets expenses at current rent levels.

- The project is operated on a for-profit basis, and the rent change would result in rents higher than what tenants can afford. This condition is established by comparing rents with 30 percent of tenant-adjusted incomes. If it is shown that tenants would be paying in excess of 30 percent of their adjusted incomes with new rents and the increase is not necessary to meet projected costs, then the increase must not be approved.

Addressing Rent Increases

Loan Servicers must make every effort to review budgets with significant rent increases within the time limits. Postponing approval is not an acceptable way to address rent increases.

b. Denial of Rent Change Requests

If the Loan Servicer denies the change request, the borrower must be notified of the denial and be provided with appeal rights. (See Chapter 1)

c. Effective Dates of Change

The effective dates of any approved changes will coincide with the start of the project's fiscal year or the start of the season for labor-housing projects. For a rent/utility change request on which comments were solicited and the amounts were increased from the original Notice, the borrower must deliver a notice to tenants, using Handbook Letter 204 (3560), announcing the rent or utility allowance increase to be effective 30 calendar days (or in accordance with local regulations) from the date of the notification. If the rent/utility increase will be the same as what was stated in the initial notice to the tenants, the initial notice then serves the purpose of "the Notice". HB Letter 204 (3560) will be sent to notify tenants of RD decision to approve.

If the rent/utility change figure from the original notice is revised downward, the borrower must notify the tenants of their new rents prior to the first day of the month in which the new rent amounts are due. However, the borrower does not have to give a 30-day notice of the new rents in this case.

For notices to tenants, see Appendix 4.

d. Rent Change Requests Under Special Circumstances (Mid-Year Budgets)

The Loan Servicer may accept borrower requests for rent or utility allowance changes at times other than with the annual budget

submission. Under special circumstances if a change is necessary to preserve the financial integrity of a project and the financial distress is due to circumstances beyond a borrower's control, a change request may be considered. Such circumstances might be in the event of a natural disaster, property transfer or when workout procedures and servicing actions are necessary.

When a Plan II housing project is experiencing severe vacancies due to market conditions, the Agency may allow the borrower to charge a Special Note Rent (SNR) that is less than Note Rent but higher than Basic Rent, to attract or retain tenants whose income level would require them to pay the SNR. The requirements for receiving an SNR are established in Chapter 10 of HB-3-3560.

Both of these situations would require a Mid-Year Budget be submitted to the Agency for approval.

e. Approving Utility Allowances

Agency Staff must review the utility allowance documents submitted with the budget to make sure that the numbers being used are reasonable and comparable to other projects in the same market area. In addition, the Loan Servicer should check project budgets of any other Agency-funded projects in the area to see if utility allowances are similar.

f. Rent Changes for Units Receiving HUD Project-Based Section 8 Assistance [7 CFR 3560.207, and HUD's Section 8 Renewal Policy Guide Book, Chapter 14]

The Agency has the responsibility to review and approve project budgets on an annual basis based on need to meet cash flow and expense requirements. Therefore, the Loan Servicer will not take into account HUD's automatic annual adjustment for Section 8 contract rents. The Loan Servicer must approve only the rents needed to provide sufficient income to meet approved project expenses.

The agreement in the Memorandum of Understanding (MOU) between HUD and Rural Development indicates that the RD-approved budget will be submitted to HUD by the Project Owner and will serve as the basis for the budget-based rent in the contract renewal process. The rents at initial renewal will be determined by the HUD staff, who will compare the RD-approved, budget-based rent as submitted by the Project Owner to the current rents adjusted by an Operating Cost Adjustment Factor (OCAF) and will set the contract rent at the lesser of the two amounts. HUD staff will then notify both RD and the owner of the new contract rents. Rent adjustment at subsequent renewals will be determined by OCAF unless the owner requests and HUD approves a budget-based increase that has been approved by RD.

Since HUD- and Agency-approved rental rates frequently differ, it may be necessary to have a 3-column budget in properties with HUD project-based Section 8 contracts. Exhibit 4-5 Reviewing Budgets with HUD Subsidies depicts how many columns are required in the budget, depending upon the project type.

Exhibit 4-5 Reviewing Budgets with HUD Subsidies	
<u>Project Type</u>	<u>Rents Needed In Budget</u>
• Section 8/Section 515 without interest credit.	• Note Rate Rent (HUD contract rent); difference is excess funds and deposited into reserves.
• Section 8/Section 515 with interest credit.	• Basic Rent, Note Rate Rent, and HUD contract rent.

When reviewing the budget, if the Loan Servicer concludes that the HUD-authorized rent is more than what is needed to meet project expenses, a lesser amount than the HUD rent must be approved. When this occurs, in accordance with Exhibit 4-6 Impact of Interest Credit Agreement on Ability to Cancel Interest Credit, Collect Overage, and Deposit Excess Funds in the Reserve Account, the borrower must deposit the difference between the Agency-approved Note Rate Rent and the higher HUD-authorized rate into the reserve account. The manager or borrower must use *Form RD 3560-29*, Notice of Payment Due Report, to document the required deposit in the reserve account. The Loan Servicer will monitor this deposit when reviewing the year-end actuals.

If excess HUD rents accumulate in the reserve account beyond the sum shown in the borrower's loan agreement or resolution, the Loan Servicer may reduce or cancel the interest credit on the project. The Agency may reinstate interest credit whenever HUD rent becomes lower than the Agency Note Rate Rent, determined by the Interest Credit Agreement. Refer to Exhibit 4-5.

Before depositing excess funds in the reserve account, the borrower may have to collect overage. Whether overage is collected, and a project is subject to cancellation of interest credit depends upon the issuance date and execution date of the project's interest credit agreement.

Certain early versions of the Interest Credit Agreement do not have a legal basis to support the Agency's policy to cancel interest credit or collect overage to offset interest credit. Each HUD project-based Section 8/Section 515 project needs to be categorized according to the issuance date and execution date of the project's Interest Credit Agreement on Form FHA 444-7, Interest Credit Agreement or its successor Forms FmHA 444-7, FmHA 1944-7, and RD 3560-9.

Exhibit 4-6 Impact of Interest Credit Agreement on Ability to Cancel Interest Credit, Collect Overage, and Deposit Excess Funds in the Reserve Account provides a description of the rules that apply to each interest agreement form.

Exhibit 4-6 Impact of Interest Credit Agreement on Ability to Cancel Interest Credit, Collect Overage, and Deposit Excess Funds in the Reserve Account		
Form	Executed Before October 27, 1980	Executed On Or After October 27, 1980
FHA 444-7, dated 11/17/69 and 7/27/72	No basis to cancel or reduce interest credit, collect overage, or deposit excess funds in the reserve account unless the borrower agrees.	Legal basis exists to cancel or reduce interest credit, collect overage, and deposit excess funds in the reserve account and/or apply it on the loan.
FmHA 444-7, dated 10/13/77	• If first, second, fourth or fifth block of paragraph 2 checked, no legal basis to cancel or reduce interest credit, collect overage, or deposit excess funds into reserves. • If the third block of paragraph 2 is checked, no legal basis to cancel or reduce interest credit, unless borrower agrees. However, there is legal basis to collect overage and deposit excess funds to reserves and/or apply it on the loan.	Legal basis exists to cancel or reduce interest credit, collect overage, and deposit excess funds in the reserve account and/or apply it on the loan.
FmHA 1944-7, dated 11/29/82		Legal basis exists to cancel or reduce interest credit, collect overage, and deposit excess funds in the reserve account.
FmHA 1944-7, dated 4/85		Legal basis exists to cancel or reduce interest credit, collect overage, and deposit excess funds in the reserve account.

6. *Approval or Denial of Budgets*

Once the budget analysis is complete, Loan Servicers must notify the borrower whether the budget has been approved or denied.

a. **Budget Approval**

If a budget is received with reasonable operating expenses and a rent increase request to cover turnover costs and maintenance costs in line with comparable properties, the Agency should not unreasonably withhold approval. In some cases, rents may need to be increased. When market conditions do not allow for sufficient rents to fund both operating and capital needs, the workout authorities of 7 CFR 3560, Paragraph 3560.453 should be reviewed for their applicability in the situation.

If the Loan Servicer has determined that the budget represents reasonable costs and adequately addresses all outstanding compliance issues in the budget, the reserve account is current, and the rent change (if requested) is acceptable, the budget may be approved. To approve the budget, Loan Servicers must acknowledge approval (*Form RD 3560-7*). This acknowledgement may be by letter if the budget was submitted electronically, or by signing, and returning a copy of the form to the borrower with a cover letter. The Loan Servicer must also enter the approval date in MFIS. If the approved rent/utility change is increased from the originally posted change, the borrower must deliver a notice to tenants announcing the rent or utility allowance increase to be effective 30 calendar days (or in accordance with local regulations), from the date of the notification using Handbook Letter 204 (3560).

b. **Automatic Budget Approval**

Budgets that are not reviewed within the 30-day period are automatically approved unless:

- ◊ The budget proposes a monthly rent increase above \$25/month per unit; or
- ◊ The budget is submitted late or misses other deadlines set by the Agency.
- ◊ Vacancy rates are above the allowable threshold.
- ◊ Property is under a workout plan or debt deferral.

If a budget is not eligible for automatic approval and no decision is made prior to the beginning of the project's new fiscal year, the borrower must continue operations under the previous year's budget. A denied date must be completed in MFIS at this time. In these cases, the Agency must continue to work with the borrower to address the requested increase. When an agreement is reached, a new budget may take effect.

A notice will need to be sent to the borrower when it is determined the budget submission is past the deadline set by the Agency. If no response is received within timeframes established in the Notice, servicing actions will begin using Servicing Letter #1 (HB-3, HB Letter 301 (3560)).

c. Procedure for Automatic Approval

In the case of automatic approval, the Loan Servicer must still acknowledge approval (Form RD 3560-7). This acknowledgement may be by letter if the budget was submitted electronically, or by signing and returning a copy of the form to the borrower with the letter.

d. Budget Denial

If the Loan Servicer denies the proposed budget because it is found to be unacceptable for reasons related to outstanding monitoring findings, cost reasonableness, reserves, or a rent increase, the borrower has an opportunity to address the deficiencies.

- ◊ The Loan Servicer must return the proposed budget to the borrower with a letter listing deficiencies.
- ◊ The Loan Servicer must enter the appropriate 'Denied' tracking step in MFIS.
- ◊ The borrower has 10 calendar days to submit new information to the Agency. The borrower may adjust the size of the rent increase requested or provide new documentation to justify budget items.
- ◊ The Loan Servicer must review the new submissions within 20 calendar days of receipt, and either approve or deny the budget.
- ◊ If the budget is approved based on the new submissions, the Loan Servicer must acknowledge approval. Approval may be by letter submitted electronically or by signing and returning a copy of the

form to the borrower. MFIS will be updated by removing the “Denied” step and populating the “Approved” step.

- ◊ If the budget is denied based on the new submission, the Loan Servicer must send the borrower a letter stating the deficiencies and informing the borrower that the previous year’s budget remains in effect. The borrower must be given the option to submit a new budget using the previous year’s rent levels but adjusted for projected capital expenditures and other known changes for the coming year. The borrower may appeal the budget denial in accordance with Agency appeal procedures.

SECTION 5: REPORTING AND FINANCIAL EXAMINATION

4.15 MONTHLY AND QUARTERLY REPORTS [7 CFR 3560.307]

A. Overview of Reports

Financial reporting provides the Agency and the borrower a means to monitor the project’s financial progress.

- **Quarterly Reports.**

Quarterly reports based on a Borrower’s Fiscal Year are required in the following situations:

- At completion of new construction or substantial rehabilitation;
- When the project is subject to a workout agreement; and
- In the case of reamortization and transfer of an existing project loan.

- **Monthly Reports.**

Loan Servicers may require borrowers to prepare and submit reports on a monthly basis when additional tracking and supervision are needed. For example, when a project is subject to a workout agreement; when there has been a violation of program rules or reporting requirements; or, when the project shows signs of financial distress.

Loan Servicers may notify in writing the borrower to discontinue the monthly reporting requirement for projects that have demonstrated consistent compliance with program requirements over a sufficient time. Generally, 12 months of consistent compliance is considered sufficient to discontinue the reporting requirements.

B. Review of Monthly and Quarterly Reports

The borrower must submit the required reports following the close of the reporting period (quarter or month, as appropriate), and submit them to the Agency by the 20th of the month following the reporting period via the MINC system. Upon receipt, the Loan Servicer must review the analysis report as indicated in Attachment 4-D, and review the following:

- ◇ Look for red flags such as dramatic changes in income, expenses, the general operating account, or the reserve account.
- ◇ Check balances in accounts as referenced in Paragraph 4.3 Overview of Accounts in this chapter, to make sure they are consistent with the management plan, loan agreement/resolution, and the budget.
- ◇ Check project expenditures against the budget. Make sure the project is being operated in accordance with the approved budget.
- ◇ Check progress against workout agreements. Make sure the borrower is taking any actions indicated in a workout agreement and is abiding by the established schedule for these actions.

4.16 ENGAGEMENTS AND PREPARATION OF ANNUAL FINANCIAL REPORTS [7 CFR 3560.308 and 7 CFR 3560.578]

A. General Requirements for All Borrowers: Annual Financial Reports

To ensure that the project is in sound financial condition and is complying with the program financial management requirements, the Agency requires annual financial reports to be submitted by each borrower.

All borrowers who have a Section 515 Rural Rental Housing (RRH) loan or a Section 514 Off-Farm Labor Housing loan must comply with the financial reporting requirements of this section. The requirements are established based on combined Federal Financial Assistance and risk thresholds for each borrower. Projects with fiscal years ending 12-31-19 and after are to follow the reporting requirements outlined in this Section.

Combined Federal Financial Assistances is defined as a combination of any or all of the following sources:

- Outstanding principal balance and deferred principal balance at the beginning of the fiscal year of a United States Department of Agriculture (USDA) Mortgage, a mortgage insured by the Federal Housing Administration (FHA) or HUD held mortgages and other Government insured loans (Including but not limited to HOME, and CBDG loans);
- Any USDA Rental Assistance or Project based Section 8 assistance received during the fiscal year;
- Interest reduction payments received during the year (interest subsidy);
- Federal grant funds received during the year and/or;
- Outstanding principal balance at the beginning of the fiscal year of an existing USDA Section 538 Guaranteed Rural Rental Housing loan.

Funds the borrower entity receives which must comply with Federal statutes, regulations, or terms and conditions of Federal awards will be included as Federal Financial Assistance.

Exhibit 4-7 Year End Financial Reporting Requirements outlines the financial reporting requirements for specific types of properties.

Exhibit 4-7 Year End Financial Reporting Requirements			
For-Profit or Limited Profit			
Total Borrower Federal Financial Assistance*	Forms RD 3560-7 and 3560-10	Borrower Certification of Performance Standards	Uniform Administrative Requirements Audit required
RD Borrower with less than \$500,000 in Federal financial assistance	Yes	Yes	No
RD Borrower with \$500,000 or greater in Federal financial assistance	Yes	Yes	Yes**
State and local Governments, Indian tribes and Non-Profit Organizations			
Total Borrower Federal Financial Assistance*	Forms RD 3560-7 and 3560-10	Borrower Certification of Performance Standards	Single Audit in accordance with 2 CFR part 200 subpart F
RD Borrower with less than \$750,000 in Federal financial assistance	Yes	Yes	No
RD Borrower with \$750,000 or greater in Federal financial assistance	Yes	Yes	Yes***
*See RD Programs Audit Determination Worksheet and Major Program Determination – Attachment 4-G. Compilation of Prescribed Forms may be necessary, if an audited financial statement is not required by another federal agency or other business agreement, **Must be completed by an Independent CPA. ***In accordance with the Council of Financial Assistance Reform (CoFAR) uniform guidance. This Single Audit is in accordance with 2 CFR part 200 subpart F, Appendix XI Compliance Supplement; and submitted to the Agency as part of the financial reporting requirements. Must be completed by an Independent CPA.			

Borrowers will be required to submit Forms RD 3560-7 and 3560-10 electronically through MINC. The Agency may make an exception to these requirements if the borrower submits documentation that the costs associated with electronic submission would pose a financial hardship to the project.

Borrowers with fewer than 8 units may submit hard copies to the Agency within 90 calendar days of the project's fiscal year end.

B. Budget Actuals and Balance Sheet

Year-end reporting requirements include the use of Forms RD 3560-7, *Multiple Family Housing Project Budget/Utility Allowance Budget Actuals* and Form RD 3560-10, *MFH Borrower Balance Sheet*.

- *Form RD 3560-7* is used for end-of-year reporting using actual income and expenses.
- *Form RD 3560-10* is a summary of the balances of the accounts, a listing of the liabilities, long term debts, and an indicator of the net worth of the project.

If the borrower has accurately reported actual income and expenses, specific figures on the two forms should be the same.

- Ending balances of the accounts listed on *Form RD 3560-7*, Part III should match the balances listed on *Form RD 3560-10*, lines 1-4.
- Ending cash balance on *Form RD 3560-7*, line 33 should match the balances listed on *Form RD 3560-10*, lines 1, 2, 5, and 6. These checks are a part of the analysis run in MFIS.
- Since the borrower is using the accrual method of accounting, the accrual-to-cash adjustment, *Form RD 3560-7*, line 32 must equal the difference between lines 31 and 33. This ensures *Form RD 3560-7*, lines 31 and 33 match their respective figures on *Form RD 3560-10*. The sole purpose of this adjustment is to reconcile a company's internal ledger kept on an accrual basis to the IRS forms which are required to be on a cash basis.

Borrower signatures are required on these forms. If they are submitted electronically through MINC, signed copies are not required to be submitted to the Agency.

C. Borrower Certification of Performance Standards

All financial reports must include a Borrower Certification of Performance Standards. Attachment 4-F is used by the owner to certify to these standards. The Borrower or borrower representative must sign and date this self-certification.

The Borrower must self-certify:

- ◇ Required accounts are properly maintained and tracked separately;
- ◇ Payments from operating accounts are disclosed and accurately represented;
- ◇ Reserve Account is current and maintained in a supervised account or have an approved Deposit Agreement executed after October 1, 2018 allowing for a non-supervised account, contributions are on schedule, the balance accounts for contributions less authorized withdrawals; and there are no encumbrances;
- ◇ The replacement reserve account was used for authorized purposes in accordance with 7CFR 3560.306 (g);
- ◇ Tenant security deposit accounts are fully funded and are maintained in separate accounts;
- ◇ Payment of ROI was consistent with the terms of the applicable loan agreement or loan resolution;
- ◇ Borrower/grantee has maintained proper insurance in accordance with the requirements of 7 CFR 3560.105;
- ◇ All financial records are adequate and suitable for examination.
- ◇ There have been no changes in project ownership other than those approved by the Agency and identified in the certification. All current owners are to be identified in the Status Report of Ownership table on Attachment 4-F. All Non-Profit Organizations certify that the board is active and maintains oversight of the property; and
- ◇ Real estate taxes are paid in accordance with state and/or local requirements and are current.

D. Owner's Compilation of Prescribed Forms

For-profit or limited profit borrowers that receive less than \$500,000 in combined federal financial assistance, for which there are no audit requirements per other agencies or agreements, will submit an annual owner certified compilation of prescribed forms containing Form RD 3560-7 and Form 3560-10 utilizing the accrual method of accounting in accordance with Statements on Standards for Accounting and Review Services (SSARS) promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants (AICPA). Borrowers may use a CPA to complete this report of the prescribed forms. Attachment 4-K provides an example of an Independent Accountants Compilation report on RD Prescribed forms. Attachment 4-L

provides the Owner certified Prescribe forms supporting documentation schedules.

E. Financial and Compliance audit utilizing HUD Office of Inspector General's (OIG) Consolidated Audit Guide standard

For-profit or limited profit Borrowers that receive \$500,000 or more in combined federal financial assistance must submit an independent auditors' report. A CPA must perform the audited financial statements.

Attachment 4-H is an example Engagement Letter which will be used by a CPA. This Engagement Letter should include the procedure, audit objectives to be performed and the fees associated with the service. There may be circumstances where the auditor may ask for information from Rural Development due to third party verification requirements. The Servicing Official shall receive a complete copy of this signed Engagement Letter prior to releasing information to the CPA. to include financial statements and notes to the financial statements, supplemental information containing Agency approved forms for project budgets and borrower balance sheets, a report on internal control over financial reporting and on compliance and other matters based on an audit of financial statements in accordance with Generally Accepted Government Auditing Standards; a report on compliance for each major program and internal control over compliance (if applicable). Attachment 4-M provides a typical report and supporting documents.

Borrower's s will utilize HUD's Office of Inspector General's (OIG) Consolidated Audit Guide located at <https://www.hud.gov/sites/documents/20004OIGH.PDF> in developing the audit. The audit will not utilize HUD's Chart of Accounts, nor will the report require the CPA to review any tenant files, as this compliance test is being conducted by MFH field staff during regularly scheduled supervisory visits and annual improper payment auditing.

An audit will consist of the following items (financial statements issued in two-year comparative format, as applicable):

- Independent Auditor's Report
- Financial Statements
 - Balance Sheets
 - Statements of Operations
 - Statements of Changes in Partner's Equity (Deficit)
 - Statements of Cash Flows
- Notes to the Financial Statements

- Supplemental Information
 - Management Fee Calculation
 - Insurance Disclosure
 - Return to Owner
 - Changes in Rental Property
 - Accrual to Cash Schedule
- Multiple Family Housing Borrower Balance Sheet and supporting documentation – Form RD 3560-10
- Multiple Family Housing Project Budget and supporting documentation – *Form RD 3560-7*
- Independent Auditors Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards
- Independent Auditor's Report on compliance for each major RD program and Internal control over Compliance
- Audit Findings
- Corrective Action Plan (if applicable)

F. Standards for State and local governments, Indian tribes, and Non-Profit Organizations

1. State and local governments, Indian tribes, and Non-Profit Organizations that receive less than \$750,000 in combined Federal financial assistance and there are no audit requirements per other agencies or agreements will submit an annual owner certified compilation of prescribed forms containing Forms 3560-7 and 3560-10 utilizing the accrual method of accounting in accordance with Statements on Standards for Account and Review Services. A CPA may be used to complete the prescribed forms. Attachment 4-K is provided as an example.

2. State and local governments, Indian tribes, and Non-Profit Organizations that receive \$750,000 or more in combined federal financial assistance must submit audits in accordance with 2 CFR 200, Part F, and the Office of Management and Budget's (OMB) Uniform Administrative Requirements, Cost Principles and Audit Requirements for Federal Awards. Copies of the audit will be forwarded by the borrower to the Servicing Official and the appropriate Federal cognizant

agency for audit. Within USDA, the USDA, OIG fulfills “cognizant agency” for audit responsibilities, (see “cognizant agency” defined 7 CFR 3052.105).

Attachment 4-N is provided as an example of Single Audit requirements. The auditor may refer to the American Institute of Certified Public Accountants (AICPA) for additional guidance in meeting audit requirements.

Organizations subject to 2 CFR 200, Part F, must submit the single audit along with the borrower’s certified performance standards (Attachment 4-F), Forms RD 3560-7, and 3560-10. Per Uniform Guidance the single audit should also be submitted using the Federal Audit Clearinghouse. The audit will not require the CPA to review tenant files, as this compliance test is being conducted by MFH field staff during regularly scheduled supervisory visits and annual improper payment auditing.

G. Other Financial Reports

- **Additional Opinions.**

The Agency may require additional opinions of financial condition and compliance, such as audits, to ensure the security of the asset; to determine whether the project is being operated at a reasonable cost; or to detect fraud, waste, or abuse.

- **Annual Financial Statements.**

Another regulatory agency, legal entity, and/or other business agreement may require an audit in accordance with Generally Accepted Auditing Standards or Government Auditing Standards. Any project audits independently obtained by the borrower must be submitted to the Agency.

H. Annual Financial Reporting Due Dates and Agency Review of Annual Financial Reports

1. Annual Financial Reporting Due Date

For-Profit or Limited Profit – Annual financial reports including *Form RD 3560-7* with 12 months of actual income and expenses, *Form RD 3560-10*, compilations of prescribed forms, certification of performance standards and audits, as appropriate, must be submitted to the Agency no later than 90 days following the close of the project fiscal year.

State and local Governments, Indian tribes and Non-Profit

Organizations – 2 CFR §200.512 allows the audit of Not-for-profits to be submitted within the earlier of 30 days after receipt of the auditor’s report, or 9 months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit.

If the annual financial reports cannot be submitted by the due date, the borrower must present a request for extension supported by evidence that delay is at the request of the auditor, and the request has a reasonable explanation of why an extension of the due date is needed. The Servicing Official may authorize up to a 30-day extension of the due date.

If an explanation is not forthcoming from the Borrower, or the explanation received is without good reason, or the Servicing Official otherwise suspects fiscal difficulty, the Servicing Official may request the borrower to submit to the Servicing Office for review, the project bank statements for the general operating, reserve, and investment accounts covering the most recent 60-day period.

If the borrower fails to submit the requested bank statements by the date stipulated by the Servicing Official, the Servicing Official will immediately refer the matter to the OIG.

The Servicing Official may authorize the initial verification of review to cover a period up to 18 months for a new project whose first operating year was less than 6 months or when an existing owner changes their fiscal year.

2. Agency Review of Annual Financial Reports

Loan Servicers must review financial reports within 60 days of receipt, in accordance with guidelines provided in Attachment 4-O to ensure that they meet Agency requirements. Loan Servicers will complete the checklist provided as Attachment 4-O. In particular, Loan Servicers must:

- ◇ Confirm that the engagement (audit report) was conducted as described in the requirements above;
- ◇ Confirm that the performance standards were certified as described above;
- ◇ Confirm that non-profit and public bodies have submitted any OMB required annual financial statements;
- ◇ Note any findings identified in the engagement and determine corrective actions. These would be located in the findings of the audit findings page;
- ◇ Utilize the MFIS analysis tool to perform the preliminary assessment of the financial statements. Refer to Attachment 4-D for the Analysis process;

- ◇ Confirm the information on *Forms RD 3560-7 and 3560-10*, submitted to the Agency electronically through MINC, is the same as the forms submitted with the financial reports from the auditor.
- ◇ If the Loan Servicer has determined that the annual financial reports are suitable, the reports may be accepted. To approve the financial reports, Loan Servicers must acknowledge acceptance (*Form RD 3560-7*). This acknowledgement may be by letter if the report was submitted electronically, or by signing and returning a copy of the form to the borrower with a letter. The Loan Servicer must also enter the final reviewed date in MFIS.

If the Loan Servicer has determined that the annual financial reports are not acceptable, a notice will be sent to the borrower explaining the issues and requesting a response within 30 days. If no response is received from this notice, servicing actions will begin using Servicing Letter #1 (HB-3, HB Letter 301(3560)).

X. PLANS FOR ACCOUNTING, RECORD KEEPING, AND MEETING USDA RURAL DEVELOPMENT REPORTING REQUIREMENTS

- A. The property accounting method will be _____ Cash or X Accrual basis. Tenant operating accounts will be established and maintained by the MA/MGR. Accounts established for the property will be the general operating account, insurance escrow account, reserve account, security deposit account, and satellite service fund.
- B. The interest earned on the reserve account will remain within said account and can be used to meet the required annual reserve transfer. If reserve funds for all properties with the same owner are deposited in one bank account, the interest earned will be prorated (reserve fund balance times interest rate) and each project's reserve funds tracked separately by use of USDA Rural Development Instruction 1930-C, Exhibit B-10 or similar form.
- C. The accounting program or computer software program used for the property is: Quickbooks. The bookkeeping chart of accounts and the bank accounts are compatible with Form RD 3560-7, or similar form.
- D. The MA/MGR will be responsible for the preparation and submission of the monthly, quarterly, and annual reports required by USDA Rural Development.
- E. The property annual audit or verification of review will be performed by: Agler & Gaeddert, Chtd., Certified Public Accountants, P.O. Box 1020, Ottawa, KS 66067 785.242.3170 Phone: 785.242.9250 Fax: www.agc-cpas.com.
- F. The MA/MGR will be responsible for establishing and maintaining tenant files in accordance with USDA Rural Development regulations. Said files will be retained for a minimum of three (3) years after the tenant moves out. Files on rejected applicants with supporting information will also be retained for a minimum of three (3) years.
- G. The following records subject to USDA Rural Development review will be kept on site:

Financial Records, Tenant Records

To review the records, USDA Rural Development should contact:

Name: Wendy Cherry
Address: 1016 Orchard Lane
Baldwin City, KS 66006
Phone: 785.594.6996

XI. ENERGY CONSERVATION MEASURES AND PRACTICES

- A. Tenants will directly control the conservation of energy in the following areas: timing of the use of hot water to coincide with off-peak periods, regulation of thermostats; window infiltration (application of insulated shades or other window treatment); lighting needs in their unit; and heat loss caused by opening windows for ventilation. The conservation practices will affect the use of electricity. Tenants will be oriented to energy conservation measures upon moving into the property by means of an orientation session outlining ways they can reduce energy and thus reduce overall operating costs. Tenants will be requested to practice energy conservation. To stimulate energy conservation, management will provide a continuing program of education in energy use for the tenants.
- B. Management will have direct control over such energy conservation practices as lighting used in the common areas, use of energy for heating the common areas, and the timing of such consumption. Utilities to be affected are natural gas and electricity, as applicable. Energy conservation practices to be implemented by management include installation of fluorescent fixtures to reduce the use of electricity, use of timers or photo-electric eyes to regulate consumption, weather-stripping, and lock

BRAC Accounting Practices

1016 Orchard Lane
Baldwin City, KS 66006

The accounting system (practices) must be approved by USDA as part of the Management Plan. We are required to use the accrual method of accounting for bookkeeping and budget preparations.

Borrowers must retain all financial records and supporting documents for at least three years after annual financial reports and statements.

Tenant rent is received in the form of money orders or personal checks, no cash is accepted. At this time, it is entered into our FHA (Federal Housing Assistant) software, receipts given to tenants; the rent is deposited into the BRAC operating account. The deposits are given to the manager from the rental consultant at what time the Deposits are entered into QuickBooks. Balancing is done monthly with a manager and a board member present.

USDA requires BRAC to have these types of accounts, which is in place.

- General Operating Account
- Reserve Account
- Security Deposit Account