

# Risk Based Financial Statement Review Process

## **MassHousing**

Rental Housing: Multifamily Management

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**Executive Summary**

Over the past few years, MassHousing's Asset Management Department has developed a plan of action designed to improve staff efficiency and the way in which the department interacts with its business partners. MassHousing's newly developed Risk-Based Financial Statement Review Process is an outcome of that effort.

The Financial Statement Review Process enables an Asset Manager, within the Agency's Asset Management Department, to: monitor the financial viability of a development; verify debt service payments to MassHousing; analyze payments to partners; assess compliance with contract documents, and; evaluate the sufficiency of the development's cash flow and reserves.

Traditionally, the financial statement review had been conducted as a "one size fits all" process. The audited financial statements were reviewed utilizing the same parameters for each development, regardless of risk rating, program type or history of financial performance. The process has been time consuming and has not adequately taken into consideration MassHousing's changing business environment, new lending products, and tenant assistance programs.

While the Agency had made improvements to the process over time, it became clear that an entirely new approach was needed. The new approach described below addresses the above referenced issues by employing a risk-based system coupled with substantive ratio analysis which provides a better product for both the Agency and its rental borrowers.

**Process Summary**

At the beginning of February, the Manager of Asset Management provides the Asset Management Department with a list of financed developments identifying the Physical and Compliance risk scores based on the Asset Management Reviews (AMR) conducted during the audit year. The financial risk score is calculated upon receipt of the majority of annual financial statements for the portfolio. The financial risk score with the physical condition and compliance scores calculated, becomes the new risk rating upon which the two-tier risk-based approach is based.

To achieve an overall risk rating of BBB, a development must:

- Financial – have Debt Service Coverage of 1.06, be current on its debt service, and have a positive loan to value ratio;
- Physical – have adequate funds in the replacement reserve account to fund the capital needs of the development for any 8 to 10 years of a 10-year period, as determined by the replacement reserve sufficiency analysis, the results of the physical inspection

conducted as part of the AMR, and the most recent Real Estate Assessment Center (REAC) score;

- Compliance – demonstrate adherence by the owner/agent to prescribed affordability restrictions, fiscal management, and prudent implementation of operational requirements.

Once the three risk ratings are determined, Asset Management employs the Risk Based Financial Statement Review process based on a two-tier system. Steps identified in the first tier are applied to all portfolio properties regardless of risk rating. The steps identified in tier 2 will be applied only to those developments that score less than BBB. An automated ratio analysis and operating expense review will also be conducted for all developments in this group. The development's program/subsidy type will be used to determine the appropriate ratios to be applied.

### **Tier 1**

All developments will undergo the level of financial statement review described below. The steps will be tailored to meet the requirements of the development's specific subsidy and program type. Using the Financial Statement Review Factsheet and Financial Analysis Review Workbook the Asset Manager will:

- Conduct Quality Control Review to confirm that the financial statement is signed and includes all required reports and schedules.
- Review the auditor's opinion and follow up on any pertinent issues identified in the Notes to the financial statements and the Schedule of Findings and Questioned Costs.
- Identify and follow up on any Due To/Due From issues noted in the audit.
- Process fast track distribution requests and complete a distribution worksheet, as applicable.
- Verify that the MassHousing debt service and the development's replacement reserve obligations are reflected correctly using the Project Activity Summary Report in the Agency's database and the Debt Service and Escrow Analysis worksheet.
- Identify and collect the following, as applicable:
  - Flexible subsidy payments due to HUD
  - Recap obligations
  - Residual receipts payments
  - Excess equity payments
  - Payments on cash flow notes
  - Arrearage note obligations
- Develop an "issues report" to document operational and compliance issues, as applicable to keep within the parameters of the risk analysis categories.

- Utilize the findings identified in the “issues report” to generate required monitoring plans which will guide asset management monitoring activities for the balance of the year.
- Generate a close-out letter to the owner and send the financial statement package to be scanned for record-keeping purposes.

## **Tier 2**

For all developments that have not achieved BBB risk ratings, the reason for the lesser rating is determined and the financial statement review includes the following additional steps:

- An automated ratio analysis is conducted to measure key performance indicators. This analysis is used to investigate operational issues affecting the overall performance of the development further. The ratios and benchmarks are established based on industry standards and an analysis of the overall performance of the Agency’s portfolio. Program/subsidy type are also taken into consideration as part of the analysis.
- The Income Statement Comparison Report is used to generate a report comparing the new financial statement to the Owner’s Submission from the prior year. The report is reviewed to identify significant variances and follow up with management as required. (This is not meant to be a deep dive into line item specifics.) The development’s operating budget is also be taken into consideration as the review is conducted.
- The ratio analysis and income statement comparison reports are used to determine if a further review of operations is required. This analysis is incorporated into the “issues report” and Monitoring Plan, as necessary. These reports serve as a basis for the formation of the department Risk Report.

## **Positive Outcomes**

Through this risk-based approach, MassHousing has improved its financial statement review process while maintaining the integrity of Agency’s regulatory role while simultaneously addressing the challenges of its changing portfolio. The two-tiered risk-based approach allows for substantive analysis of those developments that require additional review. With the implementation of the ratio worksheet and program specific benchmarks for performance, MassHousing has enhanced its level of analysis. Issues identified are memorialized as part of the process and inform an asset manager’s work on his or her portfolio throughout the year. This new process has become an important part of MassHousing’s dynamic and integrated process of asset management. Based on Agency data, MassHousing has determined that 45% of its portfolio underwent a Tier I level of review. By implementing the new process, the Agency has reduced the amount of staff time required to complete the process and meet a May 31 deadline successfully, an improvement of 30 days from prior years. The change in methodology and streamlined approach has been well received by our partners and the Agency anticipates implementing further improvements for an even greater level of efficiency.