

**DEPARTMENT OF HOUSING AND
URBAN DEVELOPMENT**

[Docket No. FR 4509-N-04]

**Public Housing Assessment System;
Financial Condition Scoring Process****AGENCY:** Office of the Director of the
Real Estate Assessment Center, HUD.**ACTION:** Notice.**SUMMARY:** This notice provides
additional information to public
housing agencies and members of the
public about HUD's process for issuing
scores under the Financial Condition
Indicator of the Public Housing
Assessment System (PHAS).**FOR FURTHER INFORMATION CONTACT:** For
further information contact WandaFunk, the Real Estate Assessment
Center, Department of Housing and
Urban Development, 1280 Maryland
Avenue, SW, Suite 800, Washington DC,
20024; telephone Customer Service
Center, 1-888-245-4860 (this is a toll
free number). Persons with hearing or
speech impairments may access that
number via TTY by calling the Federal
Information Relay Service at (800) 877-
8339. Additional information is
available from the REAC Internet Site
<http://www.hud.gov/reac>.**SUPPLEMENTARY INFORMATION:****Purpose of This Notice**The purpose of this Notice is to
provide additional information about
the scoring process for PHAS Indicator#2, Financial Condition. Under the
PHAS, the financial condition score is
based on financial information reported
to HUD according to generally accepted
accounting principles (GAAP). GAAP
classifies accounting data according to
standard definitions. Of the total points
available for a PHAS score, a PHA may
receive up to 30 points under the PHAS
Indicator #2. The financial condition
score is included in the aggregate PHAS
score.The chart below shows the six
components that constitute the
Financial Condition Indicator and their
assigned points.**FINANCIAL CONDITION INDICATOR**

Scoring components	Measurement	Points
Quick Ratio (QR)	Short-term liquidity	9
Months Expendable Fund Balance (MEFB)	Adequacy of reserves	9
Days Receivable Outstanding (DRO)	Ability to collect payments of tenant receivables	4.5
Occupancy Loss (L)	Ability to realize potential rental income	4.5
Expense Management (EM)	Ability to control various expenses, including utilities, adminis- trative, maintenance, general and non-routine expenses.	1.5
Net Income as a Percentage of Fund Balance (N)	Profitability against the current year's operations	1.5

The values of the six components of the Financial Indicator calculated from the financial data comprise the overall financial assessment of the PHA. The components and their relative importance to the total financial score are the result of studies of PHA financial performance and of industry portfolio management techniques to identify the most appropriate financial measures to gauge a PHA's financial position and financial management. These components represent measures that are appropriate benchmarks in any

residential real estate environment. The scoring assigned within each component is based on the distributions of that component's values and the relative relationship between the components and the PHA's overall financial performance.

Under the PHAS, the components that make up the Financial Condition Indicator are approached in the same manner for GAAP as they were for non-GAAP financial information although the thresholds may change as a result of the conversion to GAAP. For example,

a good Quick Ratio under the current basis of accounting (non-GAAP) for a small PHA may be 6 to 1 and receive the maximum 9 points. In contrast, under GAAP a good Quick Ratio may be 5 to 1 and also get the maximum 9 points. Thus, to the extent that a PHA's performance relative to its peers does not change, its score will not be affected by the conversion to GAAP. The GAAP conversion schedule by PHAs fiscal year end, shown below, is reprinted from the PHAS final rule published on September 1, 1999.

GAAP CONVERSION SCHEDULE

Fiscal year end dates for PHAs	Unaudited GAAP finan- cial data to HUD by:	Audit reports due to HUD by:
9/30/99	11/30/99	6/30/00
12/31/99	2/28/00	9/30/00
3/31/00	5/31/00	12/31/00
6/30/00	8/31/00	3/31/01

GAAP Reporting Method

Financial data for GAAP scoring is currently collected in paper form from audited financial data submitted by PHAs and entered into a database by REAC staff. PHAs, with fiscal years ending September 30, 1999, and later, will submit their unaudited financial

data electronically using the Financial Data Schedule (FDS), within 60 days of their fiscal year end. This submission will be reviewed by REAC for reasonableness. To the extent that an audit is required for a PHA under OMB Circular A-133, a PHA will submit its

audited data using the FDS within nine months of the fiscal year end.

Program Funds

The PHAS financial assessment is based on the entity-wide operations of a PHA, which includes financial information on Section 8, Community

Development Block Grants, and other HUD funding in its calculations, as well as funds from non-HUD sources.

GAAP Scoring Approach

Under PHAS, the components of the PHAS Financial Indicator were developed that both fairly and accurately assess a PHA's financial performance and financial management. As part of the development, the components were tested to establish the correlation between PHA performance under each component and the fiscal health of a PHA. As part of the development, PHAs were evaluated and assigned scores based a PHA's performance relative to its peers. In other words, all PHAs as a group determine the mean score and each PHA is then ranked accordingly. This peer assessment approach, which was formulated following extensive economic and financial analysis, examination of well-accepted business principles, and discussions with PHA industry representatives and PHA staff, provides an equitable means of measuring the financial performance of PHAs.

Comparable Scoring Systems

HUD's financial scoring process is similar to those already undertaken in the mortgage housing and securities industries. Fannie Mae, the mortgage housing industry leader, developed an assessment system with financial indicators similar to those contained in HUD's financial assessment of PHAs, such as vacancy, reserve balances, and net income. Like HUD, Fannie Mae uses these indicators to rank properties and identify those which require further attention. In the securities area, Standard & Poors conducts peer assessment of a company's operational capabilities and cash flows relative to their peers. Among federal agencies, the Department of Health and Human Services (HHS) contracts with state and local entities to perform financial audits of nursing homes and hospitals participating in the federal Medicare program. Based on these financial audits, HHS determines the continued eligibility of these health service providers in the Medicare program.

GAAP Scoring Processes

GAAP-based scores are produced using data contained in the Financial Data Schedule (FDS). The GAAP-based financial data are first used to calculate six financial components that measure various aspects of financial health, such as short-term liquidity, expense management, and collection of receivables. Each PHA is awarded

points for each component according to its performance relative to its peers. Peer groupings are established according to the size of the PHA, based on the number of public housing units operated. Peer groupings are as follows:

- Very Small (0–49 units)
- Small (50–249 units)
- Low Medium (250–499 units)
- High Medium (500–1249 units)
- Large (1250 + units)

A PHA is assigned a score for each of the six components of the Financial Indicator based on its component value relative to its peers. The minimum number of points (zero) and the maximum number of points can each be achieved over a range of values. This system allows PHAs to target a range of values which they want to avoid and target one value which they should strive to achieve. Aside from these extremes, points are assigned to component values along a continuous linear function. This means that each component value will receive a different number of points. This system ("semi-continuous scoring") ensures that points are awarded equitably to PHAs along the distribution of component values because, in most cases, small differences in component values result in only small differences in the scores of the individual components. Therefore, two PHAs of a similar size whose values for its financial condition components are in close proximity will receive only slightly different scores to capture their performance relative to each other.

The number of points assigned to each component value or range of values is based on where the thresholds for that component are set. The thresholds separate distinct ranges of scores along the distribution of component values. The thresholds and their associated scores are estimated based on well-accepted business principles and statistical distributions of values within the peer groupings of the PHAs.

Business Principles

Scoring of certain of the components follows generally recognized business principles. These principles indicate that there are certain absolute thresholds below which component values are clearly financially unacceptable and component values below that point should result in a score of zero. These principles are used in scoring the Quick Ratio and Months Expendable Fund Balance components. For both of these components, a value of less than one is financially unacceptable, regardless of PHA size, and therefore merits a score of zero.

Statistical Distributions

The remaining thresholds are estimated by examining the distributions of component values by peer group. For the four most significant components (Quick Ratio, Months Expendable Fund Balance, Days Receivable Outstanding, and Occupancy Loss), thresholds are set such that approximately 50 percent of the distribution receives the maximum number of points, as long as 50 percent of the distribution have acceptable values for the component. Thus, the highest number of points are awarded to the PHAs whose financial measures are most reasonable both relative to their peers and in an absolute business sense. The specific percentiles that make up this 50 percent of PHAs are established by identifying natural breakpoints along the distributions. For example, for the Quick Ratio and Months Expendable Fund Balance, these breakpoints fall at approximately the 30th and 80th percentiles. The remaining two components (Expense Management and Net Income as a Percentage of Fund Balance) assign zero points to PHAs that fall only in the extreme outer ranges of the distribution of values, and award 1.5 points to the remaining PHAs.

Audit Information

The information collected from the annual audit report pertains to the type of audit opinion, details of the audit opinion, and the presence of reportable conditions and material weaknesses. This information will be used as a basis for accepting or adjusting financial component scores. If the auditor's opinion is other than unqualified, points will be deducted from the financial components to determine the PHA's financial score. The points have been established by REAC using a system that considers the seriousness of the audit qualification and limits the deducted points to a reasonable portion of the PHA's available score.

Reportable conditions and material weaknesses are considered to be audit flags, alerting REAC to an internal control weakness or an instance of noncompliance with Federal laws and regulations. These flags also have the potential to adjust the PHA's financial component scores, based on the seriousness of the reported issue. REAC will review the audit and internal control flags to determine the significance as it directly pertains to the assessment of the PHA's financial condition. If the flag has no effect on the financial components or the overall financial condition of the PHA as it

relates to the PHAS assessment, the score will not be adjusted.

There are two types of adjustments related to audited financial information. The first type deals with material differences between the unaudited and audited financial information reported to HUD. The second deals with the audit flags and reports that result from the audit itself.

The purpose of a comparison of the ratios and scores resulting from the current year's unaudited Financial Data Schedule submission to the ratios and scores resulting from the current year's audited submission is to:

- Identify material changes in ratio calculation results and/or scores from the unaudited submission to the audited submission;
- Identify PHA's that consistently provide materially different data from their unaudited submission to their audited submission;
- Assess or alleviate penalties associated with the inability to provide reasonably accurate unaudited data within the required time period.

This review process will only be performed for the audited submission. In addition, it is only applicable to PHAs whose overall PHAS designation (high, standard or troubled) was reclassified to a lesser designation based on the audited submission and the reclassification was necessary because of a material change in the reported financial data affecting one or more of the six components. Materiality for purposes of this review is based on a formula within PHAS and varies based on the size and funding level of the PHA. Therefore, the materiality threshold may vary from PHA to PHA, even within the same peer group.

REAC views the transmission of materially inaccurate unaudited financial data as a more serious

condition than the late submission of unaudited data. Therefore, the penalties assessed for material differences between the unaudited and audited submission have been designed to encourage PHAs to assure financial data is as reliable as possible at the 60 day submission. The penalties to be assessed are based on the significance of the reclassification, assuming the financial data reported meets the materiality threshold. For each designation level that the PHA has been reduced, points will be deducted from the PHA's overall FASS score. The following table summarizes the point reductions.

Designation reclassification	Percent of FASS points deducted
High to Standard	1
High to Marginal	2
High to Troubled	3
Standard to Marginal	1
Standard to Troubled	2
Marginal to Troubled	1

The FASS system will automatically deduct the applicable points and this reduction will trigger the REAC analyst review.

The purpose of a review of the audit and internal control flags is to adjust the financial score as a result of the audit. These flags are collected by using the OMB A-133 Data Collection Form. This form is completed by the PHA both for the unaudited and audited submissions. At the time of the unaudited submission the form is used as a self-assessment tool and should reflect the PHA's knowledge of their financial and internal control condition and should acknowledge their understanding of what the auditor will report. In the PHAS final rule, HUD discussed the review of audit and internal control flags as follows, and also included the

following chart. (See 63 FR 46607, September 1, 1998.)

As part of the analysis of the financial health of the PHA including assessment of the potential or actual waste, fraud or abuse at a PHA, HUD will look to the Audit Opinion to provide an additional basis for accepting or adjusting financial indicator scores. The following is a summary of the types of audit opinions and the number of total financial points that will be deducted if a PHA receives such an audit opinion from its IPA:

Type of flag	PHAS points deducted
Unqualified Opinion	0
No audit opinion	30
Adverse opinion	30
Disclaimer of opinion	30
Qualified opinion	*
Going concern opinion	30
Material weakness in internal control	*
Reportable condition	*
Findings of non-compliance and/or questioned costs	*
Indicator outlier analyses	*

***Note:** See subsequent table titled "Audit Flags and Tier Classification" for FASS points to be deducted.

If the OMB A-133 Data Collection Form indicates that the auditor's opinion will be other than unqualified, PHAS will automatically deduct the appropriate points based on the above table. The points have been established by REAC using a three-tier system. The tiers are meant to give consideration to the seriousness of the audit qualification and to limit the deducted points to a reasonable portion of the PHA's total, actual score. The tiers, as established by REAC, are also defined below.

AUDIT FLAG TIERS

Tier	FASS points deducted
Tier 1	Maximum reduction: Lesser of 30 points or 100 percent of the PHA's total unadjusted FASS score.
Tier 2	Maximum reduction: 3 points or 10 percent of the PHA's total unadjusted FASS score.
Tier 3	Maximum reduction: 1.5 points or 5 percent of the PHA's total unadjusted FASS score. This maximum is cumulative and not to be assessed for each audit or internal control flag.

AUDIT FLAGS AND TIER CLASSIFICATIONS

Audit flag	Tier classification
Unqualified opinion	None
No audit opinion	Tier 1
Adverse opinion	Tier 1
Disclaimer of opinion	Tier 1
Qualified opinion:	
1. GAAP qualifications	
• Change in accounting principle	Tier 3

AUDIT FLAGS AND TIER CLASSIFICATIONS—Continued

Audit flag	Tier classification
• Change in accounting estimate	Tier 3
• Change in accounting method	Tier 3
• Departures from GAAP	Tier 2
• Financial statements using basis other than GAAP	Tier 1
• Exclusion of alternate accounting for an account or group of accounts	Tier 2
• Inconsistently applied GAAP	Tier 2
• Omissions/Inadequate Disclosure	Tier 2
2. GASS—Scope Limitations	Tier 2
• Imposed by management	Tier 2
• Imposed by circumstance	Tier 3
• Year 2000 (add back)	Tier 3
3. Report on major program compliance	Tier 3
4. Report on internal control	Tier 3
Accounting principles used caused the financial statements to be materially misstated	Tier 2
Inadequate records	Tier 2
Going concern	Tier 1
Material noncompliance disclosed	Tier 2
• Internal control weakness	Tier 3
• Compliance	Tier 3
• Opinion on Supplemental schedules	Tier 3
Reportable condition	
• Internal control	Tier 3
• Compliance	Tier 3

The graphs shown in Appendix 1 depict the approximate GAAP-based scoring functions used for each of the six components of the Financial Indicator.

Appendix 2 provides estimated GAAP-based threshold values and associated scores for each component and peer group, based on the data pool as of April 15, 1999. These GAAP thresholds are preliminary and are based upon financial data obtained for

a limited number of PHAs currently reporting under GAAP. The thresholds established for GAAP-based scores will be re-assessed on a quarterly basis to ensure their statistical validity as the data collected indicates a shift in distributions and any modifications to the thresholds will be communicated through a Notice. However, the financial components and component calculations will remain the same and the component scores for a PHA will

continue to be established on a peer assessment basis. Thus, if a PHA's performance remains consistent relative to its peers, the PHA's score will not be affected by threshold changes.

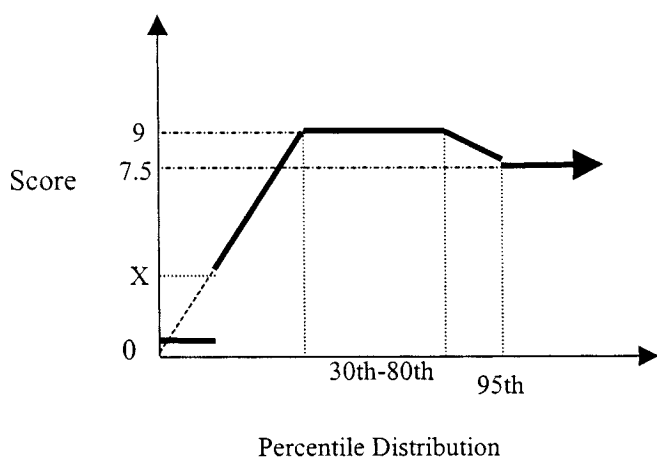
Dated: May 6, 1999.

Barbara L. Burkhalter,

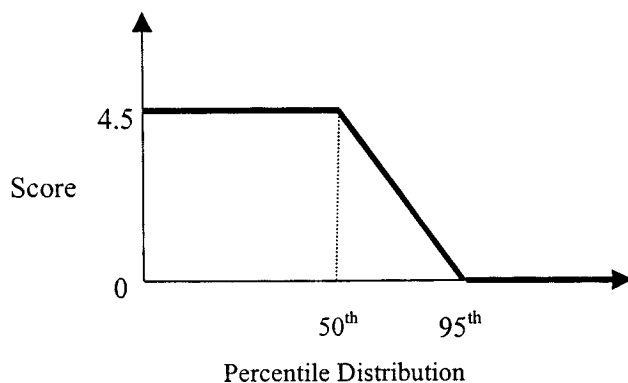
Deputy Director, Real Estate Assessment Center.

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Appendix 1 – Graphs of GAAP-Based Financial Indicators

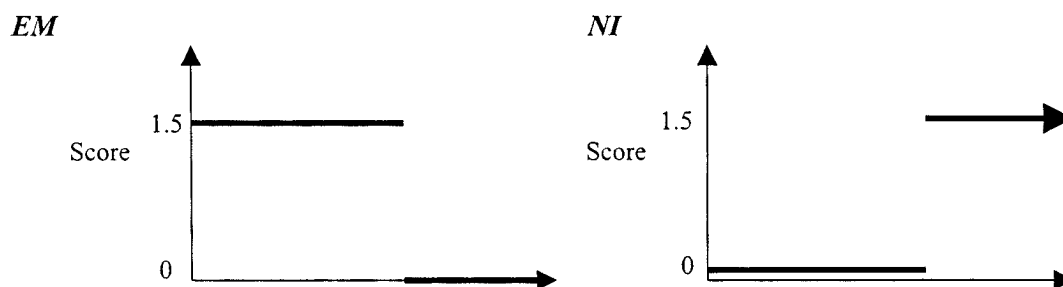
Graph 1: *QR & MEFB*

The scoring structure depicted above is established based on the distribution of data for each peer group. For both QR and MEFB, a PHA receives zero points for indicator values of less than one. With a value of one, they receive X points, which is determined by the distribution of the data, and, therefore, varies by size category. The maximum number of points is received between approximately the 30th and 80th percentiles. PHAs with values falling beyond the upper bound of this range receive incrementally fewer points because they have exceeded the acceptable levels of liquidity or reserves to operate optimally.

Graph 2: *OL & DRO*

For OL and DRO, the maximum number of possible points is 4.5, which is received up to approximately the 50th percentile. For values beyond approximately the 95th percentile, the PHA receives zero points.

Graph 3: *EM* & *NI*



For both EM and NI, a PHA can receive either 1.5 or zero points. The threshold for EM is set at 1.645 standard deviations (approximately the 95th percentile) from the mean of each distribution (which means it is in the top five percent of values for that distribution), and thus varies by size category, whereas for NI it is set at -10% across all size categories.

Appendix 2 – Threshold Tables for GAAP Scoring

These tables can be interpreted in the following manner:

- o Identify a size category for an indicator;
- o The rows under that size category identify ranges of possible values for that indicator; and
- o The column to the right labeled “Score” identifies the score or range of scores that is awarded to each range of indicator values for that size category.

Quick Ratio (QR)*					
Very Small	Score	Small	Score	Low Medium	Score
QR<1	0	QR<1	0	QR<1	0
QR=1	2.6	QR=1	2.6	QR=1	2.6
1<QR<3.5	2.6<Score<9	1<QR<3.5	2.6<Score<9	1<QR<3.5	2.6<Score<9
3.5≤QR≤12	9	3.5≤QR≤8	9	3.5≤QR≤7.5	9
12<QR<15	9>Score>7.5	8<QR<13	9>Score>7.5	7.5<QR<11	9 >Score>7.5
QR≥15	7.5	QR≥13	7.5	QR≥11	7.5

High Medium	Score	Large	Score
QR<1	0	QR<1	0
QR=1	3	QR=1	3.6
1<QR<3	3<Score<9	1<QR<2.5	3.6<Score<9
3≤QR≤6.5	9	2.5≤QR≤5.5	9
6.5<QR<8	9 >Score>7.5	5.5<QR<7	9 >Score>7.5
QR≥8	7.5	QR≥7	7.5

MONTHS EXPENDABLE FUNDS BALANCE (MEFB)*					
VERY SMALL	SCORE	SMALL	SCORE	LOW MEDIUM	SCORE
MEFB<1	0	MEFB<1	0	MEFB<1	0
MEFB=1	1.3	MEFB=1	1.8	MEFB=1	2
1<MEFB<7	1.3<SCORE<9	1<MEFB<5	1.8<SCORE<9	1<MEFB<4.5	2<SCORE<9
7≤MEFB≤15	9	5≤MEFB≤13	9	4.5≤MEFB≤12	9
15<MEFB<20	9 >SCORE>7.5	13<MEFB<18	9 >SCORE>7.5	12<MEFB<15	9 >SCORE>7.5
MEFB≥20	7.5	MEFB≥18	7.5	MEFB≥15	7.5

HIGH MEDIUM	SCORE	LARGE	SCORE
MEFB<1	0	MEFB<1	0
MEFB=1	2	MEFB=1	3
1<MEFB<4.5	2<SCORE<9	1<MEFB<3	3<SCORE<9
4.5≤MEFB≤11	9	3≤MEFB≤11	9
11<MEFB<13	9 >SCORE>7.5	11<MEFB<13	9 >SCORE>7.5
MEFB≥13	7.5	MEFB≥13	7.5

DAYS RECEIVABLE OUTSTANDING (DRO)*					
VERY SMALL	SMALL	LOW MEDIUM	HIGH MEDIUM	LARGE	SCORE
DRO≤2	DRO≤3	DRO≤7	DRO≤8	DRO≤12	4.5
2<DRO<18	3<DRO<20	7<DRO<23	8<DRO<23	12<DRO<25	4.5>SCORE>0
DRO≥18	DRO≥20	DRO≥23	DRO≥23	DRO≥25	0

OCCUPANCY LOSS (OL)*					
VERY SMALL	SMALL	LOW MEDIUM	HIGH MEDIUM	LARGE	SCORE
OL≤4.5%	OL≤4.5%	OL≤5.5%	OL≤5.5%	OL≤7%	4.5
4.5<OL<12%	4.5<OL<12%	5.5<OL<14.5%	5.5<OL<15%	7<OL<15%	4.5>SCORE>0
OL≥12%	OL≥12%	OL≥14.5%	OL≥15%	OL≥15%	0

NET INCOME (NI)*					
VERY SMALL	SMALL	LOW MEDIUM	HIGH MEDIUM	LARGE	SCORE
NI<-10%	NI<-10%	NI<-10%	NI<-10%	NI<-10%	0
NI≥-10%	NI≥-10%	NI≥-10%	NI≥-10%	NI≥-10%	1.5

EXPENSE MANAGEMENT

THE COMPONENTS OF THE EXPENSE MANAGEMENT ARE EXPRESSED IN DOLLARS PER UNIT PER MONTH. THE REAC IS ALSO EXAMINING THE IMPACT OF SEASONAL AND GEOGRAPHIC VARIATIONS ON THE EXPENSE INDICATORS. IF THE REAC'S ANALYSIS FINDS A SIGNIFICANT IMPACT ON PHA EXPENSES OF THESE REGIONAL DIFFERENCES, REGIONAL PEER GROUPINGS MAY BE ADDED TO THE SCORING OF THE EXPENSE MANAGEMENT INDICATOR.

THRESHOLDS FOR FOUR OF THE SIX COMPONENTS OF THE EXPENSE MANAGEMENT INDICATORS ARE LISTED BELOW. THRESHOLDS FOR TENANT SERVICES AND PROTECTIVE SERVICES WILL BE SET AS MORE INFORMATION IS SUBMITTED.

ADMINISTRATIVE EXPENSE (AE)*					
<u>VERY SMALL</u>	<u>SMALL</u>	<u>LOW MEDIUM</u>	<u>HIGH MEDIUM</u>	<u>LARGE</u>	<u>SCORE</u>
<u>AE<\$81</u>	<u>AE<\$75</u>	<u>AE<\$65</u>	<u>AE<\$71</u>	<u>AE<\$82</u>	<u>1.5</u>
<u>AE≥\$81</u>	<u>AE≥\$75</u>	<u>AE≥\$65</u>	<u>AE≥\$71</u>	<u>AE≥\$82</u>	<u>0</u>

UTILITIES EXPENSE (UE)*					
<u>VERY SMALL</u>	<u>SMALL</u>	<u>LOW MEDIUM</u>	<u>HIGH MEDIUM</u>	<u>LARGE</u>	<u>SCORE</u>
<u>UE<\$74</u>	<u>UE<\$93</u>	<u>UE<\$110</u>	<u>UE<\$120</u>	<u>UE<\$135</u>	<u>1.5</u>
<u>UE≥\$74</u>	<u>UE≥\$93</u>	<u>UE≥\$110</u>	<u>UE≥\$120</u>	<u>UE≥\$135</u>	<u>0</u>

ORDINARY MAINTENANCE EXPENSE (OE)*					
<u>VERY SMALL</u>	<u>SMALL</u>	<u>LOW MEDIUM</u>	<u>HIGH MEDIUM</u>	<u>LARGE</u>	<u>SCORE</u>
<u>OE<\$89</u>	<u>OE<\$88</u>	<u>OE<\$94</u>	<u>OE<\$106</u>	<u>OE<\$129</u>	<u>1.5</u>
<u>OE≥\$89</u>	<u>OE≥\$88</u>	<u>OE≥\$94</u>	<u>OE≥\$106</u>	<u>OE≥\$129</u>	<u>0</u>

<u>GENERAL EXPENSE (GE)*</u>					
<u>VERY SMALL</u>	<u>SMALL</u>	<u>LOW MEDIUM</u>	<u>HIGH MEDIUM</u>	<u>LARGE</u>	<u>SCORE</u>
<u>GE<\$54</u>	<u>GE<\$59</u>	<u>GE<\$62</u>	<u>GE<\$65</u>	<u>GE<\$70</u>	<u>1.5</u>
<u>GE≥\$54</u>	<u>GE≥\$59</u>	<u>GE≥\$62</u>	<u>GE≥\$65</u>	<u>GE≥\$70</u>	<u>0</u>

* THE ESTIMATED GAAP THRESHOLDS WERE BASED ON DATA FROM FINANCIAL INFORMATION FROM A LIMITED NUMBER OF PHAS CURRENTLY REPORTING UNDER GAAP AS OF APRIL 15, 1999. THE PHA FINANCIAL STATEMENTS HAD FISCAL YEAR ENDS RANGING BETWEEN 1996 AND 1998. AS MORE DATA IS ENTERED INTO THE SYSTEM, THESE THRESHOLDS WILL BE RE-ASSESSED TO BETTER REFLECT THE DATA DISTRIBUTIONS.

[FR Doc. 99-11914 Filed 5-12-99; 8:45 am]

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