Issue Date
November 25, 2003
Audit Case Number
2004-FO-0001

TO: John C. Weicher, Assistant Secretary for Housing-Federal Housing Commissioner, H

//signed//
FROM: Randy W. McGinnis, Director, Financial Audits Division, GAF

SUBJECT: Audit of the Federal Housing Administration's Financial Statements for Fiscal Years 2003 and 2002

In accordance with the Government Corporation Control Act as amended (31 U.S.C. 9105), the Office of Inspector General engaged the independent certified public accounting firm of KPMG LLP to audit the fiscal year 2003 and 2002 financial statements of the Federal Housing Administration (FHA). The contract required that the audit be performed according to generally accepted government auditing standards.

In its audit of the Federal Housing Administration, KPMG found:

- the financial statements were fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles,

- one material weakness in internal controls and two reportable conditions, and

- no reportable noncompliance with laws and regulations that KPMG tested.

KPMG is responsible for the attached auditor's report dated November 7, 2003 and the conclusions expressed in the report. We do not express an opinion on FHA's financial statements or conclusions on FHA's internal controls or compliance with laws and regulations.

This report includes both the Independent Auditors' Report and FHA's principal financial statements. Under Federal Accounting Standards Advisory Board (FASAB) standards a general-purpose federal financial report should include as required supplementary information a section devoted to management's discussion and analysis (MD&A) of the financial statements and related information. The MD&A is not included with this report. FHA plans to separately publish an annual report for fiscal year 2003 that conforms to FASAB standards.

Most of the recommendations in this year's report substantially repeat recommendations made in prior years' reports on FHA's financial statements. FHA has established corrective action plans for these recommendations and, in accordance with the department's audit management system, they will continue to track the resolution of these prior years' audit recommendations. Two recommendations (2.e. and 3.a.) are new to this year's report. Based on the information provided in management's response to KPMG's audit, we will record management decisions in the department's Audit Resolution and Corrective Action Tracking System for these two recommendations.

We appreciate the courtesies and cooperation extended to the KPMG and OIG audit staffs during the conduct of the audit.

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2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report

To the Inspector General
U.S. Department of Housing and Urban Development:

To the Federal Housing Administration:

We have audited the accompanying consolidated balance sheets of the Federal Housing Administration (FHA) as of September 30, 2003 and 2002 and the related consolidated statements of net cost, changes in net position and financing, and the combining statements of budgetary resources, for the years then ended (hereinafter collectively referred to as consolidated financial statements). FHA is a wholly owned government corporation within the U.S. Department of Housing and Urban Development (HUD). The objective of our audits was to express an opinion on the fair presentation of these consolidated financial statements. In connection with our audits, we also considered FHA's internal control over financial reporting and tested FHA's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its consolidated financial statements.

SUMMARY

As stated in our opinion on the consolidated financial statements, we concluded that FHA's consolidated financial statements as of and for the years ended September 30, 2003 and 2002 are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

Our consideration of internal control over financial reporting resulted in the following matters being identified as reportable conditions:

- HUD/FHA's Automated Data Processing (ADP) system environment must be enhanced to more effectively support FHA's business and budget processes;
- HUD/FHA can more effectively manage controls over the FHA ADP systems portfolio; and
- FHA must place more emphasis on monitoring lender underwriting and continue to improve early warning and loss prevention for Single Family insured mortgages.

We consider the first reportable condition above to be a material weakness.

The results of our tests of compliance with certain provisions of laws and regulations disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards* issued by the Comptroller General of the United States and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

The following sections discuss our opinion on FHA's consolidated financial statements, our consideration of FHA's internal control over financial reporting, our tests of FHA's compliance with certain provisions of applicable laws and regulations, and management's and our responsibilities.

OPINION ON THE CONSOLIDATED FINANCIAL STATEMENTS

We have audited the accompanying consolidated balance sheets of the Federal Housing Administration as of September 30, 2003 and 2002, and the related consolidated statements of net cost, changes in net position and financing, and the combined statements of budgetary resources, for the years then ended.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of FHA as of September 30, 2003 and 2002, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The information in the Required Supplementary Information section is not a required part of the consolidated financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America or OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it.

INTERNAL CONTROL OVER FINANCIAL REPORTING

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect FHA's ability to record, process, summarize, and report financial data consistent with the assertions by management in the consolidated financial statements.

Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

In our fiscal year 2003 audit, we noted certain matters, summarized below and more fully described in appendix A, involving internal control over financial reporting and its operation that we consider to be reportable conditions. The full text of management's response is included as appendix B. Our assessment of management's response is included as appendix C and the status of prior year internal control findings is included as appendix D.

We believe the following reportable condition is a material weaknesses:

- **HUD/FHA's ADP system environment must be enhanced to more effectively support FHA's business and budget processes.** HUD/FHA continues to conduct many day-to-day business operations with legacy-based systems, limiting FHA's ability to integrate its financial processing environment and to monitor budget execution. A key improvement made during fiscal year 2003 was the implementation of the FHA Subsidiary Ledger (FHASL) financial system, which automated many previously manual processes used to: (1) consolidate the accounting data received from the various

FHA operational legacy systems; and (2) prepare summary entries for posting to the FHASL. Despite this improvement, significant weaknesses still exist.

FHA's plans to fully address this material weakness by performing reengineering efforts for the Single Family and Multifamily operational systems and related business processes and by building additional automated interfaces from the operational systems to the FHASL. These system enhancements will also allow FHA to better monitor its budgetary execution process. FHA plans to fully complete these efforts by fiscal year 2007.

We also identified the following reportable conditions that are not considered material weaknesses:

- **HUD/FHA can more effectively manage controls over the FHA ADP systems portfolio.** During fiscal year 2003, FHA has taken steps to enhance its ADP systems control environment, including the implementation of the FHASL, which addressed several long-standing ADP control issues with FHA financial systems. However, improvements continue to be needed in the area of ADP application security, system support, and preparation and maintenance of system documentation.

- **FHA must place more emphasis on monitoring lender underwriting and continue to improve early warning and loss prevention for Single Family insured mortgages.** Proper standards for acceptance of lenders to FHA programs and adherence to FHA underwriting standards are FHA's first line of protection against assuming undue credit risk. Over 95% of FHA's Single Family endorsements are initiated by HUD-approved Direct Endorsement (DE) lenders; therefore, FHA significantly relies on the quality of the DE lender underwriting. FHA performs several interrelated processes to manage its insurance portfolio and account for the related risk assumed by the Mutual Mortgage Insurance Fund (MMI) and the General Insurance and Special Risk Insurance (GI/SRI) Funds. Contractors perform post-endorsement technical reviews (PETRs) on 5 to 10% of new endorsements, and the Homeownership Centers (HOCs) are required to perform quality-assurance reviews (QARs) on 5% of the PETRs completed by the contractors. However, due to a lack of precision in its risk assessment tools, FHA needs to further improve its early warning or detective control processes in order to timely prevent unplanned risks in its portfolio.

We also noted other matters involving internal control over financial reporting and its operation that we have reported to management of FHA in a separate letter dated November 7, 2003.

COMPLIANCE WITH LAWS AND REGULATIONS

Our tests of compliance with certain provisions of laws and regulations, as described in the Responsibilities section of this report, disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 01-02.

RESPONSIBILITIES

Management's Responsibilities

The Chief Financial Officers (CFO) Act of 1990 requires federal agencies and government corporations to report annually to Congress on its financial status and any other information needed to fairly present the agencies' financial position and results of operations. To meet the CFO Act reporting requirements, FHA prepares annual consolidated financial statements since FHA is a wholly owned government corporation within HUD.

Management is responsible for the financial statements, including:

- Preparing the financial statements in conformity with accounting principles generally accepted in the United States of America;
- Establishing and maintaining internal controls over financial reporting, and preparation of the Management's Discussion and Analysis (including the performance measures) and required supplementary information; and
- Complying with laws and regulations.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies. Because of inherent limitations in internal control, misstatements due to error or fraud may nevertheless occur and not be detected.

Auditors' Responsibilities

Our responsibility is to express an opinion on the fiscal years 2003 and 2002 consolidated financial statements of FHA, based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, and OMB Bulletin No. 01-02. Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- Assessing the accounting principles used and significant estimates made by management; and
- Evaluating the overall financial statement presentation.

We believe that our audits provide a reasonable basis for our opinion.

In planning and performing our fiscal year 2003 audit, we considered FHA's internal control over financial reporting by obtaining an understanding of FHA's internal control, determining whether internal controls had been placed into operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our audit was not to provide assurance on internal controls over financial reporting. Consequently, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether FHA's fiscal year 2003 consolidated financial statements are free of material misstatement, we performed tests of FHA's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of consolidated financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 01-02. Our audit procedures were not designed to test the requirements of OMB Bulletin No. 01-02 relating to the *Federal Financial Management Improvement Act* (FFMIA) of 1996, which were not considered applicable at the FHA level. FFMIA requirements will be reviewed and reported at the HUD consolidated level. We limited our tests of compliance to the provisions described above, and we did not test compliance with all laws and regulations applicable to FHA. Providing an opinion on compliance with laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

FHA has not presented Management's Discussion and Analysis as required supplementary information that accounting principles generally accepted in the United States of America has determined is necessary to supplement, although not required to be part of, the basic financial statements.

DISTRIBUTION

This report is intended for the information and use of the HUD Office of the Inspector General, the management of HUD and FHA, OMB, GAO, and the U.S. Congress, and is not intended to be, and should not be, used by anyone other than these specified parties.

KPMG LLP

November 7, 2003

INTRODUCTION

The internal control weaknesses discussed in this report and the Federal Housing Administration's (FHA's) progress toward correcting these weaknesses are discussed in the context of FHA's existing statutory and organizational structure. We recognize that any recommended automated data processing (ADP) control enhancements pertaining to FHA operations cannot be implemented solely by FHA, because most FHA applications are hosted on systems managed by the U.S. Department of Housing and Urban Development (HUD). As a result, several of the ADP control weaknesses identified in this report will require a coordinated effort from both FHA management and the HUD Office of Assistant Secretary for Administration/Chief Information Officer (OCIO). However, in several cases there are distinct and separate corrective actions needed to enhance FHA's ADP control environment. In addition, as of the date of this report, it is unclear how future legislative and budgetary changes will impact FHA and what effect such changes may have on FHA's ability to implement existing or future corrective action plans.

We acknowledge that HUD/FHA have taken certain actions to address these matters. However, we understand that implementing sufficient change to mitigate the internal control weaknesses is a multiyear task due to the complexity of the issues and impediments to changes that HUD/FHA face. These impediments involve interaction with large numbers of relevant constituencies outside of HUD/FHA and resource constraints, which can affect the timing of corrective action plan implementation.

The following section describes the material weakness and the reportable conditions as of and for the year ended September 30, 2003 and our recommendations. FHA management's response, our assessment of that response and the status of prior year internal control findings are presented in appendices B, C, and D respectively.

MATERIAL WEAKNESS

We noted the following matter during our audit that we consider to be a material weakness:

1. HUD/FHA's ADP System Environment Must Be Enhanced to More Effectively Support FHA's Business and Budget Processes

For many years, weaknesses in FHA's financial management system environment have been reported. FHA's previous challenge to acquire and implement more modern ADP financial and operational systems has significantly deterred FHA's efforts to be a more efficient and effective housing credit provider. A key improvement made during fiscal year 2003 was the implementation of the FHA Subsidiary Ledger (FHASL) financial system. The FHASL automated many previously manual processes used to consolidate the accounting data received from the various FHA legacy systems. As discussed below, and despite this improvement, HUD/FHA continues to conduct many day-to-day business operations with legacy-based systems, limiting FHA's ability to: (1) fully integrate its financial processing environment; and (2) effectively monitor budget execution related to certain funds control processes.

Many of the financial events that FHA reports in its financial statements originate in separate legacy systems that are now interfaced with FHA's new general ledger, the FHASL. Although FHA has eliminated some manual process with the implementation of these interfaces, additional opportunities exist to further reduce manual efforts. For example, within Single Family operations, there are key systems, including the Single Family Mortgage Notes System, the Single Family Premium Collection System – Periodic (SFPCS-P), and the Single Family Acquired Asset Management System (SAMS), maintained in local databases that are not efficiently integrated into the FHA financial management process. Consequently, additional manual processing is needed, potentially reducing the overall reliability of data, as well as the efficiency, of FHA personnel. Other key Single Family FHA systems affected include the

Single Family Insurance System (SFIS), SFPCS-Up Front (SFPCS-U), and the Single Family Mortgage Notes System (SFMNS).

Similarly, within Multifamily operations there are various legacy systems from which financial events originate. These systems are not integrated, elevating the potential for processing errors. For example, the Multifamily Insurance System (MFIS) and the Multifamily Insurance Claims System (MFIC) are not integrated, resulting in active insurance cases remaining in MFIS until after a claim is filed and supporting field documents are processed. In addition, these processes require delinquency reports to be manually generated, thereby increasing the risk of input errors.

The Federal Financial Management Improvement Act of 1996 (FFMIA) and the related Office of Management and Budget (OMB) Circular A-127, *Financial Management Systems*, requires federal financial management systems and processes to comply with various federal systems requirements, federal accounting standards, and to have the capability to post transactions using the U.S. Standard General Ledger (SGL). During fiscal year 2003, FHA made progress in meeting some FFMIA requirements by interfacing its legacy systems with the FHASL to post to the SGL at the transaction level. Although the improvements implemented during fiscal year 2003 help satisfy some FFMIA requirements and standards, additional and continued improvement is needed.

One of the key areas where FHA needs to further improve in order to be substantially compliant with FFMIA is management of budgetary resources. As a result of the financial and operational ADP systems noted earlier, FHA is currently unable to efficiently integrate, monitor, and control its budgetary resources. Because of these system weaknesses, FHA relies on certain manual processes and reconciliations of its operational systems to:

- Assess availability of budgetary resources prior to obligating funds;
- Compile the status of budgetary resources to prepare the SF-133, *Report on Budget Execution*; and
- Input budgetary entries to the FHASL.

Additional control risk is introduced into the budget execution process as a result of applying these manual procedures.

FFMIA and OMB Circular A-127 also call for Federal agencies to conform to functional requirements set forth by the Joint Financial Management Improvement Program (JFMIP). JFMIP, in its, *Core Financial System Requirements*, dated November 2001, requires agency core financial systems to support the budget administration and execution process by:

- Providing the capability to compare actual amounts (e.g., commitments and obligations) against the original and revised budgeted amounts consistent with each financial planning level;
- Providing the ability to manage and control prior year funds in the current year, including the capability to separately identify prior year and current year de-obligations;
- Providing control features that ensure that the amounts reflected in the funds control structure agree with the related general ledger account balances at the end of each update cycle;
- Verifying that funds distributed do not exceed the amount of funds available for allotment or sub allotment at each distribution level; and

- Providing the integration of cash management activities and contract accounting operations.

Accordingly, FHA must have funds control to monitor and control the entire budget execution process. Such control mechanisms must account for all apportionments for each fund, as well as the related allotments, obligations, and disbursements.

FHA is currently implementing a long-term plan, or "blueprint", to improve its financial systems processing environment. The implementation of the FHASL was a key step towards the completion of this plan. Additional planned steps during FY 2004 include the integration of stand-alone cash management, centralized funds control, and contract accounting operations into the FHASL, and the development of reengineering plans for Single Family and Multifamily operational systems and business processes. In addition, by early FY 2004, FHA plans to integrate existing Multifamily credit subsidy funds control procedures with the FHASL, and replace and eliminate the existing stand-alone application that currently supports this function. FHA plans to complete the implementation of the FHASL and related efforts by fiscal year 2007.

Recommendations to address the above continue to include:

1.a. The Deputy Assistant Secretary for Finance and Budget and the HUD OCIO should continue to consider the FHASL and related initiatives a high priority. As part of this effort, the Deputy Assistant Secretary for Finance and Budget should continue to ensure that the FHASL implementation follows both FFMIA requirements and HUD's System Development Life Cycle Methodology.

1.b. The Deputy Assistant Secretary for Finance and Budget should ensure that as part of the continued FHASL project, all critical manual FHA financial processes, including the budgetary execution process, are enhanced.

1.c. The HUD OCIO should ensure that as the long-term FHASL project proceeds, the project system design and specifications continue to be consistent with and reflected in the planned HUD IT enterprise architecture.

REPORTABLE CONDITIONS

We noted the following matters during our audit that we consider to be reportable conditions:

2. HUD/FHA Can More Effectively Manage Controls over the FHA ADP Systems Portfolio

HUD/FHA processes very large volumes of data. To manage and process these large volumes of data, HUD/FHA maintains a complex systems portfolio that not only processes accounting events for functions such as loan origination, servicing, and asset disposition, but also for cash receipt, disbursement, and budget execution transactions. Therefore, it is essential that FHA ensure its systems are properly controlled and maintained to: (1) prevent unauthorized access; (2) to reduce the potential for data integrity weaknesses; and (3) provide greater system continuity.

During fiscal year 2003, in response to prior year audit recommendations, HUD/FHA took several actions to enhance ADP controls over its systems, most notably the implementation of the FHASL, which addressed several long-standing ADP control issues with FHA financial systems. However, improvements are still needed in the areas of application security controls, ADP system portfolio management, and systems documentation.

Application security controls. Certain information security controls need improvement to provide HUD/FHA with a more secure ADP systems environment. These issues primarily relate to the need for stronger application access controls. Examples of systems where we identified access control weaknesses include:

- Underwriting Reporting System (URS) is used as part of an overall process by Single Family Homeownership Center (HOC) personnel and Post Endorsement Technical Review (PETR) contractors to monitor the underwriting performance of lenders with direct endorsement authority. We noted access control weaknesses continue to exist with the system. Effective access controls for URS are not only critical to ensure data integrity and processing security, but also to ensure compliance with the Privacy Act of 1974. The Privacy Act requires federal agencies to implement safeguards sufficient to ensure the security and confidentiality of individual records. URS contains sensitive information such as FHA borrower names and addresses and the results of lender reviews. Consequently, unauthorized access to URS could cause FHA to be noncompliant with the Privacy Act. FHA anticipates enhancing URS controls based on the results of a Single Family business process re-engineering effort, planned for completion during fiscal year 2004.

- Credit Subsidy Control System (CSCS), is used to monitor credit subsidies and related appropriations for Multifamily mortgages. We have noted significant access control weaknesses with CSCS in prior year audits, and according to FHA management, these were not addressed due to plans to incorporate CSCS functionality into the FHASL. In addition, CSCS lacks several key information security related documents, including a system security plan. By early fiscal year 2004, FHA plans to incorporate the existing CSCS functionality into the FHASL and to address other CSCS control weaknesses.

- Development Application Processing (DAP) system, is used as an automated underwriting system to support processing and tracking of Multifamily applications from pre-application through loan closing. FHA is aware of DAP access control weaknesses and has developed a procurement statement of work to implement additional DAP security controls during fiscal year 2004. A key reason why access controls are important for DAP is that the system maintains sensitive data, such as borrowers' personal information.

- FHA Connection (FHAC), which is an Internet-based system that allows FHA-approved lenders to have real-time access to several of FHA's systems. Specifically, FHAC password controls and the process for reviewing user accounts should be improved. Details on these weaknesses were provided to FHA management.

Establishing and maintaining effective application security controls is not only good business practice, but also is mandated by the 2002 Federal Information Security Reform Act (FISMA), and several OMB Circulars (Circular A-127, *Financial Management Systems*, and Circular A-130, *Management of Federal Information Resources*). Collectively, these regulations and guides require that federal agencies develop and implement effective information security policies, procedures, and control techniques. We recognize that many FHA systems operate on HUD platforms, and therefore are subject to HUD-managed information security controls. Consequently, the identified information security control weaknesses should be addressed in a coordinated effort between HUD and FHA.

One of the contributing causes to these issues is that FHA systems have not been consistently incorporated into HUD's security certification and accreditation (C&A) program. This program is designed to ensure that system and application information security controls are in place and operating (certification), and that the appropriate management official has formally accepted any security risks of the system (accreditation). HUD is in the process of enhancing its C&A program, and during fiscal year 2004, plans to incorporate FHA systems in this enhanced C&A program.

ADP system portfolio management. We noted that for several FHA systems being used to process key FHA financial data, the level of systems portfolio management could be improved. For example:

- URS is used for key aspects of Single Family lender monitoring and consists of separate databases at each of the four Single Family HOCs. During discussions with FHA management, it was noted that URS is a key element of Single Family processes supported by FHA's Computerized Homes Underwriting Management System (CHUMS). However, URS is not documented as part of the CHUMS security plan, is not integrated with CHUMS, lacks system change control procedures, and lacks sufficient access controls.

- CSCS is in operation but has limited support from FHA and the HUD OCIO. As noted earlier, this contributes to existing system security weaknesses.

As part of the planned FHASL project, FHA intends to perform a Single Family and Multifamily business process re-engineering effort, and one of the goals of this effort is to ensure ADP systems supporting key FHA financial and business processes are adequately supported and included in the HUD OCIO's enterprise architecture and ADP systems portfolio.

Systems documentation. During fiscal year 2003, several FHA systems, including Cash Control Accounting and Reporting System (CCARS) and the Lender Assessment Subsystem (LASS), lacked system documentation supporting current operations. This documentation is important to HUD/FHA day-to-day operation and management of systems. In addition, because many HUD/FHA personnel knowledgeable about the HUD/FHA systems environment are eligible for retirement in the near future, having fully documented systems is critical to system continuity.

Recommendations to address the above continue to include:

2.a. The Deputy Assistant Secretary for Single Family Housing, in coordination with the HUD OCIO, should ensure that application security controls are enhanced for URS to address the identified weaknesses.

2.b. The Deputy Assistant Secretary for Finance and Budget, in coordination with the HUD OCIO, should ensure that application security controls are enhanced for CSCS to address the identified weaknesses.

2.c. The Deputy Assistant Secretary for Multifamily Housing and the Deputy Assistant Secretary for Finance and Budget, in coordination with the HUD OCIO, should ensure that application security controls are enhanced for DAP to address the identified weaknesses.

2.d. The Deputy Assistant Secretaries for Single Family Housing, Multifamily Housing, and Finance and Budget, in coordination with the HUD OCIO, should ensure that as the planned Single Family and Multifamily business process re-engineering efforts are performed, key FHA system functionality, such as the functionality currently provided by URS and CSCS, is addressed.

2.e. The Director of FHA's Office of Systems and Technology and appropriate FHA system owners should coordinate with the HUD OCIO to include all major FHA systems in the HUD C&A program during fiscal year 2004.

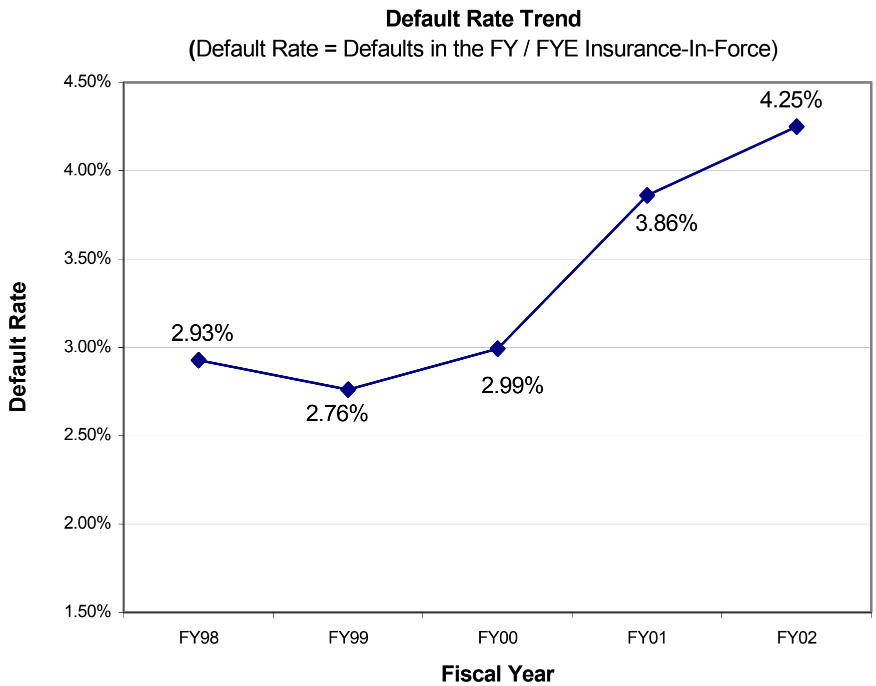
3. FHA Must Place More Emphasis on Monitoring Lender Underwriting and Continue To Improve Early Warning and Loss Prevention for Single Family Insured Mortgages

Proper standards for acceptance of lenders to FHA programs and adherence to FHA underwriting standards are FHA's first line of protection against assuming undue credit risk. Over 95% of FHA's Single Family endorsements are initiated by HUD-approved Direct Endorsement (DE) lenders. FHA significantly relies on the quality of the underwriting performed by these lenders. FHA performs several interrelated processes to manage the insurance portfolio and account for the related risk assumed by the Mutual Mortgage Insurance Fund (MMI) and the General Insurance and Special Risk Insurance (GI/SRI) Funds. These processes rely on the work of both HOC and outside contractor personnel and are conducted based on certain underlying regulations that govern the acceptance of DE lenders to the FHA program as well as annual re-certification of participating lenders. In an effort to manage the quality of endorsements, the HOCs monitor lenders through processes that track early warning indicators of substandard underwriting practices. Both headquarters and the HOCs conduct quality-assurance activities to assist in determining the adequacy of contractor and lender performance throughout the origination-to-endorsement process. These processes are intended to ensure that poorly performing lenders are identified and timely corrective action is taken to identify, manage and account for the credit risk within the portfolio.

Contractors perform PETRs on 5 to10% of new endorsements, and the HOCs are required to perform quality-assurance reviews (QARs) on 5% of the PETRs completed by the contractors. The PETR process rates an underwriter's ability to properly evaluate loan applications. Factors considered by the contractors in performing their rating include the mortgagor's credit, a valuation of the mortgaged property, and the results of a loan closing package review. Each of these factors is rated as good, fair, or poor. Currently, the PETR process is designed as a tool to assist the HOCs in reporting documentation and processing errors back to the lenders rather than to identify, with reasonable precision, loans that have a high probability of going to default or claim as a result of poor lender underwriting practices. In an effort to evaluate the predictive quality of the process, we performed an analysis of the 2,000 lenders with the highest volume of originations and found no strong correlation between the percentage of PETR poor ratings received by a lender and the lender's early default and claim rates.

Therefore, FHA could improve its early warning or detective control processes by refining monitoring and data analysis tools currently in use or development. With these improvements, FHA would be better able to quantify the risks in its portfolio, which would improve the precision of estimated program costs. As an example, the default rate has been steadily rising at each fiscal year end since 1999 as evidenced by Exhibit I:

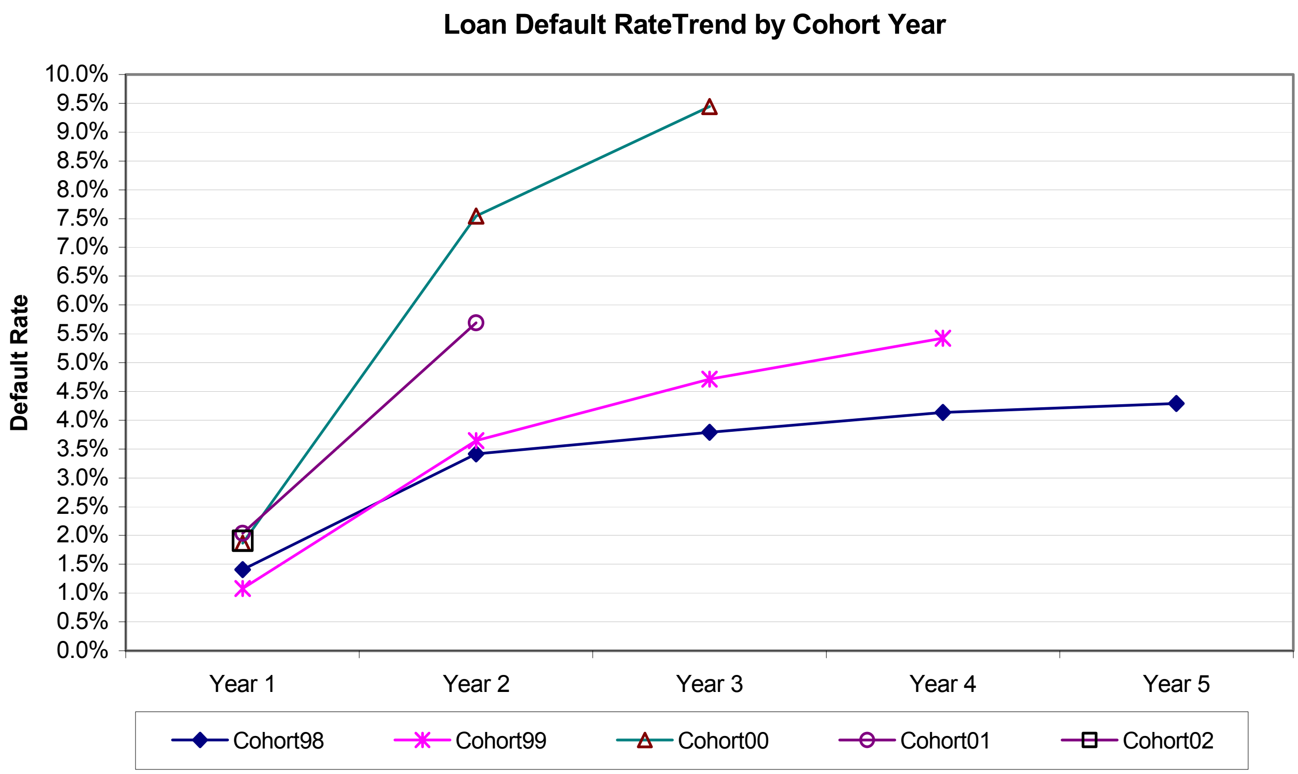
Exhibit I



Source: Single Family Data Warehouse

We also noted that loans made in recent years experienced higher default rates than loans made in the years immediately preceding them. Specifically, cohort 1999, 2000, and 2001 loans contributed over 50% to the total defaults in fiscal year 2002. In addition, we noted that loans in more recent cohorts are experiencing defaults at a faster pace than earlier cohorts as depicted in Exhibit II.

Exhibit II



Source: Single Family Data Warehouse

We recognize that economic factors such as home purchase price appreciation and increased unemployment rates have an impact on the default rate; however, changes in underwriting policies may also contribute to the higher default rates. Since 1995 there have been numerous changes to FHA's underwriting policies and procedures, which were designed to increase homeownership opportunities. Default rates are an early indication of potential loan losses. During fiscal year 2003, FHA experienced a significant increase in the number of claims. Claims increased 31% in fiscal year 2003 to 85,184. This resulted in an increase in claims paid of $5.5 billion in fiscal year 2002 to $7.8 billion in fiscal year 2003.

FHA must improve monitoring in order to fully manage the risk in the FHA portfolio, which may serve to minimize unanticipated losses to the fund. In addition, an improved risk assessment process will enhance the predictive precision of the conditional claim and prepayment rates used in the Liability for Loan Guarantee (LLG) estimation model.

Within the last 18 months, both the General Accounting Office (GAO) and the Office of Inspector General (OIG) have issued reports stating that FHA needs to improve its risk analysis on recently originated loans.

GAO[1] and OIG have reported that FHA should analyze additional data on factors that would better explain loan performance, such as borrower credit scores and qualifying ratios. The OIG[2] during its review observed several factors that correlate with performance, most of which related to the credit worthiness of borrowers. The strongest correlation noted by the OIG was with borrower credit scores. FHA is currently in the process of piloting the Technology Open to All Lenders (TOTAL) scorecard, an automated underwriting system that considers using credit scoring and systematic confirmation of the borrower's identity. As of September 30, 2003, this tool had not yet been fully implemented.

Recommendations to address the above include:

3.a. The Single Family Deputy Assistant Secretary (DAS) should analyze and consider redesigning the PETR process as an early warning control that better predicts loan performance so that the process can be used as not only a lender monitoring tool, but also an effective tool to assist FHA in identifying lenders that originate loans that have a high probability of going to default or claim.

3.b. The Single Family DAS should continue with plans to implement the TOTAL mortgage scorecard on a national basis. In addition, the Single Family DAS should enhance the functionality of the TOTAL mortgage scorecard to use recent borrower credit score data to better identify high-risk loans and to better monitor the performance of Direct Endorsement lenders. The ability to identify loans with a high risk of default or claim will also assist the Office of Evaluation to better estimate the claim and prepayment assumptions used in the LLG estimation model with greater precision.

[1] Mortgage Financing: Changes in the Performance of FHA-Insured Loans, July 10, 2002 (GAO-02-773)

[2] FHA Case File Review – Underwriting Practices and Loan Characteristics Contributing to FHA Loan Performance, May 15, 2003 (2003-SE-0001)

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

November 12, 2003

MEMORANDUM FOR: KPMG LLP

//signed//
FROM: Margaret A. Young, Deputy Assistant Secretary for Finance and Budget, HW

SUBJECT: Response to KPMG's Fiscal Year 2003 FHA Audit Report

Federal Housing Administration (FHA) management hereby presents our responses to your, November 7, 2003 audit report on the fiscal year 2003 FHA financial statements prepared in conformity with accounting principles generally accepted in the United States of America.

General Comments

We are pleased that KPMG has noted progress in many areas. The successful implementation of the FHA Subsidiary Ledger (FHASL) and the operational changes surrounding the implementation has allowed FHA to enhance and accelerate its accounting and financial reporting processes. FHA's continued focus on improvements met with a great deal of success as reflected in the current audit. FHA eliminated one material weakness and two reportable conditions. During fiscal year 2003, FHA continued to concentrate its efforts on addressing management deficiencies and improving its overall business operations. We appreciate the auditor's recognition that FHA has made progress in addressing these deficiencies and has demonstrated its ability to substantially mitigate their effects. Addressing these challenges will continue to be a priority as FHA strives to achieve its goal of becoming an even more high performing, results oriented organization that delivers quality products and services.

Report on Internal Controls – Material Weaknesses

1. HUD/FHA's ADP System Environment Must Be Enhanced to More Effectively Support FHA's Business and Budget Processes.

FHA concurs with this finding and the associated recommendations.

FHA acknowledges the need for modernization of its financial systems and operations. FHA has made the development of integrated financial systems a high priority. On October 1, 2002, FHA implemented a new transaction-based general ledger, which represents a significant step in addressing this material weakness and ushers in a whole new era for FHA financial systems and reporting. FHA now has in place the core system around which all of its financial data will be integrated. Over the next three years, using a phased approach, FHA is planning to integrate its remaining 14 legacy systems consisting of 19 interfaces into one comprehensive FHA Financial Reporting System.

Regarding the first recommendation, the Deputy Assistant Secretary for Finance and Budget will continue to give the FHASL and related work a high priority. The FHASL will continue to integrate financial operations in order to improve performance in the areas covered by the Federal Financial Management Improvement Act (FFMIA). Integration work will include: (1) replacement of existing stand-alone systems and incorporation of their functions within the FHASL core financial software; (2) FHASL participation in re-engineering of mixed financial and program systems to provide core financial system support for financial functions; and (3) improvements in the interfaces between the FHASL core financial system and remaining program and mixed systems. All work will follow HUD's System Development Methodology.

Regarding the second recommendation, the Deputy Assistant Secretary for Finance and Budget will ensure that the FHASL project provides the greatest possible automation support to critical FHA financial processes that are currently performed using manual processes, and that budgetary execution processes will have the highest priority in this work. The FHASL project will continue to implement enhancements to these critical FHA financial processes in steps, in accordance with the FHA Blueprint for Financial Management Systems, so that FHA can realize the benefits of practical improvements in each year of the FHASL project.

By April 2004, FHA is planning to integrate into the FHASL processes for controlling commitments and obligations of Multifamily and Single Family credit subsidy, which replaces the Credit Subsidy Control System (CSCS), controlling disbursements of FHA funds, replacing the interim Funds Control Database procedures, and any new business processes that are developed as a part of the Department's revised Funds Control processes.

Regarding the third recommendation, the Deputy Assistant Secretary for Finance and Budget will ensure that the FHASL project proceeds with system designs and specifications consistent with and supportive of HUD OCIO's IT enterprise architecture. The FHASL project will continue to participate in planning for HUD's new application architecture under the direction of OCIO's enterprise architecture program by providing automated support from the FHASL core financial software for all financial operations of the FHA programs. The FHASL project will also continue to support OCIO's enterprise architecture program in planning HUD's application architecture and implementing HUD's future IT infrastructure.

Report on Internal Controls - Reportable Conditions

2. HUD/FHA Can More Effectively Manage Controls Over the FHA ADP Systems Portfolio.

FHA concurs with this finding and associated recommendations.

Regarding the first recommendation, the Single Family Integration effort will provide an integrated security solution that addresses the program requirements for Single Family, including appropriate control of access and scope of user rights, and lender monitoring requirements such as those supported by Underwriting Reporting System (URS). The URS functionality will be incorporated into this integrated system. This will eliminate the stovepipe functionality associated with URS and other systems and provide a uniform and singular business system.

Regarding the second recommendation, the Deputy Assistant Secretary for Finance and Budget will ensure that FHA's automated credit subsidy control processes receive appropriate and adequate application security protection. The FHASL system replaced the CSCS stand-alone application in performing these functions in October 2003, and security controls for the FHASL system will apply. FHASL provides a fully compliant security environment providing required control on access and rights for all users.

With regards to the third recommendation, FHA is aware of Development Application Processing (DAP) security control needs, and has developed a procurement statement of work (SOW) to address these weaknesses and implement additional DAP security controls during fiscal year 2004. The SOW will be issued and awarded early in FY 2004.

Regarding the fourth recommendation, the FHASL team is actively involved in the Enterprise Architecture project and the business process re-engineering (BPR) efforts. This active level of coordination and integration of efforts within HUD allows FHA to take maximum advantage of the opportunities for integration of its business and financial operations using the Joint Financial Management Improvement Program (JFMIP) - certified capabilities of the new FHA financial system. As addressed in responses to the first and second recommendations, the CSCS will be integrated into the FHASL and URS is included in both in the BPR processes and the Enterprise Architecture.

Regarding the fifth recommendation, the Certification and Accreditation (C&A) effort coordinated by the OCIO will continue in FY 2004 and will assess FHA systems. In the significant re-engineering effort of Single Family Integration, the Housing staff and OCIO are working together to ensure all aspects of the effort comply with all requirements for system security, documentation, and the Target Enterprise Architecture.

3. FHA Must Place More Emphasis on Monitoring Lender Underwriting and Continue to Improve Early Warning and Loss Prevention for Single-Family Insured Mortgages.

FHA agrees that effective monitoring of its program participants is an important component of the organization's business and concurs with the finding and associated recommendations.

Regarding the first recommendation, the DAS for Single Family will analyze and redesign the post-endorsement technical review (PETR) process to identify lenders that originate loans that have a high probability of going to default or claim as a result of poor lender underwriting practices. The redesign of the PETR process is already underway. With support from the Office of Evaluation (OE), the Office of Single Family Housing is developing an algorithm based on an analysis of FHA loans developed by an outside contractor to target higher risk loan originations. This new process will be effective in the spring of 2004.

Regarding the second recommendation, the DAS for Single Family will implement the Technology Open to All Lenders (TOTAL) mortgage scorecard on a nationwide basis and will use the recent borrower credit score data to identify high-risk loans and improve lender monitoring. FHA will be implementing the TOTAL scorecard shortly. With the implementation of the TOTAL scorecard, FHA will have enhanced capability for monitoring high-risk loans and lender performance because it will collect the borrower's FICO score as well as the mortgage score itself, which are designed to measure risk of default and claim. However, the TOTAL mortgage scorecard is not designed to improve estimation of claim and prepayment rates. The conditional claim and prepayment rates used in the Liability for Loan Guarantees (LLG) model are produced by the annual actuarial review performed by an independent actuary. As FHA re-procures the actuarial review contract this year, it will explore additional ways of improving the econometric estimation methods used in future reviews.

Our Assessment of Management's Response

We obtained written comments on a draft of this report from Federal Housing Administration (FHA) management which is included as appendix B. We concur with management's response to our report. FHA is in the process of implementing each of the recommendations specified.

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Fiscal Year 2002 Finding	***Type***	***Fiscal Year 2003 Status***
1. HUD/FHA's ADP system environment must be enhanced to more effectively support FHA's business processes.	2002 – Material Weakness 2003 – Material Weakness (Combined with fiscal year 2002 Material Weakness No.2)	**1. HUD/FHA's ADP system environment must be enhanced to more effectively support FHA's business and budget processes.** HUD/FHA continues to conduct many day-to-day business operations with legacy-based systems, limiting FHA's ability to integrate its financial processing environment and to monitor budget execution. A key improvement made during fiscal year 2003 was the implementation of the FHA Subsidiary Ledger (FHASL) financial system, which automated many previously manual processes used to: 1) consolidate the accounting data received from the various FHA operational legacy systems; and 2) prepare summary entries for posting to the FHASL. Despite this improvement, significant weaknesses still exist. FHA plans to fully address this material weakness by performing reengineering efforts for the Single Family and Multifamily operational systems and related business processes, and by building additional automated interfaces from the operational systems to the FHASL. FHA plans to fully complete these efforts by fiscal year 2007.
2. Controls over budget execution and funds control must be improved.	2002 – Material Weakness 2003 – Combined with Material Weakness No. 1.	FHA has made progress on the issue and the remaining issues are the result of FHA's lack of system integration. Therefore, it is combined with Material Weakness No. 1 in fiscal year 2003.

Fiscal Year 2002 Finding	***Type***	***Fiscal Year 2003 Status***
Reportable Conditions:		
3. HUD/FHA can more effectively manage controls over the FHA ADP systems portfolio.	2002 – Reportable Condition 2003 – Reportable Condition	**2. HUD/FHA can more effectively manage controls over the FHA ADP systems portfolio.** During fiscal year 2003, FHA has taken additional steps to enhance its ADP systems control environment, including the implementation of the FHASL, which addressed several long-standing ADP control issues with FHA financial systems. However, improvements continue to be needed in the area of ADP application security, system support, and preparation and maintenance of system documentation.
4. FHA must place more emphasis on monitoring lender underwriting and continue to improve early warning and loss prevention for Single Family insured mortgages.	2002 – Reportable Condition 2003 – Reportable Condition	**3. FHA must place more emphasis on monitoring lender underwriting and continue to improve early warning and loss prevention for Single Family insured mortgages.** FHA performs several interrelated processes to manage its insurance portfolio and account for the related risk assumed by the Mutual Mortgage Insurance Fund (MMI) and the General Insurance and Special Risk Insurance (GI/SRI) Funds. However, due to a lack of precision in its risk assessment tools, FHA needs to further improve its early warning or detective control processes in order to better quantify the risks in its portfolio.
5. FHA must sufficiently monitor its Single Family property inventory.	2002 – Reportable Condition	Resolved.
6. FHA must improve the controls over the credit subsidy adjustment process.	2002 – Reportable Condition	Resolved.

PRINCIPAL FINANCIAL STATEMENTS

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FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED BALANCE SHEETS
As of September 30, 2003 and 2002
(Dollars in Millions)

	2003	2002
ASSETS		
Intragovernmental		
Fund Balance with U.S. Treasury (Note 3)	$ 7,934	$ 9,597
Investments (Note 4)	23,982	21,346
Other Assets (Note 7)	57	88
Total Intragovernmental	31,973	31,031
Investments (Note 4)	123	-
Accounts Receivable, Net (Note 5)	152	334
Loans Receivable and Related Foreclosed Property, Net (Note 6)	4,291	3,368
Other Assets (Note 7)	130	137
TOTAL ASSETS	**$36,669**	**$34,870**
LIABILITIES		
Intragovernmental		
Borrowings from U.S. Treasury (Note 9)	$ 8,794	$ 7,553
Other Liabilities (Note 10)	1,511	3,095
Total Intragovernmental	10,305	10,648
Accounts Payable (Note 8)	869	1,207
Loan Guarantee Liability (Note 6)	6,251	3,761
Debentures Issued to Claimants (Note 9)	270	288
Other Liabilities (Note 10)	739	839
TOTAL LIABILITIES	**18,434**	**16,743**
NET POSITION		
Unexpended Appropriations (Note 16)	576	761
Cumulative Results of Operations	17,659	17,366
TOTAL NET POSITION	**18,235**	**18,127**
TOTAL LIABILITIES AND NET POSITION	**$36,669**	**$34,870**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF NET COST
For the years ended September 30, 2003 and 2002
(Dollars in Millions)

	2003	2002
MMI/CMHI PROGRAM COSTS		
Intragovernmental Gross Costs (Note 12)	$ 583	$ 516
Less: Intragovernmental Earned Revenue (Note 13)	1,312	1,354
Intragovernmental Net Costs	(729)	(838)
Gross Costs with the Public (Note 12)	3,679	(1,084)
Less: Earned Revenue from the Public (Note 13)	445	678
Net Costs with the Public	3,234	(1,762)
NET MMI/CMHI PROGRAM COST (SURPLUS)	**2,505**	**(2,600)**
GI/SRI PROGRAM COSTS		
Intragovernmental Gross Costs (Note 12)	131	125
Less: Intragovernmental Earned Revenue (Note 13)	106	107
Intragovernmental Net Costs	25	18
Gross Costs with the Public (Note 12)	(941)	(987)
Less: Earned Revenue from the Public (Note 13)	505	366
Net Costs with the Public	(1,446)	(1,353)
NET GI/SRI PROGRAM COST (SURPLUS)	**(1,421)**	**(1,335)**
NET COST (SURPLUS) OF OPERATIONS	**$ 1,084**	**$ (3,935)**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF CHANGES IN NET POSITION
For the years ended September 30, 2003 and 2002
(Dollars in Millions)

	2003 Cumulative Results of Operations	2003 Unexpended Appropriations	2002 Cumulative Results of Operations	2002 Unexpended Appropriations
BEGINNING BALANCES	**$ 17,366**	**$ 761**	**$ 12,985**	**$ 2,129**
BUDGETARY FINANCING SOURCES				
Appropriations Received (Note 16)	-	2,402	-	2,982
Other Adjustments (Note 16)	-	(10)	-	17
Appropriations Used (Note 16)	2,258	(2,258)	2,381	(2,381)
Transfers-Out (Notes 15 and 16)	(756)	(319)	(838)	(1,986)
OTHER FINANCING SOURCES				
Transfers-Out (Note 15)	(138)	-	(1,102)	-
Imputed Financing (Note 12)	16	-	14	-
Other (Note 15)	(3)	-	(9)	-
TOTAL FINANCING SOURCES	**1,377**	**(185)**	**446**	**(1,368)**
NET (COST) SURPLUS OF OPERATIONS	**(1,084)**	-	**3,935**	-
ENDING BALANCES	**$ 17,659**	**$ 576**	**$ 17,366**	**$ 761**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
COMBINED STATEMENTS OF BUDGETARY RESOURCES
For the years ended September 30, 2003 and 2002
(Dollars in Millions)

	2003 Budgetary	2003 Non-Budgetary	2002 Budgetary	2002 Non-Budgetary
BUDGETARY RESOURCES (Note 17)				
Budget Authority:				
Appropriations	$ 2,402	$ -	$ 2,982	$ -
Borrowing Authority	205	2,890	249	3,925
Unobligated Balance Carried Forward	23,834	3,021	19,894	4,478
Spending Authority from Offsetting Collections:				
Earned				
Collected	6,569	12,549	7,535	10,211
Receivable from Federal Sources	7	(158)	(112)	12
Recoveries of Prior Year Obligations	510	77	25	50
Permanently Not Available	(760)	(1,649)	(2,203)	(916)
TOTAL BUDGETARY RESOURCES	**$ 32,767**	**$ 16,730**	**$ 28,370**	**$ 17,760**
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred	$ 5,656	$ 15,669	$ 4,536	$ 14,739
Unobligated Balance-Apportioned	225	814	625	1,466
Unobligated Balance Not Available	26,886	247	23,209	1,555
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 32,767**	**$ 16,730**	**$ 28,370**	**$ 17,760**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS				
Obligated Balance, Net, Beginning of Period	$ 1,707	$ (79)	$ 1,576	$ (99)
Obligated Balance, Net, End of Period:				
Accounts Receivable	(278)	(14)	(271)	(173)
Undelivered Orders	506	222	484	93
Accounts Payable	710	733	1,494	1
Outlays:				
Disbursements	5,907	14,731	4,492	14,657
Collections	(6,569)	(12,549)	(7,535)	(10,211)
Subtotal	(662)	2,182	(3,043)	4,446
Less: Offsetting Receipts	1,372	-	1,993	-
NET OUTLAYS	**$ (2,034)**	**$ 2,182**	**$ (5,036)**	**$ 4,446**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF FINANCING
For the years ended September 30, 2003 and 2002
(Dollars in Millions)

	2003	2002
RESOURCES USED TO FINANCE ACTIVITIES		
Obligations Incurred	$ 21,325	$ 19,275
Spending Authority from Offsetting Collections and Recoveries	(19,554)	(17,721)
Offsetting Receipts	(1,372)	(1,993)
Transfers Out	(138)	(1,102)
Imputed Financing from Costs Absorbed by Others	16	14
Other	(3)	(9)
TOTAL RESOURCES USED TO FINANCE ACTIVITIES	**274**	**(1,536)**
RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST (SURPLUS) OF OPERATIONS		
Change in Budgetary Resources Obligated for Goods and Services Ordered but not yet Provided	(116)	(154)
Resources that Fund Expenses Recognized in Prior Periods	(3,557)	(6,258)
Budgetary Offsetting Collections and Receipts that Do Not Affect the Net Cost (Surplus) of Operations	19,010	18,656
Resources that Finance the Acquisition of Assets	(15,731)	(10,355)
Transfer Out to HUD without Reimbursement Related to Salary and Expense Payments	(273)	(242)
Other Resources or Adjustments that do not Affect the Net Cost (Surplus) of Operations	(334)	599
TOTAL RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST (SURPLUS) OF OPERATIONS	**(1,001)**	**2,246**
TOTAL RESOURCES USED TO FINANCE THE NET COST (SURPLUS) OF OPERATIONS	**(727)**	**710**
COMPONENTS OF THE NET COST (SURPLUS) OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD		
Upward Reestimate of Credit Subsidy Expense	7,546	3,273
Downward Reestimate of Credit Subsidy Expense	(138)	(2,124)
Changes in Loan Loss Reserve	(1,654)	(1,275)
Changes in Bad Debt Expenses Related to Uncollectible Pre-Credit Reform Receivables	(259)	(222)
Reduction of Credit Subsidy Expense from Endorsements and Modifications of Loan Guarantees	(3,853)	(3,203)
Gains or Losses on Sales of Credit Program Assets	522	387
Revenue Recognized as Transfer-in of Budgetary Resources in the Capital Reserve Account	-	(1,014)
Other	(353)	(467)
TOTAL COMPONENTS OF THE NET COST (SURPLUS) OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD	**1,811**	**(4,645)**
NET COST (SURPLUS) OF OPERATIONS	**$ 1,084**	**$ (3,935)**

The accompanying notes are an integral part of these statements.

NOTES TO FINANCIAL STATEMENTS
September 30, 2003

Note 1. Significant Accounting Policies

Entity and Mission

The Federal Housing Administration (FHA) was established under the National Housing Act of 1934 and became a wholly owned government corporation in 1948 subject to the Government Corporation Control Act, as amended. While FHA was established as a separate Federal entity, it was subsequently merged into the Department of Housing and Urban Development (HUD) when that department was created in 1965. FHA does not maintain a separate staff or facilities; its operations are conducted, along with other Housing activities, by HUD organizations. FHA is headed by HUD's Assistant Secretary for Housing/Federal Housing Commissioner, who reports to the Secretary of HUD. FHA's activities are included in the Housing section of the HUD budget.

FHA administers a wide range of activities to make mortgage financing more accessible to the home-buying public and to increase the availability of affordable housing to families and individuals, particularly to the nation's poor and disadvantaged. FHA insures private lenders against loss on mortgages, which finance Single Family homes, Multifamily projects, health care facilities, property improvements, and manufactured homes. The objectives of the activities carried out by FHA relate directly to developing affordable housing.

FHA categorizes its activities as Single Family, Multifamily, or Title I. Single Family activities support basic home ownership; Multifamily activities support high-density housing and medical facilities; Title I activities support manufactured housing and property improvement.

FHA organizes its operations into two overall program types – MMI/CMHI and GI/SRI. These program types are composed of four major funds. The Mutual Mortgage Insurance fund (MMI), FHA's largest fund, provides basic Single Family mortgage insurance and is a mutual insurance fund, whereby mortgagors, upon non-claim termination of their mortgages, share surplus premiums paid into the MMI fund that are not required for operating expenses and losses or to build equity. The Cooperative Management Housing Insurance fund (CMHI), another mutual fund, provides mortgage insurance for management-type cooperatives. The General Insurance fund (GI), provides a large number of specialized mortgage insurance activities, including insurance of loans for property improvements, cooperatives, condominiums, housing for the elderly, land development, group practice medical facilities and nonprofit hospitals. The Special Risk Insurance fund (SRI) provides mortgage insurance on behalf of mortgagors eligible for interest reduction payments who otherwise would not be eligible for mortgage insurance.

Basis of Accounting

The principal financial statements are presented in conformity with accounting principles generally accepted in the United States of America (GAAP) applicable to Federal agencies as promulgated by the Federal Accounting Standards Advisory Board (FASAB). The recognition and measurement of budgetary resources and their status for purposes of preparing the Combined Statement of Budgetary Resources, is based on concepts and guidance provided by the Office of Management and Budget (OMB) Circular A-11, *Preparation, Submission, and Execution of the Budget*.

Reclassifications

In fiscal year 2003, FHA classified rent receivables related to foreclosed properties as part of Accounts Receivable. Prior to fiscal year 2003, these receivables were included as part of Loans Receivable and Related Foreclosed Property, Net. The fiscal year 2002 line items that are affected have been reclassified to conform to the fiscal year 2003 presentation. This change in classifications has no effect on previously reported net position.

Additionally, in fiscal year 2003, FHA classified the GI/SRI special receipt account liability as Other Liabilities, Intragovernmental, and Claim Payment Withholding Payable as Accounts Payable to the Public. Prior to fiscal year 2003, these liabilities were presented as Accounts Payable, Intragovernmental and Other Liabilities with the Public, respectively. The fiscal year 2002 line items affected by this reclassification have been adjusted to conform to the fiscal year 2003 presentation. This change has no effect on previously reported net position.

Basis of Consolidation

The accompanying principal financial statements include all Treasury Account Fund Symbols (TAFSs) designated to FHA, which consist of two principal general program funds, six revolving funds and two general funds. All inter-fund accounts receivable, accounts payable, transfers in and transfers out within these TAFSs have been eliminated to prepare the consolidated balance sheets, statements of net cost, statements of changes in net position and statements of financing. The statements of budgetary resources are prepared on a combined basis as allowed by *Form and Content of Agency Financial Statements*, OMB Bulletin 01-09.

Use of Estimates

The preparation of the principal financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

Amounts reported for net loans receivable and related foreclosed property and the loan guarantee liability represent FHA's best estimates based on pertinent information available.

To estimate the allowance for subsidy (AFS) associated with loans receivable and related to foreclosed property and the liability for loan guarantees (LLG), FHA uses cash flow model assumptions associated with loan guarantee cases subject to the Federal Credit Reform Act of 1990 (FCRA), as described in Note 6, to estimate the cash flows associated with future loan performance. To make reasonable projections of future loan performance, FHA develops assumptions, as described in Note 6, based on historical data, current and forecasted program and economic assumptions.

Certain programs have higher risks due to increased chances of fraudulent activities perpetrated against FHA. FHA accounts for these risks through the assumptions used in the liabilities for loan guarantee estimates. FHA develops the assumptions based on historical performance and management's judgments about future loan performance.

Fund Balance with U.S. Treasury

Fund balance with U.S. Treasury consists of amounts collected and available to fund payments for expenses and of amounts collected but unavailable until authorizing legislation is enacted (see Notes 2 and 3).

Credit Reform Accounting

The FCRA establishes the use of the program, financing, general fund receipt and capital reserve accounts for loan guarantees committed and direct loans obligated after September 30, 1991 (Credit Reform). It also establishes the liquidating account for activity relating to any loan guarantees committed and direct loans obligated before October 1, 1991 (pre-Credit Reform). These accounts are classified as either budgetary or non-budgetary in the Combined Statements of Budgetary Resources. The budgetary accounts include the program, capital reserve and liquidating accounts. The non-budgetary accounts consist of the credit reform financing accounts.

The program account is a budget account that receives and obligates appropriations to cover the subsidy cost of a direct loan or loan guarantee and disburses the subsidy cost to the financing account. The program account also receives appropriations for administrative expenses. The financing account is a non-budgetary account that records all of the cash flows resulting from Credit Reform direct loans or loan guarantees. It disburses loans, collects repayments and fees, makes claim payments, holds balances, borrows from U.S. Treasury, earns or pays interest, and receives the subsidy cost payment from the program account.

The general fund receipt account is a budget account used for the receipt of amounts paid from the financing account when there is a negative subsidy from the original estimate or a downward reestimate. In most cases, the receipt account is a general fund receipt account and amounts are not earmarked for the credit program. They are available for appropriations only in the sense that all general fund receipts are available for appropriations. Any assets in this account are non-entity assets and are offset by intragovernmental liabilities. At the beginning of the following fiscal year, the fund balance in the general fund receipt account is transferred to U.S. Treasury general fund. The FHA general fund receipt account of the GI and SRI funds are in this category.

In order to resolve the different requirements between the FCRA and the National Affordable Housing Act of 1990 (NAHA), OMB instructed FHA to create the capital reserve account to retain the MMI/CMHI negative subsidy and subsequent downward reestimates. Specifically, the NAHA required that FHA’s MMI fund achieve a Capital Ratio of 2.0 percent by fiscal year 2000. The Capital Ratio is defined as the ratio of economic net worth (current cash plus the present value of all future net cash flows) of the MMI fund to unamortized insurance in force (the unpaid balance of insured mortgages). Therefore, to ensure that the calculated Capital Ratio reflects the actual strength of the MMI fund, the resources of the capital reserve account, which are considered FHA assets, are included in the calculation of the MMI fund’s economic net worth. At the end of fiscal year 1995, FHA met and has since maintained the Capital Ratio requirement. FHA's actuary estimates the September 30, 2003 Capital Ratio at 5.21 percent. The fiscal year 2002 estimated Capital Ratio was 4.52 percent.

The liquidating account is a budget account that records all cash flows to and from FHA resulting from pre-Credit Reform direct loans or loan guarantees. Liquidating account collections in any year are available only for obligations incurred during that year or to repay debt. Unobligated balances remaining in the GI and SRI liquidating funds at year-end are transferred to the U.S. Treasury’s general fund. Consequently, in the event that resources in the GI/SRI liquidating account are otherwise insufficient to cover the payments for obligations or commitments, the FCRA provides the GI/SRI liquidating account with permanent indefinite authority to cover any resource shortages.

Investments

FHA investments include investments in U.S. Treasury securities and investments in private-sector entities where FHA is a member with other parties under the Accelerated Claims Disposition Demonstration program (see Note 4).

Under current legislation, FHA invests available resources in excess of its current needs (in MMI/CMHI funds) in non-marketable market-based U.S. Treasury securities. These U.S. Treasury securities may not be sold on public securities exchanges, but do reflect prices and interest rates of similar marketable U.S. Treasury securities. Investments are presented at acquisition cost net of unamortized premium or discount. Amortization of the premium or discount is recognized monthly in interest income on investments in U.S. Treasury securities on the effective interest rate basis.

The Departments of Veterans Affairs and Housing and Urban Development Appropriations Act of 1999 and Section 601 of the Independent Agencies Act of 1999 provide FHA with new flexibility in reforming its single family claims and property disposition activities. In accordance with these Acts, FHA implemented the Accelerated Claims Disposition Demonstration program (the 601 program) to shorten the claim filing process, obtain higher recoveries from its defaulted guaranteed loans, and support the Office of Housing's mission of keeping homeowners in their home. To achieve these objectives, FHA transfers assigned mortgage notes to private-sector entities in exchange for cash and equity interest. The servicing and disposition of the mortgage notes are performed by the private-sector entities whose primary mission is dedicated to these types of activity.

With the transfer of assigned mortgage notes under the 601 program, FHA obtains ownership interest in the private-sector entities. This level of ownership interest enables FHA to exercise significant influence over the operating and financial policies of the entities. Accordingly, to comply with the requirement of Opinion No. 18 issued by the Accounting Principles Board (APB 18), FHA uses the equity method of accounting to measure the value of its investments in these entities. The equity method of accounting requires FHA to record its investments in the entities at cost initially. Periodically, the carrying amount of the investments is adjusted for cash distributions to FHA and for FHA's share of the entities' earnings or losses.

Loans Receivable and Related Foreclosed Property, Net

FHA's loans receivable include purchase money mortgages (PMM) and mortgage notes assigned (MNA), also described as Secretary-held notes. Under the requirements of the FCRA, PMM notes are considered to be direct loans while MNA notes are considered to be defaulted guaranteed loans. The PMM loans are generated from the sales on credit of FHA's foreclosed properties to qualified non-profit organizations. The MNA notes are created when FHA pays the lenders for claims on defaulted guaranteed loans and takes assignment of the defaulted loans for direct collections. In addition, Multifamily and Single Family performing notes insured pursuant to Section 221(g)(4) of the National Housing Act may be assigned automatically to FHA at a pre-determined point.

In accordance with the FCRA and Statement of Federal Financial Accounting Standards (SFFAS) No. 2, *Accounting for Direct Loans and Loan Guarantees*, Credit Reform direct loans, defaulted guaranteed loans and foreclosed property are reported at the net present value of expected cash flows associated with these assets. Pre-Credit Reform loans receivable and foreclosed property in inventory are recorded at net realizable value, which is based on historical recovery rates net of any selling expenses, (see Note 6).

General Property, Plant and Equipment

FHA does not maintain separate facilities. HUD purchases and maintains all property, plant and equipment used by FHA, along with other Office of Housing activities.

Current HUD policy concerning SFFAS No. 10 *Accounting for Internal Use Software* indicates that HUD will either own the software or the functionality provided by the software in the case of licensed or leased software. This includes "commercial off-the-shelf" (COTS) software, contractor-developed software, and internally developed software. FHA had several procurement actions in place and had incurred expenses for software development. FHA identified and transferred those expenses to HUD to comply with departmental policy. The capitalizable software development costs identified and transferred to HUD by FHA in fiscal year 2003 and 2002 were $3 million and $9 million, respectively.

Loan Guarantee Liability

The potential future losses related to FHA's central business of providing mortgage insurance are accounted for as Loan Guarantee Liability in the consolidated balance sheets. As required by SFFAS No. 2, the Loan Guarantee Liability includes the Credit Reform related Liabilities for Loan Guarantees (LLG) and the pre-Credit Reform Loan Loss Reserve (LLR) (see Note 6).

The LLG and LLR are calculated as the present value of anticipated cash outflows for defaults, such as claim payments, premium refunds, property expense for on-hand properties and sale expense for sold properties, less anticipated cash inflows such as premium receipts, proceeds from asset sales and principal and interest on Secretary-held notes, as described above.

FHA records loss estimates in its MMI fund and on its single family GI/SRI loans to provide for anticipated losses incurred (e.g., claims on insured mortgages where defaults have taken place but claims have not yet been filed). Using the net realizable value method, FHA computes an estimate based on conditional claim rates and loss experience data, and adjusts the estimate to incorporate management assumptions about current economic factors.

FHA records loss estimates in its CMHI, and multifamily GI/SRI loans to provide for anticipated outflows less anticipated inflows. The LLR is now calculated in a similar manner to the financing account LLG, where the LLR is the net present value of claims less premiums, fees, and recoveries. Conditional claim rates, prepayment rates, and recovery assumptions are based on historical experience.

Unearned Premiums

Unearned premiums are recognized for pre-Credit Reform loan guarantee premiums collected but not yet earned in the liquidating account. Premiums charged by FHA's MMI fund include up-front and annual risk-based premiums. Up-front risk-based premiums are recorded as unearned revenue upon collection and are recognized as revenue over the period in which losses and insurance costs are expected to occur. Annual risk-based premiums are recognized as revenue on a straight-line basis throughout the year. FHA's other funds charge periodic insurance premiums over the mortgage insurance term. Premiums on annual installment policies are recognized for the liquidating account on a straight-line basis throughout the year. Premiums associated with Credit Reform loan guarantees are included in the calculation of the LLG and are not included in the unearned premium amounts reported in the consolidated balance sheets.

Appropriations and Monies Received from Other HUD Programs

The National Housing Act of 1990, as amended, provides for appropriations from Congress to finance the operations of GI and SRI funds. For Credit Reform loan guarantees, appropriations to the GI and SRI funds are provided at the beginning of each fiscal year to cover estimated losses on insured loans during the year. For pre-Credit Reform loan guarantees, FHA has permanent indefinite appropriation authority to finance any shortages of resources needed for operations.

Monies received from other HUD programs, such as interest subsidies and rent supplements are recorded as revenue for the liquidating accounts when services are rendered. Monies received for the financing accounts are recorded as additions to the LLG or the AFS when collected.

Full Cost Reporting

SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards*, requires that Federal agencies report the full cost of program outputs in the financial statements. Full cost reporting includes all direct, indirect, and inter-entity costs. For purposes of HUD's consolidated financial statements, HUD identifies each responsibility segment's share of the program costs or resources provided by other Federal agencies. As a responsibility segment of HUD, FHA's portion of these costs for fiscal years 2003 and 2002 was $16 million and $14 million, respectively and are included in FHA's financial statements as an imputed cost in the Consolidated Statements of Net Cost, and an imputed financing in the Consolidated Statements of Changes in Net Position and the Consolidated Statements of Financing.

In a separate effort, FHA conducts time allocation surveys of all Office of Housing operational managers. These surveys determine FHA's direct personnel costs associated with the Housing Salaries and Expenses (S&E) transfer to HUD and where to allocate these costs between the MMI/CMHI and GI/SRI programs. The HUD Chief Financial Officer (CFO) office also conducts surveys to determine how the department's fiscal year overhead, Office of Inspector General, and Working Capital Fund costs, which are paid for by S&E transfer, should be accounted for by responsibility segments. This data is an integral part of the FHA direct cost S&E allocation prepared for financial statement reporting.

Distributive Shares

As mutual funds, the MMI and CMHI funds distribute excess revenues to mortgagors at the discretion of the Secretary of HUD. Such distributions are determined based on the funds' financial positions and their projected revenues and costs. As previously discussed, in November 1990, Congress passed the NAHA, which effectively suspended payment of distributive shares from the MMI fund, other than those already declared by the Secretary, until the fund meets certain Capital Ratio requirements. Although the Capital Ratio requirement has been met since September 30, 1995, no distributive shares have been declared from the MMI fund because legislation is not yet enacted.

Liabilities Covered by Budgetary Resources

Liabilities of federal agencies are required to be classified as those covered and not covered by budgetary resources, as defined by OMB Bulletin 01-09, and in accordance with SFFAS No. 1, *Selected Assets and Liabilities*. In the event that available resources are insufficient to cover liabilities due at a point in time, FHA has authority to borrow monies from the U.S. Treasury (for post-1991 loan guarantees) or to draw on permanent indefinite appropriations (for pre-1992 loan guarantees) to satisfy the liabilities. Thus, all of FHA's liabilities are considered covered by budgetary resources.

Note 2. Non-entity Assets

Non-entity assets consist of assets that belong to other entities but are included in FHA's consolidated balance sheets. To reflect FHA's net position accurately, these non-entity assets are offset by various liabilities. FHA's non-entity assets at September 30 are as follows:

(Dollars in millions)

	2003	2002
Intragovernmental:		
Fund Balance with U.S. Treasury	$ 1,597	$ 2,048
Investments in U.S. Treasury Securities	4	2
Total Intragovernmental	1,601	2,050
Other Assets	123	123
Total Non-entity Assets	1,724	2,173
Total Entity Assets	34,945	32,697
Total Assets	**$ 36,669**	**$ 34,870**

FHA's non-entity assets consist of FHA's U.S. Treasury deposit of negative credit subsidy in the GI/SRI general fund receipt account and of escrow monies collected by FHA from the borrowers of its loans.

According to the FCRA, FHA transfers negative credit subsidy from new endorsements and downward credit subsidy reestimates from the GI/SRI financing account to the GI/SRI general fund receipt account. At the beginning of each fiscal year, fund balance in the GI/SRI general fund receipt account is transferred into the U.S. Treasury's general fund.

Other assets consisting of escrow monies collected from FHA borrowers are either deposited at the U.S. Treasury or minority-owned banks or invested in U.S. Treasury securities. Subsequently, FHA disburses these escrow monies to pay for property taxes, property insurance or maintenance expenses on behalf of the borrowers.

Note 3. Fund Balance with U.S. Treasury

FHA's fund balance with U.S. Treasury at September 30 was composed of the following:

(Dollars in millions)

	2003	2002
Fund Balances:		
Revolving Funds	$ 3,721	$ 5,550
Appropriated Funds	420	355
Other Funds	3,793	3,692
Total	**$ 7,934**	**$ 9,597**
Status of Fund Balance with U.S. Treasury:		
Unobligated Balance:		
Available	$ 1,039	$ 2,091
Unavailable	4,724	5,434
Obligated Balance not yet Disbursed	2,171	2,072
Total	**$ 7,934**	**$ 9,597**

Revolving Funds

FHA's revolving funds include the liquidating and financing accounts as required by the FCRA. These funds are created to finance a continuing cycle of business-like operations in which the fund charges for the sale of products or services. These funds also use the proceeds to finance spending, usually without requirement of annual appropriations.

Appropriated Funds

FHA's appropriated funds consist of the program accounts created by the FCRA. Annual or multi-year program accounts expire at the end of the time period specified in the authorizing legislation. For the subsequent five fiscal years after expiration, the resources are available only to liquidate valid obligations incurred during the unexpired period. Adjustments are allowed to increase or decrease valid obligations incurred during the unexpired period that were not previously reported. At the end of the fifth expired year, the annual and multi-year program accounts are cancelled and any remaining resources are returned to the U.S. Treasury.

Other Funds

FHA's other funds include the general fund receipt accounts established under the FCRA. Additionally, included with these funds is the capital reserve account that is used to retain the MMI/CMHI negative subsidy and downward credit subsidy reestimates transferred from the financing account. If subsequent upward credit subsidy reestimates are calculated in the financing account or there is shortage of budgetary resources in the liquidating account, the capital reserve account will return the retained negative subsidy to the financing account or transfer the needed funds to the liquidating account, respectively.

Status of Fund Balance with U.S. Treasury

Unobligated Fund Balance with U.S. Treasury represents Fund Balance with U.S. Treasury that has not been obligated to purchase goods or services either because FHA has not received apportionment authority from OMB to use the resources (unavailable unobligated balance) or because FHA has not obligated the apportioned resources (available unobligated balance). Fund Balance with U.S. Treasury that is obligated, but not yet disbursed, consists of resources that have been obligated for goods or services but not yet disbursed either because the ordered goods or services have not been delivered or because FHA has not yet paid for goods or services received by the end of the fiscal year.

Note 4. Investments

Investment in U.S. Treasury Securities

As discussed in Note 1, all FHA investments in Treasury securities are in non-marketable securities issued by the U.S. Treasury. These securities carry market-based interest rates. The market value of these securities is calculated using the bid amount of similar marketable U.S. Treasury securities as of September 30. The cost, par value, net unamortized discount, net investment, and market values of FHA's investments in U.S. Treasury securities as of September 30, 2003 were as follows:

(Dollars in millions)	Cost	Par Value	Unamortized Premium (Discount), Net	Investment, Net	Market Value
MMI/CMHI Investments	$ 23,575	$ 23,819	$ (118)	$ 23,701	$ 25,199
GI/SRI Investments	4	4	-	4	4
Subtotal	23,579	23,823	(118)	23,705	25,203
MMI/CMHI Accrued Interest	-	-	-	277	-
Total	**$ 23,579**	**$ 23,823**	**$ (118)**	**$ 23,982**	**$ 25,203**

The cost, par value, net unamortized discount, net investment, and market values as of September 30, 2002 were as follows:

(Dollars in millions)	Cost	Par Value	Unamortized Premium (Discount), Net	Investment, Net	Market Value
MMI/CMHI Investments	$ 20,908	$ 21,249	$ (172)	$ 21,077	$ 23,012
GI/SRI Investments	2	2	-	2	2
Subtotal	20,910	21,251	(172)	21,079	23,014
MMI/CMHI Accrued Interest	-	-	-	267	-
Total	**$ 20,910**	**$ 21,251**	**$ (172)**	**$ 21,346**	**$ 23,014**

Investments in Private-Sector Entities

The following table presents financial data on FHA's investments in private-sector entities as of September 30:

(Dollars in millions)

	Beginning Balance	New Acquisitions	Share of Earnings or Losses	Return of Investment	Other Adjustments	Ending Balance
FY 2003	**$ -**	**$ 133**	**$ 4**	**$ (14)**	**$ -**	**$ 123**

These investments in private-sector entities are the result of FHA's participation in the Accelerated Claims Disposition Demonstration program in fiscal year 2003 as discussed in Note 1.

The condensed, audited financial information related to these private-sector entities for the period from inception to June 30, 2003 is summarized below.

(Dollars in millions)	**2003**
Total assets, primarily mortgage loans	$ 323
Liabilities	-
Partners' capital	323
Total liabilities and partners' capital	$ 323
Revenues	$ 25
Expenses	(2)
Net Income	$ 23

Note 5. Accounts Receivable, Net

Accounts receivable, net, as of September 30 are as follows:

	Gross		**Allowance**		**Net**	
(Dollars in millions)	**2003**	**2002**	**2003**	**2002**	**2003**	**2002**
From the Public:						
Receivables related to credit program assets	$ 103	$ 90	$ (14)	$ -	$ 89	$ 90
Premiums receivable	26	207	-	-	26	207
Miscellaneous receivables	115	116	(78)	(79)	37	37
Total	**$ 244**	**$ 413**	**$ (92)**	**$ (79)**	**$ 152**	**$ 334**

Receivables Related to Credit Program Assets

These receivables include sale proceeds receivable and rents receivable from FHA's foreclosed properties.

Premiums Receivable

These amounts consist of the up-front and periodic premiums due to FHA from the mortgagors at the end of the reporting period. The details of FHA premium structure are discussed in Note 13 – Earned Revenue/Premium Revenue.

Miscellaneous Receivables

Miscellaneous receivables include late charges and penalties receivable on premiums receivable, generic debt receivables, refunds receivable from overpayments of claims and distributive shares and other immaterial receivables.

Allowance for Loss

The allowance for loss for these receivables is calculated based on FHA's historical loss experience and management's judgment concerning current economic factors.

Note 6. Direct Loans and Loan Guarantees, Non-Federal Borrowers

FHA Direct Loan and Loan Guarantee Programs and the related loans receivable, foreclosed property, and loan guarantee liability as of September 30 are as follows:

Direct Loan and Loan Guarantee Programs Administered by FHA Include:
MMI/CMHI Direct Loan Program
GI/SRI Direct Loan Program
MMI/CMHI Loan Guarantee Program
GI/SRI Loan Guarantee Program

Direct Loans Obligated Prior to Fiscal Year 1992 (Allowance for Loss Method):

(Dollars in millions)

Direct Loan Programs	**Loans Receivable, Gross**	**Interest Receivable**	**Allowance for Loan Losses**	**Foreclosed Property**	**Value of Assets Related to Direct Loans**
FY 2003: MMI/CMHI	$ 1	$ -	$ -	$ -	$ 1
GI/SRI	21	1	(8)	-	14
FY 2003 Total	**$ 22**	**$ 1**	**$ (8)**	**$ -**	**$ 15**
FY 2002: MMI/CMHI	$ 2	$ -	$ (2)	$ -	$ -
GI/SRI	25	-	(8)	-	17
FY 2002 Total	**$ 27**	**$ -**	**$ (10)**	**$ -**	**$ 17**

Direct Loans Obligated After Fiscal Year 1991:

(Dollars in millions)

Direct Loan Programs	**Loans Receivable, Gross**	**Interest Receivable**	**Foreclosed Property**	**Allowance for Subsidy Cost**	**Value of Assets Related to Direct Loans**
FY 2003: MMI/CMHI	$ -	$ -	$ -	$ (3)	$ (3)
GI/SRI	-	-	-	-	-
FY 2003 Total	**$ -**	**$ -**	**$ -**	**$ (3)**	**$ (3)**
FY 2002: MMI/CMHI	$ 1	$ -	$ -	$ (2)	$ (1)
GI/SRI	-	-	-	-	-
FY 2002 Total	**$ 1**	**$ -**	**$ -**	**$ (2)**	**$ (1)**

Defaulted Guaranteed Loans from Pre-1992 Guarantees (Allowance for Loss Method):

(Dollars in millions) **Loan Guarantee Programs**		**Defaulted Guaranteed Loans Receivable, Gross**	**Interest Receivable**	**Allowance for Loan Losses**	**Foreclosed Property**	**Value of Assets Related to Defaulted Guaranteed Loans Receivable, Net**
FY 2003:	MMI/CMHI	$ 8	$ 16	$ (4)	$ 33	$ 53
	GI/SRI	2,420	144	(878)	9	1,695
	FY 2003 Total	**$ 2,428**	**$ 160**	**$ (882)**	**$ 42**	**$ 1,748**
FY 2002:	MMI/CMHI	$ 16	$ 1	$ (6)	$ 133	$ 144
	GI/SRI	2,285	106	(979)	68	1,480
	FY 2002 Total	**$ 2,301**	**$ 107**	**$ (985)**	**$ 201**	**$ 1,624**

Defaulted Guaranteed Loans from Post-1991 Guarantees:

(Dollars in millions) **Loan Guarantee Programs**		**Defaulted Guaranteed Loans Receivable, Gross**	**Interest Receivable**	**Foreclosed Property**	**Allowance for Subsidy Cost**	**Value of Assets Related to Defaulted Guaranteed Loans Receivable, Net**
FY 2003:	MMI/CMHI	$ 232	$ -	$ 2,773	$ (841)	$ 2,164
	GI/SRI	584	48	420	(685)	367
	FY 2003 Total	**$ 816**	**$ 48**	**$ 3,193**	**$ (1,526)**	**$ 2,531**
FY 2002:	MMI/CMHI	$ 180	$ -	$ 2,138	$ (864)	$ 1,454
	GI/SRI	637	23	206	(592)	274
	FY 2002 Total	**$ 817**	**$ 23**	**$ 2,344**	**$ (1,456)**	**$ 1,728**

Guaranteed Loans Outstanding:

(Dollars in millions)

Loan Guarantee Programs	Outstanding Principal of Guaranteed Loans, Face Value	Amount of Outstanding Principal Guaranteed
Guaranteed Loans Outstanding (FY 2003):		
MMI/CMHI	$ 434,002	$ 404,506
GI/SRI	101,197	85,619
Total	**$ 535,199**	**$ 490,125**
Guaranteed Loans Outstanding (FY 2002):		
MMI/CMHI	$ 501,289	$ 467,554
GI/SRI	106,800	95,824
Total	**$ 608,089**	**$ 563,378**
New Guaranteed Loans Disbursed (FY 2003):		
MMI/CMHI	$ 144,227	$ 129,306
GI/SRI	19,004	17,451
Total	**$ 163,231**	**$ 146,757**
New Guaranteed Loans Disbursed (FY 2002):		
MMI/CMHI	$ 96,444	$ 95,834
GI/SRI	16,266	14,808
Total	**$ 112,710**	**$ 110,642**

Loan Guarantee Liability, Net:

(Dollars in millions)

Loan Guarantee Programs	Liabilities for Losses on Pre-1992 Guarantees, Estimated Future Default Claims (LLR)	Liabilities for Loan Guarantees for Post-1991 Guarantees (LLG)	Total Loan Guarantee Liability, Net
FY 2003: MMI/CMHI	$ 111	$ 2,008	$ 2,119
GI/SRI	3,324	808	4,132
FY 2003 Total	**$ 3,435**	**$ 2,816**	**$ 6,251**
FY 2002: MMI/CMHI	$ 139	$ (1,864)	$ (1,725)
GI/SRI	4,950	536	5,486
FY 2002 Total	**$ 5,089**	**$ (1,328)**	**$ 3,761**

Subsidy Expense for Loan Guarantees by Program and Component:

(Dollars in millions)

Subsidy Expense for New Loan Guarantees	Defaults	Fees and Other Collections	Other	Total
FY 2003: MMI/CMHI	$ 2,003	$ (6,066)	$ 479	$ (3,584)
GI/SRI	759	(1,026)	-	(267)
FY 2003 Total	**$ 2,762**	**$ (7,092)**	**$ 479**	**$ (3,851)**
FY 2002: MMI/CMHI	$ 1,962	$ (5,072)	$ 258	$ (2,852)
GI/SRI	555	(892)	-	(337)
FY 2002 Total	**$ 2,517**	**$ (5,964)**	**$ 258**	**$ (3,189)**

(Dollars in millions)

Subsidy Expense for Modifications and Reestimates	Total Modifications	Interest Rate Reestimates	Technical Reestimates	Total Reestimates
FY 2003: MMI/CMHI	$ -	$ -	$ 5,947	$ 5,947
GI/SRI	-	-	352	352
FY 2003 Total	**$ -**	**$ -**	**$ 6,299**	**$ 6,299**
FY 2002: MMI/CMHI	$ -	$ -	$ 1,100	$ 1,100
GI/SRI	-	-	(149)	(149)
FY 2002 Total	**$ -**	**$ -**	**$ 951**	**$ 951**

(Dollars in millions)

Total Loan Guarantee Subsidy Expense	2003	2002
MMI/CMHI	$ 2,363	$ (1,752)
GI/SRI	85	(486)
Total	**$ 2,448**	**$ (2,238)**

Subsidy Rates for Loan Guarantees by Program and Component:

(Percentage)

	Defaults	Fees and Other Collections	Other	Total
Budget Subsidy Rates for Loan Guarantees of FY 2003 Cohort:				
MMI/CMHI	1.55	(4.08)	-	(2.53)
GI/SRI	4.75	(5.88)	-	(1.13)
Budget Subsidy Rates for Loan Guarantees of FY 2002 Cohort:				
MMI/CMHI	1.54	(3.77)	0.16	(2.07)
GI/SRI	2.88	(4.48)	-	(1.60)

Schedule for Reconciling Loan Guarantee Liability Balances:

(Dollars in millions)	2003 LLR	2003 LLG	2002 LLR	2002 LLG
Beginning Balance of the Loan Guarantee Liability	**$ 5,089**	**$ (1,328)**	**$ 6,364**	**$ (311)**
Add: Subsidy Expense for guaranteed loans disbursed during the reporting fiscal years by component:				
Default Costs (Net of Recoveries)	-	2,762	-	2,517
Fees and Other Collections	-	(7,092)	-	(5,964)
Other Subsidy Costs	-	479	-	258
Total of the above subsidy expense components	**-**	**(3,851)**	**-**	**(3,189)**
Adjustments:				
Fees Received	-	3,085	-	2,946
Foreclosed Property and Loans Acquired	-	6,527	-	3,313
Claim Payments to Lenders	-	(8,934)	-	(5,889)
Interest Accumulation on the Liability Balance	-	(326)	-	(152)
Adjustments of prior years' credit subsidy reestimates	-	-	-	(227)
Other	-	235	-	92
Ending Balance before Reestimates	**5,089**	**(4,592)**	**6,364**	**(3,417)**
Add or Subtract Subsidy Reestimates by Component:				
Technical/Default Reestimate:				
Subsidy Expense Component		6,299		951
Interest Expense Component		1,109		1,138
Total Technical/Default Reestimate	**(1,654)**	**7,408**	**(1,275)**	**2,089**
Ending Balance of the Loan Guarantee Liability	**$ 3,435**	**$ 2,816**	**$ 5,089**	**$ (1,328)**

Administrative Expense:

(Dollars in millions)	2003	2002
MMI/CMHI	$ 219	$ 268
GI/SRI	227	243
Total	**$ 446**	**$ 511**

Pre-Credit Reform Valuation Methodology

FHA values its pre-Credit Reform LLR and related notes and properties in inventory at net realizable value, determined on the basis of net cash flows. To value these items, FHA uses historical claim data, revenues from premiums and recoveries, and expenses of selling and maintaining property.

FHA records loss estimates in its MMI fund and single family GI/SRI loans to provide for anticipated losses incurred (e.g., claims on insured mortgages where defaults have taken place but claims have not yet been filed). Using the net realizable value method, FHA computes an estimate based on conditional claim rates and loss experience data, and adjusts the estimate to incorporate management assumptions about current economic factors.

FHA records loss estimates in its CMHI, and multifamily GI/SRI loans to provide for anticipated outflows less anticipated inflows. The LLR is now calculated in a similar manner to the financing account LLG, where the LLR is the net present value of claims less premiums, fees, and recoveries. Conditional claim rates, prepayment rates, and recovery assumptions are based on historical experience.

A separate analysis was conducted to adjust the loan loss estimate for planned reductions in project-based Section 8 rental assistance subsidies administered by the Office of Multifamily Housing Assistance Restructuring (OMHAR). All projects that submitted annual financial statements, received Section 8 assistance and had rents exceeding fair market value were included. In the analysis, the gross rent for these projects was reduced to bring the rent for assisted units to fair market levels. The effects of this rent reduction on projects' financial health was assessed and the projects were grouped into the following three categories:

<u>No action:</u> Projects that could continue to pay their operating expenses and mortgage payment from remaining revenues.

<u>Partial claim:</u> Projects that could pay their operating expenses but could not make a full mortgage payment.

<u>Full Claim:</u> Projects that could no longer meet their mortgage payment and operating expenses.

Based on this analysis, appropriate adjustments were made to each project's loan loss estimate. No changes were made for projects requiring no action. For those classified as a partial claim, a new sustainable mortgage amount was calculated. The loss estimated on loans classified as partial claims was based on the amount of the claim payment. For loans classified as full claim, the loss estimate was set to 100 percent of the project's unpaid principal balance.

Pre-Credit Reform loans receivable are recorded at the lower of cost or fair value. Fair value is estimated based on the prevailing market interest rates at the date of the loan assignment. When fair value is less than cost, discounts are recorded and amortized to interest income over the remaining terms of the loans or upon sale of the loans. Pre-Credit Reform loans are reported net of allowance for loss and any unamortized discount. The estimate for the allowance for loss is based on historical recovery rates, net of selling expense. Pre-Credit Reform foreclosed property is reported at cost less allowance for loss, which is calculated based on historical recovery rates, net of selling expense.

Credit Reform Valuation Methodology

FHA values its Credit Reform LLG and related receivables on notes and properties in inventory at the net present value of their estimated future cash flows. The disbursement weighted interest rate on U.S. Treasury securities of maturity comparable to the guaranteed loan term is the discount factor used in the present value calculation for cohorts 1992 to 2000. For the 2001 and future cohorts, the rate on U.S. Treasury securities of maturity comparable to the term of each cash flow for the loan guarantee is used in the present value calculation. This methodology is referred to as the basket of zeros discounting methodology. OMB provides these rates to all Federal agencies for use in preparing credit subsidy estimates and requires their use under OMB Circular A-11, Part 4, "Instructions on Budget Execution." The basket of zeros discount factors are also disbursement weighted.

To apply the present value computations, FHA divides the loans into cohorts. Individual cohorts are defined by year of insurance activity and program type. Multifamily cohorts are defined based on the year in which loan guarantee commitments are made. Single Family mortgages are grouped into cohorts based on loan endorsement dates for the GI/SRI fund and commitment dates for the MMI fund. A loan can be disbursed in a year after the one in which it was obligated. Within each cohort year, loans are subdivided by risk categories. Each risk category has characteristics that distinguish it from others, including risk profile, premium structure, and the type and quality of collateral underlying the loan.

The cash flow estimates that underlie the present value calculations are determined using the significant assumptions detailed below.

Significant Assumptions – FHA developed financial models in order to estimate the present value of future program cash flows. The models incorporate information on the cash flows' expected magnitude and timing. The models rely heavily on the following loan performance assumptions:

- Conditional Termination Rates: The estimated probability of an insurance policy claim or non-claim termination in each year of the loan guarantee's term.
- Recovery Rates: The estimated percentage of a claim payment that is recovered through disposition of a mortgage note or underlying property.
- Claim Amount: The estimated amount of the claim payment relative to the unpaid principal balance at the time the claim occurs.

Additional information about loan performance assumptions is provided below:

Sources of data: FHA developed assumptions for claim rates, prepayment rates, claim amounts, and recoveries based on historical data obtained from its systems.

Economic assumptions: Forecasts of economic conditions used in conjunction with loan-level data to generate Single Family and Multifamily claim and prepayment rates were obtained from Global Insights (formerly DRI) forecasts of U.S. annual economic figures. The liability for loan guarantee estimate is likely to change depending on the time at which the economic forecasts are collected. OMB provides other economic assumptions used, such as discount rates.

Reliance on historical performance: FHA relies on the average historical performance of its insured portfolio to forecast future performance of that portfolio. Changes in legislation, subsidy programs, tax treatment and economic factors all influence loan performance. FHA assumes that similar events may occur during the remaining life of existing mortgage guarantees, which can be as long as 40 years for Multifamily programs and affect loan performance accordingly.

Current legislation and regulatory structure: FHA's future plans allowed under current legislative authority have been taken into account in formulating assumptions when relevant. In contrast, future changes in legislative authority may affect the cash flows associated with FHA insurance programs. These changes cannot be reflected in LLG calculations because of uncertainty over their nature and outcome.

Single Family loss mitigation program: FHA's estimates relating to claim payments are affected by assumptions made about the loss mitigation program, which became effective in April 1996. FHA based these assumptions on recent experience and the industry expertise of FHA staff.

Because of uncertainties inherent in the loan performance assumptions underlying the LLG and related receivables on notes and properties in inventory, actual cash flows will vary from the estimates over time. A reestimate process each year allows for estimates to be adjusted.

Discussion of Change in the Liability for Loan Guarantees

FHA has estimated and applied credit subsidy rates to each FHA loan guarantee program since fiscal year 1992. Over this time FHA's credit subsidy rates have varied. The variance is caused by two factors: (1) additional loan performance data underlying the credit subsidy rate estimates, and (2) revisions to the calculation methodology used to estimate the credit subsidy rates. Loan performance data, which reflect mortgage market performance and FHA policy direction, are added as they become available. Revisions to the estimation methodology result from legislative direction and technical enhancements.

FHA estimated the credit subsidy rates for the 2003 cohort in fiscal year 2001. At the time of budget submission, the rates reflected prevailing policy and loan performance assumptions based on the most recent information available. These credit subsidy rates can be compared to the credit subsidy rates estimated at the end of 2003. The two rates can be reconciled through credit subsidy reestimates, which allow FHA to adjust the LLG and subsidy expense to reflect the most current and accurate credit subsidy rate.

Described below are the programs that comprise the majority of FHA's fiscal year 2003 new business. In addition, the Hospital Insurance program is also described. These descriptions highlight the factors that contributed to changing credit subsidy rates and the credit subsidy reestimate. Overall, FHA's liability increased by $2.5 billion from the fiscal year 2002 values.

Mutual Mortgage Insurance (MMI) - The MMI fund provides insurance for private lenders against losses on Single Family mortgages. The fund protects lenders against loan default on mortgages for properties that meet certain minimum requirements. This allows lenders to provide credit to borrowers who might not meet conventional underwriting requirements.

Due to the magnitude of the MMI fund, program changes can significantly affect the overall LLG and subsidy expense recorded in the financial statements. During fiscal year 2003, recent data and changing methodologies increased the liability of the MMI fund. The majority of this change is due to the increased claims being predicted by the claim and prepayment rates taken from the *Actuarial Review of the MMI Fund as of FY 2003*. In addition, the LLG was also increased by the removal of the loss mitigation downward adjustment to the conditional claim and prepayment rates.

GI/SRI Section 221(d)(4) **-** The Section 221(d)(4) program was established to provide mortgage insurance for the construction or substantial rehabilitation of Multifamily rental properties with five or more units. Under this program, HUD may insure up to 90 percent of the total project cost and is prohibited from insuring loans with HUD-subsidized interest rates. The Section 221(d)(4) program is the largest Multifamily program in the GI/SRI fund. The Section 221(d)(4) liability increased in FY 2003 and was impacted by two major changes.

First, FHA revised the data used to forecast conditional claim and prepayment rates in the econometric analysis. Previously, one claim and prepayment curve was generated for each cohort. Now a separate claim and prepayment curve is generated using economic and policy variables specific to that cohort. This results in an increase in the LLG.

Second, FHA revised cash flow modeling of claim recoveries. Previously, three types of recoveries were included in modeling: note sales, property sales and paid in full. Recovery data related to foreclosure sales was combined with note sale data. In FY 2003, separate note holding period and sale recovery assumptions are calculated for foreclosure sales. 221(d)(4) has a high recovery disposition from note sales, which typically generates higher recovery income than foreclosure sales. This change slightly offsets the claim and prepayment impact.

GI/SRI Section 242 - The Office of Insured Health Care Facilities (OIHCF) operates within FHA. The OIHCF provides loan insurance through the Section 242 mortgage insurance program for the new construction of hospitals or the refinancing of existing FHA-insured hospitals. Many of the hospitals insured through the Section 242 program serve as community anchors that provide jobs and health care services to populations in need. Hospitals in New York State constitute approximately 86 percent of the Section 242 portfolio. The LLG estimate for the Section 242 program increased in 2003 due to the following modeling methodology changes.

The methodology used to supplement historical data on Section 242 program claim terminations was modified in FY 2003. Previously, an OMB-designed defaulting methodology was used where, currently insured hospital loans are defaulted artificially in the data if they fail to meet three measures of financial strength and are on the Department of Health and Human Services (HHS) Priority Watch List (PWL). In FY 2003, a methodology designed by the Office of Insured Health Care Facilities is used. Under this methodology, currently insured hospitals are defaulted in the data if they are on the PWL and fail to meet a specified score based on various financial ratios including days cash on hand, operating margin and debt service coverage ratio. It also includes other information such as the impact of interventions, the release of funds from the mortgage reserve fund, HUD appointed consultants, and state funded assistance. This new methodology, a revised HHS PWL and updated financial criteria data led to an increase in the number of hospitals artificially defaulted in fiscal year 2003, which increased the claim termination rates and the 242 liability.

GI/SRI Section 234(c) **-** The Section 234(c) program insures a loan for as many as 30 years to purchase a unit in a condominium building. One of the many purposes of FHA's mortgage insurance programs is to encourage lenders to make affordable mortgage credit available for non-conventional forms of ownership. Condominium ownership, in which the separate owners of the individual units jointly own the development's common areas and facilities, is one particularly popular alternative. The Section 234(c) program is FHA's largest Single Family program in the GI/SRI fund. Historically, the program generates a reduction in credit subsidy expense.

The majority of this change is due to removal of the loss mitigation downward adjustment to the conditional claim and prepayment rates. In addition, the LLG was also increased by additional claims being predicted by the conditional claim and prepayment rates.

GI/SRI Section 203(k) - The section 203(k) program allows a homebuyer to finance the purchase and rehabilitation of a Single Family property with a single mortgage loan insured by FHA. In the past, this program encountered incidents of fraud and FHA explicitly accounts for these risks through its LLG estimates.

FHA developed these assumptions based on data and management's judgments about future loan performance and related risk. Overall, the claim costs plus the additional rehabilitation and maintenance costs increased the LLG by approximately $58 million.

Note 7. Other Assets

The following table presents the composition of other assets held by FHA as of September 30:

(Dollars in millions)

	2003	2002
Intragovernmental:		
Advances to HUD for Working Capital Fund Expenses	$ 53	$ 88
Miscellaneous Assets	4	-
Total	**$ 57**	**$ 88**
With the Public:		
Escrow Monies Deposited at Minority-Owned Banks	$ 123	$ 123
Undistributed Charges	7	14
Total	**$ 130**	**$ 137**

Advances to HUD for Working Capital Fund Expenses

The Working Capital Fund was established by HUD to consolidate, at the department level, the acquisition of certain property and equipment to be used by different organizations within HUD. Advances to HUD for Working Capital Fund expenses represent the amount of payments made by FHA to reimburse the HUD Working Capital Fund for its share of the fund's expenses prior to the receipt of goods or services from this fund.

Escrow Monies Deposited at Minority-Owned Banks

FHA holds in trust escrow monies received from the borrowers of its Multifamily mortgage notes to cover property repairs and renovations expenses. These escrow monies are deposited at the U.S. Treasury (see Note 2), invested in U.S. Treasury securities (see Note 4 - GI/SRI Investments) or deposited at minority-owned banks.

Undistributed Charges

Undistributed charges include FHA disbursements processed by the U.S. Treasury but the identification of the specific FHA operating area associated with the disbursement has not been determined by the end of the reporting period. When the FHA operating area that initiated the disbursement is identified, the undistributed charges are reclassified by recognizing new expenses or by liquidating previously established accounts payable.

Note 8. Accounts Payable

Accounts payable as of September 30 are as follows:

(Dollars in millions)

	2003	2002
With the Public:		
Claims Payable	$ 428	$ 561
Premium Refunds and Distributive Shares Payable	121	470
Disbursements in Transit	160	92
Miscellaneous Payables	160	84
Total	**$ 869**	**$ 1,207**

Claims Payable

Claims payable represents the amount of claims that have been processed by FHA, but the disbursement of payment to lenders has not taken place at the end of the reporting period.

Premium Refunds and Distributive Shares Payable

Premium refunds payable are refunds of previously collected Single Family premiums that will be returned to the borrowers resulting from prepayment of the insured mortgages. Distributive shares payable represents the amount of excess revenues in the liquidating account of the CMHI fund that is to be distributed to the mortgagors at the discretion of the Secretary of HUD.

Disbursements in Transit

Disbursements in transit represent the payments recorded in FHA financial systems that have not been processed by the U.S. Treasury. The disbursements in transit will be reclassified into the reductions of the Fund Balance with U.S. Treasury once the disbursements are confirmed as paid by the U.S. Treasury.

Miscellaneous Payables

Miscellaneous payables include interest enhancement payables, interest penalty payables for late payment of claims, generic debt payables and other payables related to various operating areas within FHA.

Note 9. Debt

The following tables describe the composition of debt held by FHA as of September 30:

(Dollars in millions)	2002 Beginning Balance	2002 Net Borrowing	2002 Ending Balance	2003 Net Borrowing	2003 Ending Balance
Agency Debt:					
Debentures Issued to Claimants	$ 224	$ 64	$ 288	$ (18)	$ 270
Other Debt:					
Borrowings from U.S. Treasury	4,544	3,009	7,553	1,241	8,794
Total	**$ 4,768**	**$ 3,073**	**$ 7,841**	**$ 1,223**	**$ 9,064**

	2003	2002
Classification of Debt:		
Intragovernmental Debt	$ 8,794	$ 7,553
Debt held by the Public	270	288
Total	**$ 9,064**	**$ 7,841**

Debentures Issued to Public

The National Housing Act authorizes FHA, in certain cases, to issue debentures in lieu of cash to settle claims. FHA-issued debentures bear interest at rates established by the U.S. Treasury. Interest rates related to the outstanding debentures ranged from 4.00 percent to 13.375 percent in fiscal year 2003 and from 4.00 percent to 12.875 percent in fiscal year 2002. FHA debentures may be redeemed by lenders prior to maturity to pay mortgage insurance premiums to FHA, or they may be called with the approval of the Secretary of the U.S. Treasury.

The par value of debentures outstanding at September 30 was $265 million in fiscal year 2003 and $284 million in fiscal year 2002. The fair values for fiscal years 2003 and 2002 were $367 and $368, respectively.

Borrowings from U.S. Treasury

In accordance with Credit Reform accounting, FHA borrows from the U.S. Treasury when cash is needed in its financing accounts. Usually, the need for cash arises when FHA has to transfer the negative credit subsidy amounts related to new loan disbursements, and existing loan modifications from the financing accounts to the general fund receipt account (for cases in GI/SRI funds) or to the liquidating account (for cases in MMI/CMHI funds). In some instances, borrowings are also needed to transfer the credit subsidy related to downward reestimates from the GI/SRI financing account to the GI/SRI receipt account or when available cash is less than claim payments due.

During fiscal year 2003, FHA's U.S. Treasury borrowings carried interest rates ranging from 4.76 percent to 7.36 percent. In fiscal year 2002 the carried interest rates ranged from 5.47 percent to 7.59 percent. Fiscal year 2003 maturity dates occur from September 2004 – September 2022. Loans may be repaid in whole or in part without penalty at any time prior to maturity.

Note 10. Other Liabilities

The following table describes the composition of other liabilities as of September 30:

(Dollars in millions)	Current		Non-Current		Total	
	2003	**2002**	**2003**	**2002**	**2003**	**2002**
Intragovernmental:						
Special Receipt Account Liability	$ 1,511	$ 3,095	$ -	$ -	$ 1,511	$ 3,095
Total	**$ 1,511**	**$ 3,095**	**$ -**	**$ -**	**$ 1,511**	**$ 3,095**
With the Public:						
Trust and Deposit Liabilities	$ 240	$ 269	$ -	$ -	$ 240	$ 269
Unearned Premiums	49	66	232	315	281	381
Undistributed Credits	98	87	-	-	98	87
Miscellaneous Liabilities	120	102	-	-	120	102
Total	**$507**	**$ 524**	**$ 232**	**$ 315**	**$ 739**	**$ 839**

Special Receipt Account Liability

The special receipt account liability is created from negative subsidy endorsements and downward credit subsidy in the GI/SRI special receipt account.

Trust and Deposit Liabilities

Trust and deposit liabilities include mainly escrow monies received by FHA for the borrowers of its mortgage notes and earnest money received from potential purchasers of the FHA foreclosed properties. The escrow monies are eventually disbursed to pay for insurance, property taxes, and maintenance expenses on behalf of the borrowers. The earnest money becomes part of the sale proceeds or is returned to any unsuccessful bidders.

Unearned Premiums

As discussed in Note 1, unearned premiums represent premiums collected for the pre-1992 loan guarantees, but not recognized as revenue because the earning process has not been completed.

Undistributed Credits

Undistributed credits represent FHA collections processed by U.S. Treasury, but the identification of the specific operating area associated with the collections has not been determined at the end of the reporting period. When the FHA operating area that is entitled to the collections is identified, the undistributed credits are reclassified by recognizing revenue or by liquidating previously established accounts receivable.

Miscellaneous Liabilities

Miscellaneous liabilities include mainly other unearned revenue from Single Family and Multifamily operations.

Note 11. Commitments and Contingencies

Litigation

FHA is party in various legal actions and claims brought by or against it. In the opinion of management and general counsel, the ultimate resolution of the majority of these legal actions and claims will not materially affect FHA's consolidated financial statements as of, and for, the fiscal years ended September 30, 2003 and 2002.

Note 12. Gross Costs

Gross costs incurred by FHA for the fiscal years ended on September 30 are as follows:

(Dollars in millions)	2003		2002	
	MMI/CMHI	**GI/SRI**	**MMI/CMHI**	**GI/SRI**
Intragovernmental:				
Interest Expense	$ 525	101	$ 433	$ 92
Imputed Costs	7	9	6	8
Other Expenses	51	21	77	25
Total	**$ 583**	**$ 131**	**$ 516**	**$ 125**
With the Public:				
Salary and Administrative Expenses	$ 168	$ 206	$ 190	$ 218
Subsidy Expense	2,363	85	(1,752)	(486)
Interest Expense	1,102	163	427	42
Bad Debt Expense	(17)	(242)	(40)	(183)
Loan Loss Reserve Expense	(28)	(1,626)	(167)	(1,108)
Other Expenses	91	473	258	530
Total	**$ 3,679**	**$ (941)**	**$ (1,084)**	**$ (987)**

Interest Expense

Intragovernmental interest expense includes interest expense on borrowings from U.S. Treasury in the financing account. Interest expense is calculated annually for each cohort using the interest rates provided by the U.S Treasury. Interest expense with the public consists of interest expense on debentures issued to claimants to settle claim payments and interest expense on the annual credit subsidy reestimates.

Imputed Costs/Imputed Financing

Imputed costs represent FHA's share of the departmental imputed cost calculated and allocated to FHA by the HUD CFO office. Federal agencies are required by SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards,* to account for costs assumed by other Federal organizations on their behalf. The HUD CFO receives its imputed cost data from the Office of Personnel Management (OPM) for pension costs, federal employee health benefits (FEHB) and life insurance costs. It also receives Federal Employee Compensated Absences (FECA) costs from the Department of Labor (DOL). Subsequently, using its internally developed allocation basis, HUD CFO allocates the imputed cost data to each of its reporting offices. The imputed costs reported by FHA in its Statements of Net Cost are equal to the amounts of imputed financing in its Statements of Changes in Net Position.

Salary and Administrative Expenses

Salary and administrative expenses include FHA's reimbursement to HUD for FHA personnel costs and FHA's payments to third party contractors for administrative contract expenses.

Subsidy Expense

Subsidy expense, positive and negative, consists of credit subsidy expense from new endorsements, modifications, and annual credit subsidy reestimates and the subsidy expense incurred by the Church Arson program. Credit subsidy expense is the estimated long-term cost to the U.S. Government of a direct loan or loan guarantee, calculated on a net present value basis of the estimated future cash flows associated with the direct loan or loan guarantee. Subsidy expense incurred by the Church Arson program is the expense of a HUD program administered by the Office of Community Planning and Development (CPD) even though its cost is funded through a FHA program account.

Bad Debt Expense

Bad debt expense represents the provision for loss recorded for uncollectible amounts related to FHA's pre-1992 accounts receivable and credit program assets. FHA calculates its bad debt expense based on the estimated change of these assets' historical loss experience and FHA management's judgment concerning current economic factors.

Loan Loss Reserve Expense

Loan loss reserve expense is recorded to account for the change in the balance of the loan loss reserve liabilities associated with FHA's pre-1992 loan guarantees. The loan loss reserve is provided for the estimated losses incurred by FHA to pay claims on its pre-1992 insured mortgages when defaults have taken place but, the claims have not yet been filed with FHA.

Other Expenses

Other expenses with the public include only those associated with the FHA pre-1992 loan guarantees. They consist of net losses or gains on sales of FHA credit program assets, insurance claim expenses, fee expenses, and other miscellaneous expenses incurred to carry out FHA operations. Other intragovernmental expenses include FHA's share of HUD expenses incurred in the Working Capital Fund.

Note 13. Earned Revenue

Earned revenue generated by FHA for the fiscal years ended on September 30 are as follows:

(Dollars in millions)	2003		2002	
	MMI/CMHI	**GI/SRI**	**MMI/CMHI**	**GI/SRI**
Intragovernmental:				
Interest Revenue from Deposits at U.S. Treasury	$ 192	$ 106	$ 265	$ 107
Interest Revenue from MMI/CMHI Investments	1,120	-	1,089	-
Total	**$ 1,312**	**$ 106**	**$ 1,354**	**$ 107**
With the Public:				
Premium Revenue	$ 88	$ 130	$ 366	$ 115
Interest Revenue	370	82	11	6
Other Revenue	(13)	293	301	245
Total	**$ 445**	**$ 505**	**$ 678**	**$ 366**

Interest Revenue

Intragovernmental interest revenue includes interest revenue from deposits at U.S. Treasury and investments in U.S. Treasury securities. FHA's U.S. Treasury deposits are generated from post-1991 loan guarantees and direct loans in the financing accounts. FHA's investments in U.S. Treasury securities consist of investments of surplus resources in the MMI/CMHI liquidating accounts and of escrow monies collected from borrowers in the GI/SRI liquidating accounts.

Interest revenue with the public is generated mainly from FHA's acquisition of pre-1992 performing MNA notes from payments to lenders for defaulted guaranteed loans. Interest revenue associated with the post-1991 MNA notes is included in the Allowance for Subsidy balance.

Premium Revenue

According to the FCRA accounting, FHA's premium revenue includes only premiums associated with the pre-1992 loan guarantee business. Premium revenue for post-1991 loan guarantee cases is included in the balance of the LLG. The FHA premium structure, set by the National Affordable Housing Act and published in the Code of Federal Regulations, which became effective July 1991, includes both up-front premiums and annual periodic premiums.

Up-front Premiums

The up-front premium rates, which are set by legislation, vary according to the mortgage type and the year of origination. The pre-1992 up-front premiums in the MMI fund were recorded as unearned revenue upon collection and are recognized as revenue over the period in which losses and insurance costs are expected to occur. Other FHA funds' unearned revenue is recognized monthly as revenue on a straight-line basis. In fiscal year 2003, FHA increased the premiums charged on positive credit subsidy loan guarantees from .50% to 1%. This change in policy affected Section 221(d)(4) and other loan guarantees made for new construction, substantial rehabilitation, or additions for apartments. FHA continued to endorse all other loan guarantees at .50% premiums for fiscal year 2003.

The FHA up-front premium rates in fiscal year 2003 were:

	Premium Rate
Single Family	1.50%
Multifamily	.50%, .57%, .61%, .80%, or 1.0%

Periodic Premiums

The periodic premium rate is used to calculate monthly or annual premiums receivable. These rates, which are also legislated, vary by mortgage type and program. The FHA periodic premium rate in fiscal year 2003 for Single Family and Multifamily were:

	Mortgage Term 15 Years or Less	Mortgage Term More Than 15 Years
Single Family	.25%	.50%
Multifamily	.50%, .57%, .61%, or .80%	.50%, .57%, .61%, or .80%

For Title I, the maximum insurance premium paid for guaranteed cases endorsed in years 1992 through 2001 is equal to 0.50 percent of the loan amount multiplied by the number of years of the loan term. The annual insurance premium for a Title I Property Improvement loan is 0.50 percent of the loan amount until the maximum insurance charge is paid. The annual insurance premium of a Title I Manufactured Housing loan is calculated in tiers by loan term until the maximum insurance charge is paid. For guaranteed cases endorsed in fiscal years 2002 and 2003, the Title I annual insurance premium is 1.00 percent of the loan amount until maturity.

Other Revenue

Other revenue includes revenue associated with FHA pre-1992 loan guarantees. FHA's other revenue consists of late charges and penalty revenue, fee income, and miscellaneous income generated from FHA operations.

Note 14. Gross Cost and Earned Revenue by Budget Functional Classification

FHA cost and earned revenue reported on the Statements of Net Cost is categorized under the budget functional classification (BFC) for Mortgage Credit (371). All FHA U.S. Treasury account symbols found under the department code "86" for Department of Housing and Urban Development appear with the Mortgage Credit BFC.

Note 15. Transfers Out

Transfers out incurred by FHA for the fiscal years ended on September 30 are as follows:

(Dollars in millions)	U.S. Treasury	HUD	Total
Budgetary Financing Sources	$ 802	$ 273	$ 1,075
Other Financing Sources	138	-	138
Other	-	3	3
FY 2003 Total	**$ 940**	**$ 276**	**$ 1,216**
Budgetary Financing Sources	$ 2,582	$ 242	$ 2,824
Other Financing Sources	1,102	-	1,102
Other	-	9	9
FY 2002 Total	**$ 3,684**	**$ 251**	**$ 3,935**

Transfers Out to U.S. Treasury

Transfers out to U.S. Treasury consists of negative subsidy from new endorsements, modifications and downward credit subsidy reestimates in the GI/SRI general fund receipt account, and the prior year unobligated balance of budgetary resources in the GI/SRI liquidating account.

Transfers Out to HUD

Transfers out to HUD include a certain portion of FHA's monthly payments to HUD for salaries and expenses as well as amounts related to FHA's share in the departmental Working Capital Fund capitalized expense.

Note 16. Unexpended Appropriations

Unexpended appropriation balances at September 30 are as follows:

(Dollars in millions)	Beginning Balance	Appropriations Received	Other Adjustments	Appropriations Used	Transfers-Out	Ending Balance
Positive Subsidy	$ 65	$ 15	$ (6)	$ (2)	$ -	$ 72
Administrative Expenses	377	751	(4)	(730)	-	394
Reestimates	-	1,167	-	(1,167)	-	-
GI/SRI Liquidating	319	469	-	(359)	(319)	110
FY 2003 Total	**$ 761**	**$ 2,402**	**$ (10)**	**$ (2,258)**	**$ (319)**	**$ 576**
Positive Subsidy	$ 92	$ 15	$ (27)	$ (15)	$ -	$ 65
Administrative Expenses	211	878	44	(756)	-	377
Reestimates	-	995	-	(995)	-	-
GI/SRI Liquidating	1,826	1,094	-	(615)	(1,986)	319
FY 2002 Total	**$ 2,129**	**$ 2,982**	**$ 17**	**$ (2,381)**	**$ (1,986)**	**$ 761**

As required under FCRA, FHA receives appropriations to cover expenses or fund shortages related to its loan guarantee and direct loan operations.

FHA receives appropriations in the annual program accounts for administrative and contract expenses. The GI/SRI no-year program account also receives appropriations for positive credit subsidy and upward reestimates. Additionally, FHA obtains permanent indefinite appropriations to cover any shortfalls for its GI/SRI pre-1992 loan guarantee operations.

When appropriations are first received, they are reported as unexpended appropriations. As these appropriations are expended, appropriations used are increased and unexpended appropriations are decreased. Additionally, unexpended appropriations are decreased when: the year-end unobligated balance in the GI/SRI liquidating account is returned to the U.S. Treasury; appropriations are rescinded; or other miscellaneous adjustments are required.

Note 17. Budgetary Resources

FHA has two program, two liquidating, and four financing appropriations. The Statement of Budgetary Resources has been prepared as a combined statement and as such, intra-entity transactions have not been eliminated.

Budget authority is the authorization provided by law to enter into obligations to carry out the guaranteed and direct loan programs and their associated administrative costs, which would result in immediate or future outlays of federal funds. FHA's budgetary resources include current budgetary authority (i.e., appropriations and borrowing authority) and unobligated balances brought forward from multi-year and no-year budget authority received in prior years, and recoveries of prior year obligations. Budgetary resources also include spending authority from offsetting collections credited to an appropriation or fund account.

Unobligated balances associated with appropriations that expire at the end of the fiscal year remain available for obligation adjustments, but not for new obligations, until that account is canceled. When accounts are canceled, five years after they expire, amounts are not available for obligations or expenditure for any purpose.

FHA funds its programs through borrowings from the U.S. Treasury and debentures issued to the public. These borrowings and debentures are authorized through an indefinite permanent authority at interest rates set each year by the U.S. Treasury and the prevailing market rates.

Financing sources for repayments are from premiums earned, and the maturity dates on these borrowings are generally 20 years or more. The balances of the Permanently Not Available line item in the Statements of Budgetary Resources in fiscal year 2003 and fiscal year 2002 are $2,409 million and $3,119 million respectively. In fiscal year 2003, the $2,409 million amount is composed of a repayment of $224 million for debentures, a repayment of $1,649 million for borrowing from the U.S. Treasury, a return to U.S. Treasury of $5 million for rescinded and cancelled appropriations, and a transfer to the U.S. Treasury of $531 million of unobligated balances that remained in the GI/SRI liquidating account at the end of fiscal year 2002.

Information from the fiscal year 2003 Statement of Budgetary Resources will be presented in the fiscal year 2005 Budget of the U.S. Government. The Budget will be transmitted to Congress on the first Monday in February 2004 and will be available from the Government Printing Office at that time.

Required Supplementary Information

Schedule A: Intragovernmental Assets

FHA's intragovernmental assets, by federal entity, are as follows on September 30, 2003 and 2002:

(Dollars in millions)

Agency	Fund Balance with U.S. Treasury	Investments in U.S. Treasury Securities	Other Assets
U.S. Treasury	$ 7,934	$ 23,982	$ -
HUD	-	-	53
Other	-	-	4
FY 2003 Total	**$ 7,934**	**$ 23,982**	**$ 57**
U.S. Treasury	$ 9,597	$ 21,346	$ -
HUD	-	-	88
FY 2002 Total	**$ 9,597**	**$ 21,346**	**$ 88**

Schedule B: Intragovernmental Liabilities

FHA's intragovernmental liabilities, by federal entity, are as follows on September 30, 2003 and 2002:

(Dollars in millions)

Agency	Borrowings from U.S. Treasury	Other Liabilities
U.S. Treasury	$ 8,794	$ 1,511
FY 2003 Total	**$ 8,794**	**$ 1,511**
U.S. Treasury	7,553	3,095
FY 2002 Total	**$ 7,553**	**$ 3,095**

Required Supplementary Information

Schedule C: Comparative Combining Statement of Budgetary Resources by FHA Program

(Dollars in millions)	MMI/CMHI		GI/SRI		Total	
	2003	2002	2003	2002	2003	2002
BUDGETARY RESOURCES						
Budget Authority:						
Appropriations received	$ 434	$ 513	$ 1,968	$ 2,469	$ 2,402	$ 2,982
Borrowing Authority	2,575	3,400	520	774	3,095	4,174
Unobligated Balance Carried Forward						
Beginning of period	24,722	20,471	2,133	3,901	26,855	24,372
Net Transfers						
Spending Authority from Offsetting Collections:						
Earned						
Collected	15,963	14,734	3,155	3,012	19,118	17,746
Receivable from Federal Sources	7	(134)	(158)	34	(151)	(100)
Recoveries of Prior Year Obligations	542	55	45	20	587	75
Permanently Not Available	(755)	(755)	(1,654)	(2,364)	(2,409)	(3,119)
TOTAL BUDGETARY RESOURCES	**$ 43,488**	**$ 38,284**	**$ 6,009**	**$ 7,846**	**$ 49,497**	**$ 46,130**
STATUS OF BUDGETARY RESOURCES						
Obligations Incurred	$ 16,374	$ 13,561	$ 4,951	$ 5,714	$ 21,325	$ 19,275
Unobligated Balance-Apportioned	438	1,164	601	927	1,039	2,091
Unobligated Balance Not Available	26,676	23,559	457	1,205	27,133	24,764
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 43,488**	**$ 38,284**	**$ 6,009**	**$ 7,846**	**$ 49,497**	**$ 46,130**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS						
Obligated Balance, Net, Beginning of Period	$ 823	$ 686	$ 805	$ 791	$ 1,628	$ 1,477
Obligated Balance, Net, End of Period:						
Accounts Receivable	(277)	(271)	(15)	(173)	(292)	(444)
Undelivered Orders	274	174	454	403	728	577
Accounts Payable	1,086	918	357	577	1,443	1,495
Outlays:						
Disbursements	15,564	13,503	5,074	5,646	20,638	19,149
Collections	(15,963)	(14,734)	(3,155)	(3,012)	(19,118)	(17,746)
Subtotal	(399)	(1,231)	1,919	2,634	1,520	1,403
Less: Offsetting Receipts		-	1,372	1,993	1,372	1,993
NET OUTLAYS	**$ (399)**	**$ (1,231)**	**$ 547**	**$ 641**	**$ 148**	**$ (590)**

Required Supplementary Information

Schedule D: Comparative Combining Budgetary Resources by Appropriation for the MMI/CMHI Program–Fiscal Year 2003

(Dollars in millions)

	86 0183	86x4070	86x4587 & 86x4242	86x0236	MMI/CMHI Total
BUDGETARY RESOURCES					
Budget Authority:					
Appropriations received	$ 434	$ -	$ -	$ -	$ 434
Borrowing Authority	-	-	2,575	-	2,575
Unobligated Balance Carried Forward					
Beginning of period	29	244	1,602	22,847	24,722
Net Transfers	2,390	-	-	(2,390)	-
Spending Authority from Offsetting Collections:					
Earned					
Collected	-	179	10,068	5,716	15,963
Receivable from Federal Sources	-	(3)	-	10	7
Recoveries of Prior Year Obligations	-	469	73	-	542
Permanently Not Available	(3)	-	(752)	-	(755)
TOTAL BUDGETARY RESOURCES	**$ 2,850**	**$ 889**	**$ 13,566**	**$ 26,183**	**$ 43,488**
STATUS OF BUDGETARY RESOURCES					
Obligations Incurred	$ 2,812	$ 306	$ 13,256	$ -	$ 16,374
Unobligated Balance-Apportioned	9	119	310	-	438
Unobligated Balance Not Available	29	464	-	26,183	26,676
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 2,850**	**$ 889**	**$ 13,566**	**$ 26,183**	**$ 43,488**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS					
Obligated Balance, Net, Beginning of Period	$ 61	$ 949	$ 80	$ (267)	$ 823
Obligated Balance, Net, End of Period:					
Accounts Receivable	-	-	-	(277)	(277)
Undelivered Orders	68	16	190	-	274
Accounts Payable	4	440	642	-	1,086
Outlays:					
Disbursements	2,800	334	12,430	-	15,564
Collections	-	(179)	(10,068)	(5,716)	(15,963)
Subtotal	2,800	155	2,362	(5,716)	(399)
Less: Offsetting Receipts					
NET OUTLAYS	**$ 2,800**	**$ 155**	**$ 2,362**	**$ (5,716)**	**$ (399)**

Required Supplementary Information

Schedule D: Comparative Combining Budgetary Resources by Appropriation for the MMI/CMHI Program–Fiscal Year 2002

(Dollars in millions)

	86 0183	86x4070	86x4587 & 86x4242	86x0236	MMI/CMHI Total
BUDGETARY RESOURCES					
Budget Authority:					
Appropriations received	$ 513	$ -	$ -	$ -	$ 513
Borrowing Authority	-	-	3,400	-	3,400
Unobligated Balance Carried Forward					
Beginning of period	14	17,746	2,711	-	20,471
Net Transfers	1,017	(20,881)	-	19,864	-
Spending Authority from Offsetting Collections:					
Earned					
Collected	-	4,080	7,938	2,716	14,734
Receivable from Federal Sources	-	(370)	(31)	267	(134)
Recoveries of Prior Year Obligations	4	5	46	-	55
Permanently Not Available	-	-	(755)	-	(755)
TOTAL BUDGETARY RESOURCES	**$ 1,548**	**$ 580**	**$ 13,309**	**$ 22,847**	**$ 38,284**
STATUS OF BUDGETARY RESOURCES					
Obligations Incurred	$ 1,518	$ 336	$ 11,707	$ -	$ 13,561
Unobligated Balance-Apportioned	14	206	944	-	1,164
Unobligated Balance Not Available	16	38	658	22,847	23,559
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 1,548**	**$ 580**	**$ 13,309**	**$ 22,847**	**$ 38,284**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS					
Obligated Balance, Net, Beginning of Period	$ 120	$ 542	$ 24	$ -	$ 686
Obligated Balance, Net, End of Period:					
Accounts Receivable	-	(4)	-	(267)	(271)
Undelivered Orders	60	36	78	-	174
Accounts Payable	1	916	1	-	918
Outlays:					
Disbursements	1,574	293	11,636	-	13,503
Collections	-	(4,080)	(7,938)	(2,716)	(14,734)
Subtotal	1,574	(3,787)	3,698	(2,716)	(1,231)
Less: Offsetting Receipts	-	-	-	-	-
NET OUTLAYS	**$ 1,574**	**$ (3,787)**	**$ 3,698**	**$ (2,716)**	**$ (1,231)**

Required Supplementary Information

Schedule E: Comparative Combining Budgetary Resources by Appropriation for the GI/SRI Program–Fiscal Year 2003

(Dollars in millions)

	86 0200	86x4072	86x4077 & 86x4105	GI/SRI Total
BUDGETARY RESOURCES				
Budget Authority:				
Appropriations received	$ 1,499	$ 469	$ -	$ 1,968
Borrowing Authority	-	205	315	520
Unobligated Balance Carried Forward				
Beginning of period	183	531	1,419	2,133
Net Transfers				
Spending Authority from Offsetting Collections:				
Earned				
Collected	-	674	2,481	3,155
Receivable from Federal Sources	-	-	(158)	(158)
Recoveries of Prior Year Obligations	2	39	4	45
Permanently Not Available	(4)	(754)	(896)	(1,654)
TOTAL BUDGETARY RESOURCES	**$ 1,680**	**$ 1,164**	**$ 3,165**	**$ 6,009**
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred	$ 1,458	$ 1,080	$ 2,413	$ 4,951
Unobligated Balance-Apportioned	52	45	504	601
Unobligated Balance Not Available	170	39	248	457
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 1,680**	**$ 1,164**	**$ 3,165**	**$ 6,009**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS				
Obligated Balance, Net, Beginning of Period	$ 77	$ 886	$ (158)	$ 805
Obligated Balance, Net, End of Period:				
Accounts Receivable	-	(1)	(14)	(15)
Undelivered Orders	83	339	32	454
Accounts Payable	4	262	91	357
Outlays:				
Disbursements	1,446	1,326	2,302	5,074
Collections	-	(674)	(2,481)	(3,155)
Subtotal	1,446	652	(179)	1,919
Less: Offsetting Receipts (Memorandum)	-	-	-	1,372
NET OUTLAYS	**$ 1,446**	**$ 652**	**$ (179)**	**$ 547**

Required Supplementary Information

Schedule E: Comparative Combining Budgetary Resources by Appropriation for the GI/SRI Program–Fiscal Year 2002

(Dollars in millions)

	86 0200	86x4072	86x4077 & 86x4105	GI/SRI Total
BUDGETARY RESOURCES				
Budget Authority:				
Appropriations received	$ 1,375	$ 1,094	$ -	$ 2,469
Borrowing Authority	-	249	525	774
Unobligated Balance Carried Forward				
Beginning of period	148	1,986	1,767	3,901
Net Transfers				
Spending Authority from Offsetting Collections:				
Earned				
Collected	-	739	2,273	3,012
Receivable from Federal Sources	-	(9)	43	34
Recoveries of Prior Year Obligations	7	10	3	20
Permanently Not Available	(34)	(2,169)	(161)	(2,364)
TOTAL BUDGETARY RESOURCES	**$ 1,496**	**$ 1,900**	**$ 4,450**	**$ 7,846**
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred	$ 1,313	$ 1,369	$ 3,032	$ 5,714
Unobligated Balance-Apportioned	69	336	522	927
Unobligated Balance Not Available	114	195	896	1,205
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 1,496**	**$ 1,900**	**$ 4,450**	**$ 7,846**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS				
Obligated Balance, Net, Beginning of Period	$ 112	$ 801	$ (122)	$ 791
Obligated Balance, Net, End of Period:				
Accounts Receivable	-	-	(173)	(173)
Undelivered Orders	76	312	15	403
Accounts Payable	2	575	-	577
Outlays:				
Disbursements	1,340	1,285	3,021	5,646
Collections	-	(739)	(2,273)	(3,012)
Subtotal	1,340	546	748	2,634
Less: Offsetting Receipts (Memorandum)	-	-	-	1,993
NET OUTLAYS	**$ 1,340**	**$ 546**	**$ 748**	**$ 641**