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TO: De W. Ritchie, Deputy Chief Financial Officer, F

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

**SUBJECT: Audit of the U.S. Department of Housing and Urban Development (HUD)
Financial Statements for Fiscal Years 2003 and 2002**

In accordance with the Chief Financial Officers (CFO) Act of 1990, as amended, this report presents the results of our audit of HUD's principal financial statements for the years ended September 30, 2003 and 2002. Also provided are assessments of HUD's internal controls and compliance with laws and regulations. Our report includes a copy of HUD's principal financial statements. By January 31, 2004, HUD is required to submit the audit report to the Office of Management and Budget (OMB) along with additional required supplementary information, including Management's Discussion and Analysis, Required Supplementary Stewardship Information and information on intra-governmental amounts. Pursuant to the Reports Consolidation Act of 2000 (PL 106-531), HUD is preparing its *Fiscal Year 2003 Performance and Accountability Report*, which will consolidate these and other reports, including HUD's fiscal year 2003 performance report required by the Government Performance and Results Act and a statement prepared by the HUD Inspector General that summarizes what he considers to be the most serious management and performance challenges facing HUD. The *Fiscal Year 2003 Performance and Accountability Report* is to be submitted by HUD to OMB and appropriate committees and subcommittees of the Congress no later than January 31, 2004. We also identified several matters which, although not reportable conditions, will be communicated in a separate management letter to the Department. We appreciate the courtesies and cooperation extended to the OIG staff and our contractor.

In accordance with HUD Handbook 2000.6 REV-3, within 60 days, please submit to me, for each recommendation listed in the first section of Appendix B that is addressed to the CFO, a status report on: (1) the corrective action taken; (2) the proposed corrective action and target completion dates; or (3) why action is considered unnecessary. For recommendations addressed to the Deputy Secretary, the assistant secretaries or their staffs, please coordinate their response or, at your option, request that they respond directly to me. An additional status report is required on any recommendation without a management decision after 110 days. A status report is not required for recommendation 2.b because final action has been taken during the audit and a management decision will be recognized concurrent with the issuance of this report. Also, please furnish us with copies of any correspondence or directives issued in response to our report.

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Abbreviations:

BRP	business resumption plan
CM	configuration management
CFO	Chief Financial Officer
CIO	Chief Information Officer
DEC	Departmental Enforcement Center
FFMIA	Federal Financial Management Improvement Act
FHA	Federal Housing Administration FMC
FISCAM	Federal Information Systems Controls Audit Manual
FMC	Financial Management Center (Section 8)
FMFIA	Federal Managers' Financial Integrity Act
FSI	Financial Systems Integration
GAO	General Accounting Office
Ginnie Mae	Government National Mortgage Association
GPRA	Government Performance and Results Act
GTM	Government Technical Managers
GTR	Government Technical Representative
HA	housing authority
HAP	housing assistance payment
HUD	Department of Housing and Urban Development
HUDCAPS	HUD's Central Accounting and Program System
IA	independent auditor
IBS	Integrated Business System
IDIS	Integrated Disbursement and Information System
IRS	Internal Revenue Service
IT	information technology
LOCCS	Line of Credit and Control System
MTCS	Multifamily Tenant Characteristics System
NIST	National Institute of Standards and Technology
OIG	Office of Inspector General
OMB	Office of Management and Budget
PAS	Program Accounting System
PHAS	Public Housing Assessment System
PHMAP	Public Housing Management Assessment Program
PIH	Office of Public and Indian Housing
REAC	Real Estate Assessment Center
REAP	Resource Estimation and Allocation Process
REMS	Real Estate Management System
RHIIP	Rental Housing Integrity Improvement Project
SEMAP	Section 8 Management Assessment Program
SFFAS	Statement of Federal Financial Accounting Standards
SGL	Standard General Ledger (of the United States Government)
SHFA	State Housing Finance Agency
SS	Social Security
SSA	Social Security Administration
SSI	Supplemental Security Income
TARC	Troubled Agency Recovery Center
TRACS	Tenant Rental Assistance Certification System

Independent Auditor's Report

To the Secretary,
U.S. Department of Housing and Urban Development:

In accordance with the Chief Financial Officers (CFO) Act of 1990, we have audited the accompanying consolidated balance sheets of the Department of Housing and Urban Development (HUD) as of September 30, 2003 and 2002, and the related consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources for the fiscal years then ended. The objective of our audit was to express an opinion on the fair presentation of these principal financial statements. We did not audit the financial statements of the Federal Housing Administration (FHA) and the Government National Mortgage Association (Ginnie Mae), whose combined statements reflect total assets constituting 39 percent of the related consolidated totals. Other auditors, whose reports have been furnished to us, audited those statements and our opinion, insofar as it relates to the amounts included for FHA and Ginnie Mae, is based solely on the reports of the other auditors. In connection with our audit, we also considered HUD's internal control over financial reporting and tested HUD's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its principal financial statements.

Opinion on the Financial Statements

In our opinion, based on our audit and the reports of other auditors, the accompanying principal financial statements present fairly, in all material respects, the financial position of HUD 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 fiscal years then ended, in conformity with accounting principles generally accepted in the United States of America.

Our audit also disclosed:

- Material weaknesses in internal controls in fiscal year 2003 related to the need to:
 - comply with Federal financial management system requirements, including the need to enhance FHA information technology systems to more effectively support FHA's business and budget processes; and
 - improve oversight and monitoring of subsidy calculations and intermediaries' program performance.

- Reportable conditions in internal controls in fiscal year 2003 related to the need to:
 - improve quality control over performance measures data;
 - improve controls over project-based subsidy payments;
 - strengthen controls over HUD's computing environment;
 - improve personnel security practices for access to the Department's critical financial systems;
 - improve processes for reviewing obligation balances;
 - more effectively manage controls over the FHA systems' portfolio; and
 - place more emphasis on monitoring lender underwriting and improving early warning and loss prevention for FHA single-family insured mortgages.

Most of these control weaknesses were reported in prior efforts to audit HUD's financial statements and represent long-standing problems. Our findings also include the following instance of non-compliance with applicable laws and regulations:

- HUD did not substantially comply with the Federal Financial Management Improvement Act (FFMIA). In this regard, HUD's financial management systems did not substantially comply with (1) Federal Financial Management Systems Requirements, and (2) applicable accounting standards.

Consolidating Financial Information

We conducted our audit for the purpose of forming an opinion on the fiscal years 2003 and 2002 principal financial statements taken as a whole. HUD is presenting consolidating balance sheets and related consolidating statements of net costs and changes in net position, and combining statements of budgetary resources and financing as supplementary information in its *Fiscal Year 2003 Performance and Accountability Report*. The consolidating and combining financial information is to be presented for purposes of additional analysis of the financial statements rather than to present the financial position, changes in net position, budgetary resources, and net costs of HUD's major activities. The consolidating and combining financial information is not a required part of the principal financial statements. The financial information has been subjected to the auditing procedures applied to the principal financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

Required Supplementary Information

In their *Fiscal Year 2003 Performance and Accountability Report*, HUD plans to present "Required Supplemental Stewardship Information," specifically, information on investments in non-Federal physical property and human capital. In addition, HUD plans to present a (Management's) "Discussion and Analysis of Operations" and information on intra-governmental balances. This information is not a required part of the basic financial statements but is supplementary information required by the Federal Accounting Standards Advisory Board and Office of Management and Budget (OMB) Bulletin 01-09, *Form and Content of Agency Financial Statements*. We did not audit and do not express an opinion on this information, however, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. In accordance with OMB Bulletin 01-09, the Department, through confirmations, reconciled their intragovernmental transactions with their trading partners with immaterial differences.

The following contents of this summary letter, as well as the detailed sections of this report that follow, elaborate on: (1) the serious problems with HUD's internal controls and (2) instances where HUD had not complied with applicable laws and regulations.

Issues with HUD's Internal Control Environment

Most of the material weaknesses and reportable conditions discussed in this report relate to issues discussed in prior years' reports on HUD's financial statements. HUD has been taking actions to address the weaknesses and in some instances has made progress in correcting them. For the most part, progress has been at a slow pace because HUD needs to address issues that fundamentally impact its internal control environment. These issues are Department-wide in scope and must be addressed for HUD to more effectively manage its programs. We have reported for the past several years that HUD has made progress toward overhauling its operations and addressing its management problems through these efforts, but challenges remain. As discussed below, HUD's ability to address its problems will substantially improve if it completes the efforts to:

- deploy a reliable financial management system that meets its program and financial management needs and complies with Federal requirements, and
- continue with the implementation of its process to identify and justify its staff resource requirements.

The most critical need faced by HUD in improving its control environment is to complete development of adequate systems. The lack of an integrated financial system in compliance with Federal financial system requirements has been reported as a material weakness since fiscal year 1991. To correct financial management deficiencies in a Department-wide manner, HUD initiated a project to design and implement an integrated financial system consisting of both financial and mixed systems. Over the years, the Department's plans have experienced significant schedule delays, changes in direction and cost overruns.

In addition to improving its financial systems, HUD will need to more effectively manage its limited staff resources. Many of the weaknesses discussed in this report, particularly those concerning HUD's oversight of program recipients, are exacerbated by HUD's resource management shortcomings. Accordingly, we consider it critical for the Department to address these shortcomings through the successful completion of ongoing plans.

Later in the report, we elaborate on the need for improved systems and resource management. In addition, we discuss the need for HUD to improve quality controls over performance measure data.

Housing Assistance Program Delivery

HUD provides housing assistance funds under various grant and subsidy programs to multifamily project owners (both nonprofits and for profit) and HAs. These intermediaries, in-turn, provide housing assistance to benefit primarily low-income households. HUD spent about \$24.6 billion in fiscal year 2003 to provide rent and operating subsidies that benefited over 4.8 million households. Weaknesses exist in HUD's control structure such that HUD cannot be assured that these funds are expended in accordance with the laws and regulations authorizing the grant and subsidy programs.

Legislation authorizing HUD's housing assistance programs includes specific criteria concerning tenant eligibility and providing assistance for housing that meets acceptable physical standards. Moreover, legislation authorizing HUD's programs also establishes minimum performance levels to be achieved. For example, subsidized housing must comply with HUD's housing quality standards.

HUD relies heavily upon intermediaries to ensure that rent calculations for assisted households are based on HUD requirements. Ultimately, these rent calculations determine the amount of subsidy HUD pays on behalf of the assisted household. Under project-based programs administered by the Office of Housing, the individual project owners or agents carry out this responsibility. Under public housing and tenant-based Section 8 programs, the HAs determine eligibility and rent amounts for eligible households residing in public housing or at approved housing provided by private landlords. In prior reports on HUD's financial statements, we have expressed concerns about the significant risk to HUD that these intermediaries are not properly carrying out this responsibility. HUD's control structure does not adequately address this risk due to insufficient on-site monitoring along with the absence of an on-going quality control program that would periodically assess the accuracy of intermediaries' rent determinations.

The estimate of erroneous payments that HUD reports in its financial statements relates to HUD's inability to ensure or verify the accuracy of subsidy payments being determined and paid to assisted households. This year's contracted study of HUD's three major assisted housing programs estimated that the rent determinations errors made by the intermediaries resulted in substantial subsidy overpayments and underpayments. The study was based on analyses of a statistical sample of tenant files, tenant interviews, and income verification data. This study also reports subsidy payment inconsistencies such that HUD incorrectly paid \$1.549 billion in annual housing subsidies of which about \$987 million in subsidies was overpaid on behalf of households paying too little rent, and about \$562 million in subsidies was underpaid on behalf of households paying too much rent based on HUD requirements.

The estimate of erroneous payments reported this year also includes overpaid subsidies from underreported and unreported income and

intermediaries billings errors. For this year's estimate from underreported and unreported income, HUD restated its FY 2002 estimate of an additional \$978 million in overpayments. A new estimate for income underreporting will be developed for next year based on the tenant data from this year's contracted study of rental assistance determinations. Also HUD conducted a quality control review to revise the estimate of erroneous payments for its intermediary's subsidy billings errors reported last year. We reviewed the quality control results and found that erroneous payments had resulted from the intermediaries' failure to accurately report or maintain required subsidy determination documentation, along with bookkeeping or procedural errors. Based on the payments errors that were identified, we substantiated an estimated \$614 million in billings errors, which consists of \$379.2 million in overpayments and \$235.2 million in underpayments errors.

In fiscal year 2001, HUD initiated the Rental Housing Integrity Improvement Project (RHIP). This Secretarial initiative is designed to reduce errors and improper payments by (1) simplifying the payment process, (2) enhancing administrative capacity, and (3) establishing better controls, incentives, and sanctions. These improvements will be implemented over the next several years with a fiscal year 2005 goal of reducing by 50 percent the frequency of calculation processing errors and the amount of subsidy overpayments.

Later in this report we elaborate on a long-standing reportable condition involving internal control weaknesses with the processing of subsidy payments under the project-based programs administered by the Office of Housing.

System and Accounting Issues

In our earlier discussion of concerns we have with HUD's internal control environment, we stressed the need for HUD to complete on-going efforts to improve its financial systems. Because of the large volume of financial transactions, HUD relies heavily on automated information systems. In prior years, we reported on security weaknesses in both HUD's general processing and specific applications such that HUD could not be reasonably assured that assets are adequately safeguarded against waste, loss, and unauthorized use or misappropriation. Progress in improving these controls has been slow. The weaknesses noted in our current audit relate to the need to improve:

- controls over the computing environment; and
- administration of personnel security operations.

We also noted the need for HUD to improve the processes for reviewing outstanding obligations to ensure that unneeded amounts are deobligated in a timely manner. A lack of integration between accounting systems and the need for accurate databases has hampered HUD's ability to evaluate unexpended obligations.

Results of the Audit of FHA's Financial Statements

A separate audit was performed of FHA's fiscal year 2003 and 2002 financial statements by the independent certified public accounting firm of KPMG LLP. Their report on FHA's financial statements, dated November 7, 2003,¹ includes an unqualified opinion on FHA's financial statements, along with discussions of one material weakness and two reportable conditions. The FHA material weakness follows:

- HUD/FHA's ADP system environment must be enhanced to more effectively support FHA's business and budget processes. HUD and FHA are conducting day-to-day business with legacy-based systems, limiting FHA's ability to integrate its financial processing environment and to monitor budget execution.

KPMG LLP also notes two reportable conditions regarding the need for FHA and HUD to: (1) more effectively manage controls over the FHA ADP systems portfolio, and (2) place more emphasis on monitoring lender underwriting and improving early warning and loss prevention for single family insured mortgages.

We consider the above issues to be material weaknesses and reportable conditions at the Departmental level. A more detailed discussion of these issues can be found in KPMG LLP's report on FHA's fiscal years 2003 and 2002 financial statements.

Results of the Audit of Ginnie Mae's Financial Statements

KPMG LLP performed a separate audit of the Ginnie Mae financial statements for fiscal years 2003 and 2002. Their report on Ginnie Mae's financial statements, dated December 3, 2003,² includes an unqualified opinion on these financial statements. In addition, the audit results indicate that there were no material weaknesses or reportable conditions with Ginnie Mae's internal controls, or material instances of non-compliance with laws and regulations.

HUD Has Made Progress in Addressing Management Deficiencies, but More Progress is Needed

Most of the issues described in this report represent long-standing weaknesses that will be difficult to resolve. HUD's management deficiencies have received much attention in recent years. For example, in January 1994, GAO designated HUD as a high-risk area, the first time such a designation was given to a cabinet level agency. Since that time, HUD has devoted considerable attention and priority to addressing the Department's management deficiencies and has made some progress. In their January 2003 update, GAO noted that HUD has made progress since 2001 in addressing identified weaknesses in its high-risk program areas. However, GAO continues to maintain the Department's single-

¹ KPMG LLP's report on FHA entitled, "Audit of Federal Housing Administration Financial Statements for Fiscal Years 2003 and 2002" (2004-FO-0001, dated November 25, 2003) was incorporated in our report.

² KPMG LLP's report on Ginnie Mae entitled, "Audit of Government National Mortgage Association Financial Statements for Fiscal Years 2003 and 2002" (2004-FO-0002, dated December 19, 2003) was incorporated in our report.

family mortgage insurance and rental housing assistance program areas as high risk at this time.

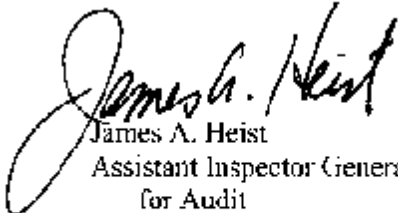
With respect to fiscal years 2003 and 2002, we were able to conclude that HUD's consolidated financial statements were reliable in all material respects. However, because of continued weaknesses in HUD's internal controls and financial management systems, HUD continues to rely on extensive ad hoc analyses and special projects to develop account balances and necessary disclosures.

In addition to the discussion that follows dealing with HUD's internal control environment, we have provided details on additional non-FHA material weaknesses and reportable conditions, the majority of which were also reported in prior years. For each of these weaknesses, HUD has developed corrective action plans but progress has generally been slow in implementation. For each weakness, we discuss the problem, the actions HUD has taken or plans to take to correct the weakness. We then provide our assessment of the planned actions and HUD's progress toward actual implementation of the plan.

Agency Comments and Our Evaluation

On December 1, 2003, we provided a draft of the internal control and compliance sections of our report to the CFO and appropriate assistant secretaries and other Departmental officials for review and comment, and requested that the CFO coordinate a Department-wide response. The CFO responded in a memorandum dated December 9, 2003, which is included in its entirety as Appendix E. Remaining sections of the draft report were provided on December 15, 2003. The Department generally agreed with our presentation of findings and recommendations subject to detailed comments included in the memorandum and attachments. The Department's response was considered in preparing the final version of this report. Our detailed evaluation of the response is included in Appendix F.

The following sections of this report provide additional details on our findings regarding HUD's internal control environment, housing assistance program delivery, system and accounting issues, and noncompliance with laws and regulations.


James A. Heist
Assistant Inspector General
for Audit

December 19, 2003

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HUD's Internal Control Environment

HUD Continues to be Impacted by Weaknesses in the Control Environment

Most of the material weaknesses and reportable conditions discussed in this report are the same as those included in prior years' reports on HUD's financial statements. HUD has been taking actions to address the weaknesses and in some instances has made progress in correcting them. However, progress has been at a slow pace in large part because HUD needs to address issues that fundamentally impact its internal control environment. These issues are Department-wide in scope and must be addressed for HUD to more effectively manage its programs. We have reported for the past several years that HUD has made progress toward overhauling its operations and addressing its management problems through these efforts but challenges remain. As discussed below, HUD's ability to address its problems will substantially improve if it completes the efforts to:

- deploy a reliable financial management system that meets its program and financial management needs and complies with Federal requirements, and
- develop a process to identify and justify its staff resource requirements.

Financial Systems

The most critical need faced by HUD in improving its control environment is to complete development of adequate systems. The lack of an integrated financial system in compliance with Federal financial system requirements has been reported as a material weakness since fiscal year 1991. To correct financial management deficiencies in a Department-wide manner, HUD initiated a project to design and implement an integrated financial system consisting of both financial and mixed systems. Over the years, the Department's plans have experienced significant schedule delays, changes in direction and cost overruns. However, we are able to report progress. One of HUD's most significant financial management systems deficiencies exist in FHA, where FHA's ADP system environment needs to be enhanced to more effectively support FHA's business and budget processes. 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, weaknesses still exist. FHA continues to conduct some day-to-day business operations with legacy-based systems, limiting FHA's ability to integrate its financial processing environment and to effectively monitor budget execution. Later in this section of this report, we more fully discuss the material weakness relating to HUD's financial systems.

Resource Management

In addition to improving its financial systems, HUD will need to more effectively manage its limited staff resources. Many of the weaknesses discussed in this report, particularly those concerning HUD's oversight of program recipients, are exacerbated by HUD's resource management shortcomings. Accordingly, we consider it critical for the Department to address these shortcomings through the successful completion of ongoing plans. However, we have not categorized resource management as a separate internal control reportable condition because the effect on HUD's financial statements can be appropriately characterized as a contributing cause for internal control weaknesses described in other sections of our report.

To operate properly and hold individuals responsible for performance, HUD needs to know that it has the right number of staff with the proper skills. We reported in prior years that HUD had not developed a comprehensive strategy to manage its resources. To address staffing imbalances and other human capital challenges, the Department has implemented the Resource Estimation and Allocation Process (REAP). The last phase of REAP, a baseline for staffing requirements, was completed in January 2002. The next step in development of the Department's resource management strategy was the implementation of the Total Estimation and Allocation Mechanism (TEAM) during June 2002. TEAM is the validation component of REAP and will collect actual workload accomplishments and staff usage for comparison against the REAP baseline.

Our review of the REAP and TEAM processes showed the Department had made progress in developing and implementing key components of its staffing workload estimate and allocation process for human resource management system since September 2000.³ However, on August 14, 2003, an OIG audit⁴, of HUD's hiring practices during fiscal year 2002, showed HUD did not use REAP and TEAM data in determining personnel needs. This resulted in the Department hiring about 300 staff over ceiling. Moreover, hiring was inconsistent with program requirements, and staffing needs. In response, HUD developed and implemented a Staffing Corrective Action Plan to bring the Department in compliance with staffing ceilings and to align with REAP allocations.

Other control environment issues

In addition to system and resource management issues, in prior years, we reported on other issues that HUD needed to address that we believed impacted its ability to effectively manage its programs. We are able to report some progress. For example, HUD has improved funds controls over public housing operating funds. This issue is no longer reported as

³ HUD OIG Memorandum No: 2003-PH-0801, dated December 2002, Subj: Assessment of HUD's Progress In Implementing the Resource Estimation and Allocation Process (REAP) and Total Estimation And Allocation Mechanism (TEAM) components of its Human Resource Management System.

⁴ HUD OIG Audit Report No: 2003-AO-0004, dated August 14, 2003, Subj: Review of the Department of Housing and Urban Development's staffing 9/30 Initiative.

a reportable condition. Presented below is a discussion of the remaining material weaknesses and reportable conditions relating to the Department's control environment.

Material Weakness:
Financial Management
Systems are Not
Substantially Compliant
with Federal Financial
System Requirements

The Federal Financial Management Improvement Act (FFMIA) requires that we report on whether the financial management systems substantially comply with the:

1. Federal financial management systems requirements, contained in OMB Circular A-127, and in the Joint Financial Management Improvement Program (JFMIP) functional requirements documents;
2. Applicable Federal accounting standards; and
3. Standard General Ledger (SGL) at the transaction level.

Besides requiring agencies to record and classify their transactions in accordance with the SGL, these criteria require that the core financial management system be integrated through automated interfaces with other agency systems (financial, program, or a mixture of both) so that transactions are entered only once.

The components of the integrated financial management system, which should be electronically linked include:

- the core financial system that provides for the agency's standard general ledger, payment, receipt, cost, funds management, and reporting;
- other financial or program systems or a mixture of both that support the agency's ability to manage and operate its mission programs and/or financial operations;
- systems shared with other government agencies, such as the U.S. Treasury; and
- an agency executive information system (e.g., data warehouse) that provides financial and program management information to all manager levels.

Based on the criteria above, the Department's financial management systems for fiscal year 2003 remain substantially noncompliant with the Federal financial management systems requirements. This noncompliance represents a material weakness in internal controls, as the risk for material misstatements in the financial statements has not been reduced to a relatively low level.

Deficiencies in the supporting financial management systems

As reported in prior fiscal years, we found deficiencies in several supporting financial management systems during fiscal year 2003. These deficiencies are as follows:

- The Department's Funds Control function occurs in multiple systems, which may not use or apply the same internal controls to consistently process similar transaction types.
- Sub-ledger activities do not automatically post to the Department's general ledger. Transaction data is passed manually or via sequential system batch processes before it posts to the general ledger. This increases the possibilities for error and builds in significant time delays before information is available.
- Current Department financial management systems architecture is composed of "stove pipe" legacy feeder systems. The number of feeder systems also requires numerous reconciliations, results in increased maintenance costs, and may diminish data integrity and accuracy.
- The Department has not met the minimum set of automated information resource controls relating to Entity-wide Security Program Planning and Management. Specifically, OIG has reported⁵ that the Department is not compliant with Federal requirements in the areas of development and maintenance of Security Plans, Independent Review of Security Plans, and Accreditation and Certification of information systems. As we noted in our audit report, information system control weaknesses could negatively affect HUD's entity-wide security program and the integrity, confidentiality, and availability of its financial data.
- The Department's financial reporting and management needs are not fully supported by key Single Integrated Financial System components. Current system components often lack the ability to automatically feed financial information to other system components. For example: (1) preparation of the consolidated financial statement is subject to increased risk of error due to a semi-automated process of providing FHA and Ginnie Mae end-of-year financial data and (2) current financial systems do not accumulate, allocate, and report costs of activities on a regular basis for financial reporting needs as well as internal use in managing programs and activities. While the Department has several ongoing core financial management systems projects, which will correct these inefficiencies, currently system interfaces are often inefficient requiring users to perform manual analyze and additional reconciliations, and enter duplicative entries.

⁵ HUD OIG Audit Report Number 2004-DP-0001, "Fiscal Year 2003 Review of Information Systems Controls in Support of the Financial Statements Audit" dated December 1, 2003.

- While the FHA Subsidiary Ledger (FHASL) project is on schedule; until the project is fully deployed FHA financial systems will continue to have instances where they are not in compliance. Currently FHA's systems do not:
 1. Provide the capability for integrated budget execution in the core financial system with accounts payable, accounts receivable and general ledger to fully integrate, monitor and control its budgetary resources. Consequently, FHA is not able 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*; or input budgetary entries to FHASL.
 2. Account for all of FHA's acquisition activities.
- Many of the 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 processes with the implementation of these interfaces, additional opportunities exist to further reduce manual efforts. For example, there are key legacy systems maintained in local databases that are not efficiently integrated into the FHA financial management process.
- HUD does not have an integrated accounting system to support the recording and reporting of commitments for the Section 236 Interest Reduction Program. As a result, commitments balances were not being timely adjusted and future contract authority was overstated (see report section beginning with "HUD needs to improve the processes for reviewing obligation balances").
- There is a lack of automated interfaces between PIH and Office of Housing subsidiary records with HUD's general ledger for the control of program funds. This necessitates that HUD and its contractors make extensive use of ad hoc analyses and special projects to review Section 8 contracts for excess funds. This has hampered HUD's ability to timely identify excess funds remaining on Section 8 contracts (see report sections beginning with "HUD needs to improve processes for reviewing obligation balances").
- HUD does not have adequate assurance about the propriety of Section 8 rental assistance payments (see report sections beginning with "Controls Over Project-based Subsidy Payments Need to be Improved").

Status of the Department's financial systems remediation plans.

Since 1997, HUD has attempted to meet OMB Circular A-127 requirements to have a single integrated accounting system for HUD. However, this goal has not been achieved because of the agency's failure to: (1) perform a complete and thorough analysis of alternatives when initially selecting a commercial "off-the-shelf" (COTS) financial

management system software package, (2) resolve weaknesses in FHA's financial management system, and (3) perform feasibility and cost benefit studies to support the new direction the Department is taking in developing a financial management system. In addition, changes in management and administrations have been a contributing cause to the delay and redirection of efforts to better integrate HUD's financial management systems.

In FY 2002 the OCFO authorized funding to contract out the feasibility and cost-benefit studies to replace HUDCAPS and the supporting payments and funds control systems, LOCCS and PAS. In FY 2003, HUD's OCFO launched the HUD Integrated Financial Management Improvement Project (HIFMIP), which will encompass all of HUD financial systems, including FHA and Ginnie Mae. The HIFMIP Project has as a deliverable the development of a Financial Management Vision and will analyze the current HUD financial systems flow, the financial event information flows, external financial information workflows, financial management challenges, systems challenges, and associated risks. The planned completion date for the studies is July 2004.

During fiscal year 2000, FHA purchased a JFMIP compliant commercial "off-the-shelf" (COTS) SGL financial system to replace the current system. As previously noted, a key improvement made during fiscal year 2003 was the implementation of the FHASL financial system. By fiscal year 2007, FHA plans to fully integrate program operations with its core financial system, eliminating some legacy systems and reengineering others in order to implement budgetary controls at the source, further reduce the need for manual processing, and improve financial operations.

HUD's Actions Planned and Underway to Improve its Financial Management Systems

As discussed under the "Status of the Department's financial systems remediation plans," HUD has established plans to improve its FHA and Departmental financial systems.

FHA continues work on their "Blueprint for Financial Management Systems." In fiscal year 2003, FHA successfully implemented the general ledger module of their core financial system. The FHASL Project will implement additional modules of their core financial system including cash management, accounts receivable, and accounts payable as well as enhancements to fund control in fiscal year 2004. Additionally, FHA has plans to integrate, modernize, or replace existing subsidiary systems and automate current manual processes that will address financial management and documented system deficiencies by fiscal year 2007.

HUD management anticipates that a successful HIFMIP implementation will resolve JFMIP and FFMIA compliance issues and satisfy the

President's Management Agenda (PMA) initiative of Improved Financial Performance.

OIG's Assessment of HUD's Planned and Completed Actions

In regard to the FHASL Project, FHA needs to continue its progress with the implementation of the new subsidiary ledger by implementing, as scheduled, the additional core financial system modules. We will monitor the next phases of the FHASL Project and will evaluate the FHASL Project's Phase 2 Implementation in fiscal year 2004.

In regard to HIFMIP, the Department needs to continue its efforts to implement a modern, integrated core financial system. We will monitor HIFMIP's progress in fiscal year 2004.

In regards to the Department's information system security related deficiencies, the Department needs to revise its business processes to fully comply with Federal information security requirements. We will be evaluating management actions to achieve compliance with Federal information system security program requirements.

Reportable Condition:
**HUD Needs to Improve
 Quality Controls over
 Performance Measures Data**

OMB Bulletin 01-09, *Form and Content of Agency Financial Statements*, requires agencies to report performance measures about the efficiency and effectiveness of their programs. In prior years, we reported that HUD's *Performance and Accountability Report* and prior accountability reports emphasized financial and non-financial operating results as input or simple output measures and lacked meaningful performance information. The Department has made major progress in solving the problems of data accuracy, timeliness, estimation, and availability of data. However, there is still work to be done to ensure that these deficiencies are fully resolved by providing adequate internal controls over the performance data measures. We noted concerns with the following key program areas that HUD is continuing to address in some manner:

- CPD's Integrated Disbursement and Information System (IDIS) was designed to provide field staffs with real-time performance data to assist monitoring efforts and ensure grantee compliance with program requirements. IDIS experienced problems during implementation and IDIS continued to undergo a massive data cleanup effort during fiscal year 2003. The objectives of this effort are to cleanup data that is currently in IDIS and maintain system data at a high quality level. The projected completion date of this effort was March 31, 2003, but administrative delays have extended this effort, which is now expected to be completed during fiscal year 2004.
- The Public Housing Information Center (PIC) system and Tenant Rental Assistance Certification system (TRACS) are used to provide performance data on several of HUD's rental subsidy programs. However, PIC systemic problems and TRACS reporting problems have prevented use of the system and data for the households

assisted. Building and units, housing choice vouchers and homeownership units have not been fully reported.

- Previously, we reported concerns about HUD's controls over the reliability of performance data as well as the adequacy of component factors to objectively determine HAs performance, from the Public Housing Assessment System (PHAS). During fiscal year 2002, administrative and legislative delays in producing PHAS scores prevented PHAS from being fully utilized. Again during fiscal year 2003, administrative delays in producing PHAS scores limited the use of PHAS as intended and raised concerns regarding the reliability of performance data.

In prior years, we reported on our concerns over performance measure data reliability and questionable data quality. Data quality is the responsibility of the Office of the Chief Information Officer (OCIO), and the OCIO implemented a data quality improvement project that should set Department-wide quality standards for HUD's mission critical data including performance data. They have established a process with a goal of cleaning up existing data and ensuring that the data maintains a high quality level. The OCIO planned to fully implement the steps of this process by January 2004 to provide the HUD offices an on-going data quality process for their systems.

Housing Assistance Program Delivery

Monitoring and Payment Processing Weaknesses Continue

Under the provisions of the U.S. Housing, Act of 1937, HUD provides housing assistance funds through various grant and subsidy programs to multifamily project owners (both nonprofits and for profit) and housing authorities. These intermediaries, acting for HUD, provide housing assistance to benefit primarily low-income families and individuals (households) that live in public housing, Section 8 and Section 202/811 assisted housing, and Native American housing. In fiscal year 2003, HUD spent about \$23 billion to provide rent and operating subsidies that benefited over 4 million households. Weaknesses continue to exist in HUD's control structure preventing HUD from assuring that these funds are expended for rent subsidies in accordance with the laws and regulations authorizing the grant and subsidy programs.

Legislation authorizing HUD's housing assistance programs includes specific criteria concerning tenant eligibility and providing assistance for housing that meets acceptable physical standards. Moreover, legislation authorizing HUD's programs also establishes minimum performance levels to be achieved. For example, subsidized housing must comply with HUD's housing quality standards.

In prior reports on HUD's financial statements, we reported on weaknesses with the monitoring of housing assistance program delivery and the verification of subsidy payments. In this report, we again focus on the impact these weaknesses have on HUD's ability to ensure that intermediaries are correctly calculating housing subsidies and ensuring safe and quality housing based on HUD requirements. The material weakness discussed below encompasses public housing and tenant-based Section 8 programs administered by PIH along with project-based subsidy programs administered by the Office of Housing. We also continue to report on a separate reportable condition relating to the project-based subsidy payment process.

Material Weakness: Improvements Needed in Oversight and Monitoring of Subsidy Calculations and Intermediaries Program Performance

As in prior reports on HUD's financial statements, we continue to express concerns about the significant risk that HUD's intermediaries are not properly carrying out their responsibility to administer assisted housing programs according to HUD requirements. We are reporting that HUD's control structure does not adequately address this risk due to insufficient on-site monitoring to ensure acceptable levels of performance are achieved along with the absence of an on-going quality control program that would periodically assess the accuracy of intermediaries rent determinations and billings. We also are reporting on significant control weaknesses in HUD's income verification process.

These weaknesses related to tenant income, which is the primary factor affecting eligibility for, and the amount of, housing assistance a family receives, and indirectly, the amount of subsidy HUD pays. Generally, HUD's subsidy payment makes up the difference between 30 percent of a household's adjusted income and the housing unit's actual rent or, under the Section 8 voucher program, a payment standard. The admission of a household to these rental assistance programs and the size of the subsidy the household receives depend directly on its self-reported income. However, significant amounts of excess subsidy payments occur as a result of intermediaries rent determinations, and undetected unreported or underreported income. In addition, significant errors were identified in the billings and payments process that result from intermediaries' housing assistance billings for HUD's subsidy payments.

By overpaying rent subsidies, HUD serves fewer families especially those who may be eligible but unable to participate because of limited funding. The impact of payment errors of this magnitude takes on added significance in light of a HUD estimate⁶ that the "worst case housing needs" is around 5.4 million households and is projected to increase at twice the rate of the population growth. This estimate relates to the number of unassisted very-low-income renters who pay more than half of their income for housing or live in severely substandard housing.

Verification of Subsidy Payments

The estimate of erroneous payments that HUD reports in its financial statements relates to HUD's inability to ensure or verify the accuracy of subsidy payments being determined and paid to assisted households. This year's contracted study of HUD's three major assisted housing programs estimated that the rent determinations errors made by the intermediaries resulted in substantial subsidy overpayments and underpayments. The study was based on analyses of a statistical sample of tenant files, tenant interviews, and income verification data. This study also reports subsidy payment inconsistencies such that HUD incorrectly paid \$1.549 billion in annual housing subsidies of which about \$987 million in subsidies was overpaid on behalf of households paying too little rent, and about \$562 million in subsidies was underpaid on behalf of households paying too much rent based on HUD requirements. The estimate of erroneous payments is reported in note 17 to the financial statements.

The estimate of erroneous payments reported this year also includes overpaid subsidies from underreported and unreported income and intermediaries billings errors. For this year's estimate from underreported and unreported income, HUD restated in note 17 its FY 2002 estimate of an additional \$978 million in overpayments. A new estimate for income underreporting will be developed for next year based on the tenant data from this year's contracted study of rental assistance

⁶ As stated in U.S. Department of Housing and Urban Development FY 2000-FY 2006 Strategic Plan, September 2000.

determinations. Also in note 17, HUD describes an estimate of erroneous payments for its intermediary's subsidy billings errors. HUD revised the estimate reported last year after conducting a quality control review of last year's results. Although HUD did not disclose the revised estimate total indicating a desire to restudy the problem, our fieldwork showed an estimated \$614 million in billing errors, which consists of \$379.2 million in overpayments and \$235.2 million in underpayments.

HUD needs to continue initiatives to use available income matching tools to detect unreported tenant income

HUD, HAs and project owners have various legal, technical and administrative obstacles that impede them from ensuring tenants report all income sources during the certification and re-certification process. Since unreported income is difficult to detect, HUD began pursuing statutory authority from Congress to access and use the Health and Human Service's National Directory of New Hires Database to detect unreported income during the certification and re-certification process. This year, legislation for this access was introduced in Congress and was still pending at the time of our report. In lieu of this statutory authority, HUD continued to encourage HAs to verify income and assisted the HA's by establishing agreements with twenty states to allow computer matching of tenant income with State wage data.

HUD's progress in its income-matching program has been limited

In 1996, HUD began sampling its household databases to estimate the amount of excess subsidy payments due to income reporting for its financial statement disclosure each year. In fiscal year 1999, a Tenant Assessment Subsystem developed by HUD provided an automated matching of tenant-reported income maintained in HUD's tenant databases with Federal tax data from the IRS and SSA on a statistical basis. HUD had also completed several annual large-scale computer income-matching projects matching 100 percent of its tenant income data and issued two reports during fiscal year 2001 that indicated the likelihood of recovery of excess rental subsidies paid diminished over time. Further, HUD needed to obtain complete and accurate electronic tenant data to identify valid actionable income discrepancies that caused excess subsidy payments or overpayments by the tenants.

During fiscal year 2003, HUD's management made a decision to temporarily discontinue the 100 percent tenant income matching with IRS data pending the outcome of their Rental Housing Integrity Improvement Project⁷ (RHIP) initiatives. However, HUD continued operations for income verification and matching involving social security (SS) and supplemental security income (SSI) information. This information is made available to HAs, project owners and administrators of the Office of Housing's rental assistance programs who access the SS and SSI information via a secure Internet facility as a "front-end" way to verify income and annual tenant re-certifications.

⁷ HUD initiated the RHIP in response to the contracted study, "Quality Control for Rental Assistance Subsidies Determinations," in an effort to develop tools and the capability to minimize erroneous rental subsidy payments, which includes the excess rental subsidy caused by unreported and underreported tenant income.

More progress needed on the RHIP initiatives

HUD's major fiscal year 2001 RHIP initiatives called for development of systems capability that would identify relevant tenant and program data for rent calculations, and required that all relevant data be submitted by HAs. HUD expected to use the data to identify HAs certification or re-certification processing deficiencies, and to conduct an "annual total error measurement process"⁸ to determine erroneous payments. Since our last report, HUD has added new RHIP initiatives. Also, HUD has made additional progress in implementing several RHIP initiatives that address the problems surrounding HAs rental subsidy determinations, underreported income and assistance billings. However, HUD has yet to achieve an automated capability to detect rent subsidy processing deficiencies or identify and measure erroneous payments, or to have HAs submit all required data.

For the RHIP initiatives accomplished this year, HUD has (1) entered into additional state income data sharing agreements that would allow HAs to access the data through a HUD web based system, (2) submitted a legislative proposal to authorize conversion of Section 8 tenant-based subsidy assistance program into a state block grants program, (3) developed non-performance civil penalties for Section 8 performance based contract administrators, (4) developed sanctions for tenant underreporting of income, (5) issued final updated housing program guidance for reduction of overpaid rent subsidies, (6) extended coverage of the rental integrity monitoring (RIM) reviews to identify incorrectly paid rental subsidy that result from incorrect rental subsidy determinations made by HAs, (7) conducted RHIP training, and (8) started initiating RIM follow-up on PHAs with identified deficiencies.

PIH and the Office of Housing needs to ensure HA reporting into its PIC and TRACS tenant databases

HUD uses the tenant data from its Public Housing Information Center (PIC) system, and the Tenant Rental Assistance Certification System (TRACS) for the income-matching program and program monitoring. For HUD's income matching and other program efforts to be effective, it is essential that the PIC and TRACS database have complete and accurate tenant information. However, PIC system problems prevented HAs from reporting for much of fiscal year 2003, and since HAs reporting requirements were again discretionary this year, not all data may have been submitted. In addition, the reporting for the TRACS database needs improvement. The TRACS deficiency will be discussed later in the reportable condition on "Controls over Project-based Subsidy Payments Need to be Improved." It was also noted that the RHIP advisory group recommendation for payment-processing incentives and sanctions to improve database reporting has yet to be implemented. Maintaining a high reporting rate is a must if the PIC and TRACS databases are to be of use in computer matching and monitoring of the HAs.

⁸ The total error measurement process is HUD's quality control process to identify and measure erroneous payments, which it plans to conduct annually. The three types of errors that are measured are rental calculation, unreported and underreported income, and intermediaries' billings errors.

PIH and the Office of Housing needs to ensure housing assistance billings are correct

HUD makes public housing and Section 8 subsidy payments to HAs and private owners (landlords) according to these housing assistance (subsidy) billings. Conceptually, the underlying basis for subsidy payments are landlord's housing assistance billings, which are derived from family reports that documents tenant income, rent, and subsidy determinations. The subsidy determination amounts should be the same as those shown on the housing assistance plan (HAP) billing registers or project rent rolls and on the subsidy billing to HUD. The amounts billed to HUD should also match the amounts paid to landlords. The subsidy bills paid should, in turn, equal the amounts shown in HUD's LOCCS accounting and subsidy payment system, and should match bank statements and financial statements. After year-end reconciliation's are complete, ideally the total subsidy determinations, the total on the HAP billing registers and the total payments to Landlord should be the same.

In fiscal year 2003, HUD conducted a quality control review of the billings study used to establish the fiscal year 2002 baseline for measuring erroneous payments resulting from housing assistance billings. The billings study identified reporting weaknesses in subsidy billings process for the Section 8 tenant-based and project-based programs and estimated that there was approximately \$257.1 million in subsidy billing errors. The fiscal year 2003 review was conducted to determine the accuracy of the estimates for the fiscal year 2002 billings study. Based on this year's review, HUD revised its estimate upward to \$614 million in erroneous payments due to billings errors, but the public housing program was again excluded from the estimate. These errors represented substantive errors in the subsidy payments or non-compliance with HUD policies and regulations. The problems identified included the failure to accurately report or maintain required subsidy determination documentation, along with bookkeeping or procedural errors. In addition, this measurement of erroneous payments resulting from intermediaries' billings is incomplete because HUD failed to include the public housing program as part of this review. Since the same intermediaries that administer the Section 8 tenant-based program administer the billing process for the public housing program, there may be problems that are similar and significant as well.

HUD's Actions Planned and Underway to Verify Tenant Income

In fiscal year 2003, HUD decided to temporarily suspend its large-scale computer matching of 100 percent of tenant income to devote resources to several more effective RHIP initiatives, such as the up-front state income verification and rental integrity monitoring. In addition, HUD plans to start providing annually its estimates of erroneous payments from rental determination errors, under and unreported income and billings errors as part of its annual total error measurement process under the RHIP. For fiscal year 2004 financial statement reporting, HUD plans to use the tenant information from its fiscal year 2003 Study of Rental Assistance Subsidies Determinations to conduct a computer match of reported tenant income to

IRS and SS data files, and provide its estimate of erroneous payments from under and unreported income.

In fiscal year 2003, the RHIP advisory group developed some new task initiatives and continued to implement a strategy of addressing the problems associated with rental subsidy calculations. Starting in fiscal year 2004, HUD plans to begin conducting annual intermediary's billings measurement process for its three major housing assistance programs as part of an annual comprehensive error measurement process. The annual measurement process will build upon existing monitoring activities by evaluating the effectiveness of the field-monitoring activities as part of the annual measurement process.

Also, this year PIH continued to implement its rental integrity monitoring (RIM) expanding its initial reviews to include 490 HAs administering 80 percent of PIH funds. In addition, HUD plans to pursue recapture of overpaid rental subsidy identified through RIM reviews as a disallowed cost. HUD is also considering incentives and sanctions to ensure proper rental subsidy determinations. However, HUD has not implemented a comprehensive evaluation program of rental determination for its Section 8 project-based program.

Last year HUD planned to upgrade the capability of PIC to provide for the collection of rent calculation information, but the plans were delayed pending security design improvements. In addition, HUD is reconsidering its previous plan to provide automated web-based interface of the rent calculation software with PIC database. Also, HUD's plans to require HAs to use the upfront income verification system are still pending. The Office of Housing continues to pursue incentives to improve TRACS data reporting, starting with an 85 percent reporting goal and also plans to provide automated web-based interface of the rent calculation software with TRACS database. Funding had been provided again in fiscal year 2003 for the business process redesign study on TRACS tenant data. This increased capability and information should simplify computer matching and intermediary's billing error measurement.

OIG's Assessment of HUD's Planned and Completed Actions

HUD should evaluate and assess the effectiveness of the total error measurement process completed, with particular emphasis on determining what effects the completed RHIP tasks have had on reducing erroneous payments and whether additional steps need to be implemented. Also, HUD should continue to pursue all alternatives identified by the RHIP, such as eliminating statutory restriction on disclosing HHS's New Hires data to HAs and project owners to improve the housing assistance program's effectiveness.

Regarding HUD's RIM review initiative, the impact and effectiveness of this initiative in reducing incorrect rental subsidy determinations could be not fully evaluated this year since most of reviews for the HAs were

performed after the cut-off date for the error measurement process. However, the RIM reviews completed did identify rental determination errors and the need for HUD to conduct these reviews for all HAs. HUD also needs to conduct follow-up at the HAs identified to have made rental determination errors to ensure corrective action was initiated.

In addition, HUD needs to (1) address deficiencies identified by its billings error study to prevent additional overpayments to HUD intermediaries and (2) complete the error measurement process for intermediaries' billings by conducting reviews of the intermediaries' billings for the public housing program.

HUD should also continue to develop the capability to obtain relevant tenant data that would allow the process to be practical and cost effective for rental calculation determinations and billings verification systems. We are also encouraged by the on-going actions HUD plans to take to improve the reporting rate and data integrity of the PIC, and its efforts to improve the capability of TRACS.

Continued Efforts Needed to Improve Housing Authority Monitoring

HUD provides grants and subsidies to approximately 3,200 HAs nationwide. In previous years, we reported that HUD's management control structure did not provide reasonable assurance that program funds were expended in compliance with the laws and regulations authorizing the programs. In fiscal year 2003, problems remain that we believe HUD needs to address to provide assurance that HAs (1) provide the correct amount of subsidies for safe, decent, and sanitary housing and (2) protect the Federal investment in their properties. Our concerns, and the efforts to address them, are discussed below.

Improved risk evaluation and monitoring of housing authorities needed

During fiscal year 2003, HUD continued to implement a performance oriented, risk based strategy for carrying out its HA oversight responsibilities. As reported in previous years, further improvements need to be made in PIH field offices' monitoring of its HAs in key areas such as: (1) HAs risk assessments and use, (2) on-site monitoring of higher risk HAs, (3) the development and use of management and performance assessment data,⁹ and (4) performance of on-site monitoring and technical assistance activities.

The primary key to implementing the monitoring process is the risk assessments that identify management, compliance, and performance areas in need of attention and help to establish the resource requirements for thorough on-site monitoring or technical assistance visits. Similar to last year, risk assessments were not consistently performed primarily

⁹ HUD utilizes the Public Housing Assessment System (PHAS) and the Section 8 Management Assessment Program (SEMAP) to measure HA management performance and provide performance scores in physical condition, financial health, management operations for public housing and the Section 8 tenant-based assistance programs.

because the PIH Information Center¹⁰ (PIC) was unavailable to perform automated assessments due to systemic programming and security problems. As a result, the field offices were not provided timely information to manage monitoring activities.

We found that all four field offices tested performed initial risk assessments of 545 HAs within their jurisdictions but only scheduled 37 of their 193 moderate and high-risk housing authorities for on-site monitoring or technical assistance. However, the four field offices did adjust their planned monitoring activities based on a subsequent risk analysis completed in April 2003 for 539 HAs, but again only scheduled 21 of the 147 moderate and high-risk HAs for on-site performance monitoring or technical assistance. We also found that the field offices were directed in April 2003 to conduct RIM reviews and had scheduled fewer performance-monitoring activities in order to accommodate the added workload.

In our testing of the field offices' risk assessments and monitoring of housing authorities' low-income and tenant-based Section 8 programs, we identified a number of key monitoring deficiencies that need to be improved to ensure housing authority monitoring is more effective. Monitoring deficiencies identified concern using the risk assessments for selecting HAs for monitoring, and identifying performance areas in need of attention.

Our analysis of the strategies for monitoring the 193 moderate and high risk HAs showed that only two of the four field offices tested used the underlying performance indicators¹¹ from the risk assessments to determine and target deficient areas of HA performance for on-site monitoring reviews. This analysis of the underlying performance indicators was necessary since the automated risk assessments did not always utilize information from the most current PHAS and SEMAP performance assessments.

On-site monitoring was limited

On-site monitoring of HAs is a key component in HUD's monitoring program. HUD performs on-site reviews to evaluate and assist HAs in improving their housing operations. In fiscal year 2003, HUD performed a limited number of on-site reviews or technical assistance visits. For the four offices we tested, the field office staff only completed 8 of 37 low-income and Section 8 on-site performance monitoring reviews. We determined that the number of on-site monitoring reviews had been

¹⁰ The PIH's Information Center (PIC) is an internet-based data system that uses data entered by HAs and the field offices. The PIC was developed as PIH's comprehensive data system to assist PIH managing its programs.

¹¹ The risk assessment rating is derived in part from a composite of the PHAS and SEMAP scores, which provides an overall assessment of a HA's performance. These scores are further comprised of subcomponents scores and indicators that can be used to identify performance deficiencies in such areas as financial, housing quality, compliance and management areas, and target these deficient areas of HA performance for on-site monitoring reviews.

impacted in the first half as the result of limited funding for travel, and during the second half of the fiscal year 2003 as the result of the field offices being directed to conduct RIM reviews. We also noted an increase for the last half of the year in the number of HAs that were moderate and high risk. We found that PIH's PIC showed an increase of sixteen HAs with higher risk at the end of the fiscal year over the previous quarter. The decreased performance of the HAs for the last half of the fiscal year is an indicator that the level of HA monitoring had not been effective, and coupled with the deficiencies in rental subsidy determinations mentioned earlier, supports the need for emphasis on monitoring.

In fiscal year 2003, REAC performed 21,254 inspections of PIH and Multifamily properties. Of the 21,254 inspections, 1,646 resulted in a failing physical score. Furthermore, 11,290 of the inspections identified one or more life threatening exigent health and safety deficiency issues. However, HUD did not start issuing the PHAS scores for fiscal year 2003 until mid-year which resulted in the field offices and the troubled agency recovery centers having limited use of the results in their monitoring programs. Consequently, under the current environment, the PHAS process has not had its fully intended impact on improving HAs performance.

PIH monitoring systems are not fully utilized

The PIC supports the management of PIH programs by tracking key information critical to PIH business processes. HUD's staff uses the system to track data that can be analyzed to determine and improve HAs performance. However, the PIC system was not available to conduct risk assessments during the first seven months of fiscal year 2003 because of systemic security and programming problems. When the PIC system was brought back online in mid-year, the four field offices we tested did utilize the system to conduct quarterly risk assessments and reduced the number of HAs scheduled for on-site monitoring to almost half based on a decline in the number of moderate and high risk HAs.

The PIC system was also not available to manage or document monitoring activities conducted by the field offices during the fiscal year. We found that the PIC system's event tracking system (ETS) was not available to enter data on completed monitoring activities or maintain the PIC management data on a current basis. In addition, the field offices used alternative tracking systems, which did not always adequately document completed monitoring activities. Additionally, PIC was not being updated timely because the data for PHAS scores was not available or system access prevented updates to the SEMAP HA assessment programs to provide timely performance data. Since PIC is PIH's primary information system to remotely monitor HAs' business processes and performance, its usefulness as an effective monitoring tool is diminished when the system cannot be used and does not contain complete, consistent, and accurate data. As such, we continue to have concerns regarding the reliability of the performance and compliance data used by HUD's field offices to evaluate HA's operations.

HUD's Actions Planned and Underway to Improve HA Monitoring

In fiscal year 2003, HUD continued the process of implementing reforms to administrative and processing activities. These changes were implemented to allow Regional offices to provide better administrative support to field office staff and allow the field office staff to concentrate on providing technical assistance and oversight to HAs with declining performance. Additionally, HUD expanded its field offices into 28 Hubs and 16 program centers; with the program centers continuing to report to the Hub directors. HUD also (1) devoted more resources to conducting rental integrity reviews, (2) developed plans to centralize trouble agency recovery efforts and assistance, (3) assigned REAC to PIH to more closely realign it with program staff functions, and (4) revised its development plans for PIC system to ensure data security. The specific structural and operational actions HUD has taken in fiscal year 2003 or intends to implement in fiscal year 2004 include:

- HUD plans to implement a more comprehensive monitoring program for its HAs in fiscal year 2004. The objective will be to streamline and coordinate the types of monitoring activities performed to improve HA performance.
- During fiscal year 2004, REAC will be using the PHAS scoring methodology they originally implemented in the FASS scoring notice published on December 21, 2000, and the PASS scoring notice published on June 28, 2000, for HAs with fiscal year ending September 30, 2003.
- As of September 30, 2003, PIH conducted RIM reviews of the 490 HAs that received eighty percent of the housing assistance funding. The field offices identified the major causes for incorrect rental determination, and requested HAs take corrective action. During fiscal year 2004, the HUD plans to evaluate the effectiveness of the corrective action by conducting another rental determination study. In addition, HUD has plans to require the HAs to repay erroneous payments that resulted because of rental determination errors, and evaluate whether to pursue action against IPAs that conducted audits of at the HAs that had rental determination errors.
- PIH will continue to address security concerns for the PIC and ensure full system capability and availability is restored. In addition, PIH has plans to enhance the capabilities of the PIC by developing tracking capability for audits and exigent health and safety issues, and incorporating rental calculation capability. They are also planning to reestablish sanctions to ensure HAs consistently provide data needed to update PIC systems.

OIG's Assessment of HUD's Planned and Completed Actions

As in previous years, we were unable to fully assess HUD's measures aimed at improving oversight of HAs since the Department's plans to monitor and improve performance are not yet being carrying out as

intended and continue to change abruptly or are disrupted by unexpected delays.

We continue to agree with HUD's efforts to use the PHAS and SEMAP scores to provide monitoring and technical assistance to HAs and to focus its limited field office resources. With the advent of official PHAS and SEMAP scores on a current basis, HUD can begin to effectively target and improve the HAs current operations and performance, instead of targeting assistance up to a year later.

Also, we agree with HUD's efforts to continue using a national risk assessment system to assess quarterly the risk associated with the HAs performance, but it needs to be used consistently. Along with this quarterly assessment, HUD should also require the field offices to evaluate HAs performance as new PHAS and SEMAP scores are made available. In addition, HUD needs to ensure its management systems are available for use, contain reliable and complete data and function as intended. These systems then, if used as intended, gives HUD the ability to uniformly assess its' staffing and funding resource needs to give priority to those HAs that are deemed to have a moderate or high performance risk, rather than what appears to be the reverse, where available funding is driving the monitoring.

The use of RIM reviews to identify HAs with rental determination problems will greatly increase HUD's efforts in reducing erroneous payments and allow HAs to provide subsidies to more needy families.

Multifamily Project Monitoring Needs to Place More Emphasis on Oversight of Subsidy Determinations

HUD is responsible for monitoring multifamily projects to assure that subsidies (1) are provided only to projects that provided decent, safe and sanitary housing and (2) have been correctly calculated based on HUD eligibility requirements. To accomplish these two program goals, the Office of Housing uses the reporting from the REAC for physical inspections (PI) and review of annual financial statements (AFS). Offices of Housing field staff or contract administrators (CA) have primary responsibility for following up on observations from REAC reporting and conducting management reviews. The Departmental Enforcement Center (DEC) handles projects, which are the most troubled based upon referral from the REAC or the Office of Housing. Monitoring of tenant eligibility at projects is accomplished by Office of Housing or CA staff performing management reviews with an added "occupancy review" component¹². Office of Housing field staff is to oversee the efforts of CAs.

¹² Occupancy reviews test compliance with occupancy requirements, generally seeking to validate that only tenants meeting eligibility requirements occupy the project, that this is documented by tenant certifications and recertifications maintained by the project owner, and that this information is correctly entered in TRACS.

HUD directly or indirectly insures or subsidizes about 32,000 multifamily projects. About 16,000 projects have FHA insured or HUD held mortgages, and 25,000 receive some form of assistance on behalf of eligible tenants residing in those projects. The principal multifamily subsidy programs are:

- The Section 8 and Section 236 programs, which provide subsidies to project owners, who, in turn, provide housing units at reduced rents to eligible households.
- The Section 202 and Section 811 programs which provide grants to non-profit institutions for the construction of projects providing reduced rent units to the elderly and disabled, respectively. Ongoing rent subsidies are also provided under these programs once the units are occupied.

Audit approach to multifamily programs for both insured and assisted projects

We tested internal controls relating to asset and risk management and delivery of benefits to eligible tenants in multifamily projects. We focused on the use of the individual monitoring tools available to the Office of Housing and the overall communication, integrated risk management and reporting from the field offices to headquarters, as was reflected in the Real Estate Management System (REMS). In conjunction with efforts by our contractor on the FHA audit, KPMG LLP, we conducted interviews at both headquarters and field offices, tested project management files, inspected properties, and performed additional procedures at six Hub sites and three PBCA locations. Our selection of project files was based on statistical samples designed by KPMG LLP and OIG. KPMG LLP statistically selected 240 project files that covered the entire range of risk for the multifamily portfolio. OIG statistically selected project files for review from the portfolios of three PBCAs. In addition, OIG judgmentally selected management and occupancy files for review at the six Hub sites visited.

Use of monitoring tools improved

Multifamily Housing's use of PI, management and occupancy reviews and the AFS improved during fiscal year 2003. The use of these monitoring tools was generally effective except for the performance of management and occupancy reviews by HUD staff, which are constrained by travel and staff resources.

The Office of Housing needs to increase the number of management and occupancy reviews performed on the portfolio administered by HUD and implement procedures to ensure that the accuracy of tenant income and subsidies are verified during management and occupancy reviews. These reviews provide HUD the opportunity to assess whether the property owner is ensuring that households receiving the benefits of subsidies and rental assistance are eligible under the statutory and program requirements and that any rental assistance provided is correctly calculated. Management and occupancy review findings identify areas that property owners need to address in order to satisfy HUD requirements.

Office of Housing or CA staff are to perform management reviews to monitor tenant eligibility and ensure accurate rents are charged at multifamily projects¹³. For 14,299 projects in place with CAs, HUD focuses its efforts on monitoring the CAs to see that they, in turn, are ensuring the housing owners are complying with statutory and regulatory requirements. For the remaining 7,844 Section 8 projects, HUD is responsible for direct oversight of the housing owner. The primary tool available to HUD is to conduct on-site reviews that assess the owners' compliance with HUD's occupancy requirements.

HUD's continued implementation of the CA initiative resulted in an increase in the total number of management reviews conducted during fiscal year 2003 compared with the previous year. However at the end of fiscal year 2003, a substantial portion of the portfolio was still HUD's direct responsibility and HUD conducted management reviews at only a small portion of that portfolio. According to data available in REMS, HUD conducted or had scheduled management reviews during fiscal year 2003 for 989 (12.6 percent) of the 7,844 projects receiving direct oversight by HUD. This represents a 2.1 percent decrease from fiscal year 2002 in the number of management and occupancy reviews performed on HUD administered properties. Additionally, HUD staff did not consistently apply the same procedures for all management and occupancy reviews. In many instances tenant income was not verified against documents in the tenants' files, the accuracy of tenant subsidies were not verified, and the results of management and occupancy reviews were not reported to the property owners within the required 30 days. For the six Hubs visited, we reviewed the factors used to determine the projects selected for management and occupancy review. We found that the selection was based primarily on factors related to the risks associated with deteriorating physical conditions and with the risks associated with loan default. The scheduling of reviews did not include an assessment of factors directly associated with the risk of owner non-compliance with occupancy requirements.

A comprehensive plan needs to be developed that would result in an increase of on-site reviews that would assess and ensure that all owners of assisted multifamily projects comply with HUD's occupancy requirements. Additionally, procedures should be implemented to ensure that tenant income is verified against source documents, the accuracy of tenant subsidies are verified, and the results of management/occupancy reviews are communicated to property owners within the required timeframe. The performance of management and occupancy reviews over assisted multifamily projects is essential in ensuring rental assistance is correctly calculated and that recipients are eligible.

¹³ Includes all types of management reviews (e.g. Management and Occupancy Reviews, Management and FHEO reviews, etc.) except "Management Review Only" and "FHEO Only" reviews, as these were not likely to address owner's compliance with occupancy requirements.

HUD's Actions Planned and Underway to Improve Multifamily Project Monitoring

Multifamily project monitoring is a combined effort on the part of HUD staff and, for the Section 8 assisted properties, the Performance-Based Contract Administrators. HUD will complete its PBCA initiative by awarding contracts in the remaining 9 geographic service areas in FY 2004. The FY 2004 Management Plan also includes a goal on maintaining the high level of management and occupancy reviews done by both PBCAs and HUD staff, by requiring at least 12,000 MORs in FY 2004. MORs will improve by having put in place at the end of FY 2003 improved occupancy and monitoring guidance to assure consistent reviews. HUD's MFH Program Office will maintain an overall comprehensive approach by requiring each office to perform risk assessments on its portfolio to prioritize its use of limited staff and travel resources. Our efforts will continue to focus on higher risk properties. Enforcement through the Departmental Enforcement Center will continue from referrals by REAC and Field offices. Other efforts supplementing risk management include implementation of the Integrated Assessment Sub-System (NASS) and the Active Partners Participation System (APPS), which gives MFH current information on properties and their owners and agents. Both systems are scheduled to come on line this Fiscal Year.

OIG's Assessment of HUD's Planned and Completed Actions

Our assessment of planned and completed actions is similar to that expressed last year. However, before repeating some cautions cited in last year's comments we would like to focus on noted improvements.

We are encouraged by the increased use PBCAs. We support the plans to increase the frequency of MORs for the assisted portfolio and suggest that similar to the approach to physical reinspections, they be performed more frequently for troubled and potentially troubled projects, and that occupancy review work be emphasized. We applaud HUD's efforts in designing the RHIIP and support the continued progress in addressing improper payments.

**Reportable Condition:
Controls over Project-Based
Subsidy Payments Need to
be Improved**

In prior reports on HUD's financial statements, we reported on long-standing weaknesses with the processing of subsidy payment requests under the project-based programs administered by the Office of Housing. PIH's Financial Management Center's (FMC) prepayment reviews of the Housing Assistance Payment (HAP) contracts administered by HUD were not sufficient to lower the risks associated with the subsidy payment process. In addition, we also reported that FMC's post payment reviews and the tracking of these review results were not an effective internal control to ensure owner compliance with HUD regulations. Historically, this process has been hampered by the need for improved information systems to eliminate manually intensive review procedures that HUD has been unable to adequately perform.

HUD administers various project-based assisted housing programs, most notably, Section 8. Although the payment processes differ under each program, HUD pays the difference between the contract rent for the units and that portion of the rent a tenant is required to pay (30 percent of income.). HUD administers about 25,000 assistance contracts. Of the estimated 25,000 assistance contracts, Contract Administrators (CAs), such as State Housing Finance Agencies (SHFA) and HAs, oversee contracts relating to about 18,000 multifamily projects. This is over half of the multifamily projects insured or assisted by HUD (32,000). The projects not subject to oversight by CAs remain under HUD's administration. Responsibility is split between the Office of Housing and PIH's FMC. For both CA and HUD administered contracts, project owners are responsible to verify household income reported by the tenants and submit requests for payments due under the HAP contracts to HUD or the CAs.

HUD's plan is for most HAP contracts to be transferred to CAs. When the contracts are transferred, the CAs will be responsible to ensure the tenant data are accurate. In addition, the CAs will be responsible for the financial management aspects of these Annual Contributions Contracts (ACCs). The CAs will verify and certify owner HAP requests and make payments based on actual amounts. Multifamily Housing staff in field offices will be responsible to monitor the performance of the CAs. Approximately 44 states and U.S territories have CAs that are currently administering HAP contracts. HUD's plan requires existing HAP Contracts (with some exceptions) to be converted to ACCs that will be administered by CAs under a performance based system. Those HAP contracts not converted to the performance based CAs will continue to be administered by HUD.

Risks associated with the subsidy payment process continue

To address the need for improved information systems for processing project-based subsidy payments, the Office of Housing developed the Tenant Rental Assistance Certification System (TRACS). Owners input tenant information into TRACS and the system calculates the HAP payment for each tenant. The Department's planned action to improve controls was to develop an automated program that compares voucher units with tenant data to determine which contracts have insufficient tenant data in TRACS. However, this goal has not been realized. The FMC conducts some testing for the Office of Housing related to the HAP contracts administered by HUD. At present, the bulk of FMC reviews compare tenant data submitted by owners to TRACS with tenant data submitted by owners in hard copy form. Reconciling owner input data to the owner prepared HAP voucher only ensures the two sets of owner data agree and the owner is consistent in what he includes on the voucher and in the system. The reconciliation does not show the tenant data is correct or payment is accurate. Housing has not directed the FMC to perform any other systematic testing of TRACS data.

Title VII, "Fiscal Guidance," of the GAO *Policy and Procedures Manual for Guidance of Federal Agencies*, requires prepayment examination of vouchers prior to their certification and payment, it permits the use of

statistical sampling for vouchers up to \$2,500. The agency is also required to review every voucher that exceeded \$2,500, but a waiver can be granted to an agency with significant number of vouchers to review if that agency establishes a sample methodology for selecting the vouchers for review. Furthermore GAO must approve the agency's sample methodology. In fiscal year 2003, approximately 61,000 vouchers with total payments of \$1.5 billion were processed for HUD administered HAP contracts. Of these 61,000 vouchers, over 53,000 (or 87 percent) had voucher amounts greater than or equal to \$2,500. However, HUD does not perform a statistical sample to consider the totality of the voucher population and does not perform a review of every voucher exceeding \$2,500. The FMC prepayment reviews uses TRACS data to identify the vouchers that exceed the 180 percent threshold. This threshold is based on an average of the last twelve payments. If the payment requested by the property owner is 180 percent or more of the average prior twelve payments then TRACS stops the payment and FMC is notified to perform a prepayment review on the voucher

Our review of the prepayment review process showed most HUD administered Section 8 HAP vouchers are being paid without sufficient review. For the first nine-month period of FY 2003, FMC's prepayment reviews covered 10 percent of the vouchers submitted for payment related to the HAP contracts administered by HUD. In addition, we found that these vouchers were paid (1) as long as 85 percent of the supporting tenant certifications were in TRACS; (2) without adjustments for errors found involving rental and utility rates; and (3) for rental subsidies claims more than one year old.

There is not an effective control to ensure compliance with HUD regulations

Historically, FMC field staff performed post payment reviews comparing information on the HAP voucher to TRACS. These comparisons, performed on a sample basis, were known as post payment reviews because the reviews were performed after the vouchers were paid. In past audits we criticized the FMC's post payment reviews because the views were not performed on a representative sample of contracts and sanctions were not enforced for violations. As previously noted the Department's planned action to improve controls over HUD administered project-base Section 8 voucher payments was to develop an automated program that compares voucher units with tenant data to determine which contracts have insufficient tenant data in TRACS. Instead of moving forward with this initiative, the Office of Housing eliminated the post-payment reviews and assumed the risks that project owners are not in compliance with HUD regulations. We continue to recommend that the Office of Housing expedite the development of the automated process to identify non-compliance with tenant reporting requirements.

HUD's Actions Planned and Underway to Improve the Subsidy Payment Process

Each report on HUD's financial statements since HUD has been subject to audit under the provisions of the CFO Act has identified the lack of effective controls over the project-based subsidy payment process. To improve the subsidy payment process, HUD has several planned development initiatives:

1. Complete the mass conversion of the section 8 contracts from HUDCAPS to PAS/LOCCS including changing the non-performance-based CAs to the PBCAs by September 2004.
2. Implement the Tenant Optimum Compliance initiative to enforce the tenant reporting requirements in TRACS. The Office of Housing is pursuing development and implementation of automated tools to identify and appropriately respond to subsidy recipients and contract administrators that are not providing the required TRACS data. The development work will be complete in early calendar year 2004. The Office of Housing is also working with the Office of General Counsel (OGC) and the Enforcement Center (EC) on authorized and appropriate actions to be implemented in response to non-compliant program participants.
3. Start the Business Process Re-engineering (BPR) of the Multi-family Housing Rental Assistance Business and develop a TRACS based eGov solution. The Multi-family Housing has long envisioned the seamless integration of the contracting process, tenant certification process, and the subsidy payment process in TRACS. At present time these processes remain disjoint in terms of TRACS transaction processing and information access.

OIG's Assessment of HUD's Planned and Completed Actions

Most HUD administered Section 8 HAPs are being paid without any HUD review because the FMC is only able to review about 10 percent of the vouchers before payment. The reviews are of limited value and only ensure the two sets of owner data agree. The reconciliation does not show the payment is accurate. HUD has elected to address the Section 8 control weakness through the transfer of the functions to CAs. HUD has transferred HAP contracts to CAs in approximately 44 states including U.S. territories thus far. HUD needs to complete the transfer, and adequately monitor the CAs' performance. At present time, the number of HUD administered Section 8 HAP contracts and the dollar amounts paid are significant enough to justify that the Office of Housing and FMC should comply with Title VII, "Fiscal Guidance," of the GAO *Policy and Procedures Manual for Guidance of Federal Agencies*, requirements.

When completely implement, the Tenant Optimum Compliance initiative and the BPR of the Multi-family Housing Rental Assistance Business should provide an effective control to ensure compliance with HUD regulations.

System and Accounting Issues

HUD Needs to Address System and Accounting Weaknesses

In our earlier discussion of concerns with HUD's internal control environment, we stressed the need for HUD to complete on-going efforts to improve its financial systems. Because of the large volume of financial transactions, HUD relies heavily on automated information systems. In prior years, we reported on security weaknesses both in HUD's general processing and specific applications such that HUD could not be reasonably assured that assets are adequately safeguarded against waste, loss, and unauthorized use or misappropriation. Progress in improving these controls has been slow. Presented below is a discussion of the weaknesses noted which relate to the need to improve:

- controls over the computing environment, and
- administration of personnel security operations.

We also discuss the need for HUD to improve its processes for reviewing outstanding obligations.

Reportable Condition: Controls Over HUD's Computing Environment Can be Further Strengthened

HUD's computing environment, data centers, networks, and servers, provide critical support to all facets of the Department's programs, mortgage insurance, servicing, and administrative operations. In prior years, we reported on various weaknesses with general system controls and controls over certain applications, as well as weak security management. These deficiencies increase risks associated with safeguarding funds, property, and assets from waste, loss, unauthorized use or misappropriation.

HUD needs to reduce the risk of unauthorized activities

We evaluated selected information systems general controls of the Department's computer systems, on which HUD's financial systems reside. We also reviewed information system application controls for the Public and Indian Housing Information Center (PIC) and the Tenant Rental Assistance Certification System (TRACS) and controls over the IT contingency planning process. This audit report summarizes the control weakness found during the review and does not contain related recommendations. The details on the result of the reviews and recommendations are reported in three separate audit reports¹⁴.

¹⁴ Audit Report Number 2004-DP-0001, "Fiscal Year 2003 Review of Information Systems Controls in Support of the Financial Statements Audit," dated December 1, 2003; Audit Report Number 2003-DP-0001, "Public and Indian Housing Information Center," dated September 10, 2003; and "Application Control Review of Tenant Rental Assistance Certification System," to be issued during January 2004.

Our review found information systems controls weaknesses that could negatively affect the integrity, confidentiality, and availability of computerized data. This is due to HUD's noncompliance with Appendix III of OMB Circular A-130, NIST requirements and standards, as well as HUD's own internal policies and procedures.

Mainframe Environment

User access administration needs to be improved.

User access administration for the Hitachi mainframe computer needs to be improved. There were user-Ids belonging to HUD employees and contractors that should have been removed because they were inactive for more than 180 days. We also found user-Ids belonging to terminated contractors still on the system even though the application program office had submitted requests to have them removed from the system. NIST SP 800-14, "*Generally Accepted Principles and Practices for Securing Information Technology Systems*," indicates that organizations should ensure effective administration of users' computer access to maintain system security, including user account management, auditing and the timely modification or removal of access. Terminated employees who continue to have access to critical or sensitive resources pose a major threat.

A system programmer also serves as backup for the Top Secret¹⁵ administrator. The GAO *Federal Information System Control Audit Manual* (FISCAM) indicates that different individuals should perform system programming and data security duties. Inadequately segregated duties increase the risk that erroneous or fraudulent transactions could be processed, that improper program changes could be implemented, and that computer resources could be damaged or destroyed.

The DB2 system audit trail reports are not reviewed.

Although the DB2 system audit trail is turned on, the reports are not being reviewed because Offices within the OCIO assumed the other parties should be responsible for their review. DB2 is IBM's database software used by HUD to manage data for at least 17 HUD applications including HUDCAPS and TRACS. GAO FISCAM and NIST SP 800-14 indicate that audit trails should be reviewed periodically; suspicious activities investigated; and appropriate action taken. By not reviewing the audit trail, unauthorized, unusual, or sensitive access activities will not be identified and appropriate action will not be taken to identify and remedy the control weaknesses. Further, violators will not be deterred from continuing inappropriate access activity, which could cause embarrassment to the Department and result in financial losses and disclosure of confidential information. HUD has indicated that while the Department currently does not have the staff or expertise to review the audit trail reports, the DB2 system audit trail reports will be reviewed under a recently awarded infrastructure contract.

¹⁵ HUD uses Top Secret as the standard security software package to secure the Department's operating system environment under the Hitachi platform.

Network Environment

Weaknesses in HUD network security were found during a vulnerability assessment.

A number of weaknesses in HUD network security were found during a vulnerability assessment performed during July by a HUD subcontractor. Some of the weaknesses had been previously reported to HUD following a vulnerability assessment performed from October 29, 2001 through November 5, 2001 by an OIG contractor. OMB A-130 indicates that Agencies shall protect information commensurate with the risk and magnitude of the harm that would result from the loss, misuse, or unauthorized access to or modification of such information. Also, HUD's Handbook 2400.24 indicates that information processed by HUD networks and associated equipment must be properly safeguarded against unauthorized access, modification, disclosure, destruction, or denial of use.

The SSO InSync software does not use triple DES to encrypt passwords.

The HUD implemented Single Sign-on (SSO) InSync software product does not use triple Data Encryption Standard (DES) to encrypt passwords. Federal Information Processing Standards Publication (FIPS PUB) 46-3, "*Data Encryption Standard*," indicates that triple DES is the approved symmetric encryption algorithm of choice. Technological advances have made it more feasible to break weak encryptions

The Department has not implemented certain password rules for the Windows 2000 Operating System as recommended by the NIST, National Security Agency (NSA), and Microsoft.

Software Configuration Management

Configuration Management (CM) is the control and documentation of changes made to a system's hardware, software and documentation throughout the development and operational life of the system. HUD uses the automated CM management tool called PVCS to control software changes and releases for applications on the client-server and web applications, and Endeavor on the IBM compatible Hitachi mainframe computers. All software changes, including emergency fixes, must go through the CM tools such as PVCS and ENDEVOR.

Inadequate CM Quality Assurance and monitoring procedures.

The Department does not have adequate CM Quality Assurance (QA) and monitoring procedures to review activities to ensure they adhere to established CM plans, standards, and procedures. Below are examples of deficiencies that could have been detected had QA procedures been implemented. Some were corrected after we brought them to the Department's attention.

- HUD has not maintained the integrity and accuracy of development versus production software inventories on the Hitachi mainframe. Software discrepancies exist for applications including SAMS and TRACS. Our review found numerous modules that exist in the production environment but are not in the Endeavor environment or vice versa. We also found that many

of the same modules in both Endeavor and Production environments are not identical.

- Instances of TRACS developers moving software into the Endeavor PROD environment were noted; however, there was no documentation to support independent review and approval of the moves.
- Some client server development contractors were granted excessive privileges in PVCS for TRACS and the Integrated Automate Travel System.
- The TRACS development team did not follow proper procedures for conducting CM emergency fixes, including the use of maintenance libraries.
- The CM implementation team did not remove access for eight contractors when TRACS submitted the request during February 2003.

NIST SP 800-14 indicates that the effectiveness of security controls also depend on such factors as system management, quality assurance, and internal and management controls. GAO FISCAM indicates that periodic management reviews are essential to make certain employees are performing their duties in accordance with established policies. Monitoring ongoing activities that assess the internal control performance over time ensures that identified deficiencies are reported to senior management.

Public and Indian Housing Information Center

PIC is designed to facilitate a more timely and accurate exchange of data between Public Housing Authorities (PHAs) and local HUD offices by allowing PHAs to electronically submit information to HUD. Since its inception in December 1999, more than 600 transactional web pages have been created; a detailed inventory of 1.3 million public housing units was established; and tenant family data for 3.5 million households was gathered. PIC represents the largest Internet-based system in HUD with over 3.6 million lines of code. There are approximately 4,000 user logins each day made by over 12,000 authorized HA and HUD users. These users upload over 800 files to PIC daily, with the PIC system processing over thirty thousand Family Reports (form HUD-50058s), which equates to over one million transactions per day.

The audit was limited to a review of the PIC Security Maintenance sub-module, which controls user access for more than 12,000 users utilizing three separate databases. It allows PIC security administrators to create and maintain users and user roles. PIC security administrators assign roles to users and determine which user roles have access to the different entities and security levels within the respective system modules.

We found that security planning in the system life cycle for the PIC system was inadequate. Comprehensive system sensitivity and risk assessments were not performed in the initiation and development/acquisition phases of the system life cycle. Additionally, we found that a comprehensive security policy and goals were not prepared in formulating the design of the security aspects of the PIC system. As a result, several operational and technical security control weaknesses were found during the audit. Specifically, we found:

- inadequate PIC system design structure and documentation has impeded PIH's ability to monitor and control users' computer access;
- no comprehensive process has been established to monitor and control PIC user access;
- access controls over the Security Administration sub-module are not adequate;
- separation of duties is needed over the System Administration function;
- inadequate controls exist over confidential and sensitive PIC data;
- access controls need to be strengthened to identify and authenticate users to the PIC application and database; and
- system and application audit logs are not being utilized for security and system maintenance purposes.

Without adequate security controls over the PIC system, HUD is at risk that data errors and omissions and system disruptions could occur, and that the system could be exploited by unauthorized individuals for fraud and identity theft as well as the potential for destruction of data by malicious hackers and disgruntled employees.

Tenant Rental Assistance Certification System

TRACS is an integrated system that serves as the sole repository of tenant certifications and contract data for the Office of Housing's rental assistance programs. These programs include Section 8, Rental Supplemental, Rental Assistance Program, Section 236, Section 202, and Section 811. TRACS provides input to payment processing of the project-based rental assistance programs administered by the Office of Housing based upon the contract and tenant data resident in the system.

Our audit of TRACS focused on reviewing the effectiveness of the system security access controls to ensure that data is protected against errors, loss, or unauthorized use. We found that:

- security controls over the TRACS database, production data files, and programs need improvement;
 - software configuration management needs improvement;
 - contractors were granted excessive access privileges to TRACS;
-

- weak personnel security practices pose a risk of unauthorized access to TRACS;
- adequate system-specific security training has not been provided;
- a lack of segregation of duties between key security personnel functions;
- a lack of audit trails at the application level to detect security violations, performance problems, or to monitor and log user activities; and
- the Test Center’s ID and password for the TRACS client server were revealed in the HUD Application Release Tracking System release document.

Well-chosen security rules and procedures protect important assets and support the organizational mission. They can reduce the frequency and severity of computer security-related losses.

Development of Contingency Plans

Contingency planning needs improvement

There is inadequate assurance that HUD can recover operational capability in a timely, orderly manner or perform essential departmental functions during an emergency or situation that may disrupt normal operations. Our review showed the current IT contingency planning process at HUD does not fully utilize the seven steps process as recommended in the NIST SP 800-34, “*Contingency Planning Guide for Information Technology Systems*.” The Department has not adopted NIST SP 800-34 definitions for contingency related plans, revised current plans, and developed additional plans to address areas defined by NIST that are not covered in existing plans. The NIST defined IT Contingency Plan is equivalent to HUD’s Business Resumption Plan (BRP). In addition, the Department has not updated the BRP to take into consideration non-traditional disasters that include massive regional power blackouts like the one that recently occurred on August 14, 2003 and terrorist strikes in the magnitude of the events of September 11, 2001.

Testing of Contingency Plans

HUD has inadequate assurance that it can recover from an emergency or situation that may disrupt normal operations.

The Department suspended annual testing of the Business Resumption Plan (BRP) during 2003 in anticipation that the new HITS contract will alter the IT infrastructure. NIST SP 800-34 states that contingency considerations should not be neglected because a computer system is retired or another system replaces it. Until the new system is operational and fully tested (including its contingency capabilities), the original system’s contingency plan should be ready for implementation. NIST recommends that existing contingency plans be tested at least annually and when significant changes are made to the IT system, supported business processes, or the IT contingency plan. Each element of the contingency plan should be tested first individually and then as a whole

to confirm the accuracy of recovery procedures and the overall effectiveness.

HUD's Actions Planned and Underway to Improve Controls Over Its Computing Environment

The Department agreed to implement our recommendations relating to the mainframe environment, software configuration management, contingency planning, and PIC.. HUD has also agreed to implement our recommendations pertaining to the network environment with the exception to implement triple DES on the InSync component of the Single Sign-on product. HUD interprets FIPS PUB 46-3 as requiring implementation of triple DES for new systems only. The Single Sign-on password synchronization product was fully implemented in May 1, 2002. Therefore, the Department does not believe this standard is applicable. HUD has verbally agreed to the findings and recommendations pertaining to TRACS. Formal responses will be incorporated in the audit report "Application Control Review of Tenant Rental Assistance Certification System," to be issued during January 2004.

OIG's Assessment of HUD's Plans and Completed Actions

We agree with the Department's intent to implement our recommendations relating to the mainframe environment, network environment, software configuration management, contingency planning, and PIC. With regard to the interpretation of FIPS PUB 46-3, the Publication is applicable to the Single Sign-on password synchronization product because the standard was reaffirmed and made available for Federal agencies' usage on October 25, 1999, more than two years prior to the product implementation date of May 1, 2002. Our discussions with the product vendor and personnel within the OCIO found that the SSO vendor intends to upgrade the InSync component to utilize the Advanced Encryption Standard (AES) in the next product release. AES is also a FIPS-approved¹⁶ encryption algorithm that was developed subsequent to DES and could be used in place of triple DES. When available, HUD should upgrade the SSO software.

Reportable Condition:
Weak Personnel Security Practices Continue to Pose Risks of Unauthorized Access to the Department's Critical Financial Systems

For several years we have reported that HUD's personnel security over critical and sensitive systems' access has been inadequate. Although HUD has made some progress to address the reported problems, risks of unauthorized access to the Department's critical financial systems remain a major concern. Without adequate personnel security practices, inappropriate individuals may be granted access to HUD's information and resources that could result in destruction or compromise of critical and sensitive data.

¹⁶ FIPS PUB 197, "Advanced Encryption Standard (AES)"

A key control over systems access by employee and contractor personnel is the requirement for background screening. OCIO is responsible for providing policy, guidance, and oversight for information security. HUD's system owners of critical and sensitive financial applications such as LOCCS, PAS and HUDCAPS, are responsible for determining the appropriate levels of access for contractors and employees. The level of access required determines the appropriate level of screening for system users. The security administrators for each of the systems are responsible for ensuring that the investigative requirements are met for each user granted more than read (query) access to mission-critical and sensitive systems. The Office of Security and Emergency Planning (OSEP) under the Office of Administration (OA) is responsible for the operations of the personnel security program, which includes the processing, tracking, and reporting of background investigations.

In last year's audit, we reported that HUD had users who were granted access to HUD's critical and sensitive systems but lacked the appropriate background investigations. Although HUD has made significant progress in reducing this backlog, weaknesses remain in this area. Our review found that OCIO does provide OSEP with a list of users with greater-than-read access to the Hitachi and Unisys mainframes. OSEP uses this list to compare against the data residing in the Security Control and Tracking System (SCATS)¹⁷ database on a periodic (at least quarterly) basis. However, this reconciliation is not accurate because the list is incomplete. Although the IT Operations Security Branch does require users to submit proper user access forms (HUD Form 22017) before they are allowed read only access to a system, the application system security administrator can grant greater-than-read access to specific applications without notifying the IT Operations Security Branch or the OSEP. In essence, although OCIO may be enforcing the policy, the process is not working as it pertains to granting greater-than-read or upgrading access privileges at the application level. In addition, the IT Operations Security Branch does not track users with greater-than-read access at the application level nor is there any mechanism or system in place that would support this effort. As a result, there are instances where users with greater-than-read access at the application level do not have background investigations.

Our audit of application controls of TRACS found 37 out of 870 TRACS users with greater-than-read access privileges who do not have background investigations. The finding indicates that inappropriate access to TRACS was granted because (1) policy requiring users requesting above read access to HUD's mission-critical and sensitive systems to submit proper investigation forms before they are allowed access to the systems is not being adhered to; (2) there is no automated

¹⁷ The SCATS database tracks background investigations for all HUD employees and contractors working in sensitive positions or employees who require certification for access to sensitive systems.

system or mechanism in place that requires the TRACS Security Administrator to coordinate with the IT Operations Security Branch and OSEP prior to granting a user greater-than read access privileges to users with existing read only access; and (3) the IT Operations Security Branch does not have a central repository that would serve as a master inventory tracking system to track all users' access levels for HUD's general support and application systems. As a result, unauthorized users have access to sensitive and critical data and may cause damage, misuse or interact in fraudulent activities and compromise the confidentiality, integrity, and availability of the critical and sensitive data.

The details on the result of the reviews and recommendations are reported in separate audit reports.¹⁸

HUD's Actions Planned and Underway to Correct Personnel Security Weaknesses

The Department agreed to implement our recommendations relating to the personnel security.

OIG's Assessment of HUD's Plans and Completed Actions

The Department has agreed to implement our recommendations relating to personnel security.

**Reportable Condition:
HUD Needs to Improve
Processes for Reviewing
Obligation Balances**

HUD needs to improve controls over the monitoring of obligated balances to determine whether they remain needed and legally valid as of the end of the fiscal year. HUD's procedures for identifying and deobligating funds that are no longer needed to meet its obligations are not always effective. This has been a long-standing weakness. Our review of the 2003 year-end obligation balances showed \$1.1 billion in excess funds that needed to be deobligated. Although HUD has made some progress in implementing procedures and improving its information systems to ensure accurate data are used, further improvements in financial systems and controls are still needed. Major deficiencies include:

- Obligations identified as invalid are not being deobligated in a timely manner.
- Timely reviews of unexpended obligations are not being performed.

¹⁸ Audit Report Number 2004-DP-0001, "Fiscal Year 2003 Review of Information Systems Controls in Support of the Financial Statements Audit," dated December 1, 2003 and "Application Control Review of Tenant Rental Assistance Certification System," to be issued during January 2004.

- A lack of integration between accounting systems and the need for accurate databases has hampered HUD's ability to evaluate unexpended Section 8 and Section 236 obligations.
- Excess funds are not being considered in the budget formulation process.

Since fiscal year 1998, our audit reports on HUD's financial statements have contained a reportable condition that HUD needs to improve processes for reviewing obligation balances. As a result of reporting requirements of the Statement of Budgetary Resources, additional deficiencies noted during this year's review, and the increased emphasis placed on the reported obligation balances by Congress and OMB, we are still assessing these concerns as a reportable condition.

Annually, HUD performs a review of unliquidated obligations to determine whether the obligations should be continued, reduced, or canceled. We evaluated HUD's internal controls for monitoring obligated balances. As in prior reports, we found a number of weaknesses in the process including: (1) offices not deobligating funds that are no longer needed to meet its obligations in a timely manner and (2) underlying financial systems do not support the process for identifying excess budget authority.

HUD is not deobligating unneeded funds in a timely manner

Requests for obligation reviews were forwarded by the CFO to the program and administrative offices. In fiscal year 2003, HUD used an automated review process and made the obligation listing accessible via the web. The focus of the review was on program obligations that exceeded a \$200,000 balance and administrative obligations that exceeded \$25,000. Excluding the Section 8 programs, which undergo a separate review process by the program offices, the total dollar amount of obligations identified for review totaled \$32 billion. Of the \$32 billion, \$169.1 million, involving 4,541 transactions, was identified for deobligation. We tested 2,580 of the 4,541 transactions to determine whether the balances had been deobligated in HUDCAPS. We found that, as of September 30, 2003, 126 of the 2,580 transactions with obligational authority of \$29 million had not been deobligated in HUDCAPS.

HUD needs to place additional emphasis on identifying excess reserves in Section 8 programs

Section 8 budget authority is generally available until expended. As a result, HUD should periodically assess and identify excess program reserves in the Section 8 programs as an offset to future budget requirements. Excess program reserves represent budget authority originally received, which will not be needed to fund the related contracts to their expiration. While HUD had taken some action to identify and recapture excess budget authority in the Section 8 programs, weaknesses in the review process and inadequate financial systems continue to hamper HUD's efforts. There is a lack of automated interfaces between PIH and the Office of Housing subsidiary records with the Department's general ledger for the control of program funds. This necessitates that HUD and its contractors make extensive use of ad

hoc analyses and special projects to review Section 8 contracts for excess funds. This has hampered HUD's ability to timely identify excess funds remaining on Section 8 contracts.

HUD needs to develop an accurate database for evaluating Section 8 project-based obligations.

The Office of Housing has been hampered in its attempts to evaluate unexpended Section 8 project-based budget authority balances. The requirement to evaluate data from two payment methods, managed by two accounting systems (HUDCAPS and PAS/LOCCS) has hampered Housing's ability to monitor obligations and execute recaptures uniformly for contracts in both systems. In fiscal year 2003, \$1.0 billion in unliquidated obligation balances were recaptured in the Section 8 project-based program on expired contracts. However, excess funds on Section 8 project-based contracts were not always being recaptured and considered in the budget process.

Housing did not consider expired budget authority from Section 8 project-based contracts maintained in HUDCAPS when formulating their budget request for contract renewals. Through the annual budget process, Housing made requests to fully fund contract renewals for Section 8 project-based contracts. In addition, any excess budget authority from the expired contracts was rolled forward to the subsequent contract renewals.

Review of the FMC budget estimate of shortfalls and excesses for project-based Section 8 contracts in HUDCAPS for fiscal year 2004 and out years showed an estimated \$351 million in excess budget authority expected to be realized during fiscal year 2004 related to expiring Section 8 project-based contracts that would be renewed. In addition, the fiscal year 2004 budget request includes full funding for Section 8 project-based contract renewals. Because Housing did not have a process in place to recapture these funds and used the excess funds for contract renewals, fiscal year 2004 budget authority was not required for these contract renewals. HUD officials stated that they did not have a system in place to estimate recoveries from expired budget authority associated with this group of contracts. As reported in last year's audit report, review of fiscal years 2002 and 2003 contract renewals showed an additional \$610 million in excess budget authority that was rolled over to contract renewals, while at the time full budgetary funding was received.

In addition, review of the Section 8 project-based contracts in HUDCAPS and PAS/LOCCS showed 685 and 152 contracts respectively that had expired prior to September 30, 2002 with available contract /budget authority. These 837 contracts had \$135 million in excess funds potentially available for immediate recapture. HUD needs to address data and systems weaknesses to ensure all contracts are considered in the recapture/shortfall budget process.

During fiscal year 2003, PIH performed an analysis of budget authority for the Section 8 tenant-based program and Moderate Rehabilitation (Mod Rehab) program and recaptured approximately \$550 million and \$277 million respectively of the unexpended budget authority. This is funding

that housing agencies received under contracts with HUD but did not expend or is not needed to make payments for housing assistance or Mod Rehab contracts.

HUD needs to continue efforts to improve the accounting for the Section 236 Interest Reduction Program

The Office of Housing and the CFO have been hampered in their attempt to determine and account for unexpended Section 236 Interest Reduction Program (IRP) budget authority balances. HUD's reporting of commitments under the insured mortgage component of the Section 236 IRP program was not accurate. There was a difference of approximately \$857 million between the subsidiary and general ledgers for the Section 236 program at the end of fiscal year 2003. The cause of the problem was the lack of an integrated accounting system to support the accounting for the Section 236 IRP Program.

The Section 236 program was created around 1965 and ceased new activity during the mid 1970's. The contracts entered into under the program typically run up to 40 years. The activities carried out by this program include making interest reduction payments directly to mortgage companies on behalf of multifamily project owners. As an incentive to attract developers into the 236 program, participants were given the right to prepay their subsidized mortgage after 20 years.

Historically, HUD has chosen to estimate the amount of Section 236 commitment balance in HUD's financial statements due to the extensive staff effort required to review manual records in order to accurately report its commitments. During fiscal year 2003 HUD reconciled the general ledger to the subsidiary ledgers, established amortizations schedules for all insured properties, and developed procedures to ensure changes in the portfolio are identified and recorded. However, HUD still needs to further develop an integrated accounting system to support the accounting for the Section 236 IRP Program. HUD reported \$5.2 billion in commitments under the insured section of the Section 236 IRP program per the Treasury SF-133 as of September 30, 2003. Review of the general ledger and subsidiary records showed that \$857 million in commitments had not been recaptured for prepayments of loans made during fiscal year 2003. Commitments associated with contracts liquidated were not being reduced in the general ledger because prepayment information was not being relayed to the accounting department regarding program participants that have prepaid and liquidated their subsidized mortgage. Once the Section 236 mortgage is prepaid and liquidated, the IRP interest subsidy contract terminates. As a consequent of not recognizing contract prepayments, the Section 236 commitment balance was overstated. HUD needs to promptly record contract liquidations and recapture the associated obligated contract authority and imputed budgeted authority.

HUD needs to recapture undisbursed contract authority for Rental Assistance and Rent Supplement programs

HUD processed an adjustment for \$857 million, but reversed the adjustment prior to closing the accounting period. As a result of our review, HUD processed an adjustment to the 2003 Consolidated Financial Statements for \$857 million in excess unexpended funds.

HUD is not timely recapturing excess undisbursed contract authority from the Rent Supplement and Rental Assistance Payments (RAP) programs. HUD needs to take the necessary steps to review and deobligate, where appropriate, prior year undisbursed amounts.

The Rent Supplement and RAP programs were created around 1965 and 1974 respectively. The Rent Supplement program under, "Section 235," and RAP, under "Section 236," operate much like the current project-based Section 8 rental assistance program. Rental assistance is paid directly to multi-family housing owners on behalf of eligible tenants.

HUD's subsidiary ledgers show, for each fiscal year, the amount authorized for disbursement and the amount that was disbursed. Funds remain in these accounts until they are paid out or deobligated by the accounting department. If the funds are not paid out or deobligated then the funds remain on the books, overstating the required contract authority.

At the end of fiscal year 2003 the general ledger balances for RAP and Rent Supplement totaled \$2.05 billion. There were 925 participants in the programs. We statistically sampled 30 of the 925 projects to determine if prior years' contract authority had been recaptured. For the 30 projects, we reviewed the subsidiary ledgers to determine if there were funds that had been authorized prior to fiscal year 2003 but not disbursed. We found that the 30 projects had \$1.2 million in undisbursed contract authority from fiscal year 2002 or prior that remained on the accounting records. Projecting our sample results to the universe of RAP and Rent Supplement contracts, we estimate that \$41 million in fiscal year 2002 and prior fiscal year funds is excess and could be recaptured.

HUD's Actions Planned and Underway to Improve the Process for Reviewing Obligation Balances

Concerning HUD not deobligating funds in a timely manner, HUD plans to deobligate the \$29 million as associated contracts are closed. In the future, HUD plans to emphasize the timely completion of contract closeouts and obligation reviews.

The Office of Multifamily Housing, Financial Management Center, and Office of the CFO are working together to eliminate the requirement to evaluate data from two payment methods, managed by two accounting systems (HUDCAPS and PAS/LOCCS) which has hampered Housing's ability to monitor obligations and execute recaptures uniformly for contracts in both systems. The effort will be made to convert contracts in HUDCAPS to the PAS/LOCCS payment method in FY 2004. If successful and when completed, the conversion will:

- a. Bring all project-based contracts under the PAS/LOCCS payment method that is based on actual subsidy, and will eliminate for Housing's Section 8 inventory the current HUDCAPS payment

method of advancing funds to housing authorities based on estimated subsidy payments;

- b. Facilitate timely recapture of expired budget authority for contracts currently in HUDCAPS;
- c. Permit budgeting for all project-based contracts in a uniform manner; and
- d. Permit application of reviews against TRACS tenant data, which cannot be accomplished as long as payments are made via the current HUDCAPS payment procedures.

For the \$135 million in unliquidated obligations for expired Section 8 project-based contracts identified as excess, HUD plans to further analyze the projects and process recaptures where warranted.

For the Section 236 IRP, HUD processed an adjustment to the 2003 Consolidated Financial Statements for \$857 million in excess unexpended funds. HUD plans to strengthen procedures to support the accounting for the Section 236 IRP program by establishing the Section 236 projects in PAS/LOCCS during fiscal year 2004.

For the \$41 million in excess undisbursed contract authority in the Rent Supplement and Rental assistance programs, HUD plans to further analyze the projects during the first quarter of fiscal year 2004 and process recaptures where warranted.

OIG's Assessment of HUD's Planned and Completed Actions

HUD's proposed actions to improve the Section 8 project-based and Section 236 IRP accounting systems and the continued emphasis on improving the integrity of the accounting information should facilitate the recapture and budgeting for Section 8 and Section 236 funds.

For the Department's program funds, HUD needs to promptly perform contract reviews and recapture the associated excess contract/budget authority. In addition, HUD needs to address data and systems weaknesses to ensure all contracts are considered in the recapture/shortfall budget process.

With respect to project-based Section 8 contracts, we recommended in our audit of the Department's fiscal year 1999 financial statements that systems be enhanced to facilitate timely close-out and recapture of funds. We also recommended at that time, that the closeout and recapture process occur periodically during the fiscal year. Implementation of the recommendations is critical so that excess contract/budget authority can be timely recaptured and considered in formulating requests for new budget authority.

HUD needs to recoup excess funds retained by PBCAs

The Office of Housing needs to recoup Section 8 funds due to HUD from Performance Based Contract Administrators (PBCAs). Our review of HUD disbursements to PBCAs showed approximately \$17.5 million in overpayments of Section 8 funds. PBCAs assist Housing in managing its portfolio of properties, including the disbursement of subsidies to property owners who participate in the Section 8 program. Beginning in fiscal year 2000, PBCAs received regularly scheduled payments throughout the year for each managed property based on the property's annual budget. At year-end, a settlement statement was to be prepared to reconcile budgeted amounts with actual expenditures. However, settlement statements were not prepared by the PBCAs for fiscal year 2000 because Housing did not issue the necessary guidance.

In April 2001, Housing replaced the budget-based process for disbursing Section 8 funds with a process based on actual expenditures. However, approximately \$17.5 million due HUD from the budget-based process was never returned to HUD from the PBCAs. Housing needs to establish year-end settlement procedures to facilitate the remittance of excess Section 8 funds retained by PBCAs.

HUD's Actions Planned and Underway to Collect Section 8 Funds from PBCAs

Housing has identified the amount of Section 8 funds due HUD from the PBCAs and the interest earned on these funds. In addition, Housing has drafted year-end settlement procedures for use by the PBCAs to facilitate the return of the excess Section 8 funds identified.

OIG Assessment of Planned Actions

Housing's proposed actions should ensure that Section 8 funds are returned to HUD

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Compliance with Laws and Regulations

HUD Did Not Substantially Comply With the Federal Financial Management Improvement Act

FFMIA requires auditors to report whether the agency's financial management systems substantially comply with the Federal financial management systems requirements, applicable accounting standards, and the SGL at the transaction level. FFMIA requires agency heads to determine, based on the audit report and other information, whether their financial management systems comply with FFMIA. If they do not, agencies are required to develop remediation plans and file them with the Office of Management and Budget (OMB).

During fiscal year 2003, the Department continued to address its financial management deficiencies and has taken steps to bring the agency's financial management systems into compliance with FFMIA. HUD has continued to obtain independent reviews of its financial management systems to verify compliance with financial system requirements, identify system and procedural weaknesses and develop the corrective actions steps to address identified weaknesses.

HUD implemented a new FHA automated general ledger in October 2002. This new system automated FHA's posting of transactions to the Standard General Ledger. This process was previously performed manually. As a result of this implementation, the Office of Housing has certified that eleven previously noncompliant systems are now substantially compliant with Federal Financial Management Guidelines. The FHA Subsidiary General Ledger Project is a multiphase project to be completed by December 2006.

With the implementation of the FHA Subsidiary System, the Department became substantially compliant with FFMIA Standard General Ledger provision and is moving in the direction of becoming FFMIA compliant with (1) Federal financial management systems requirements and (2) Federal Accounting Standards. We have included the specific nature of noncompliance issues, responsible program offices and recommended remedial actions in Appendix C of this report.

In its *Fiscal Year 2003 Accountability Report*, HUD reports that 4 of its 46 financial management systems do not comply with the requirements of FFMIA and OMB Circular A-127, *Financial Management Systems*. Even though 42 individual systems have been certified as compliant with Federal Financial Management Systems Requirements, collectively and in the aggregate, deficiencies still exist. In addition to deficiencies noted in HUD's Accountability Report, we report as a material weakness that *Financial Management Systems are Not Substantially Compliant with Federal Financial Systems Requirements*. This material weakness addresses how HUD's financial management systems remain substantially noncompliant with Federal financial management requirements, which represent a material weakness in internal controls.

Federal Financial
Management System
Requirements

We report, as a reportable condition that *Controls over HUD's Computing Environment Can be Further Strengthened*. . This reportable condition discusses how (1) the Department needs to improve its entity wide security; (2) access controls need to be improved on the IBM compatible Hitachi and network environments; and (3) quality assurance needs to be implemented to improve software change controls. Independent A-127 compliance reviews have disclosed that security over financial information is not provided in accordance with OMB Circular A-130 *Management of Federal Information Resources*, Appendix III and the Government Information Security Reform Act. In addition, OIG audit reports issued during the fiscal year have reported weaknesses in HUD's Information Security Program and deficiencies and weaknesses in the Public and Indian Housing Information Center.

Compliance with Federal Accounting Standards

KPMG LLP reported a material weakness regarding HUD/FHA's limited ability to (1) fully integrate its financial processing environment and (2) effectively monitor budget execution related to certain funds control processes. As a result of the financial and operational ADP issues, FHA is unable to fully integrate, monitor and control its budgetary resources. (Statement of Federal Financial Accounting Standards (SFFAS) Number 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*).

**PRINCIPAL
FINANCIAL
STATEMENTS**

Introduction

The principal financial statements have been prepared to report the financial position and results of operations of the Department of Housing and Urban Development, pursuant to the requirements of the Chief Financial Officers Act of 1990 (31 U.S.C. 3515 (b)). While the financial statements have been prepared from HUD's books and records in accordance with formats prescribed by the Office of Management and Budget, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

The principal financial statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. One implication is that liabilities reported in the financial statements cannot be liquidated without legislation that provides resources to do so.

The financial statements included in this annual report are as follows:

- Consolidated Balance Sheet
- Consolidating Statement of Net Cost
- Consolidated Statement of Changes in Net Position
- Combined Statement of Budgetary Resources; and
- Consolidated Statement of Financing

These financial statements include all of HUD's activities, including those of the Federal Housing Administration and the Government National Mortgage Association. These financial statements cover all of HUD's budget authority.

Department of Housing and Urban Development
Consolidated Balance Sheet
As of September 30, 2003 and 2002
(Dollars in Millions)

	2003	2002
ASSETS		
Intragovernmental		
Fund Balance with Treasury (Note 3)	\$76,458	\$77,632
Investments (Note 5)	31,260	28,342
Accounts Receivable (Note 7)	0	3
Other Assets (Note 8)	4	
Total Intragovernmental Assets (Note 6)	\$107,722	\$105,977
Investments (Net) (Note 5)	123	
Accounts Receivable (Net) (Note 7)	569	785
Credit Program Receivables and Related		
Foreclosed Property (Net) (Note 9)	12,022	11,376
General Property Plant and Equipment (Net) (Note 10)	84	87
Other Assets (Note 8)	243	152
TOTAL ASSETS (Note 6)	\$120,763	\$118,377
LIABILITIES		
Intragovernmental Liabilities		
Accounts Payable	\$0	\$0
Debt (Note 12)	12,814	11,677
Other Intragovernmental Liabilities (Note 13)	6,029	7,769
Total Intragovernmental Liabilities (Note 11)	\$18,843	\$19,446
Accounts Payable	1,120	1,408
Loan Guarantees Liabilities (Note 9)	6,313	3,814
Debt Held by the Public (Note 12)	2,210	2,508
Federal Employee and Veterans' Benefits (Note 2)	85	81
Debentures Issued to Claimants (Note 12)	0	0
Loss Reserves (Note 14)	519	539
Other Governmental Liabilities (Note 13)	1,044	1,038
TOTAL LIABILITIES (Note 11)	\$30,134	\$28,834
NET POSITION		
Unexpended Appropriations	\$64,753	\$65,407
Cumulative Results of Operations	25,876	24,136
Total Net Position	90,629	89,543
Total Liabilities and Net Position	\$120,763	\$118,377

The accompanying notes are an integral part of these statements

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
CONSOLIDATING STATEMENT OF NET COST
FOR THE PERIOD ENDED SEPTEMBER 2003
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Public and Indian Housing	Housing	Community Planning and Development	Other	Financial Statement Eliminations	Consolidated
COSTS:								
Federal Housing Administration Unsubsidized Program								
Intragovernmental	\$583						(\$71)	\$512
Intragovernmental Earned Revenues	(1,312)							(1,312)
Intragovernmental Net Costs	(\$729)	\$0	\$0	\$0	\$0	\$0	(\$71)	(\$800)
With the Public	\$3,679							\$3,679
Earned Revenue With the Public	(445)							(445)
Net Costs With the Public	\$3,234	\$0	\$0	\$0	\$0	\$0		\$3,234
Net Program Costs	\$2,505						(\$71)	\$2,434
Federal Housing Administration Subsidized Program								
Intragovernmental	\$132							\$132
Intragovernmental Earned Revenues	(106)							(106)
Intragovernmental Net Costs	\$26	\$0	\$0	\$0	\$0	\$0		\$26
With the Public	(\$941)							(\$941)
Earned Revenue With the Public	(505)							(505)
Net Costs With the Public	(\$1,446)	\$0	\$0	\$0	\$0	\$0		(\$1,446)
Net Program Costs	(\$1,420)							(\$1,420)
Government National Mortgage Association								
Intragovernmental		\$0						\$0
Intragovernmental Earned Revenues		(\$388)						(388)
Intragovernmental Net Costs	\$0	(\$388)	\$0	\$0	\$0	\$0		(\$388)
With the Public		\$68						\$68
Earned Revenues		(411)						(411)
Net Costs With the Public	\$0	(\$343)	\$0	\$0	\$0	\$0		(\$343)
Net Program Costs		(\$731)						(\$731)
Section 8								
Intragovernmental			\$13	\$35	\$0			\$48
Intragovernmental Earned Revenues								0
Intragovernmental Net Costs	\$0	\$0	\$13	\$35	\$0	\$0		\$48
With the Public			\$13,423	\$7,562	\$3			\$20,988
Earned Revenues								0
Net Costs With the Public	\$0	\$0	\$13,423	\$7,562	\$3	\$0		\$20,988
Net Program Costs			\$13,436	\$7,597	\$3			\$21,036
Low Rent Public Housing Loans and Grants								
Intragovernmental			\$160					\$160
Intragovernmental Earned Revenues								0
Intragovernmental Net Costs	\$0	\$0	\$160	\$0	\$0	\$0		\$160
With the Public			\$3,936					\$3,936
Earned Revenues			(0)					(0)
Net Costs With the Public	\$0	\$0	\$3,936	\$0	\$0	\$0		\$3,936
Net Program Costs			\$4,096					\$4,096
Operating Subsidies								
Intragovernmental			\$44					\$44
Intragovernmental Earned Revenues								0
Intragovernmental Net Costs	\$0	\$0	\$44	\$0	\$0	\$0		\$44
With the Public			\$3,462					\$3,462
Earned Revenues								0
Net Costs With the Public	\$0	\$0	\$3,462	\$0	\$0	\$0		\$3,462
Net Program Costs			\$3,506					\$3,506

The accompanying notes are an integral part of these statements

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
CONSOLIDATING STATEMENT OF NET COST
FOR THE PERIOD ENDED SEPTEMBER 2003
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Public and Indian Housing	Housing	Community Planning and Development	Other	Financial Statement Eliminations	Consolidated
Housing for the Elderly and Disabled								
Intragovernmental				\$228				\$228
Intragovernmental Earned Revenues				0				0
Intragovernmental Net Costs	\$0	\$0	\$0	\$228	\$0	\$0		\$228
With the Public				\$1,026				\$1,026
Earned Revenues				(637)				(637)
Net Costs With the Public	\$0	\$0	\$0	\$389	\$0	\$0		\$389
Net Program Costs				\$617				\$617
Community Development Block Grants								
Intragovernmental					\$33			\$33
Intragovernmental Earned Revenues								0
Intragovernmental Net Costs	\$0	\$0	\$0	\$0	\$33	\$0		\$33
With the Public					\$5,582			\$5,582
Earned Revenues								0
Net Costs With the Public	\$0	\$0	\$0	\$0	\$5,582	\$0		\$5,582
Net Program Costs					\$5,615			\$5,615
HOME								
Intragovernmental					\$14			\$14
Intragovernmental Earned Revenues								0
Intragovernmental Net Costs	\$0	\$0	\$0	\$0	\$14	\$0		\$14
With the Public					\$1,625			\$1,625
Earned Revenues								0
Net Costs With the Public	\$0	\$0	\$0	\$0	\$1,625	\$0		\$1,625
Net Program Costs					\$1,639			\$1,639
Other								
Intragovernmental			\$32	\$18	\$33	\$140		\$223
Intragovernmental Earned Revenues			(2)	(2)	(3)	(72)	71	(8)
Intragovernmental Net Costs	\$0	\$0	\$30	\$16	\$30	\$68	\$71	\$215
With the Public			\$800	\$709	\$1,536	\$386		\$3,431
Earned Revenues			(\$0)	(27)	(1)	(0)		(28)
Net Costs With the Public	\$0	\$0	\$800	\$682	\$1,535	\$386		\$3,403
Net Program Costs			\$830	\$698	\$1,565	\$454	\$71	\$3,618
Costs Not Assigned to Programs			\$208	\$55	\$156	\$1		\$420
Net Cost of Operations	\$1,085	(\$731)	\$22,076	\$8,967	\$8,978	\$455	\$0	\$40,830

The accompanying notes are an integral part of these statements

**DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
CONSOLIDATING STATEMENT OF NET COST
FOR THE PERIOD ENDED SEPTEMBER 2002
(Dollars in Millions)**

	Federal Housing Administration	Government National Mortgage Association	Public and Indian Housing	Housing	Community Planning and Development	Other	Consolidated
COSTS:							
Unsubsidized Program							
Intragovernmental Gross Cost	\$516						\$516
Intragovernmental Earned Revenue	(1,354)						(1,354)
Intragovernmental Net Costs	(\$838)	\$0	\$0	\$0	\$0	\$0	(\$838)
Gross Costs With the Public	(\$1,084)						(\$1,084)
Earned Revenue With the Public	(678)						(678)
Net Costs With the Public	(\$1,762)	\$0	\$0	\$0	\$0	\$0	(\$1,762)
Net Program Costs	(\$2,600)						(\$2,600)
Subsidized Program							
Intragovernmental Gross Cost	\$125						\$125
Intragovernmental Earned Revenue	(107)						(107)
Intragovernmental Net Costs	\$18	\$0	\$0	\$0	\$0	\$0	\$18
Gross Costs With the Public	(\$987)						(\$987)
Earned Revenue With the Public	(366)						(366)
Net Costs With the Public	(\$1,353)	\$0	\$0	\$0	\$0	\$0	(\$1,353)
Net Program Costs	(\$1,335)						(\$1,335)
Government National Mortgage Association							
Intragovernmental Gross Cost							\$0
Intragovernmental Earned Revenues		(399)					(399)
Intragovernmental Net Costs	\$0	(\$399)	\$0	\$0	\$0	\$0	(\$399)
Gross Cost With the Public		\$57					\$57
Earned Revenues		(452)					(452)
Net Costs With the Public	\$0	(\$395)	\$0	\$0	\$0	\$0	(\$395)
Net Program Costs		(\$794)					(\$794)
Section 8:							
Intragovernmental Gross Cost			\$27	\$26	\$0		\$53
Intragovernmental Earned Revenues							0
Intragovernmental Net Costs	\$0	\$0	\$27	\$26	\$0	\$0	\$53
Gross Cost With the Public			\$11,385	\$7,019	\$17		\$18,421
Earned Revenues			(175)	175			0
Net Costs With the Public	\$0	\$0	\$11,210	\$7,194	\$17	\$0	\$18,421
Net Program Costs			\$11,237	\$7,220	\$17		\$18,474
Low Rent Public Housing Loans and Grants							
Intragovernmental Gross Cost			\$214				\$214
Intragovernmental Earned Revenues							0
Intragovernmental Net Costs	\$0	\$0	\$214	\$0	\$0	\$0	\$214
Gross Cost With the Public			\$4,038				\$4,038
Earned Revenues							0
Net Costs With the Public	\$0	\$0	\$4,038	\$0	\$0	\$0	\$4,038
Net Program Costs			\$4,252				\$4,252
Operating Subsidies:							
Intragovernmental Gross Cost			\$33				\$33
Intragovernmental Earned Revenues							0
Intragovernmental Net Costs	\$0	\$0	\$33	\$0	\$0	\$0	\$33
Gross Cost With the Public			\$3,666				\$3,666
Earned Revenues							0
Net Costs With the Public	\$0	\$0	\$3,666	\$0	\$0	\$0	\$3,666
Net Program Costs			\$3,699				\$3,699

The accompanying notes are an integral part of these statements

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
CONSOLIDATING STATEMENT OF NET COST
FOR THE PERIOD ENDED SEPTEMBER 2002
(Dollars in Millions)

Housing for the Elderly and Disabled

Intragovernmental Gross Cost				\$264			\$264
Intragovernmental Earned Revenues				0			0
Intragovernmental Net Costs	\$0	\$0	\$0	\$264	\$0	\$0	\$264
Gross Cost With the Public				\$898			\$898
Earned Revenues				(846)			(646)
Net Costs With the Public	\$0	\$0	\$0	\$252	\$0	\$0	\$252
Net Program Costs				\$516			\$516

Community Development Block Grants:

Intragovernmental Gross Cost				\$26			\$26
Intragovernmental Earned Revenues				0			0
Intragovernmental Net Costs	\$0	\$0	\$0	\$0	\$26	\$0	\$26
Gross Cost With the Public					\$5,417		\$5,417
Earned Revenues					0		0
Net Costs With the Public	\$0	\$0	\$0	\$0	\$5,417	\$0	\$5,417
Net Program Costs					\$5,443		\$5,443

HOME:

Intragovernmental Gross Cost				\$14			\$14
Intragovernmental Earned Revenues				0			0
Intragovernmental Net Costs	\$0	\$0	\$0	\$0	\$14	\$0	\$14
Gross Cost With the Public					\$1,537		\$1,537
Earned Revenues					0		0
Net Costs With the Public	\$0	\$0	\$0	\$0	\$1,537	\$0	\$1,537
Net Program Costs					\$1,551		\$1,551

Other:

Intragovernmental Gross Cost			\$39	\$17	\$54	\$103	\$213
Intragovernmental Earned Revenues			(1)	(4)	(2)		(7)
Intragovernmental Net Costs	\$0	\$0	\$38	\$13	\$52	\$103	\$206
Gross Cost With the Public			\$810	\$687	\$1,495	\$232	\$3,224
Earned Revenues				(27)	(2)		(29)
Net Costs With the Public	\$0	\$0	\$810	\$660	\$1,493	\$232	\$3,195
Net Program Costs			\$848	\$673	\$1,545	\$335	\$3,401

Costs Not Assigned to Programs			\$208	\$64	\$130	\$1	\$403
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Net Cost of Operations	(\$3,935)	(\$794)	\$20,244	\$8,473	\$8,686	\$337	\$33,010
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The accompanying notes are an integral part of these statements

Department of Housing and Urban Development
Consolidated Statement of Changes in Net Position
for the period ending September 2003 and 2002

(Dollars in Millions)

	2003		2002	
	Cumulative Results of Operations	Unexpended Appropriations	Cumulative Results of Operations	Unexpended Appropriations
Net Position-Beginning of Period	(\$24,136)	(\$65,407)	(\$18,250)	(\$63,305)
Prior Period Adjustments (Note 19)	(2)	0	5	(5)
Beginning Balances, As Adjusted	(\$24,138)	(\$65,407)	(\$18,245)	(\$63,310)
Budgetary Financing Sources				
Appropriations Received		(44,674)		(45,630)
Transfers In/Out		240		1,280
Other Adjustments (Recissions, etc)	24	1,889		1,717
Appropriations Used	(43,164)	43,199	(40,542)	40,536
Transfers In/Out Without Reimbursement	482		839	
Other Budgetary Financing Sources	20		8	
Other Financing Sources				
Donations and Forfeitures of Property				
Transfers In/Out Without Reimbursement	138		865	
Imputed Financing From Costs				
Absorbed From Others	(72)		(73)	
Other	4		2	
Total Financing Sources	(\$42,568)	\$654	(\$38,901)	(\$2,097)
Net Cost of Operations	40,830		33,010	
Ending Balances	(\$25,876)	(\$64,753)	(\$24,136)	(\$65,407)

The accompanying notes are an integral part of these statements

Department of Housing and Urban Development
Combined Statement of Budgetary Resources
For the Period Ended September 2003 and 2002
(Dollars in Millions)

	2003		2002	
	Budgetary	NonBudgetary Credit Program Financing Accounts	Budgetary	NonBudgetary Credit Program Financing Accounts
Budgetary Resources:				
Budget Authority	\$44,900	\$2,890	\$45,809	\$3,925
Net Transfers, Current Year Authority	7	0	6	
Unobligated Balance-Beginning of Year	45,287	3,092	39,641	4,537
Net Transfers, Actual, Prior Year Balance			700	
Spending Authority from Offsetting Collections Adjustments	8,072	12,405	10,281	10,237
Recoveries of Prior Year Obligations Permanently not available	3,313	77	3,695	50
Cancellations-Expired and No Year Accts	(72)	0	(45)	
Enacted Recissions	(1,608)	0	(1,958)	
Capital Trans & Debt Redemption	(954)	(1,649)	(2,796)	(916)
Other Authority Withdrawn	(7,912)	0	(6,559)	
Total Budgetary Resources	\$91,033	\$16,815	\$88,774	\$17,833
Status of Budgetary Resources:				
Obligations Incurred (Note 20)	\$41,144	\$15,671	\$43,487	\$14,740
Unobligated Balances Available	10,726	814	9,362	1,467
Unobligated Balances Not Available	39,163	330	35,925	\$1,626
Total Status of Budgetary Resources	\$91,033	\$16,815	\$88,774	\$17,833
Obligated Balance, Net-Beg of Period	\$89,706	(\$98)	\$94,000	(\$119)
Obligated Balance Transferred, Net	0	0		
Obligated Balance, Net - End of Period	80,663	921	89,706	(98)
Outlays				
Disbursements	\$46,880	\$14,733	\$44,216	\$14,658
Collections	(8,078)	(12,562)	(10,410)	(10,226)
Subtotal	\$38,802	\$2,171	\$33,806	\$4,432
Less: Offsetting Receipts	(1,382)	0	(2,001)	
Net Outlays	\$37,420	\$2,171	\$31,805	\$4,432

The accompanying notes are an integral part of these statements

Department of Housing and Urban Development
Consolidated Statement of Financing
For the Year Ended September 2003 and 2002
(Dollars in Millions)

	2003	2002
Resources Used to Finance Activities:		
Budgetary Resources Obligated		
Obligations Incurred	\$56,815	\$58,227
Less: Spending Authority from Offsetting Collections & Recoveries	(23,866)	(24,263)
Obligations Net of Offsetting Collections	\$32,949	\$33,964
Less: Offsetting Receipts	(1,381)	(2,001)
Net Obligations	\$31,568	\$31,963
Other Resources		
Transfers In/Out Without Reimbursement	(139)	(865)
Imputed Financing from Costs Absorbed by Others	72	73
Other Resources	(31)	6
Net Other Resources Used to Finance Activities	(398)	(786)
Total Resources Used to Finance Activities	\$31,470	\$31,177
Resources Used to Finance Items Not Part of the Net Cost of Operations		
Change in Budgetary Resources Obligated for Goods Services/Benefits Ordered but not yet Provided	\$8,157	\$4,199
Resources That Fund Expenses from Prior Periods	(3,556)	(6,261)
Budgetary Offsetting Collections and Receipts Not Affecting Net Cost of Operations	19,871	19,488
Resources Financing Acquisition of Assets	(15,652)	(10,335)
Other Changes to Net Obligated Resources Not Affecting Net Cost of Operations	(701)	4
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	\$8,119	\$7,095
Total Resources Used to Finance the Net Cost of Operations	\$39,589	\$38,272
Components of Net Cost of Operations Not Requiring/Generating Resources in the Current Period:		
Components Requiring or Generating Resources in Future Periods		
Increase in Annual Leave Liability (Note 22)	\$0	\$2
Reestimates of Credit Subsidy Expense	7,407	1,149
Exchange Revenue Receivable from the Public	(6,410)	(657)
Other	3	
Total Requiring/Generating Resources in Future Periods	\$1,000	\$494
Components Not Requiring/Generating Resources		
Depreciation and Amortization	\$10	\$13
Revaluation of Assets or Liabilities	522	(1,275)
Other	(291)	(4,494)
Total Components of Net Cost of Operation Not Requiring/Generating Resources	\$241	(\$5,756)
Total Components of Net Cost of Operations Not Requiring/Generating Resources in the Current Period	\$1,241	(\$5,262)
Net Cost of Operations	\$40,830	\$33,010

The accompanying notes are an integral part of these statements

Notes to Financial Statements

September 30, 2003 and 2002

NOTE 1 - ENTITY AND MISSION

The U.S. Department of Housing and Urban Development (HUD) was created in 1965 to (1) provide housing subsidies for low and moderate income families, (2) provide grants to states and communities for community development activities, (3) provide direct loans and capital advances for construction and rehabilitation of housing projects for the elderly and persons with disabilities, and (4) promote and enforce fair housing and equal housing opportunity. In addition, HUD insures mortgages for single family and multifamily dwellings; insures loans for home improvements and manufactured homes; and facilitates financing for the purchase or refinancing of millions of American homes.

HUD's major programs are as follows:

The **Federal Housing Administration (FHA)** was created as a Government corporation within HUD and administers active mortgage insurance programs, which are designed to make mortgage financing more accessible to the home buying public and thereby to develop affordable housing. FHA insures private lenders against loss on mortgages, which finance single-family homes, multifamily projects, health care facilities, property improvements, and manufactured homes.

The **Government National Mortgage Association (Ginnie Mae)** was created as a Government corporation within HUD to administer mortgage support programs that could not be carried out in the private market. Ginnie Mae guarantees the timely payment of principal and interest on mortgage-backed securities issued by approved private mortgage institutions and backed by pools of mortgages insured or guaranteed by FHA, the Rural Housing Service (RHS), the Department of Veterans Affairs (VA) and the HUD Office of Public and Indian Housing (PIH).

The **Section 8 Rental Assistance** programs assist low- and very low-income families in obtaining decent and safe rental housing. HUD makes up the difference between what a low- and very low-income family can afford and the approved rent for an adequate housing unit.

Operating Subsidies are provided to Public Housing Authorities (PHAs) and Tribally Designated Housing Entities (TDHEs) to help finance the operations and maintenance costs of their housing projects.

The **Community Development Block Grant (CDBG)** programs provide funds for metropolitan cities, urban counties, and other communities to use for neighborhood revitalization, economic development, and improved community facilities and services. The United States Congress appropriated \$2 billion in FY 2002 and \$783 million in emergency supplemental appropriations in FY 2001 for "Community Development Fund" for emergency expenses to respond to the September 11, 2002 terrorist attacks on the United States. Of the amounts appropriated, \$649 million was expensed in FY 2003 and \$312.5 was expensed in FY 2002. Any remaining un-obligated balances shall remain available until expended.

The **Low Rent Public Housing Grants** program provides grants to PHAs and TDHEs for construction and rehabilitation of low-rent housing. This program is a continuation of the Low Rent Public Housing Loan program,

which pays principal and interest on long-term loans made to PHAs and TDHEs for construction and rehabilitation of low-rent housing.

The **Section 202/811 Supportive Housing for the Elderly and Persons with Disabilities** programs, prior to fiscal 1992, provided 40-year loans to nonprofit organizations sponsoring rental housing for the elderly or disabled. During fiscal 1992, the program was converted to a grant program. The grant program provides long-term supportive housing for the elderly (Section 202) and disabled (Section 811).

The **Home Investments Partnerships** program provides grants to States, local Governments, and Indian tribes to implement local housing strategies designed to increase home ownership and affordable housing opportunities for low- and very low-income Americans.

Other Programs not included above consist of other smaller programs which provide grant, subsidy funding, and direct loans to support other HUD objectives such as fair housing and equal opportunity, energy conservation, assistance for the homeless, rehabilitation of housing units, and home ownership. These programs comprise approximately 8.6 percent of HUD's consolidated assets and 8.3 percent of HUD's consolidated revenues and financing sources for fiscal 2003 and 9.1 percent of HUD's consolidated assets and 8.2 percent of HUD's consolidated revenues and financing sources for fiscal 2002.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Consolidation

The financial statements include all funds and programs for which HUD is responsible. All significant intra-fund balances and transactions have been eliminated in consolidation. Transfer appropriations are consolidated into the financial statements based on an evaluation of their relationship with HUD.

B. Basis of Accounting

The financial statements include the accounts and transactions of the Ginnie Mae, FHA, and HUD's Grant, Subsidy and Loan programs.

The financial statements are presented in accordance with the Office of Management and Budget (OMB) Bulletin 01-09, Form and Content of Agency Financial Statements, and in conformance with the Federal Accounting Standards Advisory Board's (FASAB) Statements of Federal Financial Accounting Standards (SFFAS).

The financial statements are presented on the accrual basis of accounting. Under this method, HUD recognizes revenues when earned, and expenses when a liability is incurred, without regard to receipt or payment of cash. Generally, procedures for HUD's major grant and subsidy programs require recipients to request periodic disbursement concurrent with incurring eligible costs.

The department's disbursement policy permits grantees/recipients to request funds to meet immediate cash needs to reimburse themselves for eligible incurred expenses and eligible expenses expected to be received and paid within three days. HUD's disbursement of funds for these purposes are not considered advance payments, but are viewed as good cash management between the department and the grantees. In the event it is determined that the grantee/recipient did not disburse the funds within the three days time frame, interest earned must be returned to HUD and deposited into one of Treasury's miscellaneous receipt accounts.

C. Operating Revenue and Financing Sources

HUD finances operations principally through appropriations, collection of premiums and fees on its FHA and Ginnie Mae programs, and interest income on its mortgage notes, loans, and investments portfolio.

Appropriations for Grant and Subsidy Programs

HUD receives both annual and multi-year appropriations, and recognizes those appropriations as revenue when related program expenses are incurred. Accordingly, HUD recognizes grant-related revenue and related expenses as recipients perform under the contracts. HUD recognizes subsidy-related revenue and related expenses when the underlying assistance (e.g., provision of a Section 8 rental unit by a housing owner) is provided.

FHA Unearned Premiums

Premiums charged by FHA for single family mortgage insurance provided by its Mutual Mortgage Insurance (MMI) Fund and Cooperative Management Housing Insurance (CMHI) Fund include up-front and annual risk based premiums. Pre-credit reform 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 activities charge periodic insurance premiums over the mortgage insurance term. Premiums on annual installment policies are recognized for the liquidating accounts on a straight-line basis throughout the year.

Premiums associated with Credit Reform loan guarantees are included in the calculation of the liability for loan guarantees (LLG) and not included in the unearned premium amount reported on the Balance Sheet, since the LLG represents the net present value of future cash flows associated with those insurance portfolios.

Ginnie Mae Fees

Ginnie Mae receives monthly guaranty fees for each MBS mortgage pool based on a percentage of the pool's outstanding balance. Fees received for Ginnie Mae's guaranty of MBS are recognized when earned. Ginnie Mae receives commitment fees as issuers request Commitment Authority and recognizes the commitment fees as income as issuers use their Commitment Authority, with the balance deferred until earned or expired whichever occurs first. Fees from expired Commitment Authority are not returned to issuers. Ginnie Mae recognizes as income the major portion of fees related to the issuance of multiclass securities in the period the fees are received, with the balance deferred and amortized over the weighted average life of the underlying mortgages to match the recognition of related administrative expenses. Losses on assets acquired through liquidation and claims against HUD/FHA and VA are recognized when they occur.

D. Appropriations and Moneys Received from Other HUD Programs

The National Housing Act of 1990, as amended, provides for appropriations from Congress to finance the operations of General Insurance (GI) and Special Risk Insurance (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 Allowance for Subsidy when collected.

E. Investments

HUD limits its investments, principally comprised of investments by FHA's MMI/CMHI Fund and by Ginnie Mae, to non-marketable market-based Treasury interest-bearing obligations (i.e., investments not sold in public markets). The market value and interest rates established for such investments are the same as those for similar Treasury issues, which are publicly marketed.

HUD's investment decisions are limited by Treasury policy which: (1) only allows investment in Treasury notes, bills, and bonds; and (2) prohibits HUD from engaging in practices that result in "windfall" gains and profits, such as security trading and full scale restructuring of portfolios, in order to take advantage of interest rate fluctuations.

FHA's normal policy is to hold investments in U.S. Government securities to maturity. However, as a result of Credit Reform, cash collected on insurance endorsed on or after October 1, 1991, is no longer available to invest in U.S. Government securities, and may only be used to finance claims arising from insurance endorsed during or after fiscal 1992. FHA may have to liquidate its U.S. Government securities before maturity to finance claim payments from pre-fiscal year 1992 insurance endorsements. However, management does not expect early liquidation of any U.S. Government Securities and believes it has the ability to hold these securities to maturity.

HUD reports investments in U.S. Government securities at amortized cost. Premiums or discounts are amortized into interest income over the term of the investment. HUD intends to hold investments to maturity, unless needed for operations. No provision is made to record unrealized gains or losses on these securities because, in the majority of cases, they are held to maturity.

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.

F. Credit Program Receivables and Related Foreclosed Property

HUD finances mortgages and provides loans to support construction and rehabilitation of low rent housing, principally for the elderly and disabled under the Section 202/811 program. Prior to April 1996, mortgages were also assigned to HUD through FHA claims settlement (i.e., mortgage notes assigned (MNAs)). Single family mortgages were assigned to FHA when the mortgagor defaulted due to certain "temporary hardship" conditions beyond the control of the mortgagor, and when, in management's judgment, it is likely that the mortgage could be brought current in the future. During fiscal 2003, FHA continued to take single family assignments on those defaulted notes that were in process at the time the assignment program was terminated. In addition, multifamily mortgages are assigned to FHA when lenders file mortgage insurance claims for defaulted notes.

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.

Credit program receivables for direct loan programs and defaulted guaranteed loans assigned for direct collection are valued differently based on the direct loan obligation or loan guarantee commitment date. These valuations are in accordance with the Federal Credit Reform Act of 1990 and SFFAS No. 2, "Accounting for Direct Loans and Loan Guarantees," as amended by SFFAS No. 18. Those obligated or committed on or after October 1, 1991 (post-Credit Reform) are valued at the net present value of expected cash flows from the related receivables.

Credit program receivables resulting from obligations or commitments prior to October 1, 1991 (pre-Credit Reform) are recorded at the lower of cost or fair value (net realizable value). Fair value is estimated based on the prevailing market interest rates at the date of mortgage assignment. When fair value is less than cost, discounts are recorded and amortized to interest income over the remaining terms of the mortgages or upon sale of the mortgages. Interest is recognized as income when earned. However, when full collection of principal is considered doubtful, the accrual of interest income is suspended and receipts (both interest and principal) are recorded as collections of principal. Pre-Credit Reform loans are reported net of allowance for loss and any unamortized discount. The estimate for the allowance on credit program receivables is based on historical loss rates and recovery rates resulting from asset sales and property recovery rates, net of cost of sales.

Foreclosed property acquired as a result of defaults of loans obligated or loan guarantees committed on or after October 1, 1991, is valued at the net present value of the projected cash flows associated with the property. Foreclosed property acquired as a result in defaulted loans obligated or loan guarantees committed prior to 1992 is valued at net realizable value. The estimate for the allowance for loss related to the net realizable value of

foreclosed property is based on historical loss rates and recovery rates resulting from property sales, net of cost of sales.

G. Liability for Loan Guarantees

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).

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.

The pre-Credit Reform LLG is computed using the net realizable value method. The LLG for pre-Credit Reform single family insured mortgages includes estimates for defaults that have taken place, but where claims have not yet been filed with FHA. In addition, the LLG for pre-Credit Reform multifamily insured mortgages includes estimates for defaults, which are considered probable but have not been reported to FHA.

H. Full Cost Reporting

Beginning in fiscal 1998, SFFAS No. 4 required that full costing of program outputs be included in Federal agency financial statements. Full cost reporting includes direct, indirect, and inter-entity costs. For purposes of the

consolidated department financial statements, HUD identified each responsible segment's share of the program costs or resources provided by HUD or other Federal agencies. These costs are treated as imputed cost for the Statement of Net Cost, and imputed financing for the Statement of Changes in Net Position and the Statement of Financing.

I. Accrued Unfunded Leave and Federal Employees Compensation Act (FECA) Liabilities

Annual leave and compensatory time are accrued as earned and the liability is reduced as leave is taken. The liability at year-end reflects cumulative leave earned but not taken, priced at current wage rates. Earned leave deferred to future periods is to be funded by future appropriations. HUD offsets this unfunded liability by recording future financing sources in the Net Position section of its Consolidated Balance Sheet. Sick leave and other types of leave are expensed as taken.

HUD also accrues the portion of the estimated liability for disability benefits assigned to the agency under the FECA, administered and determined by the Department of Labor. The liability, based on the net present value of estimated future payments based on a study conducted by the Department of Labor, was \$85 million as of September 30, 2003 and \$81 million as of September 30, 2002. Future payments on this liability are to be funded by future appropriations. HUD offsets this unfunded liability by recording future financing sources.

J. Loss Reserves

HUD records loss reserves for its mortgage insurance programs operated through FHA and its financial guaranty programs operated by Ginnie Mae. FHA loss reserves are recorded for the net present value of estimated future cash flows associated with FHA-insured mortgage loans endorsed before fiscal year 1992. Ginnie Mae establishes reserves for actual and probable defaults of issuers of Ginnie Mae-guaranteed mortgage-backed securities. Such reserves are based on management's judgment about historical claim and loss information and current economic factors.

K. Retirement Plans

The majority of HUD's employees participate in either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS). FERS went into effect pursuant to Public Law 99-335 on January 1, 1987. Most employees hired after December 31, 1983, are automatically covered by FERS and Social Security. Employees hired before January 1, 1984, can elect to either join FERS and Social Security or remain in CSRS. HUD expenses its contributions to the retirement plans.

A primary feature of FERS is that it offers a savings plan whereby HUD automatically contributes 1 percent of pay and matches any employee contribution up to an additional 4 percent of pay. Under CSRS, employees can contribute up to 8 percent of their pay to the savings plan, but there is no corresponding matching by HUD. Although HUD funds a portion of the benefits under FERS relating to its employees and makes the necessary withholdings from them, it has no liability for future payments to employees under these plans, nor does it report CSRS, FERS, or FECA assets, accumulated plan benefits, or unfunded liabilities applicable to its employees retirement plans. These amounts are reported by the Office of Personnel Management (OPM) and are not allocated to the individual employers. HUD's matching contribution to these retirement plans during fiscal 2003 and 2002 was \$68 million and \$71 million, respectively.

L. Federal Employee and Veterans' Benefit

The Department's Federal Employee and Veterans' benefit expenses totaled approximately \$136 million for fiscal 2003; this amount includes \$41 million to be funded by the OPM. Federal Employee and Veterans' benefit

expenses totaled approximately \$125 million for fiscal 2002; this amount includes \$31 million to be funded by the OPM. Amounts funded by the OPM are charged to expense with a corresponding amount considered as an imputed financing source in the statement of changes in net position.

M. 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. Prior to fiscal year 2003, this liability was presented as Accounts Payable, Intragovernmental. 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.

NOTE 3 – FUND BALANCE WITH THE U.S. TREASURY

The U.S. Treasury, which, in effect, maintains HUD's bank accounts, processes substantially all of HUD's receipts and disbursements. HUD's fund balances with the U.S. Treasury as of September 30, 2003 and 2002, were as follows (dollars in millions):

Description	2003	2002
Revolving Funds	\$ 8,012	\$ 9,488
Appropriated Funds	64,647	64,359
Trust Funds	6	8
Other	3,793	3,777
Total - Fund Balance	\$ 76,458	\$ 77,632

HUD's fund balances with U.S. Treasury as reflected in the entity's general ledger as of September 30, 2003 were as follows

Description	Unobligated		Obligated Not Yet Disbursed	Unfilled Customer Orders	Total Fund Balance
	Available	Unavailable			
FHA	\$ 1,039	\$ 4,723	\$ 2,171	\$ -	\$ 7,933
GNMA	-	2,932	-		2,932
Section 8 Rental Assistance	3,454	30	15,373		18,857
CDBG	1,118	29	11,375		12,522
HOME	378	9	4,917		5,304
Operating Subsidies	-	2	1,863		1,865
Low Rent Public Housing Loans and Grants	830	12	8,268		9,110
Section 202/811	1,943	562	5,338		7,843
All Other	2,730	263	7,146	47	10,092
Total	\$ 11,492	\$ 8,562	\$ 56,451	\$ 47	\$ 76,458

HUD's fund balances with U.S. Treasury as reflected in the entity's general ledger as of September 30, 2002 were as follows:

Description	Unobligated		Obligated Not Yet Disbursed	Total Fund Balance
	Available	Unavailable		
FHA	\$ 2,091	\$ 5,434	\$ 2,072	\$ 9,597
GNMA	-	2,509	-	2,509
Section 8 Rental Assistance	1,737	10	16,632	18,379
CDBG	1,756	30	11,413	13,199
HOME	257	-	4,669	4,926
Operating Subsidies	-	26	1,660	1,686
Low Rent Public Housing Loans and Grants	866	23	8,811	9,700
Section 202/811	2,501	42	4,764	7,307
All Other	2,633	519	7,177	10,329
Total	\$ 11,841	\$ 8,593	\$ 57,198	\$ 77,632

An immaterial difference exists between HUD's recorded Fund Balances with the U.S. Treasury and the U.S. Department of Treasury's records. It is the Department's practice to adjust its records to agree with Treasury's balances at the end of the fiscal year. The adjustments are reversed at the beginning of the following fiscal year.

NOTE 4 - COMMITMENTS UNDER HUD'S GRANT, SUBSIDY, AND LOAN PROGRAMS

A. Contractual Commitments

HUD has entered into extensive long-term contractual commitments under its various grant, subsidy and loan programs. These commitments consist of legally binding agreements the Department has entered into to provide grants, subsidies, or loans. Commitments become liabilities when all actions required for payment under an agreement have occurred. The mechanism for funding subsidy commitments generally differs depending on whether the agreements were entered into before or after 1988.

Prior to fiscal 1988, HUD's subsidy programs, primarily the Section 8 program and the Section 235/236 programs, operated under contract authority. Each year, Congress provided HUD the authority to enter into multiyear contracts within annual and total contract limitation ceilings. HUD then drew on and continues to draw on permanent indefinite appropriations to fund the current year's portion of those multiyear contracts. Because of the duration of these contracts (up to 40 years), significant authority exists to draw on the permanent indefinite appropriations. Beginning in fiscal 1988, the Section 8 and the Section 235/236 programs began operating under multiyear budget authority whereby the Congress appropriates the funds "up-front" for the entire contract term in the initial year.

As shown below, appropriations to fund a substantial portion of these commitments will be provided through permanent indefinite authority. These commitments relate primarily to the Section 8 program, and the Section 235/236 rental assistance and interest reduction programs, and are explained in greater detail below.

HUD's commitment balances are based on the amount of unliquidated obligations recorded in HUD's accounting records with no provision for changes in future eligibility, and thus are equal to the maximum amounts available under existing agreements and contracts. Unexpended appropriations and cumulative results of operations shown in

the Consolidated Balance Sheet comprise funds in the U.S. Treasury available to fund existing commitments that were provided through "up-front" appropriations, and also include permanent indefinite appropriations received in excess of amounts used to fund the pre-1988 subsidy contracts and offsetting collections.

The following shows HUD's obligations and contractual commitments under its grant, subsidy, and loan programs as of September 30, 2003 (dollars in millions):

<u>Programs</u>	<u>Commitments Funded Through</u>			<u>Total Contractual Commitments</u>
	<u>Unexpended Appropriations</u>	<u>Permanent Indefinite Appropriations</u>	<u>Offsetting Collection</u>	
Section 8 Rental Assistance	\$ 9,840	\$ 21,256	-	\$ 31,096
Community Development Block Grants	11,355	-	-	11,355
HOME Partnership Investment Program	4,909	-	-	4,909
Operating Subsidies	1,743	-	-	1,743
Low Rent Public Housing Grants and Loans	8,811	-	-	8,811
Housing for Elderly and Disabled	5,224	-	-	5,224
Section 235/236	297	6,398	-	6,695
All Other	6,582	37	129	6,748
Total	\$ 48,761	\$ 27,691	\$ 129	\$ 76,581

Of the total Section 8 Rental Assistance contractual commitments as of September 30, 2003, \$25.1 billion relates to project-based commitments, and \$5.9 billion relates to tenant-based commitments.

The following shows HUD's obligations and contractual commitments under its grant, subsidy, and loan programs as of September 30, 2002 (dollars in millions):

<u>Programs</u>	<u>Commitments Funded Through</u>			<u>Total Contractual Commitments</u>
	<u>Unexpended Appropriations</u>	<u>Permanent Indefinite Appropriations</u>	<u>Offsetting Collection</u>	
Section 8 Rental Assistance	\$ 16,371	\$ 21,290	-	37,661
Community Development Block Grants	11,382	-	-	11,382
HOME Partnership Investment Program	4,660	-	-	4,660
Operating Subsidies	1,590	-	-	1,590
Low Rent Public Housing Grants and Loans	8,600	-	-	8,600
Housing for Elderly and Disabled	4,636	-	-	4,636
Section 235/236	215	8,012	-	8,227
All Other	6,770	48	\$ 128	6,946
Total	\$ 54,224	\$ 29,350	\$ 128	\$ 83,702

Of the total Section 8 Rental Assistance contractual commitments as of September 30, 2002, \$28.9 billion relates to project-based commitments, and \$8.7 billion relates to tenant-based commitments. With the exception of the Housing for the Elderly and Disabled and Low Rent Public Housing Loan Programs (which have been converted to grant programs), Section 235/236, and a portion of "all other" programs, HUD management expects all of the

above programs to continue to incur new commitments under authority granted by Congress in future years. However, estimated future commitments under such new authority are not included in the amounts above.

B. Administrative Commitments

In addition to the above contractual commitments, HUD has entered into administrative commitments, which are reservations of funds for specific projects (including those for which a contract has not yet been executed) to obligate all or part of those funds. Administrative commitments become contractual commitments upon contract execution.

The following shows HUD's administrative commitments as of September 30, 2003 (dollars in millions):

<u>Programs</u>	<u>Administrative Commitments Funded Through</u>			<u>Total Reservations</u>
	<u>Unexpended Appropriations</u>	<u>Permanent Indefinite Appropriations</u>	<u>Offsetting Collections</u>	
Section 8 Rental Assistance Project-Based	\$ 326	-	-	\$ 326
Section 8 Rental Assistance Tenant-Based	53	-	-	53
Community Development Block Grants	720	-	-	720
HOME Partnership Investment Program	257	-	-	257
Low Rent Public Housing Grants and Loans	144	-	-	144
Housing for Elderly and Disabled	1,680	-	-	1,680
All Other	584	\$ 48	\$ 3	635
Total	\$ 3,764	\$ 48	\$ 3	\$ 3,815

The following shows HUD's administrative commitments as of September 30, 2002 (dollars in millions):

<u>Programs</u>	<u>Administrative Commitments Funded Through</u>			<u>Total Reservations</u>
	<u>Unexpended Appropriations</u>	<u>Permanent Indefinite Appropriations</u>	<u>Offsetting Collections</u>	
Section 8 Rental Assistance Project-Based	\$ 278.00	-	-	\$ 278.00
Section 8 Rental Assistance Tenant-Based	3	-	-	3
Community Development Block Grants	1,484	-	-	1,484
HOME Partnership Investment Program	229	-	-	229
Low Rent Public Housing Grants and Loans	747	-	-	747
Housing for Elderly and Disabled	2,310	-	-	2,310
All Other	554	\$ 11	\$ 3	568
Total	\$ 5,605	\$ 11	\$ 3	\$ 5,619

NOTE 5 - INVESTMENTS

The U.S. Government securities are non-marketable intra-governmental securities. Interest rates are established by the U.S. Treasury and during fiscal year 2003 ranged from .95 percent to 13.88 percent. During fiscal year 2002 interest rates ranged from 3 percent to 13.88 percent. The amortized cost and estimated market value of investments in debt securities as of September 30, 2003 and 2002, were as follows (dollars in millions):

	<u>Cost</u>	<u>Par Value</u>	<u>Unamortized Premium (Discount)</u>	<u>Accrued Interest</u>	<u>Net Investments</u>	<u>Unamortized Gain</u>	<u>Market Value</u>
FY2003	\$ 30,857	\$ 31,064	\$ (143)	\$ 339	\$ 31,260	\$ 1,639	\$ 32,899
FY2002	\$ 27,845	\$ 28,209	\$ (194)	\$ 327	\$ 28,342	\$ 2,208	\$ 30,550

Investments in Private-Sector Entities

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 2. The following table presents financial data on FHA's investments in private-sector entities as of September 30 (dollars in millions):

	<u>Beginning Balance</u>	<u>New Acquisitions</u>	<u>Share of Earnings or Losses</u>	<u>Return of Investments</u>	<u>Other Adjustments</u>	<u>Ending Balance</u>
FY2003	\$ -	\$ 133	\$ 4	\$ (14)	\$ -	\$ 123
FY2002	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -

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):

<u>(Dollars in Millions)</u>	<u>2003</u>	<u>2002</u>
Total assets, primarily mortgage loans	\$ 323	\$ -
Liabilities	\$ -	\$ -
Partners' capital	<u>323</u>	<u>-</u>
Total liabilities and partners's capital	<u>\$ 323</u>	<u>\$ -</u>
Revenues	\$ 24	\$ -
Expenses	<u>(2)</u>	<u>-</u>
Net Income	<u>\$ 22</u>	<u>\$ -</u>

NOTE 6 – ENTITY AND NON-ENTITY ASSETS

The following shows HUD's assets as of September 30, 2003 and 2002, were as follows (dollars in millions):

<u>Description</u>	<u>2003</u>			<u>2002</u>		
	Entity	Non-Entity	Total	Entity	Non-Entity	Total
Intragovernmental						
Fund Balance with Treasury	\$ 74,736	\$ 1,722	\$ 76,458	\$ 75,477	\$ 2,155	\$ 77,632
Investments	31,256	4	31,260	28,340	2	28,342
Accounts Receivable	-	-	-	-	3	3
Other Assets	4	-	4	-	-	-
Total Intragovernmental Assets	<u>\$ 105,996</u>	<u>\$ 1,726</u>	<u>\$ 107,722</u>	<u>\$ 103,817</u>	<u>\$ 2,160</u>	<u>\$ 105,977</u>
Investments	123		123			
Accounts Receivable (net)	435	134	569	595	190	785
Loan Receivables and						
Related Foreclosed Property (net)	12,022	-	12,022	11,369	7	11,376
General Property Plant and Equipment (net)	84	-	84	87	-	87
Other Assets	120	123	243	29	123	152
Total Assets	<u>\$ 118,780</u>	<u>\$ 1,983</u>	<u>\$ 120,763</u>	<u>\$ 115,897</u>	<u>\$ 2,480</u>	<u>\$ 118,377</u>

NOTE 7 - ACCOUNTS RECEIVABLE

The department's accounts receivable represents claims to cash from the public and state and local authorities for bond refundings, Section 8-year end settlements, sustained audit findings, FHA insurance premiums and foreclosed property proceeds. A 100 percent allowance for loss is established for all delinquent accounts 90 days and over.

Section 8 Settlements

Section 8 subsidies disbursed during the year under annual contribution contracts are based on estimated amounts due under the contracts by PHAs. At the end of each year the actual amount due under the contracts is determined. The excess of subsidies paid to PHAs during the year over the actual amount due is reflected as accounts receivable in the balance sheet. These amounts are "collected" by offsetting such amounts with subsidies due to PHAs in subsequent periods. As of September 30, 2003 and 2002 this amount totaled \$253 million and \$229 million, respectively.

Bond Refundings

Many of the Section 8 projects constructed in the late 1970s and early 1980s were financed with tax exempt bonds with maturities ranging from 20 to 40 years. The related Section 8 contracts provided that the subsidies would be based on the difference between what tenants could pay pursuant to a formula, and the total operating costs of the

Section 8 project, including debt service. The high interest rates during the construction period resulted in high subsidies. When interest rates came down in the 1980s, HUD was interested in getting the bonds refunded. One method used to account for the savings when bonds are refunded (PHA's sell a new series of bonds at a lower interest rate, to liquidate the original bonds), is to continue to pay the original amount of the bond debt service to a trustee. The amounts paid in excess of the lower "refunded" debt service and any related financing costs, are considered savings. One-half of these savings are provided to the PHA, the remaining half is returned to HUD. As of September 30, 2003 and 2002, HUD was due \$134 million and \$189 million, respectively.

Other Receivables

Other receivables include sustained audit findings, refunds of overpayment, FHA insurance premiums and foreclosed property proceeds due from the public.

The following shows accounts receivable as reflected in the Balance Sheet as of September 30, 2003 and 2002, as follows (dollars in millions):

<u>Description</u>	FY 2003			FY 2002		
	Gross Accounts Receivable	Allowance for Loss	Total	Gross Accounts Receivable	Allowance for Loss	Total
Section 8 Settlements	\$ 253	-	\$ 253	\$ 229	-	\$ 229
Bond Refundings	144	\$ (11)	133	200	(11)	189
Other Receivables:						
FHA Premiums	27	-	27	208	-	208
Other Receivables	250	(94)	156	245	(83)	162
Total	\$ 674	\$ (105)	\$ 569	\$ 882	\$ (94)	\$ 788

NOTE 8 - OTHER ASSETS

The following shows HUD's Other Assets as of September 30, 2003 (dollars in millions):

Description	FHA	Ginnie Mae	Section 8 Rental Assistance	All Other	Total
Intragovernmental Assets:					
Receivables from unapplied disbursements	-	-	-	-	-
Sec. 312 Rehabilitation Loan Program Receivables	-	-	-	-	-
Mortgagor Reserves for Replacement - Investment	-	-	-	-	-
Other Assets	4	-	-	-	4
Total Intragovernmental Assets	4	-	-	-	4
Receivables Related to Asset Sales	-	-	-	-	-
Receivables Related to Credit Program Assets	-	-	-	-	-
Equity Interest in Multifamily Mortgage Trust 1996	-	-	-	-	-
GNMA Real Estate Owned Property and Hole Mortgages	-	-	-	-	-
Mortgagor Reserves for Replacement - Cash	\$ 123	-	-	-	\$ 123
Advances from the Public	-	-	-	\$ 1	1
Other Assets	7	\$ 110	-	2	119
Total	\$ 134	\$ 110	-	\$ 3	\$ 247

The following shows HUD's Other Assets as of September 30, 2002 (dollars in millions):

Description	FHA	Ginnie Mae	Section 8 Rental Assistance	All Other	Total
Intragovernmental Assets:					
Receivables from unapplied disbursements	\$ -	-	-	-	\$ -
Sec. 312 Rehabilitation Loan Program Receivables	-	-	-	-	-
Mortgagor Reserves for Replacement - Investment	-	-	-	-	-
Other Assets	-	-	-	-	-
Total Intragovernmental Assets	\$ -	-	-	-	\$ -
Receivables Related to Asset Sales	-	-	-	-	-
Receivables Related to Credit Program Assets	-	-	-	-	-
GNMA Real Estate Owned Property and Hole Mortgages	-	\$ 10	-	-	\$ 10
Equity Interest in Multifamily Mortgage Trust 1996	-	-	-	-	-
Premiums Receivable	-	-	-	-	-
Mortgagor Reserves for Replacement - Cash	123	-	-	-	123
Advances from the Public	-	-	-	\$ 4	4
Other Assets	15	-	-	-	15
Total	\$ 138	\$ 10	\$ -	\$ 4	\$ 152

NOTE 9 - DIRECT LOANS AND LOAN GUARANTEES, NON-FEDERAL BORROWERS

HUD reports direct loan obligations or loan guarantee commitments made prior to fiscal 1992 and the resulting direct loans or defaulted guaranteed loans, net of allowance for estimated uncollectable loans or estimated losses.

Direct loan obligations or loan guarantee commitments made after fiscal 1991, and the resulting direct loans or defaulted guaranteed loans, are governed by the Federal Credit Reform Act of 1990 and are recorded as the net present value of the associated cash flows (i.e. interest rate differential, interest subsidies, estimated delinquencies and defaults, fee offsets, and other cash flows). The following is an analysis of loan receivables, loan guarantees, liability for loan guarantees, and the nature and amounts of the subsidy costs associated with the loans and loan guarantees for fiscal 2003 and 2002 were as follows:

A. List of HUD's Direct Loan and/or Loan Guarantee Programs:

1. FHA
2. Ginnie Mae
3. Housing for the Elderly and Disabled
4. Low Rent Public Housing Loan Fund
5. All Other
 - a) Revolving Fund
 - b) Flexible Subsidy
 - c) CDBG, Section 108(b)
 - d) Public and Indian Loan Guarantee
 - e) Loan Guarantee Recovery Fund
 - f) Public and Indian Housing Loan Fund
 - g) Hawaiian Home Guarantee Loan Fund
 - h) Title VI Indian Housing Loan Guarantee

B. Direct Loans Obligated Prior to FY 1992 (Allowance for Loss Method)(dollars in millions):

Direct Loan Programs	2003				
	Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Direct Loans
FHA	\$ 22	1	\$ (8)	-	\$ 15
Housing for Elderly and Disabled	7,449	\$ 79	(19)	\$ 8	7,517
Low Rent Public Housing Loans	1	1	-	-	2
All Other	727	7	(525)	2	211
Total	<u>\$ 8,199</u>	<u>\$ 88</u>	<u>\$ (552)</u>	<u>\$ 10</u>	<u>\$ 7,745</u>

Direct Loan Programs	2002				
	Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Direct Loans
FHA	\$ 27	-	\$ (9)	-	\$ 18
Housing for Elderly and Disabled	7,646	\$ 88	(19)	\$ 9	7,724
Low Rent Public Housing Loans	2	2	-	-	4
All Other	811	54	(588)	2	279
Total	<u>\$ 8,486</u>	<u>\$ 144</u>	<u>\$ (616)</u>	<u>\$ 11</u>	<u>\$ 8,025</u>

C. Direct Loans Obligated After FY 1991(dollars in millions):

Direct Loan Programs	2003				
	Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Foreclosed Property	Value of Assets Related to Direct Loans
FHA	<u>-</u>	<u>-</u>	<u>\$ (3)</u>	<u>-</u>	<u>\$ (3)</u>

Direct Loan Programs	2002				
	Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Foreclosed Property	Value of Assets Related to Direct Loans
FHA	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (3)</u>	<u>\$ -</u>	<u>\$ (3)</u>

D. Defaulted Guaranteed Loans from Pre-1992 Guarantees (Allowance for Loss Method)(dollars in millions):

		2003				
<u>Direct Loan Programs</u>	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance for Loan and Interest Losses	Foreclosed Property, Net	Defaulted Guaranteed Loans Receivable, Net	
FHA	\$ 2,429	\$ 160	\$ (882)	\$ 43	\$ 1,750	
		2002				
<u>Direct Loan Programs</u>	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance for Loan and Interest Losses	Foreclosed Property, Net	Defaulted Guaranteed Loans Receivable, Net	
FHA	\$ 2,301	\$ 107	\$ (983)	\$ 199	\$ 1,624	

E. Defaulted Guaranteed Loans From Post-FY 1991 Guarantees (dollars in millions):

		2003				
<u>Direct Loan Programs</u>	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Foreclosed Property, Gross	Value of Assets Related to Defaulted Guaranteed Loans	
FHA	\$ 816	\$ 48	\$ (1,527)	\$ 3,193	\$ 2,530	
All Other	-	-	-	-	-	
All Other	\$ 816	\$ 48	\$ (1,527)	\$ 3,193	\$ 2,530	

	2002				
<u>Direct Loan Programs</u>	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Foreclosed Property, Gross	Value of Assets Related to Defaulted Guaranteed Loans
FHA	\$ 817	\$ 23	\$ (1,455)	\$ 2,344	\$ 1,729
All Other				\$ 1	1
TOTAL	\$ 817	\$ 23	\$ (1,455)	\$ 2,345	\$ 1,730

2003 2002

Total Credit Program Receivables and Related Foreclosed Property, Net **\$12,022 11,376**

F. Guaranteed Loans Outstanding (dollars in millions):

Guaranteed Loans Outstanding:

	2003	
<u>Loan Guarantee Programs</u>	Outstanding Principal, Guaranteed Loans, Face Value	Amount of Outstanding Principal Guaranteed
FHA Programs	\$ 535,199	\$ 490,125
All Other	2,384	2,384
Total	\$ 537,583	\$ 492,509

	2002	
<u>Loan Guarantee Programs</u>	Outstanding Principal, Guaranteed Loans, Face Value	Amount of Outstanding Principal Guaranteed
FHA Programs	\$ 608,089	\$ 563,379
All Other	2,232	2,232
Total	\$ 610,321	\$ 565,611

New Guaranteed Loans Disbursed (Current Reporting Year)

<u>Loan Guarantee Programs</u>	<u>Outstanding Principal, Guaranteed Loans, Face Value</u>	<u>Amount of Outstanding Principal Guaranteed</u>
FHA Programs	\$ 163,231	\$ 146,757
All Other	370	370
Total	<u>\$ 163,601</u>	<u>\$ 147,127</u>

New Guaranteed Loans Disbursed (Prior Reporting Years)

<u>Loan Guarantee Programs</u>	<u>Outstanding Principal, Guaranteed Loans, Face Value</u>	<u>Amount of Outstanding Principal Guaranteed</u>
FHA Programs	\$ 112,710	\$ 110,642
All Other	149	149
Total	<u>\$ 112,859</u>	<u>\$ 110,791</u>

G. Liability for Loan Guarantees (Estimated Future Default Claims, Pre-1992)(dollars in millions):

<u>Loan Guarantee Programs</u>	2003		
	<u>Liabilities for Losses on Pre-1992 Guarantees, Estimated Future Default Claims</u>	<u>Liabilities for Loan Guarantees for Post-1991 Guarantees (Present Value)</u>	<u>Total Liabilities For Loan Guarantees</u>
FHA Programs	\$ 3,434	\$ 2,817	\$ 6,251
All Other	-	62	62
Total	<u>\$ 3,434</u>	<u>\$ 2,879</u>	<u>\$ 6,313</u>

Loan Guarantee Programs	2002		
	Liabilities for Losses on Pre-1992 Guarantees, Estimated Future Default Claims	Liabilities for Loan Guarantees for Post-1991 Guarantees (Present Value)	Total Liabilities For Loan Guarantees
FHA Programs	\$ 5,088	\$ (1,327)	\$ 3,761
All Other	-	53	53
Total	\$ 5,088	\$ (1,274)	\$ 3,814

H. Subsidy Expense for Post-FY 1991 Loan Guarantees:

Subsidy Expense for Current Year Loan Guarantees (dollars in millions)

Loan Guarantee Programs	2003				
	Endorsement Amount	Default Component	Fees Component	Other Component	Subsidy Amount
FHA	-	\$ 2,762	\$ (7,092)	\$ 479	\$ (3,851)
All Other	-	10	-	-	10
Total	-	\$ 2,772	\$ (7,092)	\$ 479	\$ (3,841)

Loan Guarantee Programs	2002				
	Endorsement Amount	Default Component	Fees Component	Other Component	Subsidy Amount
FHA	-	\$ 2,517	\$ (5,964)	\$ 258	\$ (3,189)
All Other	-	14	-	-	14
Total	-	\$ 2,531	\$ (5,964)	\$ 258	\$ (3,175)

Modification and Re-estimates (dollars in millions)

Loan Guarantee Programs	2003			
	Total Modifications	Interest Rate Reestimates	Technical Reestimates	Total Reestimates
FHA	-	-	\$ 6,298	\$ 6,298
Total	-	-	\$ 6,298	\$ 6,298

<u>Loan Guarantee Programs</u>	2002			
	<u>Total Modifications</u>	<u>Interest Rate Reestimates</u>	<u>Technical Reestimates</u>	<u>Total Reestimates</u>
FHA	-	-	\$ 951	\$ 951
Total	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 951</u>	<u>\$ 951</u>

Total Loan Guarantee Subsidy Expense (dollars in millions)

<u>Loan Guarantee Programs</u>	<u>Current Year</u>	<u>Prior Year</u>
FHA	\$ 2,447	\$ (2,238)
All Other	10	15
Total	<u>\$ 2,457</u>	<u>\$ (2,223)</u>

I. Subsidy Rates for Loan Guarantees by Programs and Component:

Budget Subsidy Rates for Loans Guarantee for FY 2003

<u>Loan Guarantee Program</u>	<u>Default</u>	<u>Fees and Other Collections</u>	<u>Other</u>	<u>Total</u>
FHA				
FHA	1.55%	-4.08%	0.00%	-2.53%
FHA- Other	4.75%	-5.88%		-1.13%
All Other				
Section 108 (b)	2.30%			2.30%
Indian Housing	2.43%			2.43%
Hawaiian Home	2.43%			2.43%
Title VI Indian Housing	11.07%			11.07%

The subsidy rates above pertain only to FY 2003 cohorts. These rates cannot be applied to the guarantees of loans disbursed during the current reporting year to yield the subsidy expense. The subsidy expense for new loan guarantees reported in the current year could result from disbursements of loans from both current year cohorts and prior year(s) cohort. The subsidy expense reported in the current year also includes modifications re-estimates.

J. Schedule for Reconciling Loan Guarantee Liability Balances (post 1991 Loan Guarantees):

(dollars in millions)

Beginning Balance, Changes, and Ending Balance	FY 2003	FY 2002
Beginning balance of the loan guarantee liability	\$ 3,814	\$ 6,090
Add: subsidy expense for guaranteed loans disbursed during the reporting years by component:		
(a) Interest supplement costs	-	-
(b) Default costs (net of recoveries)	2,770	2,530
(c) Fees and other collections	(7,092)	(5,964)
(d) Othe subsidy costs	479	258
Total of the above subsidy expense components	\$ (3,843)	\$ (3,176)
Adjustments:		
(a) Loan guarantee modifications	-	-
(b) Fees Received	3,085	2,946
(c) Interest supplemental paid	-	-
(d) Foreclosed property and loans acquired	6,526	3,314
(e) Claim payments to lenders	(8,933)	(5,890)
(f) Interest accumulation on the liability balance	(323)	(150)
(g) Other	235	(134)
Ending balance of the subsidy cost allowance before reestimates	\$ 561	\$ 3,000
Add or Subtract subsidy reestimates by component:		
(a) Interest rate reestimate	-	-
(b) Technical/default reestimate	5,752	814
Total of the above reestimate components	5,752	814
Ending balance of the subsidy cost allowance	\$ 6,313	\$ 3,814

K. Administrative Expense (dollars in millions):

	FY 2003	FY 2002
Loan Guarantee Program		
FHA	\$ 447	\$ 511
All Other	1	1
Total	\$ 448	\$ 512

NOTE 10 – GENERAL PROPERTY PLANT AND EQUIPMENT

General property plant and equipment consists of furniture, fixtures, equipment and data processing software used in providing goods and services that have an estimated useful life of two or more years. Purchases of \$100,000 or more are recorded as an asset and depreciated over their estimated useful life on a straight-line basis with no salvage value. Capitalized replacement and improvement costs are depreciated over the remaining useful life of the replaced or improved asset. Generally, the department's assets are depreciated over a 4-year period, unless it can be demonstrated that the estimated useful life is significantly greater than 4 years.

The following shows general property plant and equipment as of September 30, 2003 and 2002, (dollars in millions):

<u>Description</u>	FY 2003			FY 2002		
	Cost	Accum Depr and Amortization	Book Value	Cost	Accum Depr and Amortization	Book Value
Furniture, Fixtures, and Equipment	\$ 46	\$ (20)	\$ 26	\$ 61	\$ (43)	\$ 18
Data Processing Software	6	(4)	2	6	(2)	4
Internal Use Software	71	(15)	56	72	(9)	63
Other Property Plant and Equipment	-	-	-	2	-	2
Total Assets	<u>\$ 123</u>	<u>\$ (39)</u>	<u>\$ 84</u>	<u>\$ 141</u>	<u>\$ (54)</u>	<u>\$ 87</u>

NOTE 11 – LIABILITIES COVERED AND NOT COVERED BY BUDGETARY RESOURCES

The following shows HUD's liabilities as of September 30, 2003 and 2002 (dollars in millions):

Description	2003			2002		
	Covered	Not-Covered	Total	Covered	Not-Covered	Total
Intragovernmental						
Accounts Payable	\$ -	-	\$ -	\$ -	-	\$ -
Debt	11,681	\$ 1,133	12,814	10,465	\$ 1,212	11,677
Other Intragovernmental Liabilities	1,738	4,291	6,029	3,371	4,398	7,769
Total Intragovernmental Liabilities	\$ 13,419	\$ 5,424	\$ 18,843	\$ 13,836	\$ 5,610	\$ 19,446
Accounts Payable	1,120	-	1,120	1,408	-	1,408
Liabilities for Loan Guarantees	6,313	-	6,313	3,814	-	3,814
Debentures Issued to Claimants	-	-	-	-	-	-
Loss Reserves	519	-	519	539	-	539
Debt	294	1,916	2,210	318	2,190	2,508
Federal Employee and Veterans' Benefits	-	85	85	-	81	81
Other Liabilities	977	67	1,044	974	64	1,038
Total Liabilities	\$ 22,642	\$ 7,492	\$ 30,134	\$ 20,889	\$ 7,945	\$ 28,834

NOTE 12 - DEBT

Several HUD programs have the authority to borrow funds from the U.S. Treasury for program operations. Additionally, the National Housing Act authorizes FHA, in certain cases, to issue debentures in lieu of cash to pay claims. Also, PHAs and TDHEs borrowed funds from the private sector and from the Federal Financing Bank (FFB) to finance construction and rehabilitation of low rent housing. HUD is repaying these borrowings on behalf of the PHAs and TDHEs.

The following shows HUD borrowings, and borrowings by PHAs/TDHEs for which HUD is responsible for repayment, as of September 30, 2003 (dollars in millions):

<u>Description</u>	<u>Beginning Balance</u>	<u>Net Borrowings</u>	<u>Ending Balance</u>
Agency Debt:			
Held by Government Accounts	\$ 1,354	\$ (84)	\$ 1,270
Held by the Public	2,508	(298)	2,210
Total Agency Debt	<u>\$ 3,862</u>	<u>\$ (382)</u>	<u>\$ 3,480</u>
Other Debt:			
Debt to the U.S. Treasury	\$ 10,318	\$ 1,224	\$ 11,542
Debt to the Federal Financing Bank	5	(3)	2
Total Other Debt	<u>\$ 10,323</u>	<u>\$ 1,221</u>	<u>\$ 11,544</u>
Total Debt	<u>\$ 14,185</u>	<u>\$ 839</u>	<u>\$ 15,024</u>
Classification of Debt:			
Intragovernmental Debt			\$ 12,814
Debt held by the Public			2,210
Debentures Issued to Claimants			<u>-</u>
Total Debt			<u>\$ 15,024</u>

The following shows HUD borrowings, and borrowings by PHAs/TDHEs for which HUD is responsible for repayment, as of September 30, 2002 (dollars in millions):

<u>Description</u>	<u>Beginning Balance</u>	<u>Net Borrowings</u>	<u>Ending Balance</u>
Agency Debt:			
Held by Government Accounts	\$ 1,430	\$ (76)	\$ 1,354
Held by the Public	2,720	(212)	2,508
Total Agency Debt	<u>\$ 4,150</u>	<u>\$ (288)</u>	<u>\$ 3,862</u>
Other Debt:			
Debt to the U.S. Treasury	\$ 7,797	\$ 2,521	\$ 10,318
Debt to the Federal Financing Bank	8	(3)	5
Total Other Debt	<u>\$ 7,805</u>	<u>\$ 2,518</u>	<u>\$ 10,323</u>
Total Debt	<u>\$ 11,955</u>	<u>\$ 2,230</u>	<u>\$ 14,185</u>
Classification of Debt:			
Intragovernmental Debt			\$ 11,677
Debt held by the Public			2,508
Debentures Issued to Claimants			<u>-</u>
Total Debt			<u>\$ 14,185</u>

Interest paid on borrowings during the year ended September 30, 2003 and 2002, were \$1.1 billion and \$1 billion, respectively. The purpose of these borrowings is discussed in the following paragraphs.

Borrowings from the U.S. Treasury

HUD is authorized to borrow from the U.S. Treasury to finance Housing for Elderly and Disabled loans. The Treasury borrowings typically have a 15-year term, but may be repaid prior to maturity at HUD's discretion. However, such borrowings must be repaid in the sequence in which they were borrowed from Treasury. The interest rates on the borrowings are based on Treasury's 30-year bond yield at the time the notes are issued. Interest is payable on April 30 and October 31. Interest rates ranged from 7.44 percent to 9.17 percent during fiscal year 2003 and 8.69 percent to 9.17 percent for fiscal year 2002.

In fiscal 2003 and 2002, FHA borrowed \$2.9 billion and \$3.9 billion respectively from the U.S. Treasury. The borrowings were needed when FHA initially determined negative credit subsidy amounts related to new loan disbursements or to existing loan modifications. In some instances, borrowings were needed where available cash was less than claim payments due or downward subsidy-estimates. All borrowings were made by FHA's financing accounts. Negative subsidies were generated primarily by the MMI/CMHI Fund financing account; downward

re-estimates have occurred from activity of the FHA's loan guarantee financing accounts. These borrowings carried interest rates ranging from 4.76 percent to 7.36 percent during fiscal 2003 and from 5.47 percent to 7.59 percent during fiscal year 2002.

Borrowings from the Federal Financing Bank (FFB) and the Public

During the 1960s, 1970s, and 1980s, PHAs obtained loans from the private sector and from the FFB to finance development and rehabilitation of low rent housing projects. HUD is repaying these borrowings on behalf of the PHAs, through the Low Rent Public Housing program. For borrowings from the Public, interest is payable throughout the year. Interest rates range from 3.25 percent to 6 percent during fiscal 2003 and from 2.25 percent to 6 percent during fiscal year 2002. The borrowings from the FFB and the private sector have terms up to 40 years. FFB interest is payable annually on November 1. Interest rates range from 10.67 percent to 16.18 percent during both fiscal year 2003 and 2002.

Before July 1, 1986, the FFB purchased notes issued by units of general local government and guaranteed by HUD under Section 108. These notes had various maturities and carried interest rates that were one-eighth of one percent above rates on comparable Treasury obligations. The FFB still holds substantially all outstanding notes, and no note purchased by the FFB has ever been declared in default.

Debentures Issued To Claimants

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 13.38 percent for fiscal 2003 and 2002 and from 4.00 percent to 12.88 percent in fiscal year 2002. 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.

NOTE 13 - OTHER LIABILITIES

The following shows HUD's Other Liabilities as of September 30, 2003 (dollars in millions):

<u>Description</u>	<u>Non-Current</u>	<u>Current</u>	<u>Total</u>
Intragovernmental Liabilities			
FHA Payable from Unapplied Receipts			
Recorded by Treasury	-	-	-
Special Receipt Account Liability	-	1,510	1,510
HUD-Section 312 Rehabilitation Program Payable	-	-	-
Unfunded FECA Liability	-	\$ 17	\$ 17
Resource Payable to Treasury	\$ 4,291	-	4,291
Miscellaneous Receipts Payable to Treasury	209	-	209
Deposit Funds	-	-	-
Other Liabilities	-	2	2
Total Intragovernmental Liabilities	<u>\$ 4,500</u>	<u>\$ 1,529</u>	<u>\$ 6,029</u>
Other Liabilities			
FHA Other Liabilities	\$ -	\$ 218	\$ 218
FHA Escrow Funds Related to Mortgage Notes	-	240	240
FHA Unearned Premiums	-	-	-
Ginnie Mae Deferred Income	-	150	150
Deferred Credits	232	50	282
Deposit Funds	32	27	59
Accrued Unfunded Annual Leave	67	-	67
Accrued Funded Payroll Benefits	28	-	28
Other	-	-	-
Total Other Liabilities	<u>\$ 4,859</u>	<u>\$ 2,214</u>	<u>\$ 7,073</u>

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.

The following shows HUD's Other Liabilities as of September 30, 2002 (dollars in millions):

<u>Description</u>	<u>Non-Current</u>	<u>Current</u>	<u>Total</u>
Intragovernmental Liabilities			
FHA Payable from Unapplied Receipts			
Recorded by Treasury	-	-	-
Special Receipt Account Liability	-	3,095	3,095
HUD-Section 312 Rehabilitation Program Payable	-	-	-
Unfunded FECA Liability	-	\$ 17	\$ 17
Resource Payable to Treasury	\$ 4,381	-	4,381
Miscellaneous Receipts Payable to Treasury	273	-	273
Other Liabilities	-	3	3
Total Intragovernmental Liabilities	<u>\$ 4,654</u>	<u>\$ 3,115</u>	<u>\$ 7,769</u>
Other Liabilities			
FHA Other Liabilities	\$ -	\$ 189	\$ 189
FHA Escrow Funds Related to Mortgage Notes	-	269	269
FHA Unearned Premiums	-	-	-
Ginnie Mae Deferred Income	-	65	65
Deferred Credits	318	66	384
Deposit Funds	12	31	43
Accrued Unfunded Annual Leave	64	-	64
Accrued Funded Payroll Benefits	24	-	24
Other	-	-	-
Total Other Liabilities	<u>\$ 5,072</u>	<u>\$ 3,735</u>	<u>\$ 8,807</u>

NOTE 14 - LOSS RESERVES

For fiscal years 2003 and 2002, Ginnie Mae established loss reserves of \$519 million and \$539 million, respectively, which represents probable defaults by issuers of mortgage-backed securities, through a provision charged to operations. The reserve is relieved as losses are realized from the disposal of the defaulted issuers' portfolios. Ginnie Mae recovers part of its losses through servicing fees on the performing portion of the portfolios and the sale of servicing rights, which transfers to Ginnie Mae upon the default of the issuer. Ginnie Mae management believes that its reserve is adequate to cover probable losses from defaults by issuers of Ginnie Mae guaranteed mortgage-backed securities.

Ginnie Mae incurs losses when insurance and guarantees do not cover expenses that result from issuer defaults. Such expenses include: (1) unrecoverable losses on individual mortgage defaults because of coverage limitations

on mortgage insurance or guarantees, (2) ineligible mortgages included in defaulted Ginnie Mae pools, (3) improper use of proceeds by an issuer, and (4) non-reimbursable administrative expenses and costs incurred to service and liquidate portfolios of defaulted issuers.

NOTE 15 - FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

Some of HUD's programs, principally those operated through FHA and Ginnie Mae, enter into financial arrangements with off-balance sheet risk in the normal course of their operations.

A. FHA Mortgage Insurance

Unamortized insurance in force outstanding for FHA's mortgage insurance programs as of September 30, 2003 and 2002, was \$535 billion and \$608 billion, respectively and is discussed in Note 9F.

B. Ginnie Mae Mortgage-Backed Securities

Ginnie Mae financial instruments with off-balance sheet risk include guarantees of Mortgage-Backed Securities (MBS) and commitments to guaranty MBS. The securities are backed by pools of FHA-insured, RHS-insured, and VA-guaranteed mortgage loans. Ginnie Mae is exposed to credit loss in the event of non-performance by other parties to the financial instruments. The total amount of Ginnie Mae guaranteed securities outstanding at

September 30, 2003 and 2002, was approximately \$473.9 billion and \$568.4 billion, respectively. However, Ginnie Mae's potential loss is considerably less because the FHA and RHS insurance and VA guaranty serve to indemnify Ginnie Mae for most losses. Also, as a result of the structure of the security, Ginnie Mae bears no interest rate or liquidity risk.

During the mortgage closing period and prior to granting its guaranty, Ginnie Mae enters into commitments to guaranty MBS. The commitment ends when the MBS are issued or when the commitment period expires. Ginnie Mae's risks related to outstanding commitments are much less than for outstanding securities due, in part, to Ginnie Mae's ability to limit commitment authority granted to individual issuers of MBS. Outstanding commitments as of September 30, 2003 and 2002, were \$46.4 billion and \$43.2 billion, respectively. Generally, Ginnie Mae's MBS pools are diversified among issuers and geographic areas. No significant geographic concentrations of credit risk exist; however, to a limited extent, securities are concentrated among issuers.

In fiscal 2003 and 2002, Ginnie Mae issued a total of \$106.1 billion and \$122.9 billion respectively in its multi-class securities program. The estimated outstanding balance at September 30, 2003 and 2002, were \$182.9 billion and \$214.4 billion, respectively. These guaranteed securities do not subject Ginnie Mae to additional credit risk beyond that assumed under the MBS program.

C. Section 108 Loan Guarantees

Under HUD's Section 108 Loan Guarantee program, recipients of CDBG Entitlement Grant program funds may pledge future grant funds as collateral for loans guaranteed by HUD (these loans were provided from private lenders since July 1, 1986). This Loan Guarantee Program provides entitlement communities with a source of financing for

projects that are too large to be financed from annual grants. The amount of loan guarantees outstanding as of September 30, 2003 and 2002, were \$2.2 billion and \$2 billion, respectively. HUD's management believes its exposure in providing these loan guarantees is limited, since loan repayments can be offset from future CDBG Entitlement Program Funds and, if necessary, other funds provided to the recipient by HUD. HUD has never had a loss under this program since its inception in 1974.

NOTE 16 - CONTINGENCIES

Lawsuits and Other

HUD is party in various legal actions and claims brought against it. In the opinion of HUD's management and General Counsel, the ultimate resolution of these legal actions and claims will not materially affect HUD's financial position or results of operations for the fiscal year ended September 30, 2003 and 2002. Payments made out of the Claims, Judgments and Relief Acts Fund in settlement of the legal proceedings are subject to the Department of Justice's approval.

Forty-two multifamily housing projects owners filed a case alleging that the United States effected breaches of contract by enacting the Emergency Low-Income Housing Preservation Act of 1987 (ELIHPA) and the Low-Income Housing Preservation and Resident Homeownership Act of 1990 (LIHPRHA). The plaintiffs claim that these acts prevented them from prepaying their mortgages 20 years after mortgage-insurance endorsement, or alternatively, that LIHPRHA effected regulatory takings of their properties. There are nine other still-pending actions in the Court of Federal Claims, involving an additional 199 plaintiff project owners, raising identical claims. More than a dozen other LIHPRHA cases, involving some 500-plaintiff project owners, have been previously dismissed.

The Court of Federal Claims ruled that the project owners' mortgage contracts had in fact been breached by implementation of ELIHPA and LIHPRHA, and held a trial in November 1996 to determine damages, if any, with respect to that claim. The court awarded \$3,061,107 in damages to the Plaintiffs for four "test" properties jointly selected by the parties. The United States appealed this judgment. On December 7, 1998, the United States Court of Appeals for the Federal Circuit reversed the judgment of the Court of Federal Claims, holding that ELIHPA and LIHPRHA did not breach contract between the plaintiffs and HUD. The Federal Circuit remanded the action to the Court of Federal Claims for consideration of the plaintiffs' takings claim. On March 11, 1999, the Federal Circuit denied rehearing and declined rehearing en banc. On October 4, 1999, the United States Supreme Court denied certiorari.

On June 12, 2003, the Federal Circuit, once again reversing the lower court, held that LIHPRHA and ELIHPA had effected regulatory takings. The Court went on to hold that the amount that had been awarded the four "Model Plaintiffs" in the original damages judgment entered in the earlier breach of contract damages trial "be reinstated in the amount awarded therein for each of the four Model Plaintiffs." With respect to the remaining 38 non-model plaintiffs, the Court remanded the case "for the trial court to develop an appropriate record and to rule on liability, and if liability is found, also damages." The United States is currently reviewing whether to seek review en banc in the Federal Circuit and or certiorari in the United States Supreme Court. The United States intends to continue to vigorously defend all the LIHPRHA cases and is unable to form a judgment regarding the outcome with absolute certainty.

Another case was filed for breach of contract by two Corporations controlled by an individual and 20 partnerships in which he and/or the two corporations are general partners stemming from a so-called "Repayment Agreement" between HUD and them, executed on August 25, 1994. Plaintiffs allege that HUD was contractually bound to process Section 241(f) "equity loans" (an incentive offered to multifamily project owners under the LIHPRHA for 26 properties identified in Schedule D of the Repayment Agreement. Plaintiffs claim that HUD's 1997 Appropriations Act effectively modified the Repayment Agreement, by replacing HUD's authorization to provide Section 241(f) loans (which was repealed) with an obligation to provide capital (direct) loans for the 26 properties identified on Schedule D of the Agreement by specifically earmarking a \$ 75 million appropriation to HUD for that purpose. Plaintiffs claim HUD breached its contractual obligation by failing to provide capital (direct) loans for 20 of the 26 properties identified in Schedule D of the Agreement.

An answer was filed by the United States in January 2003, and extensive discovery ensued. Both the plaintiffs and the United States moved for summary judgment in April 2003. On November 25, 2003, the Court ruled on the parties' cross-motions for summary judgment on liability. The Court denied HUD's motion and granted Plaintiff's partial summary judgment on liability. The Court agreed with HUD's primary arguments, namely that the 1997 Appropriations Act did not breach the parties' contract (Repayment Agreement), and that the Act's purpose was public and general and thus was a "sovereign act" that neither party anticipated or provided for in their contract. Notwithstanding, the Court agreed with Plaintiffs' argument that HUD had offered a modification to the Repayment Agreement when it made \$25 million in capital (direct) loans available to Plaintiff and Plaintiff accepted the capital (direct) loans as complying with the contract. Consequently, according to the Court, although Congress gave HUD discretion to allocate the carve out funds among various programs; this discretion did not authorize HUD to breach a contract to which it was already a party. The court has retained jurisdiction to decide the damages issue. Plaintiffs' most current estimation of damages for breach of contract is \$33 million. The United States intends to continue to vigorously defend this case, and is unable at this time to form a judgment regarding the outcome.

Finally, a former HUD Contractor has filed a lawsuit in the Court of Federal Claims asserting that the Department misappropriated its intellectual property in connection with its performance of annual financial statements contracts it held between 1990-1994. A HUD contracting officer denied its claims, totaling \$62.5 million, and the contractor then filed its suit.

The parties have filed briefs in support of cross motions for summary judgment. In its motion, HUD argues that, even viewed in a light most favorable to the corporation, HUD is entitled to summary judgment as to all of the corporation's claims. The corporation takes a different position. It argues that, viewing the facts in a light most favorable to HUD, the corporation has proven its entitlement as to some of its claims and is entitled to summary judgment on those claims. As for the other claims, the corporation argues that the issues cannot be determined by summary judgment, and it is entitled to present its case at trial. After completing significant discovery, the parties sought to have the case decided by Summary Judgment. HUD filed a motion for Summary Judgment requesting disposal of the case in its entirety. The Corporation filed a motion for partial Summary Judgment and the parties engaged in back and forth briefing. The parties are now awaiting either a ruling from the judge or a request by the judge for oral argument. HUD will continue to vigorously defend this case, and is unable to form a judgment regarding the outcome with absolute certainty.

NOTE 17 – RENTAL HOUSING SUBSIDY PAYMENT ERRORS

HUD's rental housing assistance programs -- which include public housing and various tenant-based and project-based rental housing assistance programs -- are administered on HUD's behalf by third party program administrators including public housing agencies, private housing owners and contracted management agents. Under these programs, eligible tenants generally are required to pay 30 percent of their income towards rent, with HUD providing the balance of the rental payment. New applicants provide certain information on household characteristics, income, assets and expense activities used in determining the proper amount of rent they are to pay.

Existing tenants are required to recertify this information on an annual basis, and in certain other circumstances when there are significant changes in household income. Applicant or tenant failure to correctly report their income, or the failure of the responsible program administrator to correctly process, calculate and bill the tenant's rental assistance, may result in the Department's overpayment or underpayment of housing assistance.

In 2000, HUD began to establish a baseline error measurement to cover the three types of rental housing assistance payment errors, consisting of errors in: 1) program administrator income and rent determinations, 2) tenant reporting of income, and 3) processing of program administrator billings for assistance payments. Error estimates for each of these three components are provided in the captioned sections below. A study covering the first half of FY 2003 was used to update the 2000 baseline measurement of errors in program administrator income and rent determinations. The independent source of income data needed to do the income matching to determine tenant income reporting errors for the 2003 sample will not be available until the latter part of 2004, so the 2000 baseline estimates on that component continue to be reported. The preliminary 2000 baseline estimate for the third component, billing error, underwent further review and adjustment this period, but the results are still not considered conclusive, pending expansion of the billing study methodology to cover all possible allowable program activity. An updated set of acceptable billing studies will be performed in 2004, on FY 2003 activity, to complete a comprehensive erroneous payments estimate on FY 2003 activity for reporting in the FY 2004 financial statements.

Program Administrator Income and Rent Determinations

The 2000 baseline estimates of erroneous payments attributed to program administrator rent calculation and processing errors were based on a HUD Office of Policy Development and Research (PD&R) study of "Quality Control for Rental Assistance Subsidies Determinations," which was published as a final report in June 2001. PD&R's methodology provided for interviewing a representative sample of tenants, verifying and validating tenant income reporting, and recalculating rents for comparison to program administrator determinations for the purpose of identifying errors. The 2000 study verified rent calculations for a representative sample of 2,403 households receiving assistance at 600 projects. The 2003 study to update these estimates used the same methodology, sampling procedures, and sample sizes. The 2003 study shows a significant reduction in erroneous payments attributed to program administrator income and rent determinations, as reflected in the following table:

Rental Assistance Programs	FY 2003 Estimates of Errors In Program Administrator Income and Rent Determinations*				FY 2000 Estimates*	Percent Reduction In Gross Erroneous Payments
	Assistance Over- payments	Assistance Under- payments	Net Erroneous Payments	Gross Erroneous Payments	Gross Erroneous Payments	
Public Housing	\$248,544	\$107,496	\$141,048	\$356,040	\$631,776	43.6%
Vouchers & Mod Rehab	\$470,784	\$326,724	\$144,060	\$797,508	\$1,132,560	29.6%
Total PHA Administered	\$719,328	\$434,220	\$285,108	\$1,153,548	\$1,764,336	34.6%

Project-based Assistance	\$267,672	\$128,124	\$139,548	\$395,796	\$539,160	26.6%
Total	\$987,000	\$562,344	\$424,656	\$1,549,344	\$2,303,496	32.7%
	(+/- \$208,000)	(+/- \$287,000)	(+/- \$184,000)	(+/- \$229,000)	(+/- \$275,000)	

* - All values are presented in thousands.

Tenant Reporting of Income

The estimate of assistance overpayments attributed to tenant underreporting of income is based on a sample of 2,403 households assisted in 2000. These tenants had all been asked detailed questions about all sources of income. These responses were compared with earned and unearned household income from Social Security Administration (SSA) and Internal Revenue Service (IRS) databases. Identified cases of possible undisclosed income sources were verified with employers. The additional sources of income were also examined to determine if the additional income found would affect the computation of the correct HUD rental assistance amount, or if the income discrepancies were attributed to other causes not affecting the assistance amount (e.g., data entry errors in any of the systems involved in the matching process, timing differences in the income data being considered, or tenant income excluded by program regulation). Validated income discrepancies were further assessed against the original program administrator error estimates for these sample cases to eliminate any duplication. Based on the results of this review, the Department projects, with 95 percent confidence, that the amount of assistance overpayments attributed to intentional tenant underreporting of income was \$978 million \pm \$247 million.

Program Administrator Billings

As part of HUD's continuing efforts to improve management of its rental housing assistance programs, two reviews of billing errors were conducted during 2002. One review related to the Office of Public and Indian Housing's voucher program and the other to the Office of Housing's project-based assistance. The purpose of these reviews was to determine, on a sample basis, whether HUD assistance was billed and disbursed in accordance with HUD policies and regulations. Data for a randomly selected sample of 50 projects was collected for each program area. Fiscal year 2000 records were selected to permit use of reconciled statements and bills, which also served to maintain consistency with HUD's other 2000 baseline error estimates. The distribution of the sampled projects matched well with that of the respective program universe. Ten (10) tenant files were selected for each project in the sample. The preliminary baseline results for each program area were as follows:

Office of Public and Indian Housing (PIH): The original review projected assistance underpayments totaling an estimated \$121 million and assistance overpayments totaling an estimated \$99 million, with a possible additional estimated \$1,267 million of erroneous payments due to the 24 percent of sampled cases that did not have the expected documentation to support the validity of the billings. Program management questioned the study results and whether the reviewers had sufficient program knowledge to properly recognize program policy, accounting and record keeping nuances that might provide acceptable explanations for many of the originally perceived errors and unaccepted documentation. Program experts were sent to perform additional field work at 10 of the sampled PHA's that formed the basis for \$1,044 million of the total projected billing errors and unsupported amounts. As a result of the additional review by program experts, the amount in question was reduced by 89 percent to \$138 million in estimated error. Program staff also performed desk reviews of sample case files for an additional 10 PHAs representing another \$115 million in projected erroneous or unsupported billings and found acceptable case material to warrant a 33 percent reduction in the estimated error to \$77 million. Program staff did not review the case support for 28 other sampled

PHAs associated with \$289 million in additional projected errors or unsupported billings, but it is likely that downward adjustments to those cases would have followed a similar pattern to cases that were subjected to further review. Given the questionable and incomplete nature of the original PIH billing study, the results are considered inconclusive and unacceptable as a baseline error measurement. In FY 2004, PIH plans to develop and implement a more detailed billing study methodology, with improved training for reviewers, to establish a valid baseline of billing error in the public housing, voucher and mod rehab programs.

Office of Housing: Based on the 95 percent of sampled cases with all required supporting documentation, estimated assistance underpayments totaled \$14.7 million and assistance overpayments totaled \$22.8 million, for a net assistance overpayment estimate of \$8.1 million attributed to billing errors. The relatively small size of these errors resulted in a relatively large 95 percent estimate confidence interval of plus/minus \$0.9 million for the net error estimate. Regarding the 5 percent of sampled cases with missing tenant assistance determinations or billing records, the full value of the projected assistance associated with such cases is estimated at \$72 million. This estimate has a 95 percent confidence interval of plus/minus \$0.6 million. While the full amount of this estimate could be counted as process error because the required supporting documentation was not readily available or explainable, further review would be necessary to determine how much, if any, of this additional \$72 million estimate actually represents a valid payment error versus a program administration or record keeping deficiency.

Combined Error Impacts

The combined effect of the most recent accepted estimates of error for the three error components is summarized in the following chart:

Type of Payment Error (Period)	*Public Housing Assistance	*Vouchers & Mod Rehab Assistance	*Project-Based Assistance	*Total All Rental Assistance Programs
Gross Error In Administrator Subsidy Determinations (2003)	\$356	\$797	\$396	\$1,549
Error Due To Tenant Underreporting Of Income (2000)	\$294	\$418	\$266	\$978
Billing Error (Baseline to be established in FY 2004)	---	---	---	---
Total Gross Error	\$650	\$1,215	\$662	\$2,527
FY 2003 Program Expenditures	\$3,435	\$13,409	\$7,737	\$24,581
Percent of Erroneous Payments	18.9	9.0	8.6	10.3

* - All values are presented in millions.

Corrective Actions

HUD has taken aggressive steps to address the causes of erroneous assistance payments, including extensive on-site monitoring. It is also instituting additional controls, such as validating tenant reported income against state wage data, to better assure that payments are made in the correct amounts, in accordance with program statutory and regulatory requirements. HUD's goal is to reduce processing errors and resulting erroneous payments 50 percent by 2005. The 2003 study of administrator processing error shows significant progress in meeting this goal. HUD exceeded its interim 2003 goal of a 15 percent reduction in that component of error since 2000. It should be noted that the reduction of errors and improper payments is unlikely to have an equivalent impact on budget outlays. HUD's experience indicates that its program integrity improvement efforts are likely to result in some higher income tenants leaving assisted housing and being replaced with lower income tenants requiring increased outlays. Nevertheless, HUD's goal remains to ensure that the right benefits go to the right people.

NOTE 18 - TOTAL COST AND EARNED REVENUE BY BUDGET FUNCTIONAL CLASSIFICATION

The following shows HUD's total cost and earned revenue by budget functional classification for fiscal 2003 (dollars in millions):

<u>Budget Functional Classification</u>	<u>Gross Cost</u>	<u>Earned Revenue</u>	<u>Net Cost</u>
Intragovernmental:			
Commerce and Housing Credit	\$ 866	\$ 1,808	\$ (942)
Community and Regional			
Development	308	3	305
Income Security	221	4	217
Administration of Justice	-	-	-
Miscellaneous	-	-	-
Total Intragovernmental	<u>\$ 1,395</u>	<u>\$ 1,815</u>	<u>\$ (420)</u>
With the Public:			
Commerce and Housing Credit	\$ 2,859	\$ 2,008	\$ 851
Community and Regional			
Development	5,858	1	5,857
Income Security	34,509	17	34,492
Administration of Justice	50	-	50
Miscellaneous	-	-	-
Total with the Public	<u>\$ 43,276</u>	<u>\$ 2,026</u>	<u>\$ 41,250</u>
TOTAL:			
Commerce and Housing Credit	\$ 3,725	\$ 3,816	\$ (91)
Community and Regional	-	-	-
Development	6,166	4	6,162
Income Security	34,730	21	34,709
Administration of Justice	50	-	50
Miscellaneous	-	-	-
TOTAL:	<u>\$ 44,671</u>	<u>\$ 3,841</u>	<u>\$ 40,830</u>

The following shows HUD's total cost and earned revenue by budget functional classification for fiscal 2002 (dollars in millions):

<u>Budget Functional Classification</u>	<u>Gross Cost</u>	<u>Earned Revenue</u>	<u>Net Cost</u>
Intragovernmental:			
Commerce and Housing Credit	\$ 896	\$ 1,860	\$ (964)
Community and Regional			
Development	63	2	61
Income Security	500	4	496
Administration of Justice	-	-	-
Miscellaneous	-	-	-
Total Intragovernmental	<u>\$ 1,459</u>	<u>\$ 1,866</u>	<u>\$ (407)</u>
With the Public:			
Commerce and Housing Credit	\$ (1,984)	\$ 2,151	\$ (4,135)
Community and Regional			
Development	5,660	2	5,658
Income Security	31,868	19	31,849
Administration of Justice	43	-	43
Miscellaneous	-	-	-
Total with the Public	<u>\$ 35,587</u>	<u>\$ 2,172</u>	<u>\$ 33,415</u>
TOTAL:			
Commerce and Housing Credit	\$ (1,088)	\$ 4,011	\$ (5,099)
Community and Regional			
Development	5,723	4	5,719
Income Security	32,368	23	32,345
Administration of Justice	44	-	44
Miscellaneous	-	-	-
TOTAL:	<u>\$ 37,047</u>	<u>\$ 4,038</u>	<u>\$ 33,009</u>

NOTE 19 – PRIOR PERIOD ADJUSTMENTS

In fiscal year 2003, HUD recorded \$4,763,973 in prior period adjustments for the Working Capital Fund. This adjustment resulted from depreciation of equipment for fiscal year 2002. In addition, HUD recorded \$6,622,497 in prior period adjustments for the Rental Housing Assistance program. This adjustment resulted from an expense relating to a payable that should have been established to transfer funds to the Flexible Subsidy program in fiscal year 2002.

NOTE 20 – APPORTIONMENT CATEGORIES OF OBLIGATIONS INCURRED

HUD's categories of obligations incurred were as follows (dollars in millions):

Fiscal Year	Category A	Category B	Exempt From Apportionment	Total
FY 2003	\$1,186	\$ 55,629	\$ -	\$ 56,815
FY 2002	\$1,227	\$ 56,686	\$ 314	\$ 58,227

NOTE 21 – EXPLANATION OF DIFFERENCES BETWEEN THE STATEMENT OF BUDGETARY RESOURCES AND THE BUDGET OF THE UNITED STATES GOVERNMENT

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.

The President's Budget is not yet available for comparison to the Statement of Budgetary Resources.

NOTE 22 - EXPLANATION OF THE RELATIONSHIP BETWEEN LIABILITIES NOT COVERED BY BUDGETARY RESOURCES ON THE BALANCE SHEET AND THE CHANGES IN COMPONENTS REQUIRING OR GENERATING RESOURCES IN FUTURE PERIODS

In FY 2002, the department reported a net increase in unfunded annual leave liability, in the consolidated Statement of Financing of \$2.4 million. This unfunded leave liability is not covered by budgetary resources at the balance sheet date, as explained in note 11.

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CONSOLIDATING FINANCIAL STATEMENTS

(BY MAYOR PROGRAM AREA)

Department of Housing and Urban Development
Consolidating Balance Sheet
As of September 2003
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home	Operating Subsidies	Public and Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other	Financial Statement Eliminations	Consolidating
ASSETS											
Intragovernmental											
Fund Balance with Treasury (Note 3)	\$7,934	\$2,932	\$18,856	\$12,521	\$5,305	\$1,865	\$9,110	\$7,843	\$10,093	\$0	\$76,458
Investments (Note 5)	23,982	7,278							0	0	31,260
Accounts Receivable (Note 7)	0		0	0	0	0	0		6	(6)	0
Other Assets (Note 8)	57	0	0	0	0	0	0		(53)	0	4
Total Intragovernmental Assets (Note6)	\$31,973	\$10,210	\$18,856	\$12,521	\$5,305	\$1,865	\$9,110	\$7,843	\$10,046	(\$6)	\$107,722
Investments (Net) (Note 5)	123										123
Accounts Receivable (Net) (Note 7)	152	26	387	0	0	0	0	0	3		569
Credit Program Receivables and Related Foreclosed Property (Net) (Note 9)	4,291			0			2	7,517	211		12,022
General Property Plant and Equipment (Net) (Note 10)		8							75		84
Other Assets (Note 8)	130	110	0	0	0	0	0	0	3	0	243
TOTAL ASSETS (Note6)	\$36,669	\$10,354	\$19,243	\$12,521	\$5,305	\$1,865	\$9,112	\$15,360	\$10,339	(\$6)	\$120,763
LIABILITIES											
Intragovernmental Liabilities											
Accounts Payable	\$0	\$0	\$0	\$6	\$0	\$0	\$0	\$0	\$0	(\$6)	\$0
Debt (Note 12)	8,794						\$1,270	\$2,748	2		12,814
Other Intragovernmental Liabilities (Note 13)	1,510		\$177	1	1	1	1	4,291	47	0	6,029
Total Intragovernmental Liabilities (Note 11)	\$10,305	\$0	\$177	\$7	\$1	\$1	\$1,271	\$7,039	\$49	(\$6)	\$18,843
Accounts Payable	869	35	11	14	7	119	26	6	32		1,120
Loan Guarantees Liabilities (Note 9)	6,251								62		6,313
Debt Held by the Public (Note 12)	270			0			1,940	0		0	2,210
Federal Employee and Veterans' Benefits (Note 2)			8	7	3	5	2	2	60		85
Debentures Issued to Claimants (Note 12)	0										0
Loss Reserves (Note 14)		519									519
Other Governmental Liabilities (Note 13)	739	150	9	6	3	6	2	19	112	0	1,044
TOTAL LIABILITIES (Note11)	\$18,434	\$704	\$204	\$34	\$13	\$131	\$3,240	\$7,066	\$315	(\$6)	\$30,134
NET POSITION											
Unexpended Appropriations	\$576	\$0	\$19,039	\$12,488	\$5,291	\$1,734	\$8,928	\$7,132	\$9,564	\$0	\$64,753
Cumulative Results of Operations	17,659	\$9,650	0	0	0	0	(3,056)	1,162	459	0	25,876
Total Net Position	\$18,235	\$9,650	\$19,039	\$12,488	\$5,291	\$1,734	\$5,872	\$8,294	\$10,024	\$0	\$90,629
Total Liabilities and Net Position	\$36,669	\$10,354	\$19,243	\$12,521	\$5,305	\$1,865	\$9,112	\$15,360	\$10,339	(\$6)	\$120,763

Figures may not add to totals because of rounding.

Department of Housing and Urban Development
Consolidating Balance Sheet
As of September 2002
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home	Operating Subsidies	Public and Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other	Financial Statement Eliminations	Consolidating
ASSETS											
Intragovernmental											
Fund Balance with Treasury (Note 3)	\$9,597	\$2,509	\$18,379	\$13,199	\$4,926	\$1,686	\$9,700	\$7,307	\$10,329		\$77,632
Investments (Note 5)	21,346	6,996									28,342
Accounts Receivable (Note 7)									9	(6)	3
Other Assets (Note 8)	88		6	9	8		35	1	52	(199)	
Total Intragovernmental Assets (Note 6)	\$31,031	\$9,505	\$18,385	\$13,208	\$4,934	\$1,686	\$9,735	\$7,308	\$10,390	(\$205)	\$105,977
Investments (Net) (Note 5)											
Accounts Receivable (Net) (Note 7)	334	31	419						1		785
Credit Program Receivables and Related Foreclosed Property (Net) (Note 9)	3,367						4	7,724	280		11,376
General Property Plant and Equipment (Net) (Note 10)		9							78		87
Other Assets (Note 8)	137	10							5		152
TOTAL ASSETS (Note 6)	\$34,870	\$9,555	\$18,804	\$13,208	\$4,934	\$1,686	\$9,739	\$15,032	\$10,754	(\$205)	\$118,377
LIABILITIES											
Intragovernmental Liabilities											
Accounts Payable					\$5					(5)	\$0
Debt (Note 12)	7,552						\$1,354	\$2,766	5		11,677
Other Intragovernmental Liabilities (Note 13)	3,096		\$239					4,381	253	(199)	7,769
Total Intragovernmental Liabilities (Note 11)	\$10,648	\$0	\$239	\$6	\$0	\$0	\$1,354	\$7,147	\$258	(\$205)	\$19,446
Accounts Payable	1,207	33	7	24	8	69	29	2	30		1,408
Loan Guarantees Liabilities (Note 9)	3,761								53		3,814
Debt Held by the Public (Note 12)	288						2,220				2,508
Federal Employee and Veterans' Benefits (Note 2)									81		81
Debentures Issued to Claimants (Note 12)	0										0
Loss Reserves (Note 14)		539									539
Other Governmental Liabilities (Note 13)	839	65	4	3	1	1	6	16	101		1,038
TOTAL LIABILITIES (Note 11)	\$16,743	\$637	\$250	\$33	\$9	\$70	\$3,609	\$7,165	\$523	(\$205)	\$28,834
NET POSITION											
Unexpended Appropriations	\$761		\$18,554	\$13,175	\$4,925	\$1,616	\$9,533	\$7,109	\$9,734		\$65,407
Cumulative Results of Operations	17,366	\$8,918					(3,403)	758	497		24,136
Total Net Position	\$18,127	\$8,918	\$18,554	\$13,175	\$4,925	\$1,616	\$6,130	\$7,867	\$10,231	(\$205)	\$89,543
Total Liabilities and Net Position	\$34,870	\$9,555	\$18,804	\$13,208	\$4,934	\$1,686	\$9,739	\$15,032	\$10,754	(\$205)	\$118,377

Figures may not add to totals because of rounding.

Department of Housing and Urban Development
Consolidating Statement of Net Cost
For the Period Ended September 2003 and 2002
(Dollars in Millions)

2003	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home	Operating Subsidies	Public and Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other	Financial Statement Eliminations	Consolidating
PROGRAM COSTS											
Intragovernmental Gross Costs	\$715	\$0	\$48	\$33	\$14	\$44	\$160	\$228	\$223	(\$71)	\$1,395
Less: Intragovernmental Earned Revenue	(1,418)	(\$388)						0	(79)	71	(1,815)
Intragovernmental Net Costs	(\$703)	(\$388)	\$48	\$33	\$14	\$44	\$160	\$228	\$144	\$0	(\$420)
Gross Costs With the Public	\$2,738	\$68	\$20,988	\$5,582	\$1,625	\$3,462	\$3,936	\$1,026	\$3,431	0	\$42,856
Less: Earned Revenues	(950)	(411)					(0)	(637)	(28)		(2,026)
Net Costs With the Public	\$1,788	(\$343)	\$20,988	\$5,582	\$1,625	\$3,462	\$3,936	\$389	\$3,403	\$0	\$40,830
Total Net Costs	\$1,085	(\$731)	\$21,036	\$5,615	\$1,639	\$3,506	\$4,096	\$617	\$3,547	\$0	\$40,410
Costs Not Assigned to Programs			0	0	0	0	0	0	420		420
Net Cost of Operations	\$1,085	(\$731)	\$21,036	\$5,615	\$1,639	\$3,506	\$4,096	\$617	\$3,967	\$0	\$40,830
2002											
PROGRAM COSTS											
Intragovernmental Gross Costs	\$641		\$53	\$26	\$14	\$33	\$214	\$264	\$213		\$1,458
Less: Intragovernmental Earned Revenue	(1,461)	(\$399)							(7)		(1,867)
Intragovernmental Net Costs	(\$820)	(\$399)	\$53	\$26	\$14	\$33	\$214	\$264	\$206	\$0	(\$409)
Gross Costs With the Public	(\$2,071)	\$57	\$18,421	\$5,417	\$1,537	\$3,666	\$4,038	\$898	\$3,224		\$35,187
Less: Earned Revenues	(1,044)	(452)						(646)	(29)		(2,171)
Net Costs With the Public	(\$3,115)	(\$395)	\$18,421	\$5,417	\$1,537	\$3,666	\$4,038	\$252	\$3,195	\$0	\$33,016
Total Net Costs	(\$3,935)	(\$794)	\$18,474	\$5,443	\$1,551	\$3,699	\$4,252	\$516	\$3,401	\$0	\$32,607
Costs Not Assigned to Programs									403		403
Net Cost of Operations	(\$3,935)	(\$794)	\$18,474	\$5,443	\$1,551	\$3,699	\$4,252	\$516	\$3,804	\$0	\$33,010

Figures may not add to totals because of rounding.

**Department of Housing and Urban Development
Consolidating Statement of Changes in Net Position
for the period ended September 2002
(Dollars in Millions)**

2002	Cumulative Results of Operations										
	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home	Operating Subsidies	Public and Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other	Financial Statement Eliminations	Consolidating
Net Position-Beginning of Period	(\$12,986)	(\$8,124)		5			\$3,749	(\$365)	(\$524)		(\$18,250)
Prior Period Adjustments (Note 19)											5
Beginning Balances, As Adjusted	(\$12,986)	(\$8,124)	\$0	\$5	\$0	\$0	\$3,749	(\$365)	(\$524)	\$0	(\$18,245)
Budgetary Financing Sources											
Other Adjustments (Recissions, etc)											
Appropriations Used	(\$2,381)		(\$18,391)	(\$5,405)	(\$1,531)	(\$3,672)	(\$4,527)	(\$887)	(\$3,748)		(\$40,542)
Transfers In/Out Without Reimbursemen	839										839
Other Budgetary Financing Sources			(83)	(38)	(20)	(27)	(71)	(22)	269		8
Other Financing Sources											
Donations and Forfeitures of Property											
Transfers In/Out Without Reimbursemen	1,102								(237)		865
Imputed Financing From Costs											
Absorbed From Others	(14)								(59)		(73)
Other	9			(5)					(2)		2
Total Financing Sources	(\$445)		(\$18,474)	(\$5,448)	(\$1,551)	(\$3,699)	(\$4,598)	(\$909)	(\$3,777)	\$0	(\$38,901)
Net Cost of Operations	(3,935)	(794)	18,474	5,443	1,551	3,699	4,252	516	3,804		33,010
Ending Balances	(\$17,366)	(\$8,918)	\$0	\$0	\$0	\$0	\$3,403	(\$758)	(\$497)	\$0	(\$24,136)
Unexpended Appropriations											
Net Position-Beginning of Period	(\$2,129)		(\$17,813)	(\$10,106)	(\$4,660)	(\$1,793)	(\$10,068)	(\$6,899)	(\$9,837)		(\$63,305)
Prior Period Adjustments				(5)							(5)
Beginning Balances, As Adjusted	(\$2,129)		(\$17,813)	(\$10,111)	(\$4,660)	(\$1,793)	(\$10,068)	(\$6,899)	(\$9,837)		(\$63,310)
Budgetary Financing Sources											
Appropriations Received	(\$2,982)		(\$20,746)	(\$7,783)	(\$1,846)	(\$3,495)	(\$3,986)	(\$1,097)	(\$3,695)		(\$45,630)
Transfers In/Out	1,986			(700)					(6)		1,280
Other Adjustments (Recissions, etc)	(17)		1,614	14	50				56		1,717
Appropriations Used	2,381		18,391	5,405	1,531	3,672	4,521	887	3,748		40,536
Total Financing Sources	\$1,368		(\$741)	(\$3,064)	(\$265)	\$177	\$535	(\$210)	\$103		(\$2,097)
Ending Balances	(\$761)		(\$18,554)	(\$13,175)	(\$4,925)	(\$1,616)	(\$9,533)	(\$7,109)	(\$9,734)		(\$65,407)

Figures may not add to totals because of rounding.

Department of Housing and Urban Development
Combining Statement of Budgetary Resources
For the Period Ended September 2003
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home	Operating Subsidies	Public and Indian Housing Loans & Grants	Housing for the Elderly and Disabled	Financial Statement and Eliminations	All Other	2003 Budgetary Total	Federal Housing Administration Non Budgetary	Other Non Budgetary Credit Program Accounts	2003 Total NonBudgetary Credit Program Financing Accounts	Total
Budgetary Resources:															
Budget Authority	\$2,607	\$0	\$22,724	\$4,937	\$2,000	\$3,600	\$3,902	\$1,034	\$0	\$4,097	\$44,900	\$2,890	\$0	\$2,890	\$47,790
Net Transfers, Current Year Authority			0	0	0	0	0	0		7	7		0	0	7
Unobligated Balance-Beginning of Year	23,834	\$9,415	1,947	1,785	256	26	889	2,543		4,581	45,287	3,021	\$72	3,092	48,379
Spending Authority from Offsetting Collections	6,576	849	0	0	0	0	1	829	(6)	(176)	8,072	12,391	13	12,405	20,476
Adjustments															
Recoveries of Prior Year Obligations	510		1,616	15	13	18	20	10		1,110	3,313	77	0	77	3,390
Permanently not available															
Cancellations-Expired and No Year Accts	(1)		(10)	(21)						(39)	(72)	0	0	0	(72)
Enacted Reversions			(1,174)	(0)		0	0	0		(434)	(1,608)		0	0	(1,608)
Capital Trans & Debt Redemption	(755)						(96)	(90)		(13)	(954)	(1,649)	0	(1,649)	(2,603)
Other Authority Withdrawn	(5)	0	(5,617)	(32)	(13)	(23)	(529)	(7)		(1,687)	(7,912)	0	0	0	(7,913)
Total Budgetary Resources	\$32,767	\$10,264	\$19,486	\$6,684	\$2,257	\$3,621	\$4,186	\$4,320	(\$6)	\$7,455	\$91,033	\$16,730	\$85	\$16,815	\$107,848
Status of Budgetary Resources:															
Obligations Incurred (Note 20)	\$5,656	\$158	\$16,003	\$5,537	\$1,869	\$3,618	\$3,344	\$1,814	(\$6)	\$3,151	\$41,144	\$15,669	\$2	\$15,671	\$56,815
Unobligated Balances Available	225	0	3,454	1,118	378	0	831	1,943	0	2,777	10,726	814	0	814	11,540
Unobligated Balances Not Available	26,886	10,106	30	29	9	2	12	562	0	1,527	39,163	247	83	330	39,493
Total Status of Budgetary Resources	\$32,767	\$10,264	\$19,486	\$6,684	\$2,257	\$3,621	\$4,186	\$4,320	(\$6)	\$7,455	\$91,033	\$16,730	\$85	\$16,815	\$107,848
Obligated Balance, Net-Beg of Period	\$1,707	\$6	\$37,664	\$11,409	\$4,667	\$1,658	\$12,609	\$4,762		\$15,224	\$89,706	(\$79)	(\$19)	(\$98)	\$89,608
Obligated Balance Transferred, Net			0	0	0			0		0	0		0	0	0
Obligated Balance, Net - End of Period	938	27	31,108	11,375	4,917	1,863	11,595	5,338	13	13,490	80,663	941	(\$20)	921	81,584
Outlays															
Disbursements	5,907	137	20,944	5,557	1,606	3,395	4,337	1,228	(13)	3,781	46,880	14,731	2	14,733	61,613
Collections	(6,569)	(849)		0			(1)	(829)	0	170	(8,078)	(12,549)	(12)	(12,562)	(20,639)
Subtotal	(\$662)	(\$712)	\$20,944	\$5,557	\$1,606	\$3,395	\$4,337	\$400	(\$13)	\$3,951	\$38,802	\$2,182	(\$10)	\$2,171	\$40,973
Less: Offsetting Receipts	(1,372)	0	0	0	0	0	0	0	0	(10)	(1,382)	0	0	0	(1,382)
Net Outlays	(\$2,034)	(\$712)	\$20,944	\$5,557	\$1,606	\$3,395	\$4,337	\$400	(\$13)	\$3,941	\$37,420	\$2,182	(\$10)	\$2,171	\$39,592

Figures may not add to totals because of rounding.

**Combining Statement of Budgetary Resources
For the Period Ended September 2002
(Dollars in Millions)**

	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home	Operating Subsidies	Public and Indian Housing Loans & Grants	Housing for the Elderly and Disabled	All Other	2002 Budgetary Total	Federal Housing Administration Non Budgetary	Other Non Budgetary Credit Program Accounts	2002 Total NonBudgetary Credit Program Financing Accounts	Total
Budgetary Resources:														
Budget Authority	\$3,231		\$20,641	\$7,783	\$1,846	\$3,495	\$4,011	\$1,097	\$3,705	\$45,809	\$3,925		\$3,925	\$49,734
Net Transfers, Current Year Authority									6	6				6
Unobligated Balance-Beginning of Year	19,894	\$8,605	1,685	1,054	284	141	882	2,922	4,174	39,641	4,478	\$59	4,537	44,178
Net Transfers, Actual, Prior Year Balance				700						700				700
Spending Authority from Offsetting Collections	7,423	931	105				72	807	943	10,281	10,223	14	10,237	20,518
Adjustments														
Recoveries of Prior Year Obligations Permanently not available	25		2,634	9	3	26	42	14	942	3,685	50		50	3,745
Cancellations-Expired and No Year Accts	(4)			(4)					(37)	(45)				(45)
Enacted Recissions			(1,588)		(50)				(320)	(1,958)				(1,958)
Capital Trans & Debt Redemption	(2,199)						(90)	(489)	(18)	(2,796)	(916)		(916)	(3,712)
Other Authority Withdrawn			(5,122)				(522)	(73)	(842)	(6,559)				(6,559)
Total Budgetary Resources	\$28,370	\$9,536	\$18,355	\$9,542	\$2,083	\$3,662	\$4,395	\$4,278	\$8,553	\$88,774	\$17,760	\$73	\$17,833	\$106,607
Status of Budgetary Resources:														
Obligations Incurred (Note 20)	\$4,536	\$121	\$16,408	\$7,756	\$1,827	\$3,636	\$3,506	\$1,735	\$3,962	\$43,487	\$14,739	\$1	\$14,740	\$58,227
Unobligated Balances Available	625		665	1,756	256		867	2,501	2,692	9,362	1,467		1,467	10,829
Unobligated Balances Not Available	23,209	9,415	1,282	30		26	22	42	1,899	35,925	1,554	72	1,626	37,551
Total Status of Budgetary Resources	\$28,370	\$9,536	\$18,355	\$9,542	\$2,083	\$3,662	\$4,395	\$4,278	\$8,553	\$88,774	\$17,760	\$73	\$17,833	\$106,607
Obligated Balance, Net-Beg of Period	\$1,576	(\$39)	\$42,494	\$9,091	\$4,383	\$1,683	\$13,711	\$4,215	\$16,886	\$94,000	(\$98)	(\$21)	(\$119)	\$93,881
Obligated Balance Transferred, Net														
Obligated Balance, Net - End of Period	1,707	6	37,664	11,409	4,667	1,658	12,609	4,762	15,224	89,706	(79)	(19)	(98)	89,608
Outlays														
Disbursements	4,492	76	18,604	5,429	1,540	3,635	4,566	1,174	4,700	44,216	14,657	1	14,658	58,874
Collections	(7,535)	(931)	(105)				(72)	(807)	(960)	(10,410)	(10,211)	(15)	(10,226)	(20,636)
Subtotal	(\$3,043)	(\$855)	\$18,499	\$5,429	\$1,540	\$3,635	\$4,494	\$367	\$3,740	\$33,806	\$4,446	(\$14)	\$4,432	\$38,238
Less: Offsetting Receipts	(1,993)								(8)	(2,001)				(2,001)
Net Outlays	(\$5,036)	(\$855)	\$18,499	\$5,429	\$1,540	\$3,635	\$4,494	\$367	\$3,732	\$31,805	\$4,446	(\$14)	\$4,432	\$36,237

Figures may not add to totals because of rounding.

Department of Housing and Urban Development
Consolidating Statement of Financing
For the Year Ended September 2003
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home	Operating Subsidies	Public and Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other	Financial Statement Eliminations	Consolidating
Resources Used to Finance Activities:											
Budgetary Resources Obligated											
Obligations Incurred	\$21,325	\$158	\$16,003	\$5,537	\$1,869	\$3,618	\$3,344	\$1,814	\$3,153	(\$6)	\$56,815
Less: Spending Authority from Offsetting											
Collections & Recoveries	(19,554)	(849)	(1,616)	(15)	(13)	(16)	(21)	(839)	(947)	6	(23,866)
Obligations Net of Offsetting Collections	\$1,771	(\$691)	\$14,387	\$5,523	\$1,856	\$3,600	\$3,323	\$975	\$2,206	\$0	\$32,949
Less: Offsetting Receipts	(1,372)	0	0	0	0	0	0	0	(10)	0	(1,381)
Net Obligations	\$399	(\$691)	\$14,387	\$5,523	\$1,856	\$3,600	\$3,323	\$975	\$2,196	\$0	\$31,568
Other Resources											
Donations & Forfeitures of Property								0	0		0
Transfers In/Out Without Reimbursement	(\$136)	0							\$0		(\$136)
Imputed Financing from Costs Absorbed by Others	16								66		72
Other Resources	(3)	(\$40)							12	0	(31)
Net Other Resources Used to Finance Activities	(\$125)	(\$40)							\$68	0	(\$65)
Total Resources Used to Finance Activities	\$273	(\$731)	\$14,387	\$5,523	\$1,856	\$3,600	\$3,323	\$975	\$2,264	\$0	\$31,470
Resources Used to Finance Items Not Part of the Net Cost of Operations											
Change in Budgetary Resources Obligated for Goods											
Services/Benefits Ordered but not yet Provided	(\$116)		\$6,567	\$35	(\$241)	(\$153)	\$1,026	(\$568)	\$1,626	\$0	\$6,157
Resources That Fund Expenses from Prior Periods	(3,557)		0	0	0	0	0	0	1	0	(3,556)
Budgetary Offsetting Collections and Receipts Not Affecting Net Cost of Operations	19,010	0	0	0	0	0	0	629	34	0	19,671
Resources Financing Acquisition of Assets	(15,731)						74	17	(13)		(15,652)
Other Changes to Net Obligated Resources Not Affecting Net Cost of Operations	(607)		82	58	25	59	(330)	20	(9)	0	(701)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	(\$1,001)	\$0	\$6,650	\$93	(\$216)	(\$95)	\$771	\$278	\$1,639	\$0	\$6,119
Total Resources Used to Finance the Net Cost of Operations	(\$728)	(\$731)	\$21,037	\$5,616	\$1,640	\$3,506	\$4,094	\$1,254	\$3,903	\$0	\$39,589
Components of Net Cost of Operations Not Requiring/Generating Resources in the Current Period:											
Components Requiring or Generating Resources in Future Periods											
Increase in Annual Leave Liability (Note 22)			0			0			\$0		\$0
Increase in Environmental/Disposal Liability			0	0	0	0	0	0	0	0	0
Reestimates of Credit Subsidy Expense	\$7,406								(1)		7,407
Exchange Revenue Receivable from the Public	(5,767)		0	0	0	0	0	(\$637)	(6)		(6,410)
Other	0	\$0	0	0	0	0	0	0	3	0	3
Total Requiring/Generating Resources in Future Periods	\$1,641	\$0	\$0	\$0	\$0	\$0	\$0	(\$637)	(\$5)	\$0	\$1,000
Components Not Requiring/Generating Resources											
Depreciation and Amortization									\$10		\$10
Revaluation of Assets or Liabilities	\$522	0	0	0	0	0	0	0	0	0	522
Other	(352)	0					\$2	0	59		(291)
Total Components of Net Cost of Operation Not Requiring/Generating Resources	\$171	\$0	\$0	\$0	\$0	\$0	\$2	\$0	\$69	\$0	\$241
Total Components of Net Cost of Operations Not Requiring/Generating Resources in the Current Period	\$1,812	\$0	\$0	\$0	\$0	\$0	\$2	(\$637)	\$64	\$0	\$1,241
Net Cost of Operations	\$1,084	(\$731)	\$21,037	\$5,616	\$1,640	\$3,506	\$4,096	\$616	\$3,967	\$0	\$40,630

Figures may not add to totals because of rounding.

Department of Housing and Urban Development
 Consolidating Statement of Financing
 For the Year Ended September 2002
 (Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home Ownership Subsidies	Public and Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other	Financial Statement Eliminations	Consolidating
Resources Used to Finance Activities:										
Budgetary Resources Obligated										
Obligations Incurred	\$19,275	\$121	\$16,408	\$7,756	\$1,627	\$3,636	\$3,506	\$1,735	\$3,963	\$58,227
Less: Spending Authority from Offsetting										
Collections & Recoveries	(17,721)	(931)	(2,759)	(9)	(3)	(26)	(114)	(821)	(1,689)	(24,263)
Obligations Net of Offsetting Collections	\$1,554	(\$510)	\$13,649	\$7,747	\$1,624	\$3,610	\$3,392	\$914	\$2,064	\$33,964
Less: Offsetting Receipts	(1,993)								(9)	(2,001)
Net Obligations	(\$439)	(\$510)	\$13,649	\$7,747	\$1,624	\$3,610	\$3,392	\$914	\$2,055	\$31,963
Other Resources										
Donations & Forfeitures of Property										
Transfers In/Out Without Reimbursement	(\$1,102)							\$237		(\$865)
Imputed Financing from Costs Absorbed by Others	14							69		73
Other Resources	(9)	\$16						(1)		6
Net Other Resources Used to Finance Activities	(\$1,097)	\$16						\$295		(\$786)
Total Resources Used to Finance Activities	(\$1,536)	(\$794)	\$13,649	\$7,747	\$1,624	\$3,610	\$3,392	\$914	\$2,351	\$31,177
Resources Used to Finance Items Not Part of the Net Cost of Operations:										
Change in Budgetary Resources Obligated for Goods										
Services/Benefits Ordered but not yet Provided	(\$164)		\$4,722	(\$2,357)	(\$293)	\$62	\$1,063	(\$590)	\$1,716	\$4,199
Resources That Fund Expenses from Prior Periods	(6,268)								(9)	(6,261)
Budgetary Offsetting Collections and Receipts										
Not Affecting Net Cost of Operations	18,656							806	26	19,488
Resources Financing Acquisition of Assets	(10,365)						72		(92)	(10,335)
Other Changes to Net Obligated Resources										
Not Affecting Net Cost of Operations	357		83	33	20	27	(275)	22	(283)	4
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	\$2,246	\$0	\$4,805	(\$2,304)	(\$273)	\$89	\$860	\$248	\$1,424	\$7,096
Total Resources Used to Finance the Net Cost of Operations	\$710	(\$794)	\$18,474	\$5,443	\$1,551	\$3,699	\$4,252	\$1,162	\$3,775	\$38,272
Components of Net Cost of Operations Not Requiring/Generating Resources in the Current Period:										
Components Requiring or Generating Resources in Future Periods:										
Increase in Annual Leave Liability (Note 22)									2	2
Increase in Environmental/Disposal Liability										
Reestimates of Credit Subsidy Expense	1,149									1,149
Exchange Revenue Receivable from the Public								(646)	(11)	(657)
Other										
Total Requiring/Generating Resources in Future Periods	\$1,149	\$0	\$0	\$0	\$0	\$0	\$0	(\$646)	(\$9)	\$494
Components Not Requiring/Generating Resources:										
Depreciation and Amortization									\$13	\$13
Revaluation of Assets or Liabilities	(\$1,275)									(1,275)
Other	(4,519)								25	(4,494)
Total Components of Net Cost of Operation Not Requiring/Generating Resources	(\$5,794)	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$38	(\$5,756)
Total Components of Net Cost of Operations Not Requiring/Generating Resources in the Current Period	(\$4,645)	\$0	\$0	\$0	\$0	\$0	\$0	(\$646)	\$29	(\$5,262)
Net Cost of Operations	(\$5,955)	(\$794)	\$18,474	\$5,443	\$1,551	\$3,699	\$4,252	\$516	\$3,804	\$33,010

Figures may not add to totals because of rounding.

Objectives, Scope and Methodology

Management is responsible for:

- preparing the principal financial statements in conformity with generally accepted accounting principles;
- establishing, maintaining and evaluating internal controls and systems to provide reasonable assurance that the broad objectives of FMFIA are met; and
- complying with applicable laws and regulations.

In auditing HUD's principal financial statements, we were required by *Government Auditing Standards* to obtain reasonable assurance about whether HUD's principal financial statements are free of material misstatements and presented fairly in accordance with generally accepted accounting principles. We believe that our audit provides a reasonable basis for our opinion.

In planning our audit of HUD's principal financial statements, we considered internal controls over financial reporting by obtaining an understanding of the design of HUD's internal controls, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the principal financial statements and not to provide assurance on the internal control over financial reporting. Consequently, we do not provide an opinion on internal controls. We also tested compliance with selected provisions of applicable laws and regulations that may materially affect the consolidated principal financial statements. Providing an opinion on compliance with selected provisions of laws and regulations was not an objective and, accordingly, we do not express such an opinion.

We considered HUD's internal control over Required Supplementary Stewardship Information to be reported in HUD's *Fiscal Year 2003 Performance and Accountability Report* by obtaining an understanding of the design of HUD's internal controls, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls as required by OMB Bulletin 01-02, *Audit Requirements for Federal Financial Statements* and not to provide assurance on these internal controls. Accordingly, we do not provide assurance on such controls.

With respect to internal controls related to performance measures to be reported in the "Management's Discussion and Analysis" and HUD's *Fiscal Year 2003 Performance and Accountability Report*, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin 01-02. Our procedures were not designed to provide assurance on internal control over reported performance measures and, accordingly, we do not provide an opinion on such controls. However, as reported in the "HUD's Internal Control Environment" section of this report, we noted certain significant deficiencies in internal control over certain reported performance measures that, in our judgment, could adversely affect HUD's ability to collect, process, record, and summarize those performance measurements in accordance with management's criteria.

To fulfill these responsibilities, we:

- examined, on a test basis, evidence supporting the amounts and disclosures in the consolidated principal financial statements;
- assessed the accounting principles used and the significant estimates made by management;
- evaluated the overall presentation of the consolidated principal financial statements;
- obtained an understanding of internal controls over financial reporting, executing transactions in accordance with budget authority, compliance with laws and regulations, and safeguarding assets;
- tested and evaluated the design and operating effectiveness of relevant internal controls over significant cycles, classes of transactions, and account balances;
- tested HUD's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin 01-02, including the requirements referred to in FFMIA;
- considered compliance with the process required by FMFIA for evaluating and reporting on internal control and accounting systems; and
- performed other procedures as we considered necessary in the circumstances.

We did not evaluate the internal controls relevant to operating objectives as broadly defined by FMFIA. We limited our internal control testing to those controls that are material in relation to HUD's financial statements. Because of inherent limitations in any internal control structure, misstatements may nevertheless occur and not be detected. We also caution that projections of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

Our consideration of the internal controls over financial reporting would not necessarily disclose all matters in the internal controls over financial reporting that might be reportable conditions. We noted certain matters in the internal control structure and its operation that we consider to be reportable conditions under OMB Bulletin 01-02. 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 internal control that, in our judgment, could adversely affect HUD's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements.

Certain of the reportable conditions were also considered to be material weaknesses. 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.

Our work was performed in accordance with *Government Auditing Standards* and OMB Bulletin 01-02.

This report is intended solely for the use of HUD management, OMB and the Congress. However, this report is a matter of public record and its distribution is not limited.

Recommendations

To facilitate tracking recommendations in the Audit Resolution and Corrective Action Tracking System, (ARCATS), this appendix lists the newly developed recommendations resulting from our report on HUD'S fiscal year 2003 financial statements. Also listed are recommendations from prior years' reports that have not been fully implemented. This appendix does not include recommendations pertaining to FHA issues because they are tracked under separate financial statement audit reports of that entity.

Recommendations from the Current Report

With respect to the material weakness on improvements needed in oversight and monitoring of subsidy calculations and intermediaries program performance, we recommend that the Assistant Secretary for Public and Indian Housing:

- 1.a. Initiate corrective action to address the underlying causes for the erroneous payment resulting from billing errors, such as the intermediaries' failure to accurately report or maintain required documentation of subsidy determinations, and bookkeeping and procedural errors.
- 1.b. Ensure field offices identify and include monitoring objectives that emphasize improving HAs with low performance scores in local management plans.
- 1.c. Require field offices utilize performance indicators of the PHAS and SEMAP scores to identify and schedule performance areas for on-site monitoring reviews as part of the risk assessment process.
- 1.d. Ensure field offices identify local management objectives for HAs to improve PIC database reporting in local management plans.
- 1.e. Ensure field offices document historical data on its monitoring activities.
- 1.f. Require field offices use PHAS component scores (FASS, MASS, RASS, and PASS) to improve performance of non-troubled HAs with component scores of less than 70 percent.

With respect to the reportable condition that HUD needs to improve the process for reviewing obligation balances, we recommend that the **Chief Financial Officer** in coordination with the appropriate **program offices**:

- 2.a. Deobligate all excess unexpended funds identified as a result of the fiscal year 2003 audit of financial statements.
- 2.b. Deobligate excess unexpended funds identified for Section 236 Interest Reduction Program and either use these funds to offset other requirements or withdraw the contract authority. **(Implemented)**
- 2.c. Consider expired budget authority from Section 8 project-based contracts maintained in HUDCAPS when formulating budget requests.

With respect to the reportable condition that controls over project-based subsidy payments need to be improved, we recommend that the Deputy Assistant Secretary for Multifamily Housing in coordination with Financial Management Center Director:

- 3.a. Initiate corrective action to address the underlying causes for the erroneous payment resulting from billing errors, such as the intermediaries' failure to accurately report or maintain required subsidy determination documentation, and bookkeeping and procedural errors.
- 3b. Establish controls over the HUD administered project-based Section 8 payment process at FMC to comply with Title VII of the GAO Policy and Procedures Manual for Guidance of Federal Agencies.
- 3.c. Establish criteria to enforce the accuracy of the data submitted through TRACS.

Unimplemented Recommendations from Prior Years' Reports

Not included in the recommendations listed above are recommendations from prior years' reports on the Department's financial statements that have not been fully implemented based on the status reported in the ARCATS. The Department should continue to track these under the prior years' report numbers in accordance with Departmental procedures. Each of these open recommendations and its current status is shown below. Where appropriate, we have updated the prior recommendations to reflect changes in emphasis resulting from more recent work or management decisions.

OIG Report Number 1997-FO-177-0003 (Fiscal Year 1996 Financial Statements)

With respect to the reportable condition that HUD needs to continue efforts to develop improved performance measures, we recommend that the **Chief Financial Officer**:

- 2.a. Assess the readiness of HUD to meet Statement of Federal Financial Accounting Standards No. 4, Managerial Cost Accounting Concepts and Standards, in Fiscal Year 1997 and to recommend a coordinated plan of action for HUD's major operating components that accomplish the Government Performance and Results Act and Statement of Federal Financial Accounting Standards objectives. (Final action target date is June 30, 2003.)

OIG Report Number 1999-FO-177-0003 (Fiscal Year 1998 Financial Statements)

With respect to the reportable condition that controls over project-based subsidy payments need to be improved, we recommend that the **Director, Section 8 Financial Management Center** (Note: subsequent to the issuance of our fiscal year 1998 report, responsibility for this recommendation was transferred to the **Office of Housing**):

- 3.a. Verify that project-based Section 8 payments are accurate and allowable by testing source documentation through verification of tenant data. Examples of procedures that do this include confirmations and on-site reviews. (Final action target date is December 30, 2002.)

With respect to the reportable condition that HUD needs to improve processes for reviewing obligation balances, we recommend that the **Assistant Secretary for Housing-Federal Housing Commissioner**:

- 10.d. Ensure that data used in reviewing unliquidated obligation balances are complete, current, and accurate. (Final action target date is September 30, 2002.)
- 10.e. Ensure that all contract amounts determined to have excess budget authority are deobligated and recaptured. (Final action target date is September 30, 2002.)

OIG Report Number 2000-FO-177-0003 (Fiscal Year 1999 Financial Statements)

With respect to the reportable condition on management control program issues, we recommend that the **Chief Financial Officer**:

- 2.b. Report to the Deputy Secretary issues that are not resolved. (Final action target date is July 31, 2002.)
- 2.c. Establish due dates for responses to CFO reviews and hold program offices accountable. (Final action target date is July 31, 2002.)

With respect to the material weakness on improvements needed in multifamily project monitoring, and the reportable condition on controls over project based subsidy payments, we recommend that the **Assistant Secretary for Housing-Federal Housing Commissioner**, in consultation with the **Director, Section 8 Financial Management Center**:

- 3.a. Finalize plans to improve administration of HAP contracts remaining under HUD responsibility after the transfer to contract administrators is completed. In formulating these plans, HUD should consider the responsibilities being placed on contract administrators and design a comparable oversight strategy, establish organizational responsibilities, and at a minimum, address the following areas:
 - management and occupancy reviews,
 - rental adjustments,
 - opt-out and contract termination,
 - HAP payment processing including review of monthly vouchers,
 - follow-up on health and safety issues and community/resident concerns,
 - resolving deficient annual financial statements and physical inspection results, and
 - renewing expiring assistance contracts.

(Final action target date is September 30, 2003.)

With respect to the reportable condition that HUD needs to improve its processes for reviewing obligation balances, the following recommendations remain open because the Office of Public and Indian Housing has been waiting on a decision from the Comptroller General since August 15, 2000. We recommend that the **Assistant Secretary for Public and Indian Housing**:

- 9.c. Enforce the requirement of the United States Housing Act of 1937, as amended by the Quality Housing and Work Responsibility Act of 1998 for the expenditure of public housing capital funds through default remedies up to and including the withdrawal of funds. (Final action target date is December 31, 2000.)
- 9.d. Issue clarifying guidance that is in accordance with the United States Housing Act of 1937, as amended by the Quality Housing and Work Responsibility Act's provisions regarding the obligation, by HAs, of capital funds. (Final action target date is December 31, 2000.)

(These recommendations are suspended in the audit tracking system.)

We recommend that the **Assistant Secretary for Housing-Federal Housing Commissioner**, in consultation with the **Chief Financial Officer**:

- 9.f. Improve systems and procedures to facilitate timely contract closeout and identification and recapture of excess budget authority on expired project based Section 8 contracts. This process should occur periodically during the fiscal year rather than after fiscal year end. (Final action target date is September 30, 2002.)

OIG Report Number 2001-FO-0003 (Fiscal Year 2000 Financial Statements)

With regards to the material weakness that HUD needs to improve oversight and monitoring of housing subsidy determinations, we recommend that the **Assistant Secretary for Public and Indian Housing**:

- 1.e. Redirect priorities to fully implement the PIC capabilities for tracking and monitoring housing quality inspection deficiencies and IA audit report recommendations. In addition, hold the field office accountable for obtaining current and complete data from the HAs and for maintaining current and complete data in PIH's IBS and PIC in a timely manner. (Final action target date is March 30, 2004.)

We recommend that the **Deputy Assistant Secretary for Multifamily Housing**:

- 1.g. Continue plans to upgrade the reporting in REMS to provide for a dynamically updated computer ranking combining all the major monitoring tools available to the Office of Housing, as applicable, to the project being ranked. Specifically, we suggest the following upgrades to REMS, and in its use:
 - Establish fields for each major monitoring tool indicating the proper date for the “next to be conducted” scoring or evaluation according to the protocol and populated this field by computer dating based on the last time the monitoring tool was used and rank reported.
 - Establish a field that combines the ranking from all current monitoring tools used as applicable and conducted resulting in an overall ranking by the computer. This does not replace the existing judgment based ranking, but would be used to produce reporting when these rankings varied.
 - Periodically review (no less than quarterly), the overall risk ranking for each HUB and any justifications for variance between the computer and judgment rankings as necessary. (Final action target date is September 30, 2003.)

OIG Report Number 2002-FO-0003 (Fiscal Year 2001 Financial Statements)

With respect to the material weakness that HUD's financial management systems are not substantially compliant with Federal financial system requirements, we recommend that the **Chief Financial Officer**:

- 1.e. Initiate and complete independent and unbiased feasibility and cost-benefit studies for the “Departmental General Ledger” project, and ensure that any system solution considered be consistent with the Department's Enterprise Architecture Plan being developed. (Final action target date is July 31, 2004.)

We recommend that the **Deputy Assistant Secretary for Multifamily Housing**:

- 2.e. Develop a plan with milestones that would increase, for that portion of the Section 8 portfolio that remains HUD's responsibility, the number of on-site management reviews conducted annually and would ensure owners of assisted multifamily projects comply with HUD's occupancy requirements. (Final action target date is September 30, 2003.)

With respect to the reportable condition that controls over project-based subsidy payments need to be improved, we recommend that the **Deputy Assistant Secretary for Multifamily Housing**:

- 2.f. Make resources available to develop a realistic method to identify tenants/owners who erroneously report income. (Final action target date is September 30, 2003.)

With respect to the reportable condition that HUD still needs to strengthen the controls over its computing environment in regards to physical security, we recommend that the **Chief Information Officer**:

- 4.i. Conduct a risk analysis to determine whether the protective measures for the data center and the backup facility identified in the July, 2000 HUD' Critical Infrastructure Protection Plan are warranted. The risk analysis should also consider whether a card key entry control system need to be installed to control exits in backup facility. The protective measures include barriers around the building, magnetometer and x-ray scanner for screening incoming personnel, screening of mail and delivery packages before being brought into the center, and blast-resistant coating on street level windows. (Final action target is January 30, 2004.)

OIG Report Number 2003-FO-0004 (Fiscal Year 2002 Financial Statements)

With respect to the material weakness on improvements needed in oversight and monitoring of subsidy determinations, we recommend that the **Chief Financial Officer** in coordination with the appropriate **program offices**:

- 1.a. Conduct a review of the public housing subsidies and intermediaries' billings to determine whether the subsidies were recorded, billed and collected in accordance with HUD policies and regulations. The review should establish the amount of erroneous payments resulting from intermediaries' billings to HUD for the public housing program, and service as a baseline for implementing corrective action to reduce or eliminate the erroneous payments resulting from intermediary's billings. (Final action target date is December 31, 2003.)

With respect to the material weakness on improvements needed in oversight and monitoring of subsidy determinations, we recommend that the **Assistant Secretary for Public and Indian Housing**:

- 2.d. Direct that PIC access protocols be evaluated to eliminate access problems and ensure users full access to PIC. (Final action target date is December 31, 2003.)

With respect to the reportable condition that controls over project-based subsidy payments need to be improved, we recommend that the **Deputy Assistant Secretary for Multifamily Housing**:

- 3.a. Make resources available to develop a realistic method to identify tenants/owners who erroneously report income in TRACS. (Final action target date is December 31, 2003.)
- 3.b. Implement a policy and procedure for suspending payments on contracts where non-compliance with tenant reporting requirements has been determined by the Multifamily HUD Office or the FMC. (Final action target date is September 30, 2003.)

With respect to the reportable condition that HUD needs to strengthen the controls over its computing environment in regards to the Hitachi environment, we recommend that the **Chief Information Officer**:

- 4.b. Provide adequate technical training to the HUD ADP Security group so that the Department is able to monitor contractors' activities. (Final action target date is February 28, 2004.)

In regards to disaster recovery, we recommend that the **Chief Information Officer**:

- 5.a. Revise the Department's contingency planning processes based on guidelines defined in the NIST Special Publication 800-34 issued June 2002. Specifically, the OCIO should conduct a Business Impact Analysis to help identify and prioritize critical IT systems and components to determine contingency requirements and priorities. (Final action target date is December 31, 2003.)

In regards to CM implementation, we recommend the **Chief Information Officer**:

- 6.b. Perform reconciliation between all of the modules contained within the production environments and the modules under the control of PVCS for all client/server applications using the component-level release approach. (Final action target date is February 28, 2005.)
- 6.c. Establish a process to remove obsolete modules from the production environment and to separate obsolete modules within PVCS to prevent them from being used in the future. (Final action target date is February 28, 2005.)

With respect to the reportable condition that HUD needs to improve funds control over public housing operating funds, we recommend that the **Chief Financial Officer**:

- 9.b. Monitor the use of operating subsidy funds to prevent the unauthorized use of obligations and expenditures, and to prevent potential violations of the Antideficiency Act. (Final action target date is May 31, 2004.)

With respect to the reportable condition that HUD needs to improve the process for reviewing obligation balances, we recommend that the **Chief Financial Officer** in coordination with the appropriate **program offices**:

- 10.b. Strengthen procedures to annually or more frequently review Section 8 programs for unexpended funds that can be recaptured and used to offset future budget requirements. (Final action target date is September 3, 2004.)
- 10.c. Strengthen accounting procedures for the Section 236 IRP program to (1) record prepayments and remove inactive contracts in a timely manner, and (2) compute estimated subsidy payments using proper amortization factors. (Final action target date is April 8, 2004.)
- 10.d. Strengthen the accounting for the Section 236 IRP program by developing an integrated automated system. (Final action target date is September 30, 2004.)

Federal Financial Management Improvement Act Noncompliance, Responsible Program Offices and Recommended Remedial Actions

This Appendix provides details required under FFMIA reporting requirements. To meet those requirements, we performed tests of compliance using the implementation guidance for FFMIA issued by OMB and GAO's Financial Audit Manual. The results of our tests disclosed HUD's systems did not substantially comply with the foregoing requirements. The details for our basis of reporting substantial noncompliance, responsible parties, primary causes and the Department's intended remedial actions are included in the following sections.

Federal Financial Management Systems Requirements

1. HUD's annual assurance statement issued pursuant to Section 4 of FFMIA will report four non-conforming systems¹⁹.

The organizations responsible for systems that were found not to comply with the requirements of OMB Circular A-127 based on the Department's assessments are as follows:

<u>Responsible Office</u>	<u>Number of Systems</u>	<u>Non-Conforming Systems</u>
Office of Housing	20	3
Chief Financial Officer	15	1
Office of Administration	3	0
Office of Public and Indian Housing	2	0
Government National Mortgage Association	3	0
Office of Community Planning and Development	3	0
	<u>46</u>	<u>4</u>

¹⁹ The four nonconforming systems are: A21-Loan Accounting system, A80N-SF Mortgage Notes Serving, A80S-SF Acquired Asset Management, and F47 Multifamily Insurance.

The following section outlines the Department’s plan to correct specific A-127 system non-conformances. In addition to the four nonconforming systems, we will continue to include remediation plans for previously nonconforming systems where target completion dates have not been met.

Office of Housing

<u>System</u>	<u>Outstanding Noncompliance Issue @ 09/30/03</u>	<u>Plan @9/30/03</u>	<u>Target date to Complete all Phases</u>	<u>Resources</u>
A43 Single Family Insurance System A43C Single Family Claims System A80B Single Family Premium Collection System –Periodic A80D Single Family Distributive Shares Refund System A80N Single Family Mortgage Notes Servicing A80R Single Family Premium Collection System – Upfront A80S Acquired Asset Management System F12 Home Equity Conversion Mortgage System F31 Cash, Control Accounting and Reporting System F47 Multifamily Insurance System F71 Title I Notes Servicing System F72 Title I Insurance and Claims System	<ul style="list-style-type: none"> • Classification structure • Integrated FMS • Application of SGL • Federal Accounting Standards • Financial Reporting • Budget Reporting • Functional Requirements (F31 only) 	<p>Short term: Implement a new FHA general ledger to automate FHA headquarters’ funds control processes, financial statement reporting, and updates to the departmental general ledger</p> <p>Mid Term:</p> <ul style="list-style-type: none"> • Automate funds control processes for FHA field offices • Implement a new FHA payment and collection software to improve FHA’s accounting operations Note: The F31 system will be terminated at completion of this phase <p>Midterm Intermediate:</p> <ul style="list-style-type: none"> • Upgrade PeopleSoft to current web-based version, from 7.5 to 8.4 <ul style="list-style-type: none"> ○ Implement version 8.4 for FY2004 ○ Convert FY2003 data to new format and close out 7.5 system databases • Implement General Ledger Improvements • Incorporate Credit Subside Control processing <ul style="list-style-type: none"> ○ Implement initial functionality ○ Convert FY 2003 data to new format • Incorporate Funds Control Database processing • Incorporate Cash Management function • Re-engineer Single Family Acquired Asset Management System (A80S, SAMS) 	<p>10/2002 (complete)</p> <p>12/2004</p> <p>04/2004</p> <p>10/2003</p> <p>03/2004</p> <p>01/2004</p> <p>10/2003</p> <p>03/2004</p> <p>03/2004</p> <p>03/2004</p> <p>03/2004</p> <p>04/2005</p>	<p>FY00 and prior - \$2,381,000 FY01-\$5,250,000 FY02-\$8,800,000 FY03-\$8,600,000 FY04-\$7,322,000 FY05-\$5,444,000 FY06-\$5,067,000</p>

<u>System</u>	<u>Outstanding Noncompliance Issue @ 09/30/03</u>	<u>Plan @9/30/03</u>	<u>Target date to Complete all Phases</u>	<u>Resources</u>
		<p>Long Term: Integrate or replace FHA insurance systems with the FHA subsidiary ledger software to improve accounting and insurance operations</p> <p>Long-Term Intermediate Milestones</p> <ul style="list-style-type: none"> • Replace Distributive Shares and Refunds System (A80D) • Replace Multifamily Insurance System (F47) • Improve Integration with Single Family Claims System (A43C) • Improve Integration with Multifamily Claims (F75) • Replace Single Family Premiums Collection System-Periodic (A80B) • Replace Single Family Premiums Collection System-Upfront (A80R) <p>Turn over operational responsibility to user areas</p>	<p>12/2006</p> <p>04/2005</p> <p>04/2005</p> <p>04/2005</p> <p>04/2005</p> <p>03/2006</p> <p>03/2006</p> <p>12/2006</p>	
F75 Multifamily Claims System	<p>In addition to issues above,</p> <ul style="list-style-type: none"> • Functional requirements • Clear Documentation • Training/User Support 	Upgrade F75 to integrate with the FHA Subsidiary Ledger. Requirements for replacement or modification have not yet been identified	04/2005	FY01-\$456,561 FY02-\$366,000
F87 Tenant Rental Assistance Certification System (TRACS)	<ul style="list-style-type: none"> • A-127 review determines system is compliant, however, data quality problems impact the effectiveness of TRACS operations. • 	To be determined	To be determined	To be determined.

Office of the Chief Financial Officer

<u>System</u>	<u>Outstanding Noncompliance Issue @ 09/30/03</u>	<u>Plan @9/30/03</u>	<u>Target date to Complete all Phases</u>	<u>Resources</u>
A21 - Loan Accounting System	<ul style="list-style-type: none"> Integrated Financial Management System 	Initiate Stage Begin Procurement Effort Award Contract Develop Functional Requirements Complete Functional Requirements	05/02 Actual 7/29/02 Actual 09/30/02 Actual 10/2002 Actual 10/2003	\$225,779

2. Our audit disclosed reportable conditions regarding the security over financial information. Similar conditions have also been noted in HUD's A127 reviews and other OIG audit reports. We are including security issues as a basis for noncompliance with FFMIA because of the collective effect of the issue and noncompliance with Circular A-130, Appendix 3 and the Government Information Security Reform Act (GISRA) The responsible office, nature of the problem and primary causes are summarized below.²⁰

<u>Responsible Office</u>	<u>Nature of the Problem</u>
Office of Administration/Chief Information Officer	<p>(1) The Department needs to improve its entity wide security</p> <p>(2) Access controls need to be improved on the IBM compatible Hitachi and network environments; and</p> <p>Quality Assurance needs to be implemented to improve software change controls</p>

The primary causes for these occurrences are: (1) the agency is in transition for a new infrastructure contract, *HUD Information Technology Service (HITS)* (2) lack of action plan to comply with Office of Management and Budget (OMB), National Institute of Standards and Technology (NIST) and HUD standards, (3) lack of adequate configuration management quality assurance and monitoring procedures,

Office of Administration/Chief Information Officer	There is inadequate assurance that HUD can recover operational capability in a timely, orderly manner or perform essential departmental functions during an emergency or situation that may disrupt normal operations.
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The primary cause for this occurrence is that HUD has not revised its current IT contingency planning process to fully utilize the seven step process recommended in the NIST SP 800-34, "*Contingency Planning Guide for Information Technology Systems*"

Office of Administration/Chief Information Officer	HUD may be at substantial risk that inappropriate individuals may have gained access to its facilities, information, and resources
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The primary cause is that personnel security policies have not been enforced

Office of Housing and CIO	Certain information security controls need improvement to provide HUD/FHA with a more secure ADP systems environment.
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The primary cause for this is because FHA systems have not been consistently incorporated into HUD's security certification and accreditation program.

Office of Housing and CIO	The level of systems portfolio management could be improved for FHA systems used to process key FHA financial data
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The primary cause for this is that the FHA Subsidiary Ledger project is not yet complete and intends to perform a Single Family and Multifamily business process re-engineering effort that will ensure ADP

¹⁷ The issues are discussed in greater detail in a separate report issued by the Information Systems Audit Division entitled "Fiscal Year 2003 Review of Information Systems Controls in Support of the Financial Statement Audit" Also, KPMG LLP's separate report on their audit of FHA's fiscal year 20023 financial statements includes a reportable condition relating to "FHA/HUD Can More Effectively Manage Controls Over the FHA ADP Systems Portfolio".

<u>Responsible Office</u>	<u>Nature of the Problem</u>
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systems supporting key FHA financial and business processes are adequately supported and included in HUD OCIO's enterprise architecture and ADP systems portfolio.

Office of Housing and CIO	Several FHA systems, including CCARS and the Lender Approval Subsystem (LASS), lacked system documentation supporting current operations.
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HUD/FHA personnel are knowledgeable about the HUD/FHA systems, however, many are eligible for retirement in the near future.

Specific recommendations to correct security weaknesses are listed in the OIG Information Systems Division's "*Fiscal Year 2003 Review of Information Systems Controls in Support of the Financial Statements Audit*" and KPMG LLP's report on their audit of FHA's fiscal years 2003 and 2002 financial statements.

Federal Accounting Standards

KPMG LLP reported in a material weakness that 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. FHA is currently implementing a long-term plan to improve its financial systems processing environment, however, full implementation is expected by fiscal year 2007. Specific accounting standards affected are:

:

- Budgetary controls to prevent misreporting of budget execution information relating to FHA appropriations (Statement of Federal Financial Accounting Standards (SFFAS) Number 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*).
- Review and reconcile obligations in order to provide complete financial information (*SFFAS Number 7, Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*).
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Specific recommendations to correct the weaknesses are listed in KPMG LLP's report on their audit of FHA's fiscal years 2003 and 2002 financial statements.

Schedule of Questioned Costs and Funds Put to Better Use

Recommendation	<u>Type of Questioned Cost</u>		Funds Put to
<u>Number</u>	<u>Ineligible 1/</u>	<u>Unsupported 2/</u>	<u>Better Use 3/</u>
2.a.			\$222,000,000
2.b.			\$857,000,000
2.c.			\$351,000,000

1/ Ineligible costs are those that are questioned because of an alleged violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the expenditure of funds.

2/ Unsupported costs are those whose eligibility cannot be clearly determined during the audit since such costs were not supported by adequate documentation.

3/ Funds put to better use include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred, avoidance of unnecessary expenditures, loans or guarantees not made, and other savings

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U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-3000

CHIEF FINANCIAL OFFICER

December 9, 2003

MEMORANDUM FOR: Randy McGinnis, Financial Audits Division, GAF
FROM: De W. Riche, Deputy Chief Financial Officer, F
SUBJECT: Management Comments on Draft Report on HUD's
Fiscal Year 2003 Financial Statements – Internal Control
and Compliance Sections

Attached are the Department's detailed comments on the subject draft report's internal control and compliance sections, as requested in your memorandum of December 1, 2003. HUD management generally agrees with the substance of the internal control and compliance issues discussed in the draft report with exceptions noted below and in the Attachment. Although you have not yet rendered the auditor's opinion, we have not been advised of any issues that would preclude the OIG from the issuance of an unqualified opinion on the Department's Fiscal Year (FY) 2003 consolidated financial statements. We were particularly pleased to note there were no new material weaknesses or reportable conditions identified in the draft report, and that one material weakness and three reportable conditions are targeted for removal from this year's report. We remain fully committed to maintaining progress in resolving HUD's remaining material weaknesses and reportable conditions.

The following is a summary of the major concerns we have with the presentation of internal control weakness issues in the draft report, and we request consideration of our concerns and attached comments as you complete your final report. Other comments on suggested editorial revisions to the draft report were previously provided to you, and those comment are omitted from this response based on your agreement to make those revisions in the final audit report.

Financial Management Systems Weakness Issue and Progress

While we acknowledge that we cannot yet report that the Department is substantially compliant with the Federal Financial Management Improvement Act (FFMIA), we also believe that significant progress was made in FY 2003 and that the Department will be in a position to report substantial compliance in the foreseeable future, pending completion of on-going corrective actions to strengthen systems support for: FHA's budgetary accounting and funds control; controls over rental housing assistance contract funds; and other deficiencies in the remaining four non-compliant systems out of HUD's total inventory of 46 financial systems. The implementation and use of the new FHA general ledger system in FY 2003 improved HUD's compliance with the U.S. Standard General Ledger, enabled FHA to close its books and issue audited financial statements within 45 days of the end of the fiscal year, and facilitated improved monthly and quarterly reporting, as well as accelerated issuance of HUD's pending annual consolidated financial statements.

We appreciate the draft audit report's recognition of some of HUD's recent financial management systems improvements and continuing planned actions, but disagree with the report's overly broad interpretation and application of financial systems requirements for electronic integration, as well as the focus on theoretical potential problems without evidence of specific internal control weaknesses that have a material impact on HUD's actual financial management information needs. Contrary to the draft report's position on the need for electronic integration of all Departmental financial systems and other mission critical program and mixed systems, the actual requirements of OMB's implementing guidelines for FFMIA and A-127 are not that stringent. We request that page 1 and pages 3 through 7 of the draft report be revised to correctly reflect financial management systems requirements and to only address specific compliance deficiencies that represent actual internal control weaknesses with a material impact on HUD's financial management information needs.

Rental Housing Assistance Programs Weakness Issue and Progress

We agree that the Department's management control improvements over its rental housing assistance programs have not yet progressed to the point where they reduce to an acceptable level the risk of erroneous payments due to tenant underreporting of income or program administrator errors in income and rent determinations or billings to HUD. However, a study of program administrator income and rent determinations in the first six months of FY 2003 found a 30 percent reduction in the 2000 baseline estimate of \$2.3 billion of gross annual erroneous payments attributed to this error component. Throughout FY 2003, HUD significantly increased its monitoring and assistance efforts related to program administrator performance of the occupancy function, which should have an even greater impact on error reduction in future periods. As indicated in the draft audit report, the Office of Public and Indian Housing (PIH) completed Rental Integrity Monitoring reviews at 490 Public Housing Agencies that receive 80 percent of PIH's public and assisted housing funding. Also, the Office of Housing completed over 12,000 on-site Management and Occupancy Reviews in FY 2003, by either its rental housing assistance contract administrators or field staff. HUD also continued to improve the use of existing statutory authority, and to pursue increased statutory authority, to perform more effective upfront verification of tenant income with independent sources of income data. Automated upfront income verification efforts have the potential to eliminate over half of the estimated erroneous rental housing assistance payments.

While both program areas have placed a special focus on improving controls over the long neglected occupancy function, they also continued to maintain their remote monitoring systems on the physical, financial and other management conditions in their respective public and assisted housing portfolios to: 1) identify and communicate all detected deficiencies for program partner correction, and 2) target risk-based HUD assistance and intervention actions on more egregious deficiencies. While HUD continues to perfect these other aspects of its improved program control structure, we do not agree that they warrant continued reporting as part of a material weakness or reportable condition in the financial statement audit, and request that pages 15 through 19 and other relevant references in the draft report be deleted. Evidence of the effectiveness of these controls is apparent in program performance information, such as the significant improvement in the baseline physical inspection scores for the overall portfolio.

We also request consideration of combining the separate reportable condition on controls over project-based subsidy payments (draft report pages 22 through 25) with the overall material weakness on improvements needed in oversight and monitoring of subsidy calculations and intermediaries program performance (draft report pages 9 through 22). The primary issues raised in the reportable condition – the need for improved tenant data reporting and both automated and on-site reviews of supporting documentation for assistance billings and payments -- are already duplicated as part of the material weakness write-up, which also covers controls over the subsidy billing process.

Budgetary Accounting Issues and Progress

HUD continued to implement corrective action plans to improve controls over its monitoring of obligated funds balances in FY 2003, but disagrees with the following aspects of the draft reportable condition on the need to improve processes for reviewing obligation balances and funding authority:

- Adjusting Account Balances Based on Statistical Audit Projections – On pages 38, 45 and 57 of the draft audit report, the auditors cite their use of statistical sampling to project an estimated amount of unneeded funding authority on the Rent Supplement and Rental Assistance Payments programs with a recommendation that the projected amounts be recaptured and put to a better use. In general, HUD is unable to use statistical projections to adjust account balances that are based on legal transactions that obligate the government, without going through the proper transaction analysis or closeout process to determine the actual amount available for deobligation and recapture or withdrawal at the individual transaction level. Failure to do so would subject the Department to an undue risk of Antideficiency Act violations and the need for possible deficiency appropriations. While auditors can use statistical projections as the demonstrated possible “effect” of audit findings in support of recommendations for more timely analysis and action on unexpended funds balances, they should not require management to prematurely post any accounting adjustments, pending completion of the detailed transaction analysis and processing of any required transaction close-out action. The draft report should be revised to limit the use of statistical projections of possible funding adjustments in this manner, subject to the audit recommendation management decision-making process. In making management decisions on audit recommendations to alter the nature or timing of existing recapture processes, management must consider other factors such as the existence of budget rescission targets that must be met.
- Reporting of HUD Analysis and Adjustments as Auditor-Identified Savings Opportunities – As a result of an audit issue raised in the FY 2002 consolidated financial statement audit, staff from the Office of Housing and the Office of the Chief Financial Officer reconciled program and financial records on the Section 236 Interest Reduction Program (IRP) and determined the need to post an \$857 million accounting adjustment. On page 38, the draft audit report states that the \$857 million adjustment was the result of the FY 2003 audit work, and page 57 of the draft report also includes this \$857 million amount in the total funds the auditors claim they were responsible for identifying as funds that could be put to better use. To the contrary, HUD management undertook the analysis and initiated the proper accounting entries for the required \$857 million adjustment. While the final year-end posting of the adjustment was delayed to allow time to verify the numbers and perform legal research on the nature of the adjustment, it

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was always management's intent to reflect this adjustment in the final financial statements for FY 2003. Even if the auditors had been responsible for the analysis and adjustment, they could not claim the full amount as "funds put to better use" because our legal research concluded that all but \$99 million of the adjustment needed to be recorded as a withdrawal of funding authority that is not available for obligation or rescission. We request that all references to this analysis and adjustment be deleted from the final report.

The directed acceleration of the preparation and audit of HUD's FY 2003 financial statement was a major challenge for the Department and its auditors. I want to thank the Inspector General's auditors, as well as HUD financial managers and staff, for all their efforts in bringing this annual cycle to the anticipated successful and timely conclusion.

As noted in your memorandum, work on the audit continues and further changes to the report may be necessary. If new significant issues arise, please be sure to provide the Department an opportunity to comment on these issues. If you have any questions on our comments, please contact me on (202) 708-0614, extension 2481, or James Martin of my staff at extension 3706.

Attachment

Detailed Comments on OIG's Draft 2003 Internal Control & Compliance Report

No.	Draft Report Reference	Management Comments for OIG's Consideration
1	Pages 3 – 7, Material Weakness on Financial Management Systems Compliance	<p>Based on our separate meeting on this issue, we understand that this section of the draft report is being re-written to reflect the actual OMB Circular A-127 criteria on systems integration, and to provide more specific information on the nature of systems compliance deficiencies that have a material impact on the financial management information needs of the Department. We herein repeat our requests that the revisions include:</p> <ul style="list-style-type: none"> • Removal of the FHA-GNMA-HUDCAPS integration issue, based on an earlier accord reached that it is acceptable and preferred from a business sense for the stand-alone FHA and GNMA financial statement information to be consolidated with HUDCAPS information on general program activity through the Hyperion consolidated reporting process outside of HUDCAPS. • Removal of any inference that completion of the HUD Integrated Financial Management Improvement Project (HIFMIP) is necessary to bring the Department into substantial compliance with FFMIA and A-127 and JFMIP requirements. While HIFMIP will strengthen compliance and provide for more cost-efficient operations, HUD's existing core systems will be substantially compliant upon completion of on-going actions to strengthen systems support for FHA's controls over budget execution and funds control and controls over rental housing assistance funds.
2	Page 5, 1 st Bullet	<p>The 1st sentence states that FHA's legacy systems "...necessitate significant manual analysis and/or translation." [Emphasis added]. In October 2002 FHA automated many of the manual steps that were formerly required to translate data from legacy systems to produce its financial statements. FHA's FY2003 audit report, completed on November 15, 2003, acknowledged on page 6 that FHA had automated many manual processes and concluded on page 7 that "Although the improvements implemented during fiscal year 2003 help satisfy some FFMIA requirements and standards, additional and continued improvement is needed." This comment should be modified to reflect the final FHA Audit Report.</p>
3	Page 5 Last Paragraph	<p>The 2nd sentence states that the agency failed to "...(2) resolve uncorrected weaknesses in FHA's financial management system and its interface with the Department's general ledger, and..."</p> <p>FHA's FY2003 audit report, completed on November 15, 2003, acknowledged that FHA had made "a key improvement" with the implementation of the FHA Subsidiary Ledger financial system. Please modify this comment to reflect the final FHA Audit Report.</p>

4	Page 9, 3 rd paragraph, 2 nd sentence	HUD disagrees with the statement that we again have reportable internal control weaknesses that impact our ability to ensure "...safe and quality housing based on HUD requirements." We believe that our physical inspection process provides adequate controls for ensuring the quality of HUD-supported housing, and we request that this and any other references to control weaknesses in this area be deleted from the final report.
5	Pages 9 - 22, Material Weakness: Improvements Needed in Oversight and Monitoring of Subsidy Calculations and Intermediaries Program Performance	<p>While we acknowledge that material weaknesses still exist in our controls over tenant income verification and program administrator calculation and billing of subsidies, we request that this section of the draft report be revised to better focus on those remaining weaknesses. Given our demonstrated progress in FY 2003, we disagree with the lead-in statement on page 9 that: "We are reporting that HUD's control structure does not adequately address this risk due to insufficient on-site monitoring to ensure acceptable levels of performance are achieved..." In summary PIH management believes it has implemented a sound, cost effective monitoring program as follows:</p> <ul style="list-style-type: none"> • We have undertaken initiatives to improve the accuracy of subsidy calculations <ul style="list-style-type: none"> ○ Produced a reduction of 35% in error rate versus a target of 15% for this year. ○ Performed RIM reviews at 700+ PHAs that account for over 80% of HUD's rental assistance subsidies. ○ Performed follow-up reviews on 45 of those PHAs with significant errors in the first two months of this fiscal year. ○ Developed an upfront income verification protocol, piloted with 40 PHAs and 2 states and are currently covering eight states and 42 PHAs. • The monitoring of Intermediary program performance in other areas is robust and some of our accomplishments are: <ul style="list-style-type: none"> ○ Performed extensive monitoring of almost 800 (20% of PHAs: 642 on-site, 154 remote) this year despite reprioritization of a significant portion of our travel budget to accomplish the RIM reviews ○ Identified and took control of PHAs with serious control and financial issues (Virgin Islands and Sanford) ○ Monitored the activities of independent public accountants and fee accountants performing audits/services of PHAs <ul style="list-style-type: none"> • Our annual work plan included quality assurance reviews of 30 firms one of which was referred to the Departmental Enforcement Center for proposed debarment action.

		<ul style="list-style-type: none"> • Nine firms were referred to their respective State Board(s) of Accountancy • Six firms were referred to the AICPA Ethics Division for further investigation. • Of the total of 7 firms that were referred to the Enforcement Center during FY 2002-2003, one case is awaiting final decision by the presiding Administrative Law Judge, one firm voluntarily agreed to significantly limit its HUD work and pay a monetary amount, and 5 cases are actively being litigated. <p>With the pending full implementation of the Upfront Income Verification system, and a continuation of the above levels of monitoring, we expect to be able to eliminate this material weakness issue by the end of FY 2005.</p>
6	Page 9, Paragraph 4	<p>In reference to the 2nd Sentence phrase on the need for "...on-going quality control program that would periodically assess the accuracy of intermediaries rent determinations and billings" please consider the following:</p> <p>HUD's control structure has addressed the financial risk to the Department of intermediaries rent determination. Through September 30, 2003, PIH completed fieldwork on extensive reviews of income and rent calculations at approximately 700 PHAs that manage over 80% of the public housing subsidies.</p> <p>An independent study conducted by Macro, Inc., shows an overall decrease in subsidy error calculations of over 40% and close to 30% for the Public Housing and Section 8 subsidy programs, respectively.</p> <p>As of November 30, 2003, PIH has completed fieldwork for 45 follow-up reviews and in the approved Management Plan has instructed the field to complete over 400 additional follow-up reviews of these large PHAs.</p> <p>PIH certainly recognizes that improvements will accrue in future periods, however, PIH believes that it has clearly demonstrated that it has created the appropriate strategy to address the issue of rent verification and has demonstrated significant progress in this area.</p>
7	Page 10, Paragraph 3	<p>The paragraph should be rewritten to note the significant reduction in subsidy error from the 2000 study that more than meets the FY2003 target (actual of 35% vs. target of 15% (an overall reduction of 35%).</p> <p>Also, all references to the billing study should be changed to reflect the changes to Note 17 to the financial statements.</p>
8	Page 11, Paragraph 4	<p>The 1st sentence begins "During fiscal year 2003, HUD's management made a decision to temporarily [emphasis added] discontinue the 100% tenant income matching..."</p>

		<p>This phrase is not correct. The decision to discontinue IRS income matching was made in FY 2001 based on a study by the CFO's office that the IRS matching project created 89% false positives and therefore was not cost beneficial. The RHIIP was initiated to prevent subsidy errors and address the IG's FY 2001 recommendations.</p> <p>The sentence should be modified to reflect the decision was made in 2001 and was not temporary.</p>
9	Page 12 Paragraph 2[The paragraph should be modified to acknowledge RHIIP training conducted in July/August 2003.
10	Page 12, Paragraph 3	<p>Revise the 3rd sentence to read: "However, PIC system problems in the first quarter of FY2003 hampered HA reporting, and since sanctions were removed from HAs not all data may have been submitted."</p> <p>Rationale: PIC did have system bugs that hampered but not stop reporting. The system bugs were addressed in the first quarter to ensure the availability of system to support HA reporting.</p>
11	Page 12, RHIIP Initiatives	<p>The RHIIP related comments on beginning on page 12 should reflect that:</p> <p>HUD has an automated capability to detect potential deficiencies through the Up-Front Income Verification system (UIV) that began its pilot phase with two states and 40 PHAs in August 2003. As of November 30, 2003, the pilot has been expanded to 8 states, 42 PHAs and over 350 users.</p> <p>As of September 30, 2003, HUD has entered into 21 agreements with states to provide State wage data, has piloted the UIV system release 2.2.2 and conducted rental integrity reviews at approximately 700 PHAs that together manage over 80% of PIH's subsidies. Also, FY 2003 RHIIPs accomplishments included: income/rent training for PIH and Housing staff; issuance of income/rent program guidebooks; establishment of RHIIP web-sites including posting of guidance material and FAQs; and RHIIP presentations at over 25 national/regional/state industry and tenant conferences</p>
12	Pages 12, 14, and 22-25	<p>The middle of the 3rd paragraph of page 12, 4th sentence states: "In addition the reporting for the TRACS database needs improvement. The TRACS deficiency will be discussed later in the reportable condition on "Controls over Project-based Subsidy Payments Need to be Improved."</p> <p>There is related discussion on pages 13 and 14 and under <i>HUD's Actions Planned and Underway to Verify Tenant Income</i>, in the middle of the 3rd full paragraph, the report acknowledges that "The Office of Housing continues to pursue incentives to improve TRACS data reporting, starting with an 85 percent reporting goal..." and goes on to say on page 15, 3rd paragraph, 1st sentence that "HUD should also continue to develop the capability to obtain relevant tenant data..." and that "We [OIG] are encouraged by...its [HUD's]</p>

		<p>efforts to improve the capability of TRACS.”</p> <p>However, the report seems to contradict its own statements in the section on the reportable condition on “Controls over Project-based Subsidy Payments Need to be Improved.” On page 24, referring to the Department’s plans to improve controls over HUD administered project-based Section 8 voucher payments by developing an automated program to determine which contracts have insufficient tenant data in TRACS, the middle of the 3rd paragraph states that “Instead of HUD moving forward with this initiative, the Office of Housing eliminated the post-payment reviews and assumed the risks that project owners are not in compliance with HUD regulations. We continue to recommend that the Office of Housing expedite the development of the automated process to identify non-compliance with tenant reporting requirements.”</p> <p>The above areas of the report should recognize that the Office of Housing is aggressively pursuing development and implementation of automated tools to identify and appropriately respond to subsidy recipients and contract administrators that are not providing the required TRACS data. The development work is well underway and on-schedule for completion in early calendar year 2004. In anticipation of the enhanced TRACS system capabilities. Housing is working with the Office of General Counsel (OGC) and the Enforcement Center (EC) on authorized and appropriate actions to be implemented in response to non-compliant program participants.</p> <p>The report also suggests that Housing is not responding to previous audit findings to increase the review of subsidy data and develop incentives and sanctions accordingly. In fact Housing intends to implement an automated review of data supporting all vouchers and timely referral to HUD’s Enforcement Center of those found to be non-compliant.</p> <p>Housing also believes that the section on the “Reportable Condition: Controls over Project-Based Subsidy Payments Need to be Improved” (pages 22-25) inaccurately assesses the issue of voucher reviews. The report states GAO requirements that an agency provide adequate review of vouchers, especially vouchers greater than \$2,500 and reports the volume of approximately 25,000 assistance contracts for which the Office of Housing is responsible. Prior to the latest contract administrator initiative, which the report acknowledges, over 20,000 of those contracts were HUD-administered and contract administrators oversaw only about 4,500 of the total. Now that contract administrators and state housing finance agencies oversee about 18,000 of those contracts, as indicated in the report, and those contract administrators are responsible for performing a pre-payment review of all vouchers, the percentage of contracts for which reviews are performed has been increased substantially. The report states that “HUD’s plan is for most HAP contracts to be transferred to CAs” and “When the contracts are transferred, the CAs will be responsible to ensure the tenant data are accurate,”—future tense—failing to acknowledge the substantial progress already made under the PBCA initiative, which has as a major purpose improving the Department’s performance against requirements for voucher reviews. This progress should</p>
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		<p>be acknowledged.</p> <p>Finally, on the matter of reviews of vouchers on HUD-administered contracts, the report incorrectly suggests that the purpose of reviews currently performed by the PIH Financial Management Center (FMC) Voucher Processing Division is to meet the GAO requirements for prepayment examination of program payments. The current review criterion is a reasonableness test. A previous HUD reorganization subsumed Housing's Voucher Processing Center into the PIH Financial Management Center without a staff provision for project-based voucher reviews. Housing's need for additional staff to perform voucher reviews based on a statistical sample of HUD-administered contracts, or according to the amount of the voucher, etc. will be addressed in conjunction with the transfer of Housing contracts from the FMC and its budget-based HUDCAPS payment procedure (see page 29).</p> <p>In summary, the draft should be corrected to:</p> <ol style="list-style-type: none"> 1. Correct the analysis under <i>Reportable Condition: Controls over Project-based Subsidy Payment Need to be Improved.</i>" 2. Revise the discussion under the same Reportable Condition to acknowledge that a comprehensive plan is underway to address controls over payments, and that substantial progress has been made to date. 3. Acknowledge that accomplishment of some important initiatives, such as assigning HUD-administered assisted housing contracts other than Section 8 to contract administrators, depend on passage of legislation, availability of adequate resources for systems development, availability of contractor support for corresponding systems development, and availability of adequate human capital resources within HUD, and the efforts that HUD is taking to acquire these prerequisites.
13	Page 13, Paragraph 2	<p>Please change the language in accordance with Note 17 to the financial statements.</p> <p>The last sentence is incorrect. Billing for the Public Housing subsidy program is completely different than the Section 8 tenant-based program. Section 8 billing is based on the monthly HAP amount paid to an owner plus an administrative fee to the PHA and those amounts vary from month to month. The Public Housing operating subsidy is based on a standard allowable expense level minus the annualized tenant contributions based on one rent roll and the subsidy levels are established once a year.</p>
14	Page 13, last Paragraph to Page 14 top	<p>Note that HUD does not plan to use IRS for the estimation of erroneous payments using 2003 data. HUD plans to use the National Directory of New Hires, if legislation-approving access is passed, or data obtained through existing agreements with state wage information agencies.</p>

15	Page Paragraph 3	14,	<p>The 1st sentence states: “Last year HUD planned to upgrade the capability of PIC to provide the collection of rent calculation information, but the plans were delayed pending security design improvements.”</p> <p>Recommended change: Drop completely, there is no security design improvement documented, reported or known to restrict implementation of a rent calculator.</p>
16	Page Paragraph 5	14,	<p>HUD completed 45 RIM follow-up reviews by November 30, 2003 and provided the data to Econometrica, Inc. to analyze the impact of RIM reviews by comparing the follow-up results to the results from the initial review.</p> <p>The results of that study are expected in time for the PAR. Our plans include a similar study for fiscal year 2004 with approximately 50 PHAs that includes what impact, if any, implementation of the UIV system has had on those entities.</p>
17	Page Paragraph 1	15,	<p>The 1st complete sentence states: “However, the RIM reviews completed did identify rental determination errors and the need for HUD to conduct these reviews for all HAs.”</p> <p>This statement should be deleted. PIH does not have the resources to perform 4,300 RIM reviews. We currently are performing reviews of approximately 20% of the locations covering 80% of PIH subsidies. This is a valid, cost effective financial risk management strategy. In its 2004 management plan, PIH has already directed FOs to conduct follow-up reviews of those large entities where deficiencies were found. As of 11/30/03 we have already completed 45 such reviews.</p>
18	Page Paragraph 2 and 3	15,	<p>There is no basis or evidence that the public housing program has significant billing deficiencies. Program office follow-up on the initial Section 8 billing studies proved to the OIG that over 89% of the identified deficiencies do not exist. PIH will conduct a detailed analysis in 2004 to determine the extent of the problem, if any, but no evidence exists that this is a problem. Billing for Section 8, as explained in our comments to page 13, paragraph 2, is significantly different than for Public Housing.</p>
19	Page Paragraph 6	15	<p>Change the 2nd sentence to read “Similar to last year, risk assessments were not consistently performed primarily due to problems with PIC to provide the risk assessment services.”</p> <p>Rationale: This problem was an operational issue, which had nothing to do with “systemic programming” or security problems. It was an operational issue with the maintenance contractor.</p>
20	Page 16		<p>The four field offices reviewed comprise 8.8% of the entire Office of Public Housing field structure of 45 Hub and Program Center offices. Those four offices had a collective inventory of 737 Housing Agencies (only 17% of the national inventory).</p> <p>A national review of all field offices by the Director of Field Operations’ staff</p>

		<p>highlights that PIH field offices as a whole, conducted monitoring in accordance with published guidance and Headquarters directives.</p> <p>Per the Management Plan guidance, the four field offices reviewed scheduled on-site reviews for high and moderate risk PHAs as resources permitted. However, Field Offices are not required to conduct on-site reviews for all high-risk PHAs as noted in the Management Plan guidance for Fiscal Year 2003.</p> <p>Though on-site review of a high risk PHA is desirable, as noted in previous responses to annual financial statement audits (and accepted in previous management decisions by OIG), PIH cannot commit to insuring ALL high risk locations will be visited because of the volatility of the funding of travel costs.</p> <p>The Department cannot guarantee that every high risk PHA will receive an annual on-site review because of funding limitations, nor is it always fiscally prudent to do so. For example, if the field office has a working knowledge of the PHA’s problems and is working with them remotely to resolve them this could prove just as effective as an on-site visit.</p> <p>To enhance the monitoring of PHAs where the financial risk to the Department was the greatest, PIH employed a modified monitoring approach in FY 2003 by focusing monitoring resources on those PHAs receiving at least 80% of PIH funding through the RIM review effort commenced in April 2003. The OIG should be well aware that, due to the late appropriations passage for FY 2003, HUD did not receive full travel funding until March 2003 (six months into the fiscal year). As noted in this report, the field offices OIG reviewed, modified their monitoring schedule to accommodate the RIM review effort in accordance with Headquarters guidance.</p> <p>As noted in the PIH FY 04 Management Plan, PIH will continue to focus it’s monitoring efforts in Fiscal Year 2004 via follow-up reviews of the PHAs who had RIM reviews in FY2003</p> <p>As a point of reference, nationwide, the field offices conducted 796 in-depth reviews (642 onsite, 154 remote) in addition to the 480 RIM reviews conducted in Fiscal Year 2003. This is a significant accomplishment given the resources available and demonstrates PIH’s commitment to enhanced monitoring procedures.</p> <p>Lastly, the report indicates that there was an increase of 16 PHAs as high/moderate. This represents a change of only 3% (19% vs. 22%) of the PHAs being monitored by the test locations. This is an insignificant change.</p>
<p>21</p>	<p>Page 17 Paragraph 1</p>	<p>The 2nd complete sentence notes that there was an increase of 16 PHAs designated as high/moderate risk. This was interpreted as an indication of a failure of PIH’s monitoring efforts. However, the converse is true.</p> <p>More PHAs have become high risk because of enhanced monitoring and the residual effect of PHAs reporting more accurate PHAS and SEMAP</p>

		<p>information and field office efforts to reduce scores where inconsistencies were noted. We've also noted downward trends in PHAS scores as PHAs are now tackling some of their biggest problems such as long-term vacant units or financial difficulties in order to eventually improve their score.</p> <p>It should also be noted though that the risk scores are based on three indicators – performance (PHAS for public housing and SEMAP for Housing Choice Vouchers), funding and compliance. A slight change in any one of these indicators or the identification of a PHA being designated Troubled which triggers an automatic high-risk designation, may have caused the PHA to be listed as “high risk.”</p> <p>The report should be amended to reflect the above.</p>
22	Pg 17, Paragraph 2	<p>The Integrated Subsystem (NASS) is responsible for issuing the PHA's overall PHAS score. NASS requires the scores from RASS, PASS, MASS (Management Indicator), and FASS (the Financial indicator) in order to release a PHA's overall PHAS score.</p> <p>However, the timing of the issuance of an overall PHAS score would have had little or no effect on the monitoring of EH&S issues. Notices of EHS deficiencies are provided to the PHA management representative at the end of each day. When inspections are uploaded and processed, the EHS deficiencies are displayed in the REAC system and an email is automatically sent to the Field Office notifying them of the EHS so that they can follow up with the PHA to ensure that the deficiencies have been abated.</p> <p>The erroneous implication from the wording of the draft paragraph is that safety is being threatened because scores are issued late. We recommend removing this entire paragraph.</p>
23	Page 17, Paragraph 3	<p>Delete the 3rd sentence of this paragraph and replace with, “Similar to last year, risk assessments were not consistently performed primarily because of PIH Information Center (PIC) to provide the risk assessment services.”</p> <p>Rationale: This problem was an operational issue, which had nothing to do with “systemic programming” or security problems. It was an operational issue with the maintenance contractor.</p>
24	Page 18, 4 th bullet	<p>Change first sentence of this bullet to read: “PIH will ensure full system capability and availability is restored to the user community.”</p> <p>Rationale for change: while there are documented security risks in PIC, none have affected the availability or capability of PIC to provide service to users.</p>
25	Pgs. 20 to 22, 47 and 48	<p>The 1st sentence of the final paragraph on page 20 states that, “The Office of Housing needs to increase the number of management and occupancy reviews...” On page 21 the caption (gray block) caption states that, “HUD needs to develop a comprehensive plan to...” The discussion on that page focuses on work done by HUD staff. The statistics cited are somewhat misleading. While the text acknowledges an increase in the total number of</p>

		<p>management reviews done under the CA initiative the numbers do not include those reviews.</p> <p>On page 22 in the 1st paragraph section concerning HUD's Actions Planned, the auditors have not included the MORs performed by HUD staff.</p> <p>While MFH appreciates the auditor's positive comments in their OIG Assessment of HUD's planned and Completed Actions on page 22 of the draft, we do not see the acknowledgement of these efforts affecting key sections of the reporting.</p> <p>Our records indicate that over 12,000 MORs were conducted in FY 2003 by either CAs or HUD staff. Our comprehensive approach to monitoring using the MORs utilizes both contract and HUD staff, as our plans and goals indicate on page 22 of the draft.</p> <p>Finally, on pages 47 and 48, the auditors list recommendation 3.a. from the FY 1999 audit that recommended an oversight strategy for HAP contract monitoring for the contracts remaining under HUD control; and recommendation 2.e. from the FY 2001 audit that recommended that HUD increase the number of on-site management reviews done for the portfolio which remains a HUD responsibility (i.e. not monitored under the PBCA program).</p> <p>In FY99 when the PBCA initiative was not as advanced as it is in FY 2003, the recommendation regarding HUD staff had some relevancy. However, at the current time, this recommendation is not relevant.</p> <p>We believe that the draft should be corrected to:</p> <ol style="list-style-type: none"> 1. Show that over 12,000 MORs were conducted involving occupancy reviews. 2. Eliminate the reference in the caption on page 21 to a comprehensive plan, since MFH is following a comprehensive plan. 3. Consolidate recommendations 3.a. from the FY 1999 audit with recommendation 2.e. from the FY 2001 audit and revise to acknowledge the impact of the PBCA initiative
26	Page 23, Paragraph 2	<p>The 4th sentence of this paragraph states, "The CAs will approve the budgets, make monthly advances, and perform year end settlement statements."</p> <p>As communicated in our response to the NFR related to the issues in this paragraph, effective April 1, 2001, HUD would no longer be advancing HAP payments monthly based on a budget. Therefore, CAs are no longer required provide budgets or submit year-end settlement statements. Effective April 1, 2001 CAs will verify and certify owner HAP requests and make payments based on actual amounts. Additionally, since the payment process has transitioned from estimates to actuals, year-end settlement statements are no</p>

		<p>longer being required.</p> <p>However, recognizing that the CAs may accrue interest on HAP payments received prior to payment to the owner, the CAs are required to provide an annual interest certification statement and remit any accrued interest to the Department accordingly.</p> <p>Please amend the report accordingly.</p>
27	Page 27 and 28	The draft's discussion on pages 27 and 28 should reflect that an independent A-130 Review of TRACS conducted by the Office of CIO noted that TRACS was found compliant with OMB Circular A-130.
28	Page 28 Paragraph 2	<p>The last sentence reads: "The Department has indicated that it will work with the vendor to incorporate triple DES within SSO software."</p> <p>In recent meetings with the OIG, they agreed with the department that the following sentences should replace the above sentence: "The Advanced Encryption Standard (AES) is also a FIPS-approved encryption algorithm that was developed subsequent to DES and could be used in place of triple DES. The SSO vendor intends to upgrade the InSync software to utilize AES in the next product release."</p> <p>The revisions should be made as agreed.</p>
29	Page 29 1 st and 3 rd Bullets	<p>The Draft should be corrected:</p> <p>First Bullet- The TRACS team has documented procedures for moving software in the Endeavor PROD environment detailed in the TRACS Configuration Management Plan.</p> <p>Third Bullet- The TRACS Team has thoroughly documented and implemented, in its TRACS Configuration Management (CM) Plan, the procedures for handling emergency fixes—they are handled through the Change Control Process and Procedures. The Department has not officially documented the 'proper' procedures for conducting emergency fixes using maintenance libraries; therefore the procedures used by the TRACS team are explicitly documented in the TRACS (application-specific) CM Plan.</p>
30	Page 30 Paragraph 3	The Draft should be corrected as follows: First ¶-TRACS is an integrated system that serves as the sole repository of tenant certifications and contract data for the Office of Housing's rental assistance programs. These programs include... TRACS provides input to payment processing of the project-based rental assistance programs administered by the Office of Housing—based upon the contract and tenant data resident in the system.
31	Page 31 Bullets at the top of the page	<p>The report should be modified to note that some of the issues cited in the bullets have been addressed. Specifically:</p> <p>TRACS has already adjusted the assignment of Security Administrator duties and responsibilities to correct the separation of duties and has delineated that</p>

	Last paragraph	<p>fact in the updated TRACS Security Plan, dated September 2003.</p> <p>The TRACS team has terminated the practice of disclosing the User ID and password through the HUD Application Release Tracking System (HARTS) instructions.</p> <p>The TRACS has submitted a Production Access Plan to the ADP Security Office for approval that addresses the issue of greater than read access.</p> <p>The OIG Financial Statement Report asserts that Housing agrees with the TRACS audit findings. Housing has not completely agreed to all of the notifications of recommendations relating to the mainframe environment and software configuration for TRACS.</p>
32	Page 34	<p>In reference to the Reportable Condition concerning obligated balances, we request that the findings relating to the timeliness of the deobligation process and the use of deobligated balances in the Budget Formulation process be deleted. Deobligated funds are included in the Department's overall Budget planning. Specifically, as this finding relates to the balances that will be available from the deobligation of FY 2003 balances, it is anticipated that these funds will be required to meet the Administration proposed rescission in the FY 2004 Budget. This proposed utilization of available balances is a component of the Budget Formulation process. Because these funds will not be needed until the end of FY 2004, there is no compelling need to effect the recapture, which is a very labor-intensive process, in advance of the need to meet the rescission requirement. In addition, HUD did not report the funds as available for use because these funds were programmed for the rescission.</p>
33	Page 35 Caption - "HUD is not deobligating unneeded funds in a timely manner".	<p>This section states "Excluding the Section 8 programs, which undergo a separate review process by the program offices, the total dollar amount of obligations identified for review totaled \$32 billion. Of the \$32 billion, \$169.1 million, involving 4,541 transactions, was identified for deobligation. We tested 2,580 of the 4,541 transactions to determine whether the balances had been deobligated in HUDCAPS. We found that, as of September 30, 2003, 116 of the 2,580 transactions with obligational authority of \$29 million had not been deobligated in HUDCAPS."</p> <p>Comment: In order to convey the significance of the degree of deobligation that is not occurring, suggest the addition of the following sentence. "This amount (\$29 million) represents 0.091% of the total obligated balance (\$32 billion) reviewed."</p>
34	Pages 35 and 36	<p>The Office of Housing has several TRACS development initiatives planned for FY 2004 that are being undertaken to implement OIG recommendations to improve control over HUD administered project-based Section 8 voucher payments. Details of those plans were provided to OIG under separate cover and we request that the draft audit report be revised to reflect these planned improvements.</p>
35	Page 35 Paragraph 3, last	<p>We suggest it be noted that \$23 million of the \$29 million cited as not deobligated by 9/30/03 is related to contracts that must be closed out by the</p>

	sentence	Office of the Chief Procurement Officer in coordination with the appropriate program office.
36	Pg 36 Shaded paragraph on Section 8 Mod Rehab	Please delete or update this section from last year's audit.
37	Pg 37 Shaded paragraph on PIH Sec 8 recaptures	Please delete or update this section from last year's audit.
38	Pages. 37, 38 and 39	We suggest the discussion on pages 37, 38 and 39, regarding the Section 236 Interest Reduction Program, be re-written to recognize the work the Office of Housing and the OCFO accomplished in 2003. Following the management decision on this finding in 2002, we worked from March through September 2003 to reconcile Housing's records with OCFO's, to establish amortization schedules for all insured projects in line with OIG's recommended methodology, to develop procedures to ensure all changes in the portfolio are identified and reported to OCFO timely, and to prepare to establish these projects in PAS/LOCCS in FY 2004. OCFO identified the \$857 million difference between the project-level detail and the G/L and recorded it before OIG began work in this area. OCFO reversed the adjustment and with Housing double-checked the portfolio, then recorded the \$857 million adjustment again. OIG's draft report reads, "As a result of our review, HUD processed an adjustment to the 2003 Consolidated Financial Statements for \$857 million in excess unexpended funds." OCFO recorded that adjustment <u>before</u> OIG began their review, not as a result of their review. See also our comments on page 57.
39	Page 38	The RAP/Rent Supplement discussion on recaptures should note that the OCFO intends to process recaptures in the 1 st quarter of FY 2004.
40	Page 38 Paragraph 6	Page 38 of the draft report identifies a possible \$41 million of Rental Assistance Payments consisting of FY 2002 and prior year excess funds, as <i>funds put to better use</i> , based on a statistical projection from a sample size of 3.25% (30 projects and a \$1.2 million finding). The OCFO cannot globally deobligate funds from 925 individual projects based on this extrapolation, as each project would require a detailed review to prevent possible multiple violations of the Antideficiency Act. While the Department intends to make improvements in this area, we believe the \$1.2 million is the more appropriate amount to be identified at this time as <i>funds put to better use</i> . We also request case specific details behind the \$1.2 million identified excess funds to pursue the proper adjustments. See also our comments regarding page 57.
41	Page 45 Appendix B	The following draft recommendations are already part of current practice (see comments below). Accordingly, we recommend they be deleted from the report. <u>Recommendation</u> 1.a. Ensure field offices identify and include monitoring objectives that emphasize improving HAs with low performance scores in

		<p>local management plans.</p> <p>Response – PIH presently ensures compliance regarding the above as part of the Field Office’s FY04 HUD Management Plan process.</p> <ul style="list-style-type: none"> • Quarterly updates are performed in the PIC Risk Assessment system to collect recent performance, funding and compliance information. • As noted in the Management Plan Guidance issued on November 12, 2003, <ul style="list-style-type: none"> ○ “A new risk ranking is produced and the field shall review subsequent rankings, assign new qualitative factors if they apply, and modify monitoring strategies to successfully address newly identified risks.” (page III-59) ○ “The risk assessment program and its various incarnations have strived to use all data available to the Department, either in headquarters or in the field, to determine those PHAs that need our technical assistance and oversight. This will ensure that resources are more effectively deployed to address the needs and allow time for field staff to work at resolving the complex, deep-rooted problems experienced by the ○ PHAs and residents. (page III-51). <p>This guidance satisfies the requirements of the recommended action.</p> <p>Recommendation 1.b. Require field offices utilize performance indicators of the PHAS and SEMAP scores to identify and schedule performance areas for on-site monitoring reviews as part of the risk assessment process.</p> <p>Response – PIH presently ensures compliance regarding the above as part of the Field Office’s FY04 HUD Management Plan process.</p> <p>As noted in the Management Plan guidance issued on November 12, 2003, the combination of the risk rank and review and assignment of qualitative factors will allow the Hub Director to determine the monitoring strategy that will be applied to that PHA, be it an on-site review, remote monitoring, technical assistance, or routine monitoring.</p> <p>Based on these reports, analysis of relevant information and the qualitative assessment analysis performed by staff, the field office then needs to identify the final risk rank and design the local office monitoring strategy in the Monitoring and Travel Plan Summary.</p> <p>The use of all reports will allow for a more comprehensive analysis of program-specific indicators as identified in the PIC Risk Assessment system and allow for incorporation of other headquarters-mandated monitoring activities to ensure a cost effective monitoring approach. High-risk PHAs should be selected from the final LR ordered list and from the final Section 8</p>
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		<p>ordered list to prepare an office monitoring and travel plan.</p> <p>This guidance satisfies the requirements of the recommended action.</p> <p>Recommendation 1.c. Ensure field offices identify local management objectives for HAs to improve PIC database reporting in local management plans.</p> <p>Response – PIH presently ensures compliance regarding the above as part of the Field Office’s FY04 HUD Management Plan process.</p> <p>Please refer to goal EM.4.2.1 – “The national average PIH information Center (PIC) on-time reporting rates for public housing and Housing Choice Voucher households will be 85 percent or better.”</p> <p>In addition, PIH is working on a Notice to Public Housing Authorities to clarify exactly what data fields they are required to maintain in PIC. These efforts will help ensure accuracy and PIC reporting and satisfies the requirements of the recommended action.</p> <p>Recommendation 1.d. Ensure field offices document historical data on its monitoring activities.</p> <p>Response – PIH presently ensures compliance regarding the above mentioned as part of the Field Office’s FY04 HUD Management Plan guidance dated 11-12-03.</p> <ul style="list-style-type: none"> ○ Field Offices are required as part of their Management Plan to “document the Risk Assessment process from risk analysis through individual monitoring review and follow-up. All appropriate monitoring information should be recorded in the official tracking systems and Hub-wide file in a timely and accurate manner.” (page III-59) ○ Field Offices are also required to maintain files as follows – “General monitoring procedures require good documentation and filing procedures in order to maintain and document sound monitoring practices. Information must be kept in regular PHA files on-hand and available for inspection. General PHA files exist to provide the paper trail and sufficient confirmation to document that final action has been completed. The file has a list of documents or a certification to put closure to any deficiencies identified during the monitoring process.” (pages III-60/III-61). <p>This guidance satisfies the requirements of the recommended action.</p> <p>Recommendation 1.e. Require field offices use PHAS component scores (FASS, MASS, RASS, and PASS) to improve performance of non-troubled HAs with component scores of less than 70 percent.</p> <p>Response – Use of PHAS and its component indicators is already a</p>
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		<p>requirement by virtue of the PHAS regulations.</p> <p>As the PHAS is a strategic measure of a PHA's essential public housing operations, PIH uses PHAS information extensively for PHA oversight and technical assistance. The PIC risk assessment program allocates 50% of the risk score to PHAS for the Public Housing program and many field offices conduct detailed analyses of the PHAS scores to better target monitoring efforts. PIH ensures compliance regarding the above recommendation as part of the Field Office's FY04 HUD Management Plan dated 11-12-03 on pages III-62 and III-63 with reference to PHAS and other issued programmatic guidance.</p> <p>In addition and in accordance with 24 CFR 902.67(b)(ii)(3), a PHA that achieves a total PHAS score of less than 70 percent, but not less than 60 percent, is required by the HUB/Program Center to submit an Improvement Plan to correct identified deficiencies. Field Offices follow-up with the Improvement Plans to track PHA performance and ultimately help them resolve the noted deficiencies.</p> <p>This guidance therefore satisfies the requirements of the recommended action.</p>
42	Pg 45 Recommendation 2.b.	<p>This recommendation states "Consider expired contract authority from Section 8 project-based contracts maintained in HUDCAPS when formulating budget requests." This recommendation refers back to statements made on Pg 36 that "Housing did not consider expired contract authority from Section 8 project-based contracts maintained in HUDCAPS when formulating their budget request for contract renewals. Through the annual budget process, Housing made requests to fully fund contract renewals for Section 8 project-based contracts. In addition, any excess contract authority from the expired contracts was rolled forward to the subsequent contract renewals.</p> <p>Comment: Clarity on source of Expired Contract Authority referred to is requested. If funding is from Source Year 1974 funds, then the treatment of Contract Authority would be different than if the funding is not from Source Year 1974 funds.</p>
43	Pg 46 Recommendation 2000 1.a.	<p>This recommendation states "Direct CFO and FHA to work together to develop a general ledger interface with the FHA accounting system, which will provide for automated monthly transfers of financial information. (Final action target date is September 30, 2000)"</p> <p>Comment: There is a current automated monthly interface from OCFO/HUDCAPS to FHA accounting system which provides transfers of financial information. During FY 2003, an agreement between OCFO and OIG, regarding the need for an automated monthly interface from FHA accounting system to OCFO/HUDCAPS, led to the discontinuance of the FHA-to-HUDCAPS interface.</p>
44	Page 46, last recommendation	<p>Suggest removing from report. Letter was received from OIG stating that the interface between the FHASL and HUDCAPS was not necessary after the interface was developed, implemented and put into production by the FHASL</p>

	on page.	project team.
45	Page 49 3.b	The Optimum Compliance Initiative in TRACS will accommodate this recommendation.
46	Appendix B Page 48 Paragraph 3	Please notate in the report that on November 21, 2003, the Asst. CFO for Systems sent a memorandum to Randy McGinnis requesting a revised management decision on recommendation i.e. in report number 2002-FO-0003.
47	Page 48 Paragraph 2 Sentence 1	The OIG recommendation 1.G. from the FY 2000 audit continues to reference REMS needing to be upgraded to provide a comprehensive risk ranking. The Department plans to implement this recommendation through the development of the NASS system as opposed to REMS. We request that you change the reference accordingly and address the recommendation to the DAS for Finance and Budget who is responsible for the NASS system.
48	Pages 51 through 54 Appendix C	As written, Appendix C is confusing. The first page indicates a total of 4 noncompliant systems; however, remediation plans are included for 15 systems. In the past, the report has included remediation plans for only the systems reported as noncompliant.
49	Page 57 Appendix D	<p>In reference to the Schedule of Funds Put to Better Use.</p> <p>The \$857 million of IRP is included as Funds Put to Better Use in the \$1.056 billion schedule on page 57. As discussed in our comments regarding pages 37, 38 and 39 of the draft report, OCFO identified these excess funds for adjustment and recorded the adjustment <u>before</u> OIG began their review, consequently the identification of the funds was not a result of the audit work/review. OIG should not identify these funds as auditor recommended “funds put to better use”. You should also be advised that the budgetary nature of the \$857 million IRP funds have legal restrictions that preclude the funds from being used for other purposes, consequently are not available as “funds put to better use”.</p> <p>As a follow-up to CFO comments regarding page 38 of the draft report - in reference to an OIG identified \$41 million of Rental Assistance Payments consisting of FY 2002 and prior year excess funds, that are now identified as auditor recommended “funds put to better use”; the OCFO cannot globally deobligate specific funds from 925 individual projects based on an extrapolation from 30 projects, as each project would require a detailed review to prevent multiple violations of the Antideficiency Act. The \$1.2 million is the more appropriate amount to be identified at this time as “funds put to better use” and even that amount will require case-by-case verification.</p>

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OIG EVALUATION OF AGENCY COMMENTS

This appendix provides our comments on Attachment No. 1 to the Department's December 9, 2003 Response to the Draft Report on Internal Control and Compliance. Our individual comments correspond to the Department's numbered comments included in Attachment No. 1 to their response.

Comment Number	OIG Evaluation
1	<p>The comments were considered and the report was revised.</p> <p>However, the OIG cannot agree to the OCFO's request that we revise our report as requested in the Detailed Comments on OIG's Draft 2003 Internal Control & Compliance Report and Short Matrix on FY 2003 OIG Draft Report.</p> <p>The OIG has continuing concerns over the weakness of the controls over and the risk assumed by the Department's current consolidated financial statement preparation process.</p> <p>OIG will continue to monitor the improvements made by the Department in its integrated financial management system, and will reevaluate findings and recommendations made as improvements are made.</p>
2	The comments were considered and the report was revised.
3	The comments were considered and the report was revised.
4	The comment was considered but the report was not revised. HUD has a physical inspection process in place, however, our review of HUD's monitoring activities showed minimal on-site verification to ensure that problems identified were being corrected.
5	The comment was considered but the report was not revised. We have noted the progress HUD has made during the year, but HUD has not effectively implemented the changes to its control structure and additional changes are needed, and therefore HUD's control structure does not adequately address the risk to ensure acceptable levels of performance.
6	The comment was considered but the report was not revised. We have noted in our report HUD's progress in addressing control weaknesses in oversight and monitoring subsidy calculations and intermediaries program performance. HUD's initial efforts in reducing subsidy error calculation to acceptable levels are commendable. However, HUD's efforts have not fully addressed all the known weaknesses in the income verification process and has not acknowledged or addressed significant intermediaries billing errors that result in erroneous payments
7	The comment was considered and the report was revised to state that HUD had determined an estimate of \$614 million for erroneous payments due to billings errors for Section 8

Comment Number	OIG Evaluation
	subsidies, but choose not to use it as a baseline for future studies.
8	The comment was considered but the report was not revised. The RHIIP advisory board has indicated that the suspension was temporary pending the outcome of the RHIIP initiatives.
9	The comments were considered and the report was revised.
10	The comment was considered but the report was not revised.
11	The comment was considered but the report was not revised.
12	<p>The comment was considered and the report was clarified to recognize the Office of Housing's efforts to develop and implement automated tools to identify and appropriately respond to the non-compliance of providing the required TRACS data.</p> <p>However, our review showed that during fiscal year 2003, the Office of Housing delayed and did not implement an automated program to determine which contracts have insufficient tenant data in TRACS. Also during the fiscal year, the Office of Housing eliminated the manual processes of post-payment reviews, which were intended to check whether the property owners were in compliance with HUD regulations. Finally, HUD certifying officers are responsible and accountable for the voucher payments. To discharge the certifying officers duties, Title VII, "Fiscal Guidance," of the <i>GAO Policy and Procedures Manual for Guidance of Federal Agencies</i>, requires prepayment examination of vouchers prior to their certification and payment.</p>
13	The comment was considered and the report was revised accordingly. The revision stated that the intermediaries administering the Section 8 subsidy program also administer public housing subsidy programs.
14	The comment was considered but the report was not revised. Our statement was taken from the information provided by the RHIIP advisory board.
15	The comment was considered but the report was not revised. The reports of the RHIIP advisory committee indicated delays pending security design improvements and HUD comment number 19 supports the PIC security problems.
16	The comment was considered but the report was not revised. The actions indicated were not substantiated since they did not occur within the fiscal year 2003 timeframes reported on in the audit report.
17	The comment was considered but the report was not revised. This statement was intended to indicate that all HAs should eventually be reviewed given available funding. Also, HUD cannot assume it will continue to have significant reductions in erroneous payment by only focusing on large HAs, since it has not determined to what extent the remaining 80% of the HA have rental determination errors.
18	The comment was considered and the report was revised to indicate that HUD has substantiated that material weaknesses exist regarding intermediaries' billings and estimated

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	that \$614 million in billings errors occurred during fiscal year 2002 based on the intermediaries' failure to document or maintain required program documentation supporting rental subsidiary billings for Section 8 programs.
19	The comment was considered but the report was not revised. The PIC system was only one of the reasons the risk assessments were not consistently performed.
20	The comment was considered but the report was not revised.
21	The comment was considered but the report was not revised.
22	The comment was considered but the report was not revised.
23	The comment was considered but the report was not revised.
24	The comment was considered but the report was not revised. The PIC system was not available to the field offices to manage and document their monitoring efforts.
25	The comments were considered and the report was revised accordingly.
26	The comments were considered and the report was revised accordingly.
27	The comment was considered but the report was not revised. The CIO's office confirmed that TRACS is not compliant with OMB Circular A-130.
28	The comments were considered and the report was revised accordingly.
29	The comments were considered and the report was revised accordingly.
30	The comments were considered and the report was revised accordingly.
31	<p>The comments were considered and the report was revised accordingly.</p> <p>OIG does not have documentation supporting appropriate corrective action with respect to the separation of duties matter. In addition, the recent decision to terminate the practice through HATRS of disclosing the User ID and password still needs to be documented in the change control policy.</p> <p>On October 3, 2003, OIG met with the TRACS system owner and Project Manager to discuss the findings and recommendations. During the meeting they verbally agreed with our findings. At no time subsequent to the meeting did Housing submit verbal or written objections to the audit findings.</p>
32	The comments were considered but the report was not revised. This section is intended to show that that \$351 million in excess Section 8 contract authority expected to be realized during fiscal year 2004 is related to contracts scheduled for renewal. The Department requested full funding for all renewal contracts through the budget process for fiscal year 2004. The Department should routinely be closing out the expired contracts and recapturing

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	the excess funding in lieu of rolling the funding to the renewals.
33	The comments were considered but the report was not revised. The relative significance of this amount was considered in our concurrence with the Department's decision to wave adjustment of the financial statements for this amount.
34	The Office of Housing's planned TRACS initiatives are delineated under the reportable condition "Controls over Project-Based Subsidy Payments Need to be Improved".
35	The comments were considered but the report was not revised
36	The comments were considered and the report was revised accordingly.
37	The comments were considered and the report was revised accordingly.
38	We have addressed the Department's response in our comments to number 49.
39	The comments were considered and the report was revised accordingly.
40	We have addressed the Department's response in our comments to number 49.
41	The comments were considered but the report was not revised.
42	The comments were considered but the report was not revised
43	The comments were considered and the report was revised accordingly. The Department closed the recommendation.
44	The comments were considered and the report was revised accordingly. The Department closed the recommendation.
45	We acknowledge HUD's planned action to comply with our recommendation.
46	The comments were considered but the report was not revised.
47	This recommendation will remain until the Department implements NASS or other actions to improve risk ranking.
48	We have revised the report to clarify the four noncompliant systems, however, we will continue to report the systems that were previously under remediation plans until those plans have been completed.

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49	<p>We have considered your comments and clarified our position in the report.</p> <p>The Department has a long history of failure to recapture unneeded funds at fiscal year-end. Since fiscal year 1996, OIG has advised HUD of reporting an inaccurate balance of commitments for the Section 236 Interest Reduction Payment Program. Again in fiscal year 2003, we reviewed HUD's records and determined there was a difference of approximately \$857 million between the subsidiary and general ledgers. Based upon our review, we recommended on November 20, 2003 the \$857 million adjustment be made. HUD subsequently processed the adjustment on December 4, 2003. HUD later recorded \$758 million of the \$857 million as a withdrawal of funding authority rather than using the funds to meet rescission requirements as done in previous years. Without the discipline of the financial statement audit, HUD has long demonstrated a reluctance to recapture excess funds and associated contract authority and imputed budget authority.</p> <p>At the time of our review, the general ledger supporting the Section 236 program showed that HUD had processed an adjustment to recapture these funds on October 15, 2003, but later reversed the adjustment on November 6, 2003. As a result on November 7, 2003, HUD reported on their SF-133 Budget Execution, SF-2108 Year-end Closing Balance Reports, and Federal Agencies' Centralized Trial Balance System (FACTS) II, an overstatement in commitments of \$857 million for the Section 236 IRP program for the September 30, 2003 account balance. OMB uses the SF-133 and the SF-2108 Reports to prepare the President's Budget, which thereafter is submitted to Congress for approval. Overstating unexpended appropriations could influence OMB's process for allocating resources in the President's Budget and mislead Congressional decisions, limiting needed funds for other programs or increasing the taxpayer's burden for unneeded resources. Because the Department corrected this during our audit, we recorded a management decision with final action implemented concurrent with issuance of this report.</p> <p>In addition, we recognized the work performed by the Office of Housing and OCFO reconciling the general ledger and subsidiary ledgers, establishing amortization schedules for all insured projects, and the plan to establish these projects in PAS/LOCCS in fiscal year 2004.</p> <p>Concerning the OIG's use of statistical sampling to project unneeded funding authority on the Rent Supplement and Rental Assistance Programs, our recommendation to the Department was to take the necessary steps to review the associated contracts and deobligate, where appropriate, prior year undisbursed amounts. Our review was performed to determine if the associated account balances were materially misstated. Our report does not recommend an adjustment of the contracts for the projected \$41 million. We proposed an adjustment for the financial statements for that amount, but the Department decided not to make the adjustment, but plans to perform a detail review of the associated contracts and deobligate unneeded funding.</p>