
AUDIT REPORT



U.S. DEPARTMENT OF HOUSING
AND URBAN DEVELOPMENT
AUDIT OF FINANCIAL STATEMENTS
FISCAL YEARS 2002 AND 2001

2003-FO-0004

January 31, 2003

OFFICE OF AUDIT
FINANCIAL AUDITS DIVISION
WASHINGTON, DC



Issue Date

January 31, 2003

Case Number

2003-FO-0004

TO: Angela Antonelli, Chief Financial Officer, F

Randy W. McGinnis

FROM: 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 2002 and 2001**

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, 2002 and 2001. 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, 2003, 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 2002 Performance and Accountability Report*, which will consolidate these and other reports, including HUD's fiscal year 2002 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 2002 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, 2003. 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. 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, 2002 and 2001, 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 38 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, 2002 and 2001 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 2002 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 processes;
 - improve oversight and monitoring of subsidy calculations and intermediaries' program performance; and
 - improve FHA's controls over budget execution and funds control.

- Reportable conditions in internal controls in fiscal year 2002 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 systems;
 - improve funds controls over public housing operating funds;
 - improve processes for reviewing obligation balances;
 - more effectively manage controls over the FHA systems' portfolio;

- place more emphasis on monitoring lender underwriting and improving early warning and loss prevention for FHA single family insured mortgages;
- sufficiently monitor FHA’s single family property inventory; and
- improve FHA’s controls over the credit subsidy adjustment process.

Most of these control weaknesses were reported in prior efforts to audit HUD’s financial statements and represent long-standing problems. It should be noted, we have combined two material weaknesses reported in prior years relating to the need to “improve oversight and monitoring of housing subsidy determinations” and “ensure that subsidies are based on correct tenant income.” Those material weaknesses are now reported as “Improvements needed in oversight and monitoring of subsidy calculations and intermediaries’ program performance.”

In its *Fiscal Year 2002 Performance and Accountability Report*, HUD reported that it complied with Section 2 of the Federal Managers’ Financial Integrity Act (FMFIA), with the exception of the material weaknesses and nonconformances specifically identified in that report. Section 2 and related guidance require that: (1) an agency’s internal accounting and administrative controls provide reasonable assurance that obligations and costs are in compliance with applicable laws; (2) funds, property and assets are adequately safeguarded; and (3) revenues and expenditures are properly and reliably accounted for and reported. HUD was unable to report compliance with Section 4, which requires that accounting systems conform to applicable accounting principles and standards. For fiscal year 2001 and prior years, we disagreed with the Department’s statement of overall assurance in the Department’s *Accountability Reports*. HUD’s compliance determinations did not fully consider the magnitude of the problems HUD acknowledges in its own FMFIA process. As permitted by the Reports Consolidation Act of 2000 (PL 106-531), HUD did not prepare a separate FMFIA report for fiscal year 2002, but will be addressing those reporting requirements in its *Fiscal Year 2002 Performance and Accountability Report*. Given the magnitude of the problems that still remain, we continue to believe that an FMFIA statement of noncompliance would be appropriate for HUD.

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, (2) applicable accounting standards, and (3) the U.S. Standard General Ledger (SGL) at the transaction level.

Consolidating Financial Information

We conducted our audit for the purpose of forming an opinion on the fiscal years 2002 and 2001 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 2002 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 2002 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 \$23 billion in fiscal year 2002 to provide rent and operating subsidies that benefited over 4 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.

In November 2000, a contracted study of rent determinations under HUD's major housing assistance programs showed that estimated errors

made by project owners and HAs resulted in substantial subsidy overpayments and underpayments. The purpose of the study was to provide national estimates of the extent, severity, costs, and sources of errors occurring in the certification and recertification procedures used by HAs and owners in calculating tenant rents. The study projected that annually, about \$1.7 billion in subsidies was overpaid on behalf of households paying too little rent and about \$600 million in subsidies was underpaid on behalf of households paying too much rent based on HUD requirements. In FY 2001, HUD used the information from the study to determine the estimated errors due to unreported tenant income. Tenants often do not report income or under report income which, if not detected, causes HUD to make excessive subsidy payments. As a result of the 2001 assessment, HUD identified an additional \$ 978 million in overpaid rental subsidies.

In fiscal year 2002, HUD again added to the study by determining an estimate for errors resulting from incorrect intermediaries' billings for Section 8 rental subsidies. HUD estimated an additional \$257.1 million in erroneous payments due to intermediaries' billings. This represents \$121.5 million in overpayments and \$135.6 million in underpayments. HUD plans to provide a single updated annual error estimate combining all three measurements beginning in fiscal year 2003.

In fiscal year 2001, HUD initiated the Rental Housing Integrity Improvement Project (RHIIP). 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.

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 funds controls over public housing operating funds and processes for reviewing outstanding

obligations to ensure that unneeded amounts are deobligated in a timely manner. Major deficiencies include:

- PIH did not have an operational, information system for monitoring operating subsidy eligibility requirements and obligations during six months of fiscal year 2002.
- 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 2002 and 2001 financial statements by the independent certified public accounting firm of KPMG LLP. Their report on FHA's financial statements, dated January 21, 2003,¹ includes an unqualified opinion on FHA's financial statements, along with discussions of two material weaknesses and four reportable conditions. The FHA material weaknesses are as follows:

- HUD/FHA's ADP system environment must be enhanced to more effectively support FHA's business processes. HUD and FHA are conducting day-to-day business with legacy-based systems. Several systems directly impact FHA's financial activity and necessitate financial transactions to be processed through non-integrated systems, requiring manual analysis and summary entries to be posted to FHA's general ledger. FHA's and HUD's inability to implement modern information technology adversely affects the internal controls related to accounting and reporting financial activities.
- Controls over budget execution and funds control must be improved. FHA does not have a collection of ADP financial systems that are capable of fully monitoring and controlling budgetary resources in an ADP integrated process. Lack of efficient integration between these systems requires the use of manual analysis and reconciliation and use of additional databases to collect and summarize funds control information, which subjects the process to the risk of errors resulting from reliance on manual processes.

KPMG LLP also notes four reportable conditions regarding the need for FHA and HUD to: (1) more effectively manage controls over the FHA ADP systems portfolio, (2) place more emphasis on monitoring lender underwriting and improving early warning and loss prevention for single family insured mortgages, (3) sufficiently monitor its single family property inventory, and (4) improve the controls over credit subsidy adjustment process.

¹ KPMG LLP's report on FHA entitled, "Audit of Federal Housing Administration Financial Statements for Fiscal Years 2002 and 2001" (2003-FO-0002, dated January 21, 2003) was incorporated in our report.

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 2002 and 2001 financial statements.

Results of the Audit of Ginnie Mae's Financial Statements

A separate audit was performed of the Ginnie Mae financial statements for fiscal years 2002 and 2001 by KPMG LLP. Their report on Ginnie Mae's financial statements, dated January 30, 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 2001 update, GAO redefined and reduced the number of programs deemed to be high-risk. Specifically, because of the actions taken by HUD in response to GAO's recommendations to improve its management controls over its Community Planning and Development programs, GAO concluded that this program area is no longer high risk. However, GAO concluded that significant weaknesses still persist in two of HUD's major program areas: (1) single-family mortgage insurance and (2) rental housing assistance. In addition, HUD needs to continue addressing management challenges in two other areas: (1) information and financial management systems and (2) human capital. GAO plans to release their 2003 Performance and Accountability and High Risk Series on January 30, 2003, which will update their January 2001 assessment of HUD.

With respect to fiscal years 2002 and 2001, 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

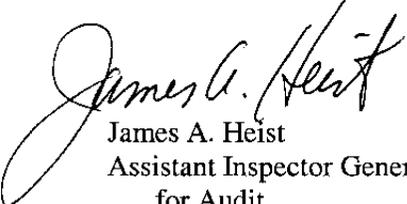
² KPMG LLP's report on Ginnie Mae entitled, "Audit of Government National Mortgage Association Financial Statements for Fiscal Years 2002 and 2001" (2003-FO-0003, dated January 30, 2003) was incorporated in our report.

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 January 3, 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 January 10, 2003, which is included in its entirety as Appendix E. Remaining sections of the draft report were provided on January 17, 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

January 27, 2003

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 some progress. HUD's most significant financial management systems deficiencies exist in FHA, where FHA needs to convert its commercial accounting system to a system that fully supports the Federal basis of accounting and budgeting. HUD has purchased a commercial off-the-shelf software package for this purpose. FHA's core general ledger system was implemented in October. FHA program systems will be integrated with the new FHA general ledger system over a multi-year period. Until these systemic solutions are fully implemented, compensating ad hoc processes and controls have been put in place to convert transactions to the standard general ledger accounts, provide for the administrative control of funds, and comply with credit reform requirements. 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. Our office and the National Academy of Public Administration (NAPA) recommended that HUD develop a resource management system to align resources with program needs. In 1997, HUD announced plans to implement a resource estimation process that "would be a disciplined and analytical approach, to identify, justify, and integrate resource requirements and budget allocations." HUD worked with NAPA to develop a methodology for resource estimation and allocation. NAPA's methodology was tested and refined in several HUD offices.

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 December 2001. The next step in development of the Department's resource management strategy is the implementation of the Total Estimation and Allocation Mechanism (TEAM). TEAM is the validation component of REAP and will collect actual workload accomplishments and staff usage for comparison against the REAP baseline.

TEAM was implemented Department-wide during June 2002 and was to be fully operational within fiscal year 2002. TEAM is a web-based application and is used to collect actual workload accomplishments and employee time usage on a sampling basis. Employees record how much time they spend working on the different activities and processes of their jobs during a randomly selected two-week period every quarter. This time reporting process proposes to validate the REAP standards or require their re-evaluation.

TEAM is comprised of eight modules which include: (1) workload (data input), (2) allocation, (3) resource, (4) set-up, (5) time reporting, (6) extracts, (7) queries, (8) and reports. The Allocation Module is the vehicle for Headquarters and the Field offices to agree on what work, based on REAP indicators, the Office will accomplish in a given fiscal year and how much staff the Office will need. The workload of the Office will be linked to the Office's Management Plan. The CFO anticipates this module should be implemented during the first quarter of

fiscal year 2003, depending on when Congress approves the Department's fiscal year 2003 appropriation. The implementation of this module should provide the Department with resource estimations and allocations thereby ensuring a stronger basis for workload and staff distribution.

GAO addressed the Department's need for a comprehensive strategic workforce plan in a recent GAO report on HUD's human capital management³. In the report, GAO indicated the compilation of data from the REAP study is an important first step for HUD toward strategic human capital planning, but additional workforce planning steps are necessary. Although REAP/TEAM is collecting valuable information about staff levels and workload, HUD still has not completed a comprehensive strategic workforce plan on how it will use the data to allocate its resources. We believe such a plan should include written guidance on how the Department plans to use data from REAP/TEAM to allocate its human resources within and among its operating components. Without such a plan, the Department's ability to accurately justify and support its human resource requirements and allocations will likely suffer.

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 is enforcing the compliance with the United States Housing Act of 1937, as amended by the Quality Housing and Work Responsibility Act of 1998 for the timely expenditure and obligation by housing authorities of public housing capital funds. 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 comply substantially 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 "HUD Human Capital Management – Comprehensive Strategic Workforce Planning Needed," (GAO-02-839, dated July 2002).

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 FY 2002 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 2002. These deficiencies are as follows:

- Several interfaces between HUD's core financial system and FHA's subsidiary ledger are either not automated or require manual analyses, reprocessing and additional entries. Currently, financial data is being manually extracted from both the FHA and the Department's general ledgers and disbursement systems. Even though both FHA and the Department need to exchange this financial data to support the agency's financial management needs, there are no automated interfaces to accomplish these tasks. FHA uses the Department's general ledger (HUDCAPS) for disbursing and budgetary/fund controls of Administrative and Church Arson contracts, and for tracking FHA Salaries and Expenses. FHA also uses the Department's supporting funds control and payments systems (PAS/LOCCS) for disbursing and budgetary/fund controls of pre-fiscal year 2000 field office contracts and up-front grants. In FY 2002, FHA SGL data was also being

manually extracted and transferred quarterly instead of monthly into HUDCAPS, but was not being used by management because the data was not current.

- The FHA general ledger and its supporting subsidiary systems remain noncompliant with SGL and JFMIP requirements. Its 19 subsidiary systems that feed transactions to its commercial general ledger system lack the capabilities to process transactions in the SGL format.
- There continues to be an inability to support adequate funds control for FHA. Although FHA has made progress in funds control, FHA continues to lack automated financial systems and processes that are capable of fully monitoring and controlling budgetary resources. For example, FHA must manually compile the status of budgetary resources to prepare a report on budget execution based on data from at least eight systems.
- PIH did not have an operational, automated system for monitoring operating subsidy eligibility requirements and obligations during fiscal year 2001 and the first six months of fiscal year 2002. As a result, timely management reports were not available to monitor budget execution and funds control over operating subsidies (see report section “HUD needs to improve funds controls over Public Housing Operating Funds”).
- 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 process for reviewing and accounting for the Section 236 Interest Reduction Program”).
- 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”).
- The Department’s financial systems continue to have access control weaknesses in the general control environment (See report section

“Controls Over HUD’s Computing Environment Can be Further Strengthened”).

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 uncorrected weaknesses in FHA’s financial management system and its interface with the Department’s general ledger, 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.

During August 2000, the “former” Deputy Chief Financial Officer issued a vision statement that concluded that HUDCAPS and the supporting payments and funds control systems, LOCCS and PAS, should be replaced. That vision statement is under reconsideration, because the necessary feasibility and cost-benefit studies to support that conclusion were not performed. In FY 2002 the OCFO created the Departmental General Ledger (DGL) project with funding authorized to contract out the feasibility and cost-benefit studies. The project has been renamed the HUD Integrated Financial Management Improvement Project (HIFMIP). Procurement of the studies has been delayed. The current target contract award date is May 2003. 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. The first phase of the implementation was completed during October 1, 2002 with the implementation of the new general ledger posting models. The subsidiary ledger is scheduled for full implementation by fiscal year 2007, by which time the new subsidiary ledger will post transactions at the SGL level, interface automatically with the HUD Departmental general ledger, and interface directly with FHA operational systems.

Other financial management system deficiencies identified

Based on our follow-up of audit work performed for the fiscal year 2001 Financial Statement Audit, the following financial management system deficiencies and noncompliance with Federal financial management systems requirements remained during fiscal year 2002:

- The Department’s Federal grant management systems and the core financial payment systems are noncompliant with JFMIP requirements for Federal grants accounting. JFMIP requires these systems to (1) record grant payments as either agency advances or expenses/payables and (2) to accrue unreimbursed grantee expenditures at fiscal year-end. Neither the Department’s automated

systems nor its manual processes have the current capability to obtain all required information.

- The crosswalk interfaces between HUDCAPS and its reporting system (Hyperion) have not been developed to transfer FHA and GNMA account balances. As a substitute, HUD is manually posting those entities' financial statement information directly into Hyperion, which increases the chances for misstatements from human error or from any unreconciled differences with recorded balances.

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. Implementation of the FHA plans was delayed due to procurement problems and the first phase of the implementation was completed October 1, 2002. Full implementation is scheduled for fiscal year 2007. In regard to the Department's plans to complete feasibility and cost-benefit studies for the HIFMIP project, procurement of the studies has been delayed. The current target award date is May 2003. The planned completion date for the studies is July 2004.

The Department has developed plans to address the deficiencies we found during fiscal year 2001. In regard to the JFMIP requirement that HUD properly account for Federal grant transactions, the Department will not change existing policies or systems but disclosed the basis of its accounting and reporting of HUD's grant program activity as a footnote to the FY 2002 consolidated financial statements. HUD will further pursue this issue through its participation on the CFO Council and OMB eGovernment/eGrants systems initiatives to determine if there is a government-wide movement towards increased grantee reporting requirements and systems changes that would cause HUD to change current policy and systems. The targeted completion date is set for June 30, 2003.

HUD will implement an automated loading process to eliminate the manual keying of FHA and GNMA financial statement data into the Hyperion reporting module for producing HUD's consolidated financial statements. The targeted completion date is March 3, 2003.

For the Section 8 project-based subsidiary records, 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.

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

FHA is moving in a positive direction with the planned implementation of the new subsidiary ledger designed to post transactions at the SGL level, interface automatically with the HUD Departmental general ledger, and interface directly with FHA operational systems. We will evaluate the results of the first phase of the implementation during fiscal year 2003.

Delays continue to plague the Department's plans to complete feasibility and cost-benefit studies for the HIFMIP project. Even though funding was allocated during FY 2002 to contract out the feasibility and cost-benefit studies, the current target award date is now set for May 2003. The studies will not be completed until July 2004.

In regard to the JFMIP requirement that HUD properly account for Federal grant transactions, the Department still needs to further pursue this issue through its participation on the CFO Council and OMB eGovernment/eGrants systems initiatives to determine if there is a government-wide movement towards increased grantee reporting requirements and systems change. This may cause HUD to change current policy and systems. In regard to developing crosswalk interfaces between the Department's core financial system's general ledger (HUDCAPS) and its reporting system (Hyperion) to transfer FHA and GNMA account balances, we agree that an automated loading process would reduce errors caused by the manual keying of information.

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 the last grantee was not converted to the system until the end of fiscal year 2000. Moreover, a regulation that only requires grantees to report performance on an annual basis, has delayed full realization of the purposes for which the system was designed. In addition, IDIS was undergoing a massive data cleanup

effort during fiscal year 2002. 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 is March 31, 2003. We also noted that Inspector General audit reports on Empowerment Zones, whose data does not come from IDIS, stated that accomplishments were not accurately 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 Housing Authority performance, from the Public Housing Management Assessment Program (PHMAP). The Public Housing Assessment System (PHAS) replaced PHMAP. During fiscal year 2000, the Real Estate Assessment Center (REAC) began compiling and reporting the results of physical inspections of public housing agencies using PHAS. However, these scores were only advisory. Additional administrative and legislative delays prevented PHAS from being fully implemented in fiscal year 2001. Again during fiscal year 2002, administrative delays in producing PHAS scores limited the use of PHAS as intended and raised concerns regarding the reliability of performance data.
- The Departmental Enforcement Center (DEC) began reporting performance information in the fiscal year 1999 Accountability Report. The information included statistics on various enforcement activities completed along with monetary recoveries. We noted that the underlying source systems for this data were in various stages of completion and none were operational. An OIG report, "Nationwide Audit, Enforcement Center," (00-NY-177-0001, dated March 28, 2000), recommended the DEC develop a HUD wide tracking system to track enforcement actions. The DEC is in the process of implementing a tracking system for enforcement actions. However, the system was not fully operational at the end of fiscal year 2002. Because of this, the DEC continued to use various sources for performance information including stand-alone computer systems. These sources are less reliable than a centralized system with good controls.

In prior years, we reported on our concerns over performance measure data reliability and the Department's plans to remedy the concern with a program requirement to submit quality assurance plans to the CFO for review and approval. A report issued by OIG resulting from a review of the reliability of data presented in HUD's fiscal year 1999 Annual Performance Report found a number of performance indicators with questionable data quality. Data quality is now the responsibility of the Office of the Chief Information Officer (OCIO). After delays due to the lack of funding, the OCIO has embarked on a data quality improvement project that will 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 plans to implement the steps of this process during the following months with a projected completion of January 2004.

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 assisted housing, and Native American housing. In fiscal year 2002, 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.

The Office of Public and Indian Housing (PIH) provides funding for rent subsidies through its public housing operating subsidies and tenant-based Section 8 rental assistance programs. These programs are administered by housing authorities (HAs) that are to provide housing to low-income households or make assistance payments to private owners who lease their rental units to assisted households.

The Office of Housing administers a variety of assisted housing programs including parts of the Section 8 program and the Section 202/811 programs. These subsidies are called "project-based" subsidies because they are tied to particular properties, therefore tenants who move from such properties may lose their rental assistance. Historically, unlike public housing and tenant-based Section 8, most of these subsidies have been provided through direct contracts with multifamily project owners. HUD has more responsibility for processing payments to project owners and ensuring that they provide support only to eligible tenants and that they comply with the contract and program laws and regulations. More recently, HUD has been contracting with "performance based contract administrators" who have begun taking over significant aspects of Section 8 contract administration. However, there remains a sizable number of project owners that HUD must monitor.

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. As in past years, 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. 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, a significant amount of excess subsidy payments occur as a result of undetected unreported or underreported income. In addition, this year we are reporting on HUD's measurement of erroneous payments resulting from intermediaries' housing assistance billings for HUD's subsidy payments that identified significant errors in the billings and payments process, and which also results in excess 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 estimate⁴ 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.

⁴ As stated in U.S. Department of Housing and Urban Development FY 2000-FY 2006 Strategic Plan, September 2000.

Verification of Subsidy Payments

A contracted study⁵ completed in November 2000, substantiated there was significant risk in HUD's reliance on intermediaries to ensure that rent calculations for assisted households were based on HUD requirements. These rent calculations determine the amount of subsidy HUD pays on behalf of the assisted household. Under project-based Section 8 programs funded through the Office of Housing, the individual project owners or agents administering the programs make the rent calculations. Under public housing and tenant-based Section 8 programs, the housing authorities (HAs) determine eligibility and rent for households residing in public housing or at approved housing provided by private owners.

The contracted study of HUD's three major assisted housing programs estimated that the rent determinations errors made by project owners and housing authorities 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. The study reported that HUD incorrectly paid \$2.3 billion in annual housing subsidies of which about \$1.7 billion in subsidies was overpaid on behalf of households paying too little rent, and about \$600 million in subsidies was underpaid on behalf of households paying too much rent based on HUD requirements. Last year, HUD revised this estimate to report an additional \$978 million in overpayments resulting from underreported and unreported income. For the fiscal year 2002 financial statements, HUD expanded its error measurement efforts to include a subsidy billing study. The preliminary estimates from the study have been reflected in HUD's fiscal year 2002 financial statement note 16, subject to further validation. HUD revised the estimate of erroneous payments to report an additional \$257.1 million in billings errors consisting of \$121.5 million in overpayments and \$135.6 million in underpayments errors. Most of the errors are related to the unavailability of underlying supporting documentation.

Underreporting or understating of income from a specific reported source is easier to detect than unreported income. Program regulations require HAs or project owners to verify through third party written documentation the applicant and tenant income and other factors relating to eligibility and rent determinations. With regard to detection of unreported 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. In addition, HUD continues to encourage HAs to

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

⁵ "Quality Control for Rental Assistance Subsidies Determinations," Final Report dated June 20, 2001.

verify income and computer match with State wage agencies to detect underreported and unreported income.

Since 1996, HUD had sampled its household databases to estimate the amount of excess subsidy payments reported for financial statement disclosure each year. During fiscal year 1999, REAC developed the Tenant Assessment Subsystem that automated the matching of tenant-reported income maintained in HUD's tenant databases with Federal tax data from the IRS and SSA. Also, HUD completed several computer income-matching projects of a sample of calendar year 1996 data and 1998 data. HUD issued reports on both matching efforts during fiscal year 2001. The reports for the matching projects indicated the likelihood of recovery of excess rental subsidies paid diminished over time due to (1) unresponsive former tenants, (2) former tenants could not be located, or (3) the HAs did not pursue resolution. Further, HUD needed to obtain complete and accurate tenant data electronically to identify valid actionable income discrepancies that result in excess subsidy payments or overpayments by the tenants. During FY 2002, HUD's management made a decision to discontinue the annual large-scale matching for the financial statements and instead, conduct the matching as part of their Rental Housing Integrity Improvement Project⁶ (RHIP), which would be performed annually using a statistically based sample.

In fiscal year 2001, HUD initiated RHIP, which called for the design of systems capability that will identify relevant tenant and program data for rent calculations, and required the data to be submitted by HAs. HUD would also use the data to identify possible HAs certification or re-certification processing deficiencies, and to conduct an "annual total error measurement process"⁷ to identify and measure erroneous payments. Since our last report, HUD has been implementing a RHIP corrective action plan to address the problems surrounding HAs rental subsidy determinations, underreported income and assistance billings.

Thus far, HUD has (1) issued a PIH notice in May 2001 to HAs on improving income integrity in efforts to reduce incorrect rental subsidy determinations, (2) made available newly developed fact sheets on rental programs and a guidebook on housing choice vouchers, (3) provided staff training on calculating rents and reviewed rental calculations during some of the on-site monitoring reviews, (4) drafted new Multifamily and Public Housing Occupancy Handbooks, (5) drafted a new Public Housing Monitoring Handbook, (6) initiated upgrades to TRACS, (7)

⁶ 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.

⁷ The total error measurement process is HUD's quality control process to identify and measure erroneous payments annually. The three types of errors that are measured are rental calculation, unreported and underreported income, and intermediaries' billings errors.

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

developed and piloted a test of rent calculator software, and (8) established a baseline for measuring erroneous payments. In addition, a major new initiative started this year by PIH was rental integrity monitoring (RIM) reviews of low-income and tenant-based Section 8 programs, which are also to be conducted on an annual basis. These are on-site reviews of housing authorities rental determinations. These reviews started in July 2002 and will be used to establish a baseline of the types of systemic errors and management issues affecting rental subsidies. The impact and effectiveness of all these initiatives will be evaluated under the RHIP annual total error measurement process to be completed in December 2004.

The Department also continued operations for the large-scale 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.

HUD uses the PIC data, and the Tenant Rental Assistance Certification System (TRACS) data 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 changes prevented HAs from reporting for most of fiscal year 2002. In addition, the reporting for the TRACS database needs improvement. This deficiency will be discussed later in the reportable condition on "Controls over Project-based Subsidy Payments Need to be Improved". The RHIP advisory group has recommended that payment-processing incentives to improve TRACS database reporting 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.

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.

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

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

In fiscal year 2002, HUD completed a review to establish a baseline for measuring erroneous payments resulting from housing assistance billings. The purpose of the review was to determine whether a sample of HUD subsidies were recorded, billed and collected in accordance with HUD policies and regulations. Tests were conducted at 98 HAs and projects randomly selected for the Section 8 tenant-based and project-based programs. The public housing program was excluded from the reviews. The review of the subsidy billings process for the Section 8 programs showed approximately \$257.1 million in subsidy billing errors. 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 billing process for the public housing program is similar to the Section 8 tenant-based program, there may be problems that are similar and significant as well.

HUD's Actions Planned and Underway to Verify Tenant Income

REAC developed the capability to implement a large-scale income verification of the information in its tenant databases. HUD made a decision to discontinue its large-scale computer matching of reported income from HUD's tenant databases to IRS and SS data files for financial statement reporting. Instead, HUD will provide estimates of erroneous payments from under and unreported income as part of its annual total error measurement process under the RHIP, starting in fiscal year 2004.

A review was conducted of the results of this year's effort to establish a benchmark of the nature and scope of billings errors. Based on this benchmark, HUD will be able to measure the accomplishments of future efforts in reducing improper payments and error rates over time. HUD's RHIP advisory group has plans to use intermediary's billings measurement process as part of an annual comprehensive error measurement process. The quality control program will build upon existing monitoring activities by evaluating the effectiveness of the field-monitoring activities as part of the annual measurement process.

HUD's Rental Housing Integrity Improvement Project (RHIP) advisory group continued to implement a strategy to address the problems associated with rental subsidy calculations. Some of these tasks have been completed, while others are in various stages of completion. Also, this year PIH came up with its own internal initiative through the creation of a program to implement rental integrity monitoring (RIM) reviews.

HUD also upgraded the capability of PIC to provide for the collection of rent calculation information. In addition, they also plan to provide automated web-based interface of the rent calculation software with PIC

database. The Office of Housing is pursuing 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 in fiscal year 2001 and 2002 for a 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 addition 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. In addition, HUD needs to complete the error measurement process for intermediaries' billings by conducting reviews of the intermediaries' billings for the public housing program. It is highly likely that there are significant errors in the public housing billing process, since it is similar to the billing process for the Section 8 tenant-based program. HUD should continue to develop the capability to obtain relevant tenant data that would allow the process to be a practical and cost effective for rental calculation determinations. We are encouraged that HUD has taken action to develop the capability to capture additional tenant data in the PIC and TRACS database, and the efforts to reduce erroneous payment errors by developing rent calculation tools and a front-end income verification system. HUD needs to ensure that the action to develop the capability to capture additional tenant data also considers the data needs for an ongoing erroneous payments measurement process.

We are also encouraged by the on-going actions HUD has taken to improve the reporting rate and data integrity of the PIC, and its efforts to improve the capability of TRACS. HUD needs to continue with its efforts to improve the quality and completeness of the PIC database by continuing to monitor and providing technical assistance to HAs and management agents who do not comply with the minimum reporting rate requirements, and as appropriate, impose administrative sanctions on those that do not comply. Also, HUD needs to continue to pursue and initiate similar actions to ensure the reporting rate and data integrity for TRACS database.

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 2002, 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 most significant concern relates to payments made by HUD, through its operating subsidies and Section 8 rental assistance programs, to assist HAs in providing affordable housing that meets the eligibility requirements and housing quality standards to house eligible low-income households. Our concerns, and the efforts to address them, are discussed below.

Improved risk evaluation and monitoring of housing authorities needed

During fiscal year 2002, 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, (2) on-site monitoring of high risk HAs, (3) the implementation and use of available management and performance assessment data (PHAS and SEMAP), 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. Unlike last year, a manual risk assessment was to be performed because the PIH Information Center (PIC) was unavailable to perform automated assessments due to systemic programming problems. We found that two of four field offices tested performed manual risk assessments of 91 of the 192 HAs within their jurisdictions and only scheduled 18 of their 65 high-risk housing authorities for on-site monitoring or technical assistance. The other two field offices reported conducting a modified risk assessment but failed to document the assessment completed. These two field offices scheduled 18 of 75 high-risk housing authorities for on-site monitoring or technical assistance.

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 the use of risk assessments, selection of housing authorities for monitoring, and identifying areas in need of attention.

According to the fiscal year 2002 planning guidance, the field offices were to use a combination of risk and qualitative factors to (1) determine the monitoring strategies and (2) establish priorities for the expenditure of resources for monitoring. However, the field offices did not always document the factors considered in selecting HAs to be monitored, or show why it was more prudent to expend the resources on those selected rather than on other high-risk HAs not selected. In addition, documentation for the remaining 104 high-risk HAs not selected for monitoring and technical assistance, did not always identify why their

selection was less prudent in relation to expending resources on those HAs selected for monitoring.

The fiscal year 2002 planning guidance also called for assessing performance monitoring requirements by identifying high-risk areas and monitoring goals, objectives and priorities. Our testing shows that the field offices did not fully assess the performance monitoring requirements, and failed to develop individual monitoring plans to focus on high-risk areas for the HAs selected for a monitoring review. For instance, one of the field offices did not develop individual plans because they always conducted a comprehensive review of the HAs selected. Focusing the monitoring reviews would have allowed a more efficient use of HUD's limited resources.

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 2002, HUD performed a limited number of on-site reviews. For the four offices we tested, the field office staff completed 60 of 88 low-income and Section 8 on-site performance reviews, and 24 of 37 rental integrity reviews, for 71 of their 192 HAs portfolio. We also noted that the field offices canceled 22 on-site performance reviews when the newly implemented rental integrity monitoring (RIM) reviews were given priority over the performance reviews. In addition, we noted the number of HAs that were high risk on May 9, 2002,⁸ increased by eight at the end of the fiscal year. The decreased performance of the HAs is an indicator that the level of HA monitoring has not been effective, and coupled with the deficiencies in rental subsidy determinations mentioned earlier, supports the need for emphasis on monitoring.

PIH monitoring systems are not fully utilized

The PIC⁹ 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 the field offices for the first seven months of fiscal year 2002 because of systemic programming problems, and access to PIC for the remainder of the year was sporadic. When the PIC system was brought back online in mid-year, the four field offices we tested did not always (1) update the system to include events that occurred while the system was not available, (2) obtain current and complete information for the housing authorities or enter the information into the PIC system, (3) use the information that was available in the PIC for performance monitoring or (4) enter data into or maintain the PIC on a current basis because the field office could

⁸ The May 9, 2002 information from PIC's automated national risk assessment feature was the first information produced by the PIC system when PIC was brought back online.

⁹ The PIH's Information Center (PIC) replaced most of PIH's IBS data management functions in August 2000. The PIC is an internet-based data system that uses data entered by HAs as well as the field offices.

not gain access or used their individual systems as an alternative. 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. Additionally, PIC was not updated timely because administrative delays also prevented the PHAS and SEMAP HA assessment programs from providing timely performance 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. A discussion of our concerns is presented in the next several sections.

In fiscal year 1998, HUD developed PHAS to provide for a more comprehensive monitoring system of public housing operations. PHAS was planned for implementation for HAs with fiscal years ending on or after September 30, 1999, but administrative and legislative delays prevented implementation until fiscal year 2001. On May 30, 2001, HUD issued a notice¹⁰ of a revised timetable for the official PHAS scores. HUD indicated in the notice that PHAS scores would be effective for HAs with fiscal year ending (FYE) September 30, 2001. However, during fiscal year 2002, delays in producing the PHAS scores limited HUD's use of the PHAS as intended. Delays in releasing scores were caused by: (1) holds placed pending a field office review, (2) delays in HAs submitting required PHAS data, (3) appeals from HAs, or (4) funding delays and problems in obtaining the contracts for processing the residential surveys for the Residential Assessment Subsystem (RASS) score. As a result of the delays, HUD had only issued the PHAS scores for 689 of 742 HAs with a FYE of September 30, 2001, and none of the 3,180 PHAS scores for fiscal year 2002 during the year. Until PHAS provides an ongoing independent program for assessing HAs performance along with information from on-site inspections of low-income HAs housing stock, its usefulness as an effective monitoring tool for improving HAs performance will be limited.

In fiscal year 2002, REAC performed 22,306 inspections of PIH and Multifamily properties. Of the 22,306 inspections, 1,932 resulted in a failing physical score. Furthermore, 11,054 of the inspections identified one or more life threatening exigent health and safety issues. However, since only the PHAS scores for September 30, 2001, were issued during fiscal year 2002, field offices and Troubled Agency Recovery Center (TARC) staff generally had limited use of the results in their monitoring programs. As a result, we noted delays in designating HAs as troubled. The designation delays also prevented the transfer of the troubled HAs to the TARC for servicing and assistance in their recovery to acceptable levels of performance. Of the 73 designated as troubled during the year, only 49 were transferred. Additionally, PIH's PIC physical inspection sub-system for tracking deficiencies and the interface with PHAS had not

¹⁰ HUD issued Federal Register Notice 4687, "Revised timetable for the issuance of management operations official scores and PHAS advisory scores."

been developed due to a low priority. Consequently, under the current environment, the PHAS process has not had its fully intended impact on improving HAs performance.

SEMAP is a management assessment program that HUD developed to measure the performance of approximately 2,600 HAs that administer tenant-based Section 8 rental assistance. Our testing showed that the initial official SEMAP performance scores for fiscal year 2001 were not available until January 2002, primarily due to delays in certifying the scores. These delays are attributed to problems with the PIC system. Also the availability of fiscal year 2002 SEMAP scores were delayed because the field offices could not gain access to data in the PIC system to certify the scores. Until SEMAP provides the field offices with pertinent current data that will assist field office staff in making sound decisions in helping to improve housing authorities performance, its usefulness as an effective monitoring tool for improving HAs performance will be limited.

HUD's Actions Planned and Underway to Improve HA Monitoring

In fiscal year 1997, HUD began the process of implementing reforms to consolidate financial, funding, and processing activities and separate troubled agency recovery activities from HA oversight and technical assistance functions. These changes were implemented to allow field office staff to concentrate on providing technical assistance and oversight to HAs with declining performance. Additionally, HUD consolidated its field offices into 27 Hubs and 16 program centers; with the program centers reporting to the Hub directors. HUD also established: (1) two TARC's to support troubled HAs, (2) REAC to assess the performance assessments of HAs, (3) the SEMAP system to provide performance information for the tenant-based Section 8 programs, and (4) PIC system to consolidate performance, financial and management data into a single system. The specific structural and operational actions HUD has taken in fiscal year 2002 or intends to implement in fiscal year 2003 include:

- During fiscal year 2002, the REAC implemented revisions to its major assessment systems that produce physical and financial management PHAS scores for approximately 3,200 housing authorities. These revisions changed how the score for physical and financial condition indicators are derived. REAC is using this interim scoring methodology for HAs with fiscal year ending September 30, 2001 through June 30, 2003.
- At September 30, 2002, PIH's two TARC's were providing service to an inventory of 35 troubled HAs, and 29 non-troubled HAs. The field offices retained servicing of 25 other troubled HAs. During the year, the TARC's had recovered 8 HAs, returning them to the field offices, and received 25 additional HAs for servicing from the field office, of which 18 were newly troubled HAs.

- PIH field operations developed a National Risk Assessment Module in PIC that allows PIH to perform quarterly risk assessments of its HAs on a national level. However, the module was not used to conduct risk assessment in fiscal year 2002 of HAs with low-income and tenant-based Section 8 programs because of ongoing system changes. Also, the FY 2003 risk assessments will be completed without current PHAS and SEMAP data, and the field offices will have to reassess the risk as new information becomes available and adjust the overall monitoring plan accordingly.
- HUD's field offices completed the certification of SEMAP scores for the housing authorities with fiscal year ending September 30, 2001. The field offices also began using the information to provide technical assistance and require submission of corrective action plans from housing authorities with failing SEMAP scores.

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

As in previous years we again 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. HUD's success in objectively assessing the quality of the public housing stock is dependent upon field offices receiving and acting on the PHAS and SEMAP performance information and inspections performed by REAC.

We agree with HUD's initial 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 will begin to effectively target and improve the HAs current operations and performance, instead of targeting them assistance up to a year later. Also, we agree with HUD's efforts to establish and implement a national risk assessment system that will assess quarterly the risk associated with the HAs performance, but it needs to be used consistently. This quarterly assessment will allow the field offices to reevaluate HAs performance as new PHAS and SEMAP scores are made available. This, 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 high performance risk, rather than what appears to be the reverse, where available funding is driving the monitoring. The implementation of SEMAP and the annual assessments will greatly increase the field offices' ability to ensure that HAs are administering Section 8 tenant-based programs properly.

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” component¹¹. Office of Housing field staff is to oversee the efforts of CAs.

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 and performed additional procedures at six locations. Our selection of project files was based on a statistical sample designed by KPMG LLP’s statistician and was used for both the FHA and HUD financial statement audits. The sample resulted in the selection of 239 project files that covered the entire range of risk for the multifamily projects.

¹¹ 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.

Use of monitoring tools improved

Multifamily Housing's use of both PI and the AFS improved during fiscal year 2002. The use of these monitoring tools was generally effective except for some follow-up efforts relating to obtaining property owner (1) certifications of corrections of Exigent Health and Safety (EH&S) deficiencies, and (2) responses to financial assessment compliance flags. In addition, we found instances where property owners did not respond to management/occupancy review findings and the responsible project managers did not conduct timely follow-up with the property owners.

Management/occupancy 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 /occupancy review findings identify areas that property owners need to address in order to satisfy HUD requirements.

HUD needs to develop a comprehensive plan to monitor project owner's compliance with subsidy program requirements

Office of Housing or CA staff are to perform management reviews to monitor tenant eligibility and ensure accurate rents are charged at multifamily projects¹². For 9,967 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 8,144 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 2002 compared with the previous year. However at the end of fiscal year 2002, 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 2002 for 1,200 (14.7 percent) of the 8,144 projects receiving direct oversight by HUD. For the six Hubs visited, we reviewed the factors used to determine the projects selected for 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.

¹² 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.

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. The performance of management reviews over assisted multifamily projects is essential in ensuring rental assistance is correctly calculated and that recipients are eligible.

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

HUD's plans include a variety of continuing efforts. Principle among these are: continued implementation of the CA initiative; increased enforcement through the DEC of project referrals because of problems detected through REAC's PI and AFS process or when owners fail to file required AFS; implementation of more targeted risk management of reinspections of properties based on baseline risk rankings according to the Final Rule¹³; use of mortgagee inspectors trained in the physical inspection data gathering protocol; increased frequency of management/occupancy reviews for assisted projects; development of an integrated risk reporting system in REMS, and the planned development of the Integrated Assessment Sub-system which will provide a comprehensive risk rating tool.

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 of the AFS for the insured portfolio, and evolving enforcement efforts by the DEC for inadequate financial status or non-filing project owners. We hope the use of the PI monitoring tool continues to be effective. We support the plans to increase the frequency of management/occupancy reviews 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 Rental Housing Integrity Improvement Program (RHIIP)¹⁴ and support the continued progress in addressing improper payments. The Office of Housing is increasingly dependent upon other HUD organizations (e.g. the REAC,

¹³ "Uniform Physical Condition Standards and Physical Inspection Requirements for Certain HUD Housing; Administrative Process for Assessment of Insured and Assisted Properties; Final Rule," 24 CFR Parts 5 and 200, dated December 8, 2000.

¹⁴ HUD initiated the RHIIP in response to a contracted study, "Quality Control for Rental Assistance Subsidies Determinations," in an effort to develop tools and the capability to minimize erroneous rental subsidy payments.

DEC and the Section 8 Financial Management Center) and external contractors. The adequacy of what the Office of Housing receives from another HUD organization or external contractor depends on clear needs definitions and adequate resources to achieve full implementation. Moreover, increased use of external contractors increases the need for monitoring of these functions by the Office of Housing.

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. 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. To address this problem, the Office of Housing developed the Tenant Rental Assistance Certification System (TRACS). Owners input tenant information into TRACS and the system calculates the proper Housing Assistance Payment (HAP) for each tenant. Office of Housing field staff then compare information on the HAP voucher to TRACS. These comparisons, done on a sample basis, are known as post payment reviews because the reviews are performed after the vouchers are paid.

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 24,800 assistance contracts. Of the estimated 24,800 assistance contracts, Contract Administrators (CAs), such as State Housing Finance Agencies (SHFA) and HAs, oversee contracts relating to about 16,200 multifamily projects. This is about 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 Financial Management Center (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.

Risks associated with the subsidy payment process continue

HUD's plan is for most HAP contracts to be transferred to CAs in the near future. 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 approve the budgets, make monthly advances, and perform year-end settlement statements. Multifamily Housing staff in field offices will be responsible to monitor the performance of the CAs. Approximately 40 states 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 new CAs under a performance based system. Those HAP contracts not converted to the performance based CAs will continue to be administered by HUD. The FMC conducts some testing for the

Office of Housing related to the HAP contracts administered by HUD. The FMC uses TRACS data to identify about 400 vouchers for pre payment review a month (or about 2 percent of the vouchers submitted per month). The FMC's Voucher Processing Division (VPD) does a 100 percent review of these vouchers before they are paid. The bulk of FMC reviews compares 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 puts on the voucher and in the system. The reconciliation does not show the tenant data is correct or payment is accurate. HUD relies on TRACS, but does not take the action necessary to ensure that the tenant data in TRACS is accurate. Housing has not directed the FMC to perform any other systematic testing of TRACS data

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

The FMC's post payment reviews and the tracking of review results are not an effective internal control to ensure owner compliance with HUD regulations. The program reviews are not performed on a representative sample of contracts and sanctions are not enforced for violations. The current voucher selection method does not ensure that all vouchers have an equal probability of being selected. Furthermore, the FMC staff's procedures are not effective in correcting discrepancies that are identified. Untimely post-payment reviews may also contribute to their ineffectiveness. Our sample indicated that a relatively significant amount of time passes between the voucher month and when the post payment review process begins. Additionally, FMC staff has not suspended payments on contracts that failed to meet the current tenant certification requirement. The Office of Housing has not authorized the FMC to suspend payments. HUD's HAP contracts with project owners authorize Housing to suspend payments; however, since the FMC is accomplishing the reviews this authority needs to be transferred to the FMC. The Office of Housing is developing an automated program that compares vouchered units with tenant data to determine which contracts have insufficient tenant data in TRACS. We recommended, in last year's report, that the FMC should, with Office of Housing concurrence, apply a sanction policy uniformly to all non-compliant owners when the automated process is in place. However, the automated program is still not in place. The Office of Housing needs to: (1) expedite the development of the automated process to identify non-compliance with tenant reporting requirements, (2) provide written policies and procedures for post payment reviews in the interim period until the automated post payment review process is operational, and (3) establish sanctions and the authority to suspend payments to owners who do not comply with HUD's regulations.

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 date, HUD does not have a process to determine the accuracy of a payment requisition.

Under current HUD procedures, TRACS identifies voucher payment requests that exceed a specified percentage of the average monthly payments made during the prior 12 months. TRACS identifies about 400 of the vouchers for pre payment review a month (or about 2 percent of the vouchers submitted per month), and the FMC performs pre-payment reviews of the vouchers before they are paid. The FMC also conducts post payment reviews using its staff in Chicago but does not have formal written procedures in place. The review process focuses on verifying that at least a specified percentage of the tenants on a subsidy voucher have a current certification in TRACS. The staff reviews vouchers that are generated in one month for a particular state. If vouchers are identified that fail to meet the specified percentage, the owner is contacted and asked to update the system within 30 days or face possible suspension of future subsidy payments. This review covers less than 1 percent of all vouchers.

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 2 percent of the vouchers before payment and less than 1 percent after 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. While the post payment review process has been successful at instigating voluntary compliance on the part of some of the owners who have been contacted as part of a review, the management information system needs an analysis function to identify the effectiveness of the process. The system in place tracks the results of their reviews, but FMC management does not use the data to track contracts that failed the review to ensure that proper follow-up action is taken. We addressed the ineffectiveness of the post payment reviews in a recommendation in last year's audit report. However, the FMC and the Office of Housing have not implemented our recommendations and the weaknesses continue to exist.

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 40 states thus far. HUD needs to complete the transfer, and adequately monitor the CAs' performance. HUD also needs to improve its own performance for those contracts not transferred. Additionally HUD needs to ensure an adequate system and policies and procedures are in place for the process.

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,
- administration of personnel security operations, and
- access controls over sensitive information.

We also discuss the need for HUD to improve funds controls over public housing operating funds and 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.

On March 1, 2002, the Department issued a Request for Proposal to replace the existing HUD Integrated Information Processing Service (HIIPS) contract that was awarded in November 1990. HIIPS currently supports all aspects of the acquisition, configuration, installation and implementation of computer hardware, software and telecommunications. The new infrastructure contract will be renamed HUD Information Technology Service (HITS). It is a performance-based, outcome-oriented infrastructure contract through a single vendor. The results of this procurement will probably alter the existing Information Technology (IT) Infrastructure. Accordingly, it is absolutely important that HUD has an adequate internal control structure in place to protect HUD's critical assets and data within the new IT Infrastructure.

HUD needs to reduce the risk of unauthorized activities

We evaluated selective system controls, software change controls, and disaster recovery and physical security procedures for the mainframe computers. We also evaluated security over networks at the field offices.

During fiscal year 2002, HUD has made improvements, particularly in the area of software change controls. However, we continue to note weaknesses with HUD's computing environment as discussed below.

Hitachi Environment

GAO FISCAM provides that logical access controls involve the use of computer hardware and software to prevent or detect unauthorized access by requiring users to input user identification numbers (IDs), passwords, or other identifiers that are linked to predetermined access privileges. This section also states that tables or lists used to define security limitations must be protected from unauthorized modification. FISCAM also explains that the most commonly used means of restricting access to data files and software programs is through the use of access control software packages, also referred to as security software. HUD uses CA-Top Secret as the standard security software package to secure the Department's operating system environment under the Hitachi mainframe platform.

Risks that unauthorized individuals could access HUD's critical data

We found that the security parameters on the Hitachi mainframe are not set to ensure (1) the user-ID or user's name is not part of the password selected and (2) that alphanumeric passwords are used. The HUD Security Handbook 2400.24 requires that passwords be non-words mixing letters and numbers and shall not be the user's name or ID. As part of the Department's Single Sign On initiative during the second quarter 2003, HUD will review the settings within the Active Directory, mainframe, and Lotus Notes, to ensure that proper security settings are established to protect HUD's critical data.

Inactive user IDs over six months have not been deleted.

We found user IDs that were inactive for more than six months and should have been deleted. This condition existed because (1) the IT security group is not utilizing the payroll report to identify and remove system access for terminated employees, (2) HUD was not utilizing a readily available reporting utility to identify those inactive user IDs that were over six months, and (3) the GTMs and GTRs for the program offices do not comply with current policy to notify the security officer of departing HUD contractors for removal of user IDs.

The HUD Security Handbook 2400.24 states that the Information Security Staff shall provide oversight on security issues within the Department including system authorization. In addition, the security administrators appointed by the system owners will (1) review quarterly, with assistance from the information security staff, all user IDs issued to determine if users still have a valid need to access at current level of privilege, and (2) notify the Information Security Staff promptly upon learning that users no longer need access to major application systems. Additionally, the Handbook requires that passwords must be suspended after 45 days of no activity and removed after six months of no activity.

Finally, the Handbook also requires that the Government Technical Managers (GTMs) and Government Technical Representatives (GTRs) shall maintain an accurate list of contractor staff authorized to work on HUD systems and be able to justify who is authorized to work on what system(s) or project.

Deleted user IDs are not removed from the internal access tables of system software resources.

We also found that deleted user IDs are not removed from the internal access tables of system software resources. The National Institute of Standards and Technology (NIST) Handbook 800-12 “Introduction to Computer Security” provides that logical access controls prescribe not only who or what has access to a specific resource but also the type of access that is permitted. These controls may be built into the operating system, may be incorporated into applications programs or utilities (e.g. database management systems or communications systems), or may be implemented through add-on security packages.

During our review, we evaluated an internal access control table of NETVIEW, a critical communication package, to determine if the user IDs were valid and authorized. We found that six user IDs were deleted from the mainframe environment but were not deleted in the internal access table of NETVIEW. After this problem was reported to IT Security, the six user IDs were deleted from the internal access table. However, as part of our verification that these six user IDs had been removed, we found another newly deleted user ID remained in the NETVIEW internal access control table. IT Security must ensure that all user IDs are deleted at both the mainframe environment and the applicable access control tables.

Without strong passwords, identification and deletion of inactive IDs and removal of deleted ID’s from internal access control tables, and promptly removing access to contractors that are terminated from employment, HUD is vulnerable to unauthorized destruction, disclosure, or modification of critical financial data.

Improvements are needed in the continuity and consistency over the security administration function and operations

We found that improvements are needed in the continuity and consistency over the security administrative function and operations. The GAO FISCAM provides that management should ensure that employees – including data owners, system users, data processing personnel, and security management personnel – have the expertise to carry out their information security responsibilities. Also, NIST SP 800-12 states that documentation of all aspects of computer support and operations is important to ensure continuity and consistency. Formalizing operational practices and procedures with sufficient detail helps to eliminate security lapses and oversights, gives new personnel sufficiently detailed instructions, and provides a quality assurance function to help ensure that operations will be performed correctly and efficiently. HUD Handbook 2400.24 requires that operation procedures be documented for backup and contingency activities. The documentation should also include descriptions of end user procedures.

Inadequate maintenance of APF libraries continues to be a problem

We found inadequate maintenance of Authorized Program Facility (APF) libraries continues to be a problem. APF is a mechanism to protect the operating system and the integrity of the overall processing environment. System guidelines recommend that all of the authorized software programs residing in the APF libraries be accurately identified in the APF entry list. An authorized software program can execute in “supervisory” mode. This would allow the program to assume total control over the computer systems and has the capability to read and modify system control tables, bypass data access controls, circumvent systems logs, and perform other activities critical to the integrity and security of the processing environment.

We used the CA-Examine tool to determine whether there were any non-existent libraries and/or libraries with incorrect volume specifications in the APF list. Based on our review we found four APF entries in the APF list for four non-existent libraries and two libraries with two incorrect volume specifications. HUD made the appropriate corrections to the APF libraries after we brought it to their attention. This condition has also been reported in previous years’ audits. Without proper management of the system software, a knowledgeable individual could place unauthorized programs into the APF. This exposure could result in loss, errors, and damage to HUD’s critical financial software and data.

System documentation needs to be developed to support daily operations and management of HUD’s systems

We found that system documentation needs to be developed to support daily operations and management of HUD’s systems. The GAO FISCAM states that entities should have a standard procedure for identifying, selecting, installing, and modifying system software to meet its operational needs. In addition, detailed, written instructions should exist and be followed to guide personnel in performing their duties.

The Department has not developed HUD customized system documentation supporting current day-to-day operations and management of systems. Instead, the Department depends on the general vendor-provided documents that are not HUD specific. Currently, the Department does not have HUD-specific implementation procedures for installing software packages (e.g. Top Secret, Endeavor, MVS and subsystems including JES2, IMS, CICS, TSO, DB2, etc.); maintenance guides for OS390 and subsystems (e.g. updating software, adding/removing I/O devices); and system backup and recovery procedures including the steps taken to bring the system back to normal operation when system volumes such as IPL volumes or spools volumes are corrupted. Other examples include, but are not limited to, procedures for identifying, selecting, installing, and modifying system software to meet the Department’s computer operational needs. Inadequate documentation could hinder maintenance activities, particularly during emergency situations when in-house systems programmers are attempting to restart a failed system and vendor assistance is not readily available.

Disaster Recovery

List of mission critical systems in HUD's BRP is outdated

We found that the list of mission critical systems in the Business Resumption Plan (BRP) is outdated. OMB Circular A-130 requires that all Federal agencies develop a plan for continuity of support and the ability to perform its critical mission functions. That plan should be current and be able to support the continuity of mission critical operations. It further defines "a critical application as a major information system that requires special attention because of its importance to an agency mission; it's high development, operating, or maintenance costs; or its significant role in the administration of agency programs, finances, programs, property or other resources."

In 1993, a departmental working group consisting of program area representatives and Systems Engineering Group created the original list of HUD's mission critical systems. Updates to this list were to be based on submission of applications security plans, which indicates the criticality of the system. However, according to IT staff, very few applications have been added to the original list because there have been no new security plans submitted that have indicated their applications as mission critical. As of October 31, 2002 the BRP listed 32 applications as mission critical. However, from our review of 150 security plans provided by the HUD IT Security office, we found five applications that indicated a criticality of C4 (needed immediately) that were not listed on the BRP mission critical list. Additionally, contributing to this problem is that a significant majority of the security plans we reviewed did not indicate the applications criticality. Our review found 133 of the 150 plans did not indicate the application's criticality. The Department should analyze systems and the contributions they make to the HUD mission and objectives to designate them as either "critical" or "non-critical".

The mission critical systems are not prioritized for testing and recovery

We found that the mission critical systems are not prioritized for testing and recovery. NIST Special Publication 800-34 "Contingency Planning Guide for Information Technology Systems" published June 2002 defines a seven-step contingency process to help agencies develop and maintain a viable contingency planning program. An OMB A-130 review of HUD's critical infrastructure "Security Architecture and Local Area Network Infrastructure Risk Analysis Report" dated January 31, 2002 found that the BRP does not specify the priority in which to restore mission critical systems following an interruption of service. The report recommended that the BRP be updated to include application sequences and priorities to ensure full restoration of HUD mission critical systems. However, to-date, this update has not been performed. Additionally, HUD has not conducted a Business Impact Analysis (BIA) to help identify and prioritize critical IT systems and components. HUD needs to conduct a BIA to ensure that mission critical systems are prioritized for testing and recovery purposes. Without this prioritization, HUD is at risk that the most mission critical systems may not be available in case of a disaster.

Software Configuration Management

The GAO FISCAM indicates controls should be established over the configuration of application software programs to ensure only authorized programs and modifications are implemented. This is accomplished by instituting policies, procedures, and techniques to ensure all software programs and program modifications are properly authorized, tested, and approved and that access to and distribution of programs is carefully controlled. GAO FISCAM also provides that work responsibilities should be segregated so that one individual does not control all critical stages of a process. Dividing duties among two or more individuals or groups diminishes the likelihood that errors and wrongful acts will go undetected because the activities of one individual or group will serve as a check on the activities of the other. Accordingly, system users should be granted access to only those resources they need to perform their official duties.

HUD made significant progress to improve configuration management but improvements are still needed

In prior reports on HUD's financial statements, we reported long-standing weaknesses on configuration management (CM). After a period of slow progress, HUD made considerable strides to improve CM during fiscal year's 2001 and 2002. This year, HUD has made significant progress in implementing the CM tools, PVCS Professional Suite for LAN-based client-server and web applications, and TeamStudio for LAN-based LotusNotes applications. The Department plans to implement the CM tool STAT to control current and future LAN-based PeopleSoft financial applications. Currently, the FHA subsidiary ledger is the only PeopleSoft application within the Department.

We evaluated three mission critical applications controlled by PVCS as follows: (1) HUD's Consolidated Financial Statement System (HCFSS) - Commercial Off The Shelf Software (COTS) application; (2) Web Access Security Subsystem (WASS) - web-based application; and (3) Line Of Credit Control System (LOCCS), mainframe/client-server interface application. We determined whether: (1) a baseline verification was performed for software releases, (2) software modifications were independently tested and documented, and (3) a proper segregation of duties exist under the change control environment to ensure users are granted access to only those resources needed to perform their duties. Our review identified several areas where improvements are needed in software configuration management as discussed below.

No assurance that source and executable codes are aligned

We found that HUD was not using PVCS to control the source code compilation for seventeen applications. Programmers maintaining applications write computer program statements in a format termed source code that is converted to machine executable code through compilation. The Department currently has seventeen applications under

control of PVCS that either uses the language Powerbuilder or Visual Basic. PVCS has a utility called Configuration Builder to control the compilation of source code into executable. However, HUD is not using this utility. Rather, HUD is using the compilers of Powerbuilder and Visual Basic for compiling source code, which is outside of PVCS. HUD and contractor staff stated that the PVCS Configuration Builder utility is not used because development languages, such as PowerBuilder, internally control their own compiling build process that cannot be automated by PVCS. However, by compiling outside of PVCS, HUD has no assurance that the executable code in production was compiled from the correct version of the source code. HUD needs to develop a solution to ensure the integrity of the source and executable modules for those applications that require source code compilations.

Baseline verification is not complete for one mission critical application

We found that the baseline verification was not complete for the WASS application. The baseline verification process synchronizes all production modules with the PVCS modules to identify any missing, mismatched or obsolete modules, and to ensure that the current version is being used in production. HUD uses either the full component or the component level approach for migrating software modules from PVCS to production. Performing a baseline verification is critical for applications that utilize the component level release approach. Using this approach, only the modules that changed are migrated to the production environment. Therefore, if a baseline verification is not performed, any mismatched, missing, or obsolete modules cannot be identified if this module is not one of the modified components.

One of the three critical applications, WASS, utilizes the component level approach for software releases. WASS was certified as being under PVCS on July 31, 2001. However, we found that a full baseline verification of the component level releases did not begin until January 2002, five months after WASS was certified and three component level releases had already been performed. HUD and contractor staffs realized that this verification process is necessary and were in the process of performing a full baseline verification of all PVCS modules to the production modules in WASS during our review. HUD needs to ensure that a baseline verification is performed on all component level releases under PVCS controlled applications

No process exists to remove obsolete modules from production or to prevent them from being accessed in PVCS.

As part of our review of the three critical applications, we also determined if there was a process in place to remove obsolete modules from the client/server production environment. Over time, changes are made to the functionality of an application that result in new software modules being added to the production environment. As new modules are added other modules become obsolete and should be removed from the production environment. If these obsolete modules remain in the production environment, there is a risk that these modules may be accidentally used for production processing.

With the exception of 13 modules, all WASS application modules in the production environment were obsolete. The PVCS Administrator

HCFSS software changes were not independently tested before being installed in production.

explained that HUD was aware of this problem and were looking into this issue. We were also informed that there are no procedures that defined a process to be used to remove obsolete modules from the production environment. HUD needs to establish adequate controls to ensure obsolete modules are removed from production.

HCFSS utilizes the COTS Hyperion Enterprise software tool to conduct financial reporting and analysis for HUD's submittals to the Treasury Department. The Department implemented the HUD Application Release Tracking System (HARTS) process to track LAN, mainframe, COTS, internet/intranet, client/server and Lotus Notes applications released into HUD's infrastructure. The process enforces the proper establishment of application release documentation, independent testing, and the proper installation of releases into HUD's production environment.

We found that HCFSS software changes were not independently tested before being installed in production. This condition exists because HCFSS does not use the HARTS process to implement new releases of the application. Our review found that the Test Center does not perform an independent test of the software being distributed and HARTS documentation is not established to support each distributed release. A disciplined process for testing and approving new and modified programs prior to their implementation is essential to ensure programs operate as intended and that no unauthorized changes are introduced.

Lack of segregation of duties between the development and testing functions for the LOCCS internet

There is a lack of segregation of duties between the development and testing functions for the LOCCS internet components. LOCCS utilizes PVCS to control software changes and releases for the Internet components of its application. We found that an individual, a programmer, is developing the LOCCS Internet programs and also performing program testing in the Integrated System Test environment. Inadequately segregated duties increases the risk that erroneous or fraudulent transactions could occur, improper program changes could be implemented, and that computer resources could be damaged or destroyed.

Production group personnel were given excessive access privileges to the UNIX production server for WASS.

We found that the production group personnel had excessive rights to the UNIX production server that allowed them the ability to modify and install program changes to the production server. WASS provides a common framework for administering application-level security for HUD systems. This sub-system resides on a UNIX production server. We evaluated the access settings on the server for those modules that used Cold Fusion and Live Wire, which are two web application languages used by developers for WASS applications, to determine if access to the production server was limited to production personnel. Although we found that only production personnel had access to the production server, these users had access privileges that were beyond their scope of duties. Our review of the security settings disclosed that the settings were set to "universal write" access which allowed all individuals who have access to the UNIX server the ability to modify and

install program changes to 27 WASS production modules. This could allow unauthorized updates to the production modules and bypass the software change controls in PVCS. Any user who has access to the production server should only have read and execute privileges. This ensures that users be granted access to only those resources they need to perform their official duties.

Physical Security

Physical security vulnerabilities identified in HUD's Critical Infrastructure Protection Plan remain unresolved

Last year, we noted that HUD's Critical Infrastructure Protection Plan (CIPP) issued in July 2000 reported a number of physical access vulnerabilities. Weaknesses were identified for both the main HUD's Computer Center (HCC) and the Development and Recovery Facility (DRF). Both the HCC and DRF lacked (1) barriers around the building, (2) magnetometer and x-ray scanner for screening incoming personnel, (3) screening of mail and delivery packages prior to being brought into the center, and (4) blast-resistant coating on street level windows. Additionally, we reported that the DRF lacked card key entry control for exits, security guards, and security cameras. In response to the report, the Department determined that the cost and practicality of changing the existing facilities out weighed any advantages to be gained. There are no plans to upgrade either facility because funding was not available and re-competition of the existing HIIPS contract may change the location of the facilities. We recommended that HUD conduct a risk analysis to determine whether the protective measures for HCC and DRF identified in the CIPP are warranted.

Several physical security vulnerabilities identified in last year's audit were addressed

We also noted in last year's audit of the financial statements, that physical access to computer equipment at field offices could be improved. There were (1) offices that did not have card entry systems and (2) telecommunication racks stored in unlocked space. The Department has since installed card access systems at two additional Information Technology Divisions (ITD) offices and plans to install the card access systems at the other field offices as funding is made available and where prudent to do so. As an interim measure, the ITDs are being instructed to have sign in/sign out sheets in all offices without card access systems to record entry to the computer rooms. In very small offices, where the server and/or communications racks are located in an office, an instructor will be sent to ensure that the equipment is secured by lock when no personnel are present. Finally, the Quality Management Review will continue to monitor offices for physical security of computer equipment as reviews are conducted.

NIST Special Publication 800-14, "Generally Accepted Principles and Practices for Securing IT Systems," states that physical and environmental security controls are implemented to protect the facility housing system resources, the system resources themselves, and the facilities used to support their operation. Organization's physical and environmental security program should address physical access controls,

fire safety, failure of supporting utilities, structural collapse, plumbing leaks, interception of data, and mobile and portable systems to help prevent interruptions in computer services, physical damage, unauthorized disclosure of information, loss of control over system integrity, and theft.

Several physical security vulnerabilities have been identified in this year's audit

Although HUD does not intend to address the vulnerabilities identified in the CIPP report until their risk assessment is completed in calendar year 2003, we did observe some physical control weaknesses during this year's review that HUD could address immediately. These physical security weaknesses are as follows:

- A broken surveillance camera at the HCC.
- The visitor badges had the return address of the facility rather than a post office address for returning lost badges. Using the facility address would expose HUD to the risk that an unauthorized individual may use the badge to gain entry into the facility.
- There were no procedures in place to ensure that all escort badges are returned and accounted.

Physical access to computer facilities should be limited to personnel with a legitimate need for access to perform their duties. Management should regularly review the list of persons authorized to have physical access to sensitive facilities. It would be difficult to determine who had access to the computing facilities in the field offices without an entry system that has an audit trail capability. Physical access to these facilities must be adequately controlled to prevent unauthorized individuals intentionally or inadvertently damaging or destroying the network server equipment.

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

The Department has agreed to implement our recommendations regarding access controls, security and APF administration, and identification of mission critical systems. However, the Department does not agree with our assessment that vendor documentation and the HUD Computer Center Business Plan (BRP) do not provide HUD the necessary customized standards and procedures to support day-to-day operations and management of computer systems. The OCIO contends that the BRP contains backup and recovery procedures for individual systems software. Appendix C contains the Critical Applications Backup and Recovery Procedures. Appendices M through S detail the steps and procedures to recover the mainframes, LAN, HINET and Notes Mail/Client Server environments. When used in conjunction with the HUD Computer Center Standard Operating Procedures (SOPs), this is sufficient to restore the entire IT infrastructure.

In regards to PVCS software configuration management for the LAN-based client-server and web applications, we have informed HUD management of our concerns regarding (1) source/load integrity; (2) obsolete modules; (3) software change controls for LOCCS and HCFSS; and (4) access controls to the production server for Live Wire and WASS. The Department has recognized these weaknesses and intends to implement our recommendations.

With respect to physical access control, the Department has replaced the broken surveillance camera at the HCC. To resolve the issue of ensuring that all escort badges are returned and accounted for, HUD will implement an expiring badge system to prevent unauthorized reuse. The badges were order on November 22, 2002 and received the following week. There was a training period to ensure the security guards understood how to use the product. The entire system, including written processes, was put in place on December 15, 2002.

OIG's Assessment of Hoods Plans and Completed Actions

We agree with the Department's intent to implement our recommendations regarding system and physical access controls, security and APF administration, mission critical systems identification, and software change controls. However, we disagree with HUD's claims regarding system documentation to support day-to-day operations and management. Vendor documentation contains generalized and not HUD specific information. For example, we would expect that system operational guides should be able to identify specific data sets on the designated volume when they upgrade and implement a new release of OS/390 operating system. Had these operational guides been available, the non-existent libraries and libraries with incorrect volume specifications found as part of our evaluation of the APF listing would not have occurred. As for the BRP, we believe it does not provide sufficient details on the processes and procedures for the recovery of the HDS/OS390 and Unisys/HMP operating systems. Our review of appendices C and M through S of the BRP found that they do not cover the daily operation/maintenance tasks and installation steps customized for HUD. Therefore, BRP documents can not serve as HUD's daily operation/maintenance and installation guides that cover topics such as adding/deleting I/O devices for OS/390; updating software for subsystems such as TSO, JES2, VTAM, CICS, NETVIEW, TMON, etc.; and special cases/fixes. Also, the mention of backup/recovery documentation in this recommendation is not referring to the full backup and recovery of the system. It is in reference to the procedures/steps to bring the system back to normal when there is corruption of system volumes such as spools, JES2, or IPL volumes. In addition, special or isolated incidents and fixes should be documented in the operation guide for future reference. Finally, Appendix O does not provide specific steps to restore DB2, IMS, CICS, MVS and Top-Secret. Also, customizing HUD's system documentation to reflect HUD's actual IT environment will be critical in maintaining service continuity when HUD awards the

Departmental IT infrastructure support contract (HITS) in the near future.

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.

HUD Handbook 2400.24 describes the information Security Program for the Department. This document provides the policies and requirements for implementing security controls over HUD's information systems. It also specifies the responsibilities for security management of HUD's information resources. The Handbook states that the Information Security Staff shall "provide oversight on security issues within the Department including...system authorization; and all other activities and documents required by Federal Laws, regulations, and directives." The Handbook also provides that the Security Administrators appointed by the System Owners will "review quarterly, with assistance from the information security staff, all user-Ids issued to determine if all users still have a valid need to access at current level of privilege."

HUD Handbook 732.3 Personnel Security/Suitability also states that COTRs and GTRs are responsible for collecting (background investigation) certifications from vendor staff who require mission-critical (sensitive) systems above query access and forwarding them through Security Administrators to OIT so that access can be granted; notifying Security Administrators when continued access should be denied for vendor staff when have failed to obtain re-certification for above query access to mission-critical (sensitive) systems; and notifying Security Administrators when a contract terminates or when contractors separate, and there is no longer a need for access to mission-critical (sensitive) systems. The Handbook also states that the Personnel Security Office is responsible for reconciling, as needed, SCATS database with the IT listing of users who require above query access to mission-critical (sensitive) systems.

A key control over systems access by employee and contractor personnel is the requirement for background screening. OIT 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.

Users granted access to HUD systems without record of background investigation.

In the last two year's, we have reported that HUD had a significant backlog of 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. During FY 2002, we found 87 users out of a total of 720 users who were granted greater-than-read access to HUD systems without record of an appropriate background investigation being performed. All 87 of these users were contractors. This condition exists because (1) HUD did not follow procedures 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, (2) periodic (quarterly) reconciliation of the SCATS database with the IT listing of users who require above query access to mission critical (sensitive) systems are not being performed, and (3) GTRs and GTMs have not notified IT security when the contractor's initial contract has ended.

System access control procedures are not being followed.

HUD is not following procedures requiring users requesting above read access to HUD's mission-critical and sensitive systems to submit proper systems access forms before they are allowed access to the systems. In November 2000, the OCIO issued a memorandum establishing new user registration procedures for IT systems access. These procedures required HUD employees and HUD contractors to use the Personnel Security and System Access User Registration form (HUD Form 22017) for requesting access to HUD's systems. This form was updated to include the Office of Security and Emergency Planning (OSEP) in this process so as to ensure that users accessing HUD's critical systems had the appropriate background investigation. However, during our review we found users that were not certified by OSEP because OIT had either not submitted the HUD Form 22017 forms to OSEP or had accepted the old HUD Form 22017 that did not include OSEP in the process.

Quarterly reconciliations are not being performed.

We found that required quarterly reconciliations of the SCATS database with the IT listing of users with above query access to mission critical (sensitive) systems are not being performed. This same weakness was reported in our previous year's report. The OCIO is not submitting to OHR the required listings of users with access to critical and sensitive HUD systems for reconciliation purposes in accordance with the Personnel Security/Suitability Handbook 732.2. This helps ensure that all users of critical and sensitive systems have the appropriate background check.

Both OSEP and OCIO personnel informed us that a manual reconciliation is no longer performed as this process has been automated thereby eliminating the need for the OCIO to provide OSEP an IT listing of users. An electronic mailbox process has been established where

users would submit their requests for access to HUD's systems electronically using the HUD form 22107 format. The user (contractor) would submit the request to the GTR for approval, who in turn, would submit it to the security administrator, then to personnel security and finally to IT Security where the contract employee is granted a user-id and general access to the system. This would allow OHR and OCIO to determine whether users have the appropriate background investigation by verifying the information in OHR's database before access is approved.

We agree that the electronic mailbox process does provide an effective method in ensuring that all users of critical and sensitive systems have the appropriate background check. However, it is only effective if the procedures are followed. As was noted above, we found during our review that the system access procedures were not being followed. We believe the quarterly reconciliation's provide an additional measure of control as it would identify those instances where access control procedures were not being followed.

GTRs and GTMs for the program offices are not consistently notifying IT security of contractor's status as required.

GTRs and GTMs for the program offices are not consistently notifying IT security when the contractor's initial contract has ended. HUD Handbook 732.3 Personnel Security/Suitability states that COTRs and GTRs are responsible for notifying Security Administrators when a contract terminates or when contractors separate, and there is no longer a need for access to mission-critical (sensitive) systems.

Our review showed that three of the 87 contractors given greater-than-read access to HUD systems without record of an appropriate background investigation being performed had separated from the Department. However, of the three contractors, OIT was notified of the departure of only one contractor.

To address this problem, we recommend that the OCIO instruct the GTRs and GTMs in the program offices to follow HUD Handbook 2400.24 by maintaining an accurate list of contractors staff with their authorized access and level of privileges and timely notify the IT security staff when contractors are terminated or no longer authorized to access information resources. We also recommend that the OCIO establish a bi-annual certification process that requires the GTRs and GTMs to re-certify contractor personnel who have access to HUD's systems to ensure that contractors are authorized and have the appropriate access to these systems.

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

The IT Security Operations Branch Chief expressed concern that a voluminous number of Contractor Support Staff are separating, or have separated from HUD, without properly notifying IT Security Operations to terminate their computer access. He emphasized that this could pose a major threat if contractor employees continue to have access to critical or

sensitive resources, especially those individuals who may have left the Agency under acrimonious circumstances. In an attempt to resolve this issue, IT Security Operations Branch Chief has recommended that a "Bi-Annual" Re-certification Process be invoked for all contractors that have access to HUD computers, if appropriate and timely notification from the GTMs and GTRs is not received. He is also recommending the suspension of all contractor accounts not verified as needed by the GTRs and GTMs be effective the first business day of July and December each calendar year. Additionally, he believes that the GTR and GTM should have more accountability for monitoring their contractor's system access.

The Office of Administration will conduct quarterly reconciliation's of access security data. The first review, to be completed in January 2003, will compare all employees and contractors with greater than read-only access to HUD's sensitive systems against the database of employees and contractors with background investigations. These reviews will continue, and be completed during the month following the end of the quarter.

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

The Department has made significant progress in reducing the number of users with access to critical systems that did not have a background investigation. HUD recognizes the severity of the risk to the Department and agreed to implement our recommendation to perform quarterly reconciliation's between all employees and contractors with greater than read-only access to HUD's sensitive systems against the database of employees and contractors with background investigations.

Reportable Condition: HUD Needs to Improve Funds Controls Over Public Housing Operating Funds

Controls over operating subsidy budget execution and funds control need to be improved. PIH did not have an operational, information system for monitoring operating subsidy eligibility requirements and obligations during fiscal year 2001 and six months of fiscal year 2002. Therefore, timely management reports were not available to monitor budget execution and funds control over operating subsidies. Changes in procedures for determining operating subsidy eligibility and the challenge of modifying existing data systems to meet the needs of the new operating subsidy eligibility procedures made it difficult for PIH to accurately determine funding requirements for fiscal years 2001 and 2002. As a result, HUD used a proration level higher than it would have if timely management reports had been available, resulting in a cumulative funding shortfall of approximately \$250 million (\$174 million for fiscal year 2001 and \$75 million for FY 2002).

Administrative Control of Funds

The Antideficiency Act (31 U.S.C. 1341) states that unless otherwise authorized by law, no officer or employee of the United States may make an expenditure, or create or involve the United States in any contract or obligation to make future expenditures, in the absence of sufficient funds in the account to cover the payment or the obligation at the time it is made or incurred

The Act further requires that the agency head prescribe a system of administrative control of funds, which is a collective set of policies and procedures by which an agency assures that its obligations and expenditures stay with legally authorized budget limits.

Furthermore, the Director of OMB has written to the Secretary on the need to strengthen HUD's policies and procedures for the administrative control of funds. In addition, the President's Management Agenda requires improvements to HUD's administrative control of funds to move HUD to a successful score on improving its financial performance.

Implementation of new formula for Operating Subsidy eligibility

Six months into fiscal year 2001, HUD implemented a new formula for the determination and distribution of operating subsidies to Public Housing Agencies (PHAs), as required by the Quality Housing and Work Responsibility Act of 1998 (QHWRA). The implementation of the new formula made it necessary for HUD to make changes in procedures for the submission, review, and approval of subsidy calculations, and required modifications to existing data systems. HUD published the interim rule in the Federal Register on March 29, 2001, effective for PHAs with fiscal years beginning on or after January 1, 2001. HUD informed PHAs in Notice PIH 2001-32 that funds appropriated by Congress were not sufficient to fully fund estimated subsidy requirements for fiscal year 2001; therefore, HUD would fund subsidy requirements for fiscal year 2001 at 99.5 percent of eligibility. Under normal circumstances, a PHA would submit its Operating Budget and/or subsidy calculation to its Field Office or Troubled Agency Recovery Center (TARC) for review and approval according to a schedule linked to the start of its fiscal year (January 1, April 1, July 1, or October 1). Data from the operating subsidy assistance package would be entered into the Regional Operating Budget and Obligations Tracking System (ROBOTS) for tracking and monitoring operating subsidy eligibility and obligations. Because HUD released the formula factors and published the interim rule six months into fiscal year 2001, HUD had to develop a new approach for the submission, review, and approval of subsidy calculations for fiscal year 2001 that recognized the increased workload involved in processing submissions from approximately 3,000 PHAs within a short period of time.

Modification of existing data systems needed to meet requirements of new formula

In October 2000, HUD officials concluded that the existing system, ROBOTS, used to track subsidy requirements and the obligation of funds, should be replaced with a new module within the PIH Information Center (PIC) system. PIH did not have an operational, data system for monitoring operating subsidy eligibility requirements and obligations during fiscal year 2001 and six months of fiscal year 2002. Therefore, timely management reports were not available to monitor budget execution and funds control over operating subsidies. The data system was not available for use until April 2002, six months after the end of fiscal year 2001.

Notification Letters used to obligate funds for fiscal years 2001 and 2002

Throughout fiscal year 2001, PIH obligated funds to PHAs based on the respective PHA's prior year budget, not the operating fund formula.

HUD sent notification letters to PHAs informing them of the amounts obligated and scheduled for disbursement. The letters noted that the funds provided were subject to adjustment after HUD review and action on submissions by PHAs for their operating subsidy eligibility requests. These changes permitted HUD to obligate its appropriated fiscal year 2001 operating subsidy funds in a timely manner, gave additional time to PHAs to prepare and submit their operating subsidy eligibility requests, and involved Field Office and TARC staff in the review and approval of budget and operating subsidy submissions. However, these obligations were made outside of the data system used to calculate the operating subsidy eligibility and without the benefit of management reports to monitor funding decisions.

HUD expected that this process would understate the actual amounts due PHAs and year-end reports showed that \$141 million of fiscal year 2001 operating subsidy funds were unobligated and would be carried forward into fiscal year 2002. HUD planned to use the carryover funds to complete the funding cycle for PHAs with fiscal years beginning in 2001 and informed Congress of this intent in its submitted Operating Plan for fiscal year 2002. HUD published Notice PIH 2002-8 in March 2002 informing PHAs that sufficient funds would be available to permit full funding of fiscal year 2002 subsidy requirements. The decision was made without the benefit of management reports showing whether the \$141 million carried over from the previous fiscal year would be sufficient to complete the fiscal year 2001 funding cycle.

In April 2002, HUD informed the Field Offices that the modifications had been made to ROBOTS so that data entry of actual requirements for fiscal year 2001 could begin. By May 2002, eight months into fiscal year 2002, HUD processed the final 2001 data into ROBOTS. The first management reports were generated showing that the actual eligibility for fiscal year 2001 could be higher than the \$141 million in available funding. HUD continued to refine the revenue shortfall for fiscal year 2001 with a revised final shortfall of \$174 million.

Furthermore, HUD had not entered the first half of the fiscal year's funding data for fiscal year 2002 into ROBOTS since the system could only accommodate one fiscal year's data at a time. HUD processed Letters of Notification outside the data system to fund fiscal year 2002 operating subsidy eligibility. By August 2002, actual eligibility requirements for the first half of fiscal year 2002 had been entered into ROBOTS. Management reports projected a cumulative funding shortfall of approximately \$250 million (\$174 million for fiscal year 2001 and \$75 million for fiscal year 2002).

Congressional and OMB concerns over practice of borrowing from next year's fund

HUD withheld the obligation of funds for PHAs with fiscal years beginning October 1, 2002. PHAs with fiscal years beginning in January, April, and July 2002, all received 100 percent of their operating subsidy eligibility, however, remaining available fiscal year 2002 operating subsidy funds were insufficient to fund PHAs with fiscal years

beginning October 1, 2002 at a 100 percent level. Past program practice in these situations has been for HUD to provide letters-of-intent to selected PHAs at less than full eligibility and then supersede the letter in the next fiscal year at an eligibility amount tied to the same proration level received by the other PHAs. Both Congress and OMB have raised concerns over this practice. We noted in House Committee Report 107-740, dated October 10, 2002, that Congress did not include language in HUD's Appropriations Bill for FY 2003 making operating funds available for two years.

HUD funds fourth quarter PHAs at 60 percent of eligibility

HUD notified the fourth quarter PHAs that the Department became aware that formula driven projections for major cost items such as the allowable expense level, utilities, and inflation factors were inadequate to meet actual eligibilities. Based on remaining fiscal year 2002 operating subsidy funds, payments to all PHAs with fiscal years beginning October 1, 2002 were based on less than 60 percent of the full eligibility, as permitted under operating subsidy regulations 24 CFR 990.112(c). HUD is considering providing, when they become available, a sufficient amount of fiscal year 2003 funds to provide equal treatment for these PHAs. Prorating fiscal year 2003 funds to all PHAs would absorb this reduction, so that PHAs would be treated equally and no funding deficiency would be carried forward to fiscal year 2004.

HUD's Actions Planned and Underway to Improve Funds Control Over Operating Subsidies

HUD has made progress in addressing its fund control issues. The Office of Public Housing is now able to capture actual subsidy calculations under ROBOTS so that timely budget and funding decisions can be made and funding shortages will be avoided.

Furthermore, the Department has updated and consolidated its previous Handbooks related to the administrative control of funds. The Handbook prescribes a system for the positive administrative control of funds designed to ensure that obligations and expenditures in each appropriation account or fund do not exceed the amount available, are within the period in which funds are made available, and are used for authorized purposes. In addition, all Funds Control Officers, Suballotment/Assignment Holders, Funding Verification Officials, Payment Certifying Officers and other officials and staff with direct funds responsibilities will be required to attend training and maintain adequate systems, records, certifications, and reports to support a positive administrative control of funds for the Department.

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

We agree with HUD's efforts to improve its funds control process through the implementation of the revised Handbook, the development of the annual funds control plans, and the training of appropriate HUD staff.

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 2002 year-end obligation balances showed over \$1.1 billion in excess funds that could be recaptured. 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.
- 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 performing the required obligation reviews or 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.

Requests for obligation reviews were forwarded by the CFO to the program and administrative offices. In fiscal year 2002, HUD automated the review process and made the obligation listing accessible via the web. The focus of the review was on obligations that exceeded a \$200,000 balance. 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 \$34 billion. Of the \$34 billion, \$94.3 million, involving 1094 program transactions, was

HUD is not deobligating unneeded funds in a timely manner

identified for deobligation. We tested the 1094 transactions to determine whether the balances had been deobligated in HUDCAPS. We found that, as of October 11, 2002, 125 of the 1094 transactions with obligational authority of \$34 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. In 1997, HUD initiated action to identify and recapture excess budget authority in its Section 8 contracts. Prior to this HUD had been unaware of the extent of excess budget authority available to offset needs for new budget authority for the Section 8 programs. 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 did not perform a review to identify excess reserves in the Section 8 Moderate Rehabilitation Program

HUD has not been consistent in assessing and identifying excess program reserves in Section 8 programs as an offset to future budget requirements. HUD had not reviewed the unexpended obligations in the Section 8 Moderate Rehabilitation (Mod Rehab) Program since fiscal year 2000. At the end of fiscal year 2000, HUD recaptured \$246 million in unexpended funds from expired Mod Rehab contracts. In November 2000, HUD completed a major effort to correct Mod Rehab unit data and contract terms in HUDCAP. However, HUD did not perform a review of unexpended obligations in the Mod Rehab Program for fiscal years 2001 and 2002. In December 2002, we requested that HUD identify Mod Rehab contracts with unexpended funds remaining that had been expired as of September 30, 2002. We found \$217 million in unexpended funds on Mod Rehab contracts that could be recaptured. As a consequence of HUD not annually reviewing the unexpended balances in the Section 8 program, excess Mod Rehab funds are not being considered in the budget process and HUD's obligation balances are overstated by the Section 8 funds available for recapture. As a result of our review, HUD processed an adjustment to the 2002 Consolidated Financial Statements for \$200 million in excess unexpended funds. HUD needs to 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.

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 2002, \$1.1 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 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.

Review of the FMC budget estimate of shortfalls and excesses for project-based Section 8 contracts in HUDCAPS for fiscal year 2003 and outyears showed an estimated \$365 million in excess contract authority expected to be realized during fiscal year 2003 related to expiring Section 8 project-based contracts that would be renewed. In addition, the FY 2003 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 2003 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 contract authority associated with this group of contracts. Review of fiscal years 2002 and 2001 contract renewals showed an additional \$245 million and \$123 million, respectively, in excess contract authority that was rolled over to contract renewals.

In addition, review of the Section 8 project-based contracts in PAS/LOCCS showed 259 contracts that had expired prior to September 30, 2001 with available contract authority. These 259 contracts had \$34 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.

In August 2002, PIH performed an analysis of budget authority for all years related to the Section 8 tenant-based program and estimated that approximately \$1.3 billion of the unexpended budget authority was available for deobligation and recapture. This is funding that housing agencies received under contracts with HUD but did not expend or is not needed to make housing assistance payments.

HUD needs to improve the process for reviewing and 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 \$790 million between the subsidiary and general ledgers for the Section 236 program at the end of fiscal year 2002. The cause of the problem was the lack of (1) an aggressive program to identify excess funds and (2) 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.

Due to extensive staff effort required to review manual records in order to accurately report its commitments, HUD has historically chosen to estimate the amount reported in HUD's financial statements. Our review of the methodology used to estimate the Section 236 IRP commitments and the Section 236 subsidiary and general ledgers showed: (1) the Department's methodology to estimate the commitment balance resulted in an overstatement in commitments by approximately \$128 million, and (2) \$487 million in contract authority associated with contracts prepaid and terminated in fiscal year 2002 had not been recaptured.

HUD reported \$4.3 billion in commitments under the insured section of the Section 236 IRP program per the Treasury SF-133 as of September 30, 2002. Review of the general ledger and subsidiary records showed that \$487 million in commitments had not been recaptured for prepayments of loans made during fiscal year 2002. 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 is overstated. HUD needs to promptly record contract liquidations and recapture the associated obligated contract authority and imputed budgeted authority.

Our review of the methodology for HUD estimates for Section 236 insured commitments showed inaccuracies which resulted in overstatements in future requirements for contract authority. HUD estimates its Section 236 insured commitments using the current year's payment projected over the remaining life of the contract. However, HUD's methodology fails to take into consideration the declining balance associated with the mortgage insurance premium. We took a statistical sample of the 2,769 project amortization schedules. Using the statistical sample of 58 projects, we computed the future required subsidy payments amortized over the life of the contract and found that

the associated commitment balances were overstated by \$2.7 million. Projecting our error rate and dollars to the universe of 2,769 projects showed that the insured Section 236 commitment balance is overstated by approximately \$128 million.

As a result of our review, HUD processed an adjustment to the 2002 Consolidated Financial Statements for \$705 million in excess unexpended funds. HUD plans to review the computation of estimated 236 subsidy payments using the proper amortization factors. In addition, for the Section 236 program HUD needs to (1) review and deobligate, where appropriate, unexpended funds no longer required (2) strengthen procedures to remove inactive contracts in a timely manner, and (3) support the accounting for the Section 236 IRP program by developing an integrated automated system.

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

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 2002 the general ledger balances for RAP and Rent Supplement totaled \$2.18 billion. There were 937 participants in the programs. We statistically sampled 57 of the 937 projects to determine if past years contract authority had been recaptured. For the 57 projects, we reviewed the subsidiary ledgers to determine if there were funds that had been authorized prior to fiscal year 2002 but not disbursed. We found that the 57 projects had \$3 million in undisbursed contract authority from fiscal year 2001 or prior that remained on the accounting records. Projecting our sample results to the universe of RAP and Rent Supplement contracts, we estimate that at least \$46 million in fiscal year 2001 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

The Department has updated and consolidated its previous Handbooks related to the administrative control of funds. The Handbook prescribes

a system for the positive administrative control of funds designed to ensure that obligations and expenditures in each appropriation account or fund do not exceed the amount available, are within the period in which funds are made available, and are used for authorized purposes. The updated Handbooks requires that all allotment holders will develop, maintain, and enforce Funds Control Plans, approved by the Chief Financial Officer.

Concerning HUD not deobligating funds in a timely manner, HUD took action during the first quarter of fiscal year 2003 to deobligate \$27.4 of the \$34 million identified. They plan to deobligate the remaining \$6.6 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 2003. 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 \$34 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 8 Mod Rehab, the Department did process an adjustment to the financial statements and recapture \$200 million in excess funds identified.

For the Section 236 IRP, HUD processed an adjustment to the 2002 Consolidated Financial Statements for \$705 million in excess unexpended funds. HUD plans to review the computation of estimated

236 subsidy payments using the proper amortization factors. In addition, HUD plans to initiate a review to automate the accounting for the Section 236 IRP.

For the \$46 million in excess undisbursed contract authority in the Rent Supplement and Rental assistance programs, HUD plans to further analyze the projects 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 authority and imputed budgeted authority. In addition, HUD needs to address data and systems weaknesses to ensure all contracts are considered in the recapture/shortfall budget process.

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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 2002, 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 will automate FHA headquarters' funds control processes, financial statement reporting, and updates to the departmental general ledger. The FHA Subsidiary General Ledger Project is a multiphase project to be completed by December 2006.

The Department is moving in the direction of becoming FFMIA compliant for three areas of substantial noncompliance: (1) Federal financial management systems requirements (2) Federal Accounting Standards and (3) the SGL at the transaction level. We have included the specific nature of the noncompliance, responsible program offices and recommended remedial actions in Appendix C of this report.

Federal Financial Management Systems Requirements

In its *Fiscal Year 2002 Accountability Report*, HUD reports that 17 of its 48 financial management systems do not comply with the requirements of FFMIA and OMB Circular A-127, *Financial Management Systems*. In addition to deficiencies noted in HUD's Accountability Report, we report as a material weakness that *HUD does not have a single integrated financial management system as required by OMB Circular A-127 and FFMIA*. This material weakness addresses how HUD's financial management systems do not meet core financial system requirements for integration through automated interfaces.

We report as a reportable condition that *Controls over HUD's Computing Environment Can be Further Strengthened*. This reportable condition discusses how software configuration management, network access controls, and physical access require additional improvement. In addition, 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.

KPMG LLP reported a material weakness regarding controls over FHA's budget execution and funds control. FHA's lack of financial systems and processes that are capable of fully monitoring and controlling budgetary resources resulted in FHA's violation of the Anti-Deficiency Act. This results in a need to:

- implement 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*).

Compliance with SGL at the transaction level

HUDCAPS is the Department's official standard general ledger system. FHA provides consolidated summary level data to HUDCAPS. FHA has 19 subsidiary systems that feed transactions to its commercial general ledger system. Fifteen of the 19 systems lack the capability to process transactions in the SGL format. To provide consolidated summary level data from FHA to HUDCAPS, FHA currently uses several manual processing steps, including the use of personal computer based software to convert the commercial accounts to government SGL, and transfer the account balances to HUDCAPS. JFMIP requires that the core financial system "...provide for automated month and year-end closing of SGL accounts and rollover of the SGL account balances".

FHA has had a plan in place for several years to improve its financial systems processing environment through implementation of a new subsidiary ledger system. The first phase of the new subsidiary ledger system, which includes the completion of the new general ledger posting models, is planned to be in place for fiscal year 2003. The full implementation of the new subsidiary ledger system is scheduled for fiscal year 2007.

**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, 2002 and 2001
(Dollars in Millions)

	2002	2001
ASSETS		
Intragovernmental		
Fund Balance with Treasury (Note 3)	\$77,632	\$73,948
Investments (Note 5)	28,342	23,979
Accounts Receivable (Net) (Note 7)	3	6
Other Assets (Note 8)		43
Total Intragovernmental Assets	<u>\$105,977</u>	<u>\$97,976</u>
Investments (Note 5)		
Accounts Receivable (Note 7)	782	679
Credit Program Receivables and Related		
Foreclosed Property (Note 9)	11,379	10,949
General Property Plant and Equipment (Note 10)	87	73
Other Assets (Note 8)	152	140
TOTAL ASSETS	<u><u>\$118,377</u></u>	<u><u>\$109,817</u></u>
LIABILITIES		
Intragovernmental Liabilities		
Accounts Payable	\$3,096	\$2,046
Debt (Note 12)	11,677	9,235
Other Intragovernmental Liabilities (Note 13)	4,674	4,941
Total Intragovernmental Liabilities	<u>\$19,447</u>	<u>\$16,222</u>
Accounts Payable	1,398	1,443
Loan Guarantees Liabilities (Note 9)	3,814	6,090
Debt Held by the Public (Note 12)	2,220	2,496
Federal Employee and Veterans' Benefits (Note 2)	81	86
Debentures Issued to Claimants (Note 12)	288	224
Loss Reserves (Note 14)	539	536
Other Governmental Liabilities (Note 13)	1,047	1,165
TOTAL LIABILITIES	<u><u>\$28,834</u></u>	<u><u>\$28,262</u></u>
NET POSITION		
Unexpended Appropriations	\$65,407	\$63,305
Cumulative Results of Operations	24,136	18,250
Total Net Position	<u><u>89,543</u></u>	<u><u>81,555</u></u>
Total Liabilities and Net Position	<u><u>\$118,377</u></u>	<u><u>\$109,817</u></u>

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)				(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)

	Federal Housing Administration	Government National Mortgage Association	Public and Indian Housing	Housing	Community Planning and Development	Other	Consolidated
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				(646)			(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
Intragovernmental Net Costs	\$0	\$0	\$0	\$0	\$26	\$0	\$26
Gross Cost With the Public					\$5,417		\$5,417
Earned Revenues							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
Intragovernmental Net Costs	\$0	\$0	\$0	\$0	\$14	\$0	\$14
Gross Cost With the Public					\$1,537		\$1,537
Earned Revenues							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			(\$0)	(27)	(2)	0	(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
Net Cost of Operations	(\$3,935)	(\$794)	\$20,244	\$8,473	\$8,686	\$337	\$33,010

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 2001
 (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	\$503						\$503
Intragovernmental Earned Revenues	(1,482)						(1,482)
Intragovernmental Net Costs	(\$979)						(\$979)
With the Public	(\$1,234)						(\$1,234)
Earned Revenue With the Public	(313)						(313)
Net Costs With the Public	(\$1,547)						(\$1,547)
Net Program Costs	(\$2,526)						(\$2,526)
Subsidized Program							
Intragovernmental	\$122						\$122
Intragovernmental Earned Revenues	(127)						(127)
Intragovernmental Net Costs	(\$5)						(\$5)
With the Public	(\$469)						(\$469)
Earned Revenue With the Public	(143)						(143)
Net Costs With the Public	(\$612)						(\$612)
Net Program Costs	(\$617)						(\$617)
Government National Mortgage Association							
Intragovernmental		\$0					\$0
Intragovernmental Earned Revenues		(430)					(430)
Intragovernmental Net Costs		(\$430)					(\$430)
With the Public		\$73					\$73
Earned Revenues		(448)					(448)
Net Costs With the Public		(\$375)					(\$375)
Net Program Costs		(\$805)					(\$805)
Section 8:							
Intragovernmental			\$7	\$24	\$0		\$31
Intragovernmental Earned Revenues							0
Intragovernmental Net Costs			\$7	\$24	\$0		\$31
With the Public			\$9,543	\$7,059	\$11		\$16,613
Earned Revenues			0	150			150
Net Costs With the Public			\$9,543	\$7,209	\$11		\$16,763
Net Program Costs			\$9,550	\$7,233	\$11		\$16,794
Low Rent Public Housing Loans and Grants							
Intragovernmental			\$204				\$204
Intragovernmental Earned Revenues							0
Intragovernmental Net Costs			\$204				\$204
With the Public			\$3,851				\$3,851
Earned Revenues							0
Net Costs With the Public			\$3,851				\$3,851
Net Program Costs			\$4,055				\$4,055
Operating Subsidies:							
Intragovernmental			\$35				\$35
Intragovernmental Earned Revenues							0
Intragovernmental Net Costs			\$35				\$35
With the Public			\$3,112				\$3,112
Earned Revenues							0
Net Costs With the Public			\$3,112				\$3,112
Net Program Costs			\$3,147				\$3,147
Housing for the Elderly and Disabled							
Intragovernmental				\$314			\$314
Intragovernmental Earned Revenues				0			0
Intragovernmental Net Costs				\$314			\$314
With the Public				\$784			\$784
Earned Revenues				(665)			(665)
Net Costs With the Public				\$119			\$119
Net Program Costs				\$433			\$433

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 2001
 (Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Public and Indian Housing	Housing	Community Planning and Development	Other	Consolidated
Community Development Block Grants:							
Intragovernmental					\$33		\$33
Intragovernmental Earned Revenues							0
Intragovernmental Net Costs					\$33		\$33
With the Public					\$4,947		\$4,947
Earned Revenues							0
Net Costs With the Public					\$4,947		\$4,947
Net Program Costs					\$4,980		\$4,980
HOME:							
Intragovernmental					\$11		\$11
Intragovernmental Earned Revenues							0
Intragovernmental Net Costs					\$11		\$11
With the Public					\$1,425		\$1,425
Earned Revenues							0
Net Costs With the Public					\$1,425		\$1,425
Net Program Costs					\$1,436		\$1,436
Other:							
Intragovernmental		\$51	\$29		\$45	\$43	\$168
Intragovernmental Earned Revenues		(1)	(10)		(2)	(1)	(14)
Intragovernmental Net Costs		\$50	\$19		\$43	\$42	\$154
With the Public		\$800	\$548		\$1,477	\$217	\$3,042
Earned Revenues			(26)		(5)	0	(31)
Net Costs With the Public		\$800	\$522		\$1,472	\$217	\$3,011
Net Program Costs		\$850	\$541		\$1,515	\$259	\$3,165
Costs Not Assigned to Programs			\$153	\$141	\$87	\$1	\$382
Net Cost of Operations	(\$3,143)	(\$805)	\$17,755	\$8,348	\$8,029	\$260	\$30,444

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 ended September 2002 and 2001
(Dollars in Millions)

	2002		2001	
	Cumulative Results of Operations	Unexpended Appropriations	Cumulative Results of Operations	Unexpended Appropriations
Net Position-Beginning of Period	(\$18,250)	(\$63,305)	(\$13,889)	(\$60,870)
Prior Period Adjustments (Note 19)	5	(5)		
Beginning Balances, As Adjusted	(\$18,245)	(\$63,310)	(\$13,889)	(\$60,870)
Budgetary Financing Sources				
Appropriations Received		(45,630)		(42,508)
Transfers In/Out		1,280		1,239
Other Adjustments (Recissions, etc)		1,717		2,601
Appropriations Used	(40,542)	40,536	(36,233)	36,233
Transfers In/Out Without Reimbursement	839		318	
Other Budgetary Financing Sources	8		(7)	
Other Financing Sources				
Donations and Forfeitures of Property				
Transfers In/Out Without Reimbursement	865		1,180	
Imputed Financing From Costs				
Absorbed From Others	(73)		(70)	
Other	2		7	
Total Financing Sources	(\$38,901)	(\$2,097)	(\$34,805)	(\$2,435)
Net Cost of Operations	33,010		30,444	0
Ending Balances	(\$24,136)	(\$65,407)	(\$18,250)	(\$63,305)

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 2002 and 2001
(Dollars in Millions)**

	<u>2002</u>		<u>2001</u>	
	Budgetary	NonBudgetary Credit Program Financing Accounts	Budgetary	NonBudgetary Credit Program Financing Accounts
Budgetary Resources:				
Budget Authority	\$45,809	\$3,925	\$46,694	\$900
Net Transfers, Current Year Authority	6		6	
Unobligated Balance-Beginning of Year	39,641	4,537	39,691	4,503
Net Transfers, Actual, Prior Year Balance	700			
Spending Authority from Offsetting Collections	10,281	10,237	8,337	12,333
Adjustments				
Recoveries of Prior Year Adjustments	3,695	50	3,275	4
Permanently not available				
Cancellations-Expired and No Year Accts	(45)		(56)	
Enacted Recissions	(1,958)		(2,534)	
Capital Trans & Debt Redemption	(2,796)	(916)	(2,252)	(3,511)
Other Authority Withdrawn	(6,559)	0	(6,863)	
Total Budgetary Resources	<u>\$88,774</u>	<u>\$17,833</u>	<u>\$86,298</u>	<u>\$14,229</u>
Status of Budgetary Resources:				
Obligations Incurred (Note 20)	\$43,487	\$14,740	\$46,656	\$9,692
Unobligated Balances Available	9,362	1,467	10,433	2,195
Unobligated Balances Not Available	35,925	\$1,626	29,209	\$2,342
Total Status of Budgetary Resources	<u>\$88,774</u>	<u>\$17,833</u>	<u>\$86,298</u>	<u>\$14,229</u>
Obligated Balance, Net-Beg of Period	\$94,000	(\$119)	\$97,502	\$212
Obligated Balance Transferred, Net	0	0		
Obligated Balance, Net - End of Period	89,706	(98)	94,000	(119)
Outlays				
Disbursements	\$44,216	\$14,658	\$47,152	\$9,953
Collections	(10,410)	(10,226)	(8,606)	(12,267)
Subtotal	\$33,806	\$4,432	\$38,546	(\$2,314)
Less: Offsetting Receipts	(2,001)		(626)	
Net Outlays	<u>\$31,805</u>	<u>\$4,432</u>	<u>\$37,920</u>	<u>(\$2,314)</u>

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 2002 and 2001
(Dollars in Millions)

	2002	2001
Resources Used to Finance Activities:		
Budgetary Resources Obligated		
Obligations Incurred	\$58,227	\$56,348
Less: Spending Authority from Offsetting Collections & Recoveries	(24,263)	(23,949)
Obligations Net of Offsetting Collections	\$33,964	\$32,399
Less: Offsetting Receipts	(2,001)	(626)
Net Obligations	\$31,963	\$31,773
Other Resources		
Transfers In/Out Without Reimbursement	(865)	(1,180)
Imputed Financing from Costs Absorbed by Others	73	70
Other Resources	6	(63)
Net Other Resources Used to Finance Activities	(786)	(1,173)
Total Resources Used to Finance Activities	\$31,177	\$30,600
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	\$4,199	\$3,957
Resources That Fund Expenses from Prior Periods	(6,261)	(9,481)
Budgetary Offsetting Collections and Receipts Not Affecting Net Cost of Operations	19,488	18,081
Resources Financing Acquisition of Assets	(10,335)	(8,550)
Other Changes to Net Obligated Resources Not Affecting Net Cost of Operations	4	(603)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	\$7,095	\$3,404
Total Resources Used to Finance the Net Cost of Operations	\$38,272	\$34,004
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	1
Reestimates of Credit Subsidy Expense	1,149	559
Exchange Revenue Receivable from the Public	(657)	(677)
Other		33
Total Requiring/Generating Resources in Future Periods	\$494	(\$84)
Components Not Requiring/Generating Resources		
Depreciation and Amortization	13	4
Revaluation of Assets or Liabilities	(1,275)	(1,124)
Other	(4,494)	(2,356)
Total Components of Net Cost of Operation Not Requiring/Generating Resources	(\$5,756)	(\$3,476)
Total Components of Net Cost of Operations Not Requiring/Generating Resources in the Current Period	(\$5,262)	(\$3,560)
Net Cost of Operations	\$33,010	\$30,444

The accompanying notes are an integral part of these statements.

Notes to Financial Statements

September 30, 2002 and 2001

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. 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, 2001 terrorist attacks on the United States. Of the amounts appropriated, \$312.5 million 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 9.1 percent of HUD's consolidated assets and 8.2 percent of HUD's consolidated revenues and financing sources for fiscal 2002 and 9.9 percent of HUD's consolidated assets and 9.1 percent of HUD's consolidated revenues and financing sources for fiscal 2001.

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 account.

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

Fees received for Ginnie Mae's guaranty of mortgage-backed securities are recognized as earned on an accrual basis. Fees received for commitments to subsequently guarantee mortgage-backed securities and commitments to fund mortgage loans are recognized when commitments are granted.

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

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

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.

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 2002, 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 mortgage 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 liability for loan guarantees (LLG) related to Credit Reform loans (made after October 1, 1991) is comprised of the present value of anticipated cash outflows for defaults such as claim payments, premium refunds, property expense for on-hand properties, and sales expense for sold properties, less anticipated cash inflows such as premium receipts, proceeds from property sales, and principal interest on Secretary-held notes.

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 \$81 million as of September 30, 2002 and \$86 million as of September 30, 2001. 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 actual or probable defaults of FHA-insured mortgage loans. 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 7 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 2002 and 2001 was \$71 million and \$66 million, respectively.

L. Federal Employee and Veteran's Benefit

The Department's Federal Employee and Veteran's benefit expenses totaled approximately \$125 million for fiscal 2002; this amount includes \$31 million to be funded by the OPM. Federal Employee and Veteran's benefit expenses totaled approximately \$122 million for fiscal 2001; this amount includes \$32 million to be funded by the OPM. Amounts funded by 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

Starting in fiscal year 2002, HUD prepared its financial statements in the format provided by OMB Bulletin 01-09, Form and Content of Agency Financial Statements. Certain prior-year financial statement line items have, therefore, been reclassified to conform to the fiscal year 2002 presentation

format. Included in these reclassifications is the addition of the general fund receipt account. The general fund receipt accounts of FHA's GI and SRI funds are used to accumulate resources related to negative credit subsidy from new endorsements and downward credit subsidy reestimates. At the beginning of the following fiscal year, these accumulated resources are transferred to the U. S. Treasury's general fund. This fund was not originally presented in the fiscal year 2001 financial statements, but it is included in these comparative statements. The addition of the general fund receipt account increased FHA's fund balances with U. S. Treasury and the payable to the U. S. Treasury by \$620 million. These changes in classification have 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, 2002 and 2001 were as follows (dollars in millions):

<u>Description</u>	<u>2002</u>	<u>2001</u>
Revolving Funds	\$ 11,187	\$ 11,819
Appropriated Funds	64,359	61,454
Trust Funds	8	4
Other	2,078	671
Total - Fund Balance	<u>\$ 77,632</u>	<u>\$ 73,948</u>

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

<u>Description</u>	<u>Unobligated</u>		Obligated Not Yet Disbursed	Total Fund Balance
	<u>Available</u>	<u>Unavailable</u>		
FHA	\$2,091	\$ 5,434	\$ 2,072	\$ 9,597
GNMA		2,509		2,509
Section 8 Rental Assistance	665	1,082	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	<u>\$ 10,769</u>	<u>\$ 9,665</u>	<u>\$ 57,198</u>	<u>\$ 77,632</u>

HUD's fund balance with U.S. Treasury as reflected in the entity's general ledger as of September 30, 2001 were as follows:

Description	Unobligated		Obligated Not Yet Disbursed	Total Fund Balance
	Available	Unavailable		
FHA	3,759	\$ 3,662	\$ 2,021	\$ 9,442
GNMA		2,043		2,043
Section 8 Rental Assistance	\$ 1,675	10	16,356	18,041
CDBG	1,029	25	9,095	10,149
HOME	284	-	4,385	4,669
Operating Subsidies	141	-	1,688	1,829
Low Rent Public Housing Loans and Grants	882	-	9,389	10,271
Section 202/811	2,848	-	4,217	7,065
All Other	3,015	115	7,309	10,439
Total	\$ 13,633	\$ 5,855	\$ 54,460	\$ 73,948

An immaterial difference exists between HUD's recorded Fund Balance with the US Treasury and the US 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, 2002 (dollars in millions):

Programs	Commitments Funded Through			Total Contractual Commitments
	Unexpended Appropriations	Permanent Indefinite Appropriations	Offsetting Collection	
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	<u>\$ 54,224</u>	<u>\$ 29,350</u>	<u>\$ 128</u>	<u>\$ 83,702</u>

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.

The following shows HUD's obligations and contractual commitments under its grant, subsidy, and loan programs as of September 30, 2001 (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	\$15,975	\$26,412		\$42,387
Community Development Block Grants	9,048			9,048
HOME Partnership Investment Program	4,370	-	-	4,370
Operating Subsidies	1,652	-	-	1,652
Low Rent Public Housing Grants and Loans	9,165			9,165
Housing for Elderly and Disabled	4,056	-	-	4,056
Section 235/236	138	9,517	-	9,655
All Other	6,993	64	110	7,167
Total	\$ 51,397	\$ 35,993	\$ 110	\$ 87,500

Of the total Section 8 Rental Assistance contractual commitments as of September 30, 2001, \$32.7 billion relates to project-based commitments, and \$9.7 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, 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			278
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

The following shows HUD's administrative commitments as of September 30, 2001 (dollars in millions):

Programs	Administrative Commitments Funded Through			Total Reservations
	Unexpended Appropriation s	Permanent Indefinite Appropriation s	Offsetting Collections	
Section 8 Rental Assistance Project-Based	\$ 152			152
Section 8 Rental Assistance Tenant-Based	4	-	-	4
Community Development Block Grants	771			771
HOME Partnership Investment Program	254			254
Low Rent Public Housing Grants and Loans	819	-	-	819
Housing for Elderly and Disabled	2,586	73	-	2,659
All Other	1,180	15	5	1,200
Total	\$ 5,766	\$ 88	\$ 5	\$ 5,859

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 2002 ranged from 3 percent to 13.88 percent. During fiscal year 2001 interest rates ranged from 2.49 percent to 13.89 percent. The amortized cost and estimated market value of investments in debt securities as of September 30, 2002 and 2001, were as follows (dollars in millions):

Fiscal Year	Cost	Par Value	Un-amortized Premium (Discount)	Accrued Interest	Net Investments	Unrealized Gain	Market Value
FY 2002	27,845	\$ 28,209	\$ (194)	\$ 327	\$ 28,342	\$ 2,208	\$ 30,550
FY 2001	23,524	\$ 23,864	\$ (195)	\$ 310	\$ 23,979	\$ 1,641	\$ 25,620

NOTE 6 – ENTITY AND NON-ENTITY ASSETS

The following shows HUD's assets as of September 30, 2002 and 2001, were as follows (dollars in millions):

Description	2002			2001		
	Entity	Non-Entity	Total	Entity	Non-Entity	Total
Intragovernmental						
Fund Balance with Treasury	\$ 75,477	\$ 2,155	\$ 77,632	\$ 72,946	\$ 1,002	\$ 73,948
Investments	28,340	2	28,342	23,972	7	23,979
Accounts Receivable	0	3	3	6	-	6
Other Assets	0	-	-	43	-	43
Total Intragovernmental Assets	\$ 103,817	\$ 2,160	\$ 105,977	\$ 96,967	\$ 1,009	\$ 97,976
Accounts Receivable	592	190	782	435	244	679
Loan Receivables and						
Related Foreclosed Property	11,372	7	11,379	10,942	7	10,949
General Property Plant and Equipm	86		87	73		73
Other Assets	29	123	152	30	110	140
Total Assets	\$ 115,896	\$ 2,480	\$ 118,377	\$ 108,447	\$ 1,370	\$ 109,817

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% allowance for loss is established for all delinquent debt 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, 2002 and 2001 this amount totaled \$229 million and \$150 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, 2002 and 2001, HUD was due \$189 million and \$240 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, 2002 and 2001, as follows (dollars in millions):

<u>Description</u>	FY 2002			FY 2001		
	Gross Accounts Receivable	Allowance for Loss	Total	Gross Accounts Receivable	Allowance for Loss	Total
Section 8 Settlements	\$ 229	\$ -	\$ 229	\$ 150	\$ -	\$ 150
Bond Refundings	200	(11)	189	252	(12)	240
Other Receivables:		-				
FHA Premiums	207	-	207	247	(34)	213
Other Receivables	243	(83)	160	146	(64)	82
Total	\$ 879	\$ (94)	\$ 785	\$ 795	\$ (110)	\$ 685

NOTE 8 - OTHER ASSETS

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

<u>Description</u>	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	-	-	-	-	-
Equity Interest in Multifamily Mortgage Trust 1996	-	-	-	-	-
GNMA RealEstate Owned Property and Hole Mortgages	-	10	-	-	10
Mortgagor Reserves for Replacement - Cash	123	-	-	-	123
Advances from the Public				4	4
Other Assets	15		-	-	15
Total	\$ 138	\$ 10	\$ -	\$ 4	\$ 152

The following shows HUD's Other Assets as of September 30, 2001 (dollars in millions):

<u>Description</u>	<u>FHA</u>	<u>Ginnie Mae</u>	<u>Section 8 Rental Assistance</u>	<u>All Other</u>	<u>Total</u>
Intragovernmental Assets:					
Receivables from unapplied disbursements	\$ 43	-	\$ -	-	43
Sec. 312 Rehabilitation Loan Program Receivables	-	-	-	-	-
Mortgagor Reserves for Replacement - Investment	-	-	-	-	-
Other Assets	-	\$ -	-	-	-
Total Intragovernmental Assets	\$ 43	\$ -	-	-	\$ 43
Other Assets:					
Receivables Related to Asset Sales	-	-	-	-	-
Receivables Related to Credit Program Assets	-	-	-	-	-
GNMA RealEstate Owned Property and Hole Mortgages	-	14	-	-	14
Equity Interest in Multifamily Mortgage Trust 1996	-	-	-	-	-
Premiums Receivable	-	-	-	-	-
Mortgagor Reserves for Replacement - Cash	110	-	-	-	110
Other Assets	15	-	-	1	16
Total	\$ 168	\$ 14	\$ -	\$ 1	\$ 183

Receivable from Unapplied Disbursements

The initial allocations of the confirmed Fund Balances with Treasury among the U.S. Treasury accounts that make up FHA are based on estimates. At the end of the fiscal year, these estimates resulted in the establishment of the receivables and payables that reflect the differences between the Fund Balance with Treasury and the estimates recorded in FHA's general ledger.

Before fiscal year 2001, the receivable and payables were classified as receivable from and payable to the U.S. Treasury. In fiscal year 2001, these receivables and payables are classified as receivables and payables between different FHA accounts to more appropriately reflect the nature of the differences. As a result, in the process of preparing the FHA consolidated statements, these intra-FHA receivables and payables are eliminated. The remaining receivable and/or payable is classified to a receivable or payable with other U.S. government agencies.

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 2001 and 2000 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):

<u>Direct Loan Programs</u>	2002				Value of Assets Related to Direct Loans
	Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	
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>

	2001				
	Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Direct Loans
<u>Direct Loan Programs</u>					
FHA	\$ 42	\$ -	\$ (23)	\$ -	\$ 19
Housing for Elderly and Disabled	7,804	98	(20)	9	7,891
Low Rent Public Housing Loans	3	2	-	-	5
All Other	807	54	(583)	2	280
Total	<u>\$ 8,656</u>	<u>\$ 154</u>	<u>\$ (626)</u>	<u>\$ 11</u>	<u>\$ 8,195</u>

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

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

	2001				
	Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Foreclosed Property	Value of Assets Related to Direct Loans
<u>Direct Loan Programs</u>					
FHA	<u>\$ 1</u>	<u>\$ -</u>	<u>\$ (2)</u>	<u>\$ -</u>	<u>\$ (1)</u>

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

	2002				
	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance for Loan and Interest Losses	Foreclosed Property, Net	Defaulted Guaranteed Loans Receivable, Net
<u>Direct Loan Programs</u>					
FHA	<u>\$ 2,301</u>	<u>\$ 107</u>	<u>\$ (984)</u>	<u>\$ 203</u>	<u>\$ 1,627</u>

	2001				
	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance for Loan and Interest Losses	Foreclosed Property, Net	Defaulted Guaranteed Loans Receivable, Net
<u>Direct Loan Programs</u>					
FHA	\$ 2,057	\$ 12	\$ (1,131)	\$ 264	\$ 1,202

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

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

	2001				
	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Foreclosed Property, Gross	Value of Assets Related to Defaulted Guaranteed Loans
<u>Direct Loan Programs</u>					
FHA	\$ 793	\$ 82	\$ (1,367)	\$ 2,045	\$ 1,553

	<u>2002</u>	<u>2001</u>
Total Credit Program Receivables and Related Foreclosed Property, Net	<u>\$11,379</u>	<u>10,949</u>

F. Guaranteed Loans Outstanding (dollars in millions):

Guarantee Loans Outstanding:

<u>Loan Guarantee Programs</u>	2002	
	<u>Outstanding Principal, Guaranteed Loans, Face Value</u>	<u>Amount of Outstanding Principal Guaranteed</u>
FHA Programs	\$ 608,889	\$ 555,463
All Other	2,232	2,232
Total	<u>\$ 611,121</u>	<u>\$ 557,695</u>

<u>Loan Guarantee Programs</u>	2001	
	<u>Outstanding Principal, Guaranteed Loans, Face Value</u>	<u>Amount of Outstanding Principal Guaranteed</u>
FHA Programs	\$ 601,715	\$ 555,463
All Other	2,049	2,049
Total	<u>\$ 603,764</u>	<u>\$ 557,512</u>

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	\$ 168,865	\$ 159,550
All Other	149	149
Total	<u>\$ 169,014</u>	<u>\$ 159,699</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	\$ 150,656	\$ 142,910
All Other	231	231
Total	<u>\$ 150,887</u>	<u>\$ 143,141</u>

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

<u>Loan Guarantee Programs</u>	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

<u>Loan Guarantee Programs</u>	2001		
	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	\$ 6,364	\$ (311)	\$ 6,053
All Other	-	37	\$ 37
Total	\$ 6,364	\$ (274)	\$ 6,090

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

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

<u>Loan Guarantee Programs</u>	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)

<u>Loan Guarantee Programs</u>	2001				
	Endorsement Amount	Default Component	Fees Component	Other Component	Subsidy Amount
FHA	\$ -	\$ 1,933	\$ (4,555)	\$ 334	\$ (2,288)
All Other	-	8	-	-	8
Total	\$ -	\$ 1,941	\$ (4,555)	\$ 334	\$ (2,280)

Modification and Reestimates dollars in millions)

<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	\$ -	\$ -	\$ 951	\$ 951

<u>Loan Guarantee Programs</u>	2001			
	<u>Total Modifications</u>	<u>Interest Rate Reestimates</u>	<u>Technical Reestimates</u>	<u>Total Reestimates</u>
FHA	\$ -	\$ -	\$ 873	\$ 873

<u>Total</u>	<u>Loan</u>	<u>Guarantee</u>	<u>Subsidy</u>	<u>Expense</u>	<u>(dollars in millions)</u>	
<u>Loan Guarantee Programs</u>			<u>Current Year</u>	<u>Prior Year</u>		
FHA			(\$2,238)	(\$1,415)		
All Other			15	8		
Total			(\$2,223)	(\$1,407)		

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

Budget Subsidy Rates for Loans Guarantee for FY 2002 (dollars in millions)

<u>Loan Guarantee Program</u>	<u>Default</u>	<u>Fees and Other Collections</u>	<u>Other</u>	<u>Total</u>
FHA				
FHA	1.54%	-3.77%	0.16%	-2.07%
FHA- Other	2.88%	-4.48%		-1.60%
All Other				
Section 108 (b)	2.30%			2.30%
Indian Housing	2.47%			2.47%
Hawaiian Home	2.47%			2.47%
Title VI Indian Housing	11.07%			11.07%

The subsidy rates above pertain only to FY 2002 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 2002	FY 2001
Beginning balance of the loan guarantee liability	\$6,090	\$7,554
Add: subsidy expense for guaranteed loans disbursed during the reporting years by component:		
(a) Interest supplement costs		
(b) Default costs (net of recoveries)	2,530	1,943
(c) Fees and other collections	(5,964)	(4,555)
(d) Other subsidy costs	258	333
Total of the above subsidy expense components	(\$3,176)	(\$2,279)
Adjustments:		
(a) Loan guarantee modifications		
(b) Fees Received	2,946	3,313
(c) Interest supplemental paid		
(d) Foreclosed property and loans acquired	3,314	2,228
(e) Claim payments to lenders	(5,890)	(5,423)
(f) Interest accumulation on the liability balance	(150)	(64)
(g) Other	(134)	2,557
Ending balance of the subsidy cost allowance before reestimates	\$3,000	\$7,886
Add or Subtract subsidy reestimates by component:		
(a) Interest rate reestimate		
(b) Technical/default reestimate	814	(1,796)
Total of the above reestimate components	814	(1,796)
Ending balance of the subsidy cost allowance	\$3,814	\$6,090

K. Administrative Expense (dollars in millions):

	FY 2002	FY 2001
Loan Guarantee Program		
FHA	\$511	\$553
All Other	\$1	\$1
Total	\$512	\$554

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 its 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, all the

department's assets are depreciated over a 4 years 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, 2002 and 2001 (dollars in millions):

<u>Description</u>	FY 2002			FY 2001		
	Cost	Accum Depr and Amortization	Book Value	Cost	Accum Depr and Amortization	Book Value
Furniture, Fixtures, and Equipment	\$ 63	\$ (45)	\$ 18	\$ 55	\$ (32)	\$ 23
Data Processing Software	6	(2)	4	-	-	-
Internal use Software in development	72	(9)	63	58	(8)	50
Other Property Plant and Equipment	2	-	2	-	-	-
Total Assets	\$ 143	\$ (56)	\$ 87	\$ 113	\$ (40)	\$ 73

NOTE 11 – LIABILITIES COVERED AND NOT COVERED BY BUDGETARY RESOURCES

The following shows HUD's liabilities as of September 30, 2002 and 2001, were as follows (dollars in millions):

<u>Description</u>	2002			2001		
	Covered	Not-Covered	Total	Covered	Not-Covered	Total
Intragovernmental						
Accounts Payable	3,096	-	\$ 3,096	\$ 2,046	-	\$ 2,046
Debt	\$ 10,465	\$ 1,212	11,677	7,948	\$ 1,287	9,235
Other Intragovernmental Liabilities	276	4,398	4,674	517	4,424	4,941
Total Intragovernmental Liabilities	\$ 13,837	\$ 5,610	\$ 19,447	\$ 10,511	\$ 5,711	\$ 16,222
Accounts Payable	1,398	-	1,398	1,443	-	1,443
Liabilities for Loan Guarantees	3,814	-	3,814	6,090	-	6,090
Debentures Issued to Claimants	288	-	288	224	-	224
Loss Reserves	539	-	539	536	-	536
Debt	30	2,190	2,220	31	2,465	2,496
Federal Employee and Veteran's Benefits	-	81	81	-	86	86
Other Liabilities	983	64	1,047	1,103	62	1,165
Total Liabilities	\$ 20,889	\$ 7,945	\$ 28,834	\$ 19,938	\$ 8,324	\$ 28,262

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, 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			2,220
Debentures Issued to Claimants			288
Total Debt			<u>\$ 14,185</u>

The following shows HUD borrowings, and borrowings by PHAs/TDHEs for which HUD is responsible for repayment, as of September 30, 2001 (dollars in millions):

<u>Description</u>	<u>Beginning Balance</u>	<u>Net Borrowings</u>	<u>Ending Balance</u>
Agency Debt:			
Held by Government Accounts	\$ 1,431	\$ (1)	\$ 1,430
Held by the Public	3,037	(317)	2,720
Total Agency Debt	<u>\$ 4,468</u>	<u>\$ (318)</u>	<u>\$ 4,150</u>
Other Debt:			
Debt to the U.S. Treasury	\$ 10,979	\$ (3,182)	\$ 7,797
Debt to the Federal Financing Bank	11	(3)	8
Total Other Debt	<u>\$ 10,990</u>	<u>\$ (3,185)</u>	<u>\$ 7,805</u>
Total Debt	<u>\$ 15,458</u>	<u>\$ (3,503)</u>	<u>\$ 11,955</u>
Classification of Debt:			
Intragovernmental Debt			\$ 9,235
Debt held by the Public			2,496
Debentures Issued to Claimants			224
Total Debt			<u>\$ 11,955</u>

Interest paid on borrowings during the year ended September 30, 2002 and 2001, were \$1 billion and \$1.2 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 8.69 percent to 9.17 percent during fiscal year 2002 and 7.44 percent to 9.2 percent for fiscal year 2001.

In fiscal 2002 and 2001, FHA borrowed \$4.2 billion and 1 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 5.47 percent to 7.59 percent during fiscal 2002 and 2001, respectively.

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 2.25 percent to 12.88 percent for both fiscal 2002 and 2001. 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 9.15 percent to 16.18 percent for both fiscal year 2002 and 2001.

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 percent to 12.88 percent for fiscal 2002 and 2001. 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, 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	\$ -	\$ -	\$ -
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
Deposit Funds	-	-	-
Other Liabilities	-	3	3
Total Intragovernmental Liabilities	\$ 4,654	\$ 20	\$ 4,674
Other Liabilities			
FHA Other Liabilities	\$ 11	\$ 189	\$ 200
FHA Escrow Funds Related to Mortgage Notes	-	269	269
FHA Unearned Premiums	381		381
Ginnie Mae Deferred Income	-	65	65
Deferred Credits	-	1	1
Deposit Funds	12	31	43
Accrued Unfunded Annual Leave	64	-	64
Accrued Funded Payroll Benefits	24	-	24
Other	-	-	-
Total Other Liabilities	\$ 5,146	\$ 575	\$ 5,721

The following shows HUD's Other Liabilities as of September 30, 2001 (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	-	\$ -	\$ -
HUD-Section 312 Rehabilitation Program Payable		\$ -	\$ -
Unfunded FECA Liability	-	17	17
Resource Payable to Treasury	\$ 4,407	-	4,407
Miscellaneous Receipts Payable to Treasury	511	-	511
Other Liabilities	-	6	6
Total Intragovernmental Liabilities	\$ 4,918	\$ 23	\$ 4,941
Other Liabilities			
FHA Other Liabilities	\$ 12	\$ 158	\$ 170
FHA Escrow Funds Related to Mortgage Notes	-	163	163
FHA Unearned Premiums	556		556
Ginnie Mae Deferred Income	-	50	50
Deferred Credits	-	4	4
Deposit Funds	34	75	109
Accrued Unfunded Annual Leave	62	1	63
Accrued Funded Payroll Benefits	49	-	49
Other	-	1	1
Total Other Liabilities	\$ 5,631	\$ 475	\$ 6,106

NOTE 14 - LOSS RESERVES

For fiscal years 2002 and 2001, Ginnie Mae established loss reserves of \$539 million and \$536 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, 2002 and 2001, was \$608 billion and \$602 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, 2002 and 2001, was approximately \$568 billion and \$604 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, 2002 and 2001, were \$43.2 billion and \$42.8 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 2002 and 2001, Ginnie Mae issued a total of \$122.2 billion and \$67.4 billion respectively in its multi-class securities program. The estimated outstanding balance at September 30, 2002 and 2001, were \$214.4 billion and 165.6 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, 2002 and 2001, were \$2 billion and 1.9billion, 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 years ended September 30, 2002 and 2001. 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.

A case was filed by owners of 43 multifamily projects regarding alleged breach of owners' mortgage contracts affected by the Emergency Low-Income Housing Preservation Act of 1987 (ELIHPA) and the Low-Income Housing Preservation and Resident Homeownership Act of 1990 (LIHPRHA). The Court of Federal Claims has ruled that the project owners' mortgage contracts had 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.

In April 2000, the Court of Federal Claims held that because plaintiffs had chosen not to pursue their prepayment options through the statutorily required process, their takings claims were not ripe for review. HUD's motion for summary judgment was granted as to both the takings claims and the breach of contract claim; and the complaint was dismissed. On June 23, 2000, plaintiffs in this case filed a notice to appeal to the Federal Circuit. On September 18, 2001, the United States Court of Appeals for the Federal Circuit reversed the Court of Federal Claims decision which had held that plaintiff's taking claims were not ripe for review. The Federal Circuit remanded the case to the Court of Federal Claims to adjudicate the takings claims of the four model plaintiffs and of the owners of the 39 other plaintiff project owners so that, if the factual circumstances of any or all of the remaining owners present a similarly compelling case of administrative futility, the trial court should adjudicate their takings claims, as well.

On December 5, 2001, in the related case, the court granted the Government's motion for summary judgment with respect to plaintiff's taking claims and dismissed the complaint. The Court concluded that the prepayment rights contained in the mortgage loan notes between plaintiffs and their private lending institutions are not properly protected by the Fifth Amendment's Just Compensation Clause.

On January 8, 2002, the court issued an order directing that judgment be entered for the Government based upon the court's opinion issued in the related case of December 5, 2001. The plaintiffs filed their Notice of Appeal on January 11, 2002.

In two-dozen similar ELIPHA/LIHPRHA cases, involving almost 800 project owners nationwide, which were brought between 1987 and 1996, more than a dozen have been dismissed, and the dismissal affirmed or not appealed. As of January 2003, only 9 other cases (involving 199 projects) were still pending.

The United States intends to continue to defend the remaining LIHPRHA cases vigorously. HUD is unable at this time to form a judgment about the likelihood of an unfavorable outcome.

A second case involves a claim filed under the Federal Tort Claims Act by an individual who claims personal injury from mold spores ("black mold") while inspecting a HUD single-family property for possible purchase. The plaintiff alleges that HUD and its agents failed to maintain the property, and

he seeks damages in the amount of \$5 million. HUD has responded to the complaint by denying the claim and asserting its defenses in the case. It will also file a motion to dismiss, or for summary judgment.

The third case involves HUD's termination of six contracts held by a management company because of their failure to properly manage HUD single-family properties. As part of the termination, HUD withheld payment on \$16.5 million of invoices. The company subsequently filed for bankruptcy and also appealed HUD's termination of the contract in the Court of Federal Claims. A tentative settlement has been reached, in which HUD will pay the \$16.5 million to the bankruptcy court for distribution to the company's creditors.

In the fourth case, a contractor alleges that HUD committed breach of contract in regard to an annual financial statements contract that the company held between 1990 and 1994. The Court of Federal Claims dismissed the contractor's initial lawsuit for \$63 million because the company had failed to comply with the Contract Disputes Act by not presenting its claims to the contracting officer before filing the suit.

The contractor then submitted three claims for intellectual property, totaling \$62.5 million, to a HUD Contracting Officer. The Contracting Officer denied all three claims on March 19, 2001. In response, the contractor filed suit once again in the Court of Federal Claims. The discovery period is ongoing. HUD intends to vigorously defend this action.

In all four of the above cases, HUD is unable at this time to make an estimate of the amount or range of potential loss if the plaintiffs should prevail. However, any adverse judgment would be paid out of the permanent indefinite appropriation established by 31 U.S.C. Section 1304 (the Government's Judgment Fund).

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 intermediaries 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 estimate 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, including: 1) program administrator income and rent determinations, 2) tenant reporting of income, and 3) program administrator billings for assistance payments. Error estimates for each of these three components are provided in the captioned sections below, based on year 2000 activity. The baseline estimates for the first two components were completed last year and the preliminary estimates for the third component, billing error, were completed this year. Starting in 2003, HUD intends to perform a single annual measurement of all error components to assess the impact of corrective actions to reduce error.

Program Administrator Income and Rent Determinations

HUD 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 study verified rent calculations for a representative sample of 2,403 households receiving assistance at 600 projects in 2000. The study found that 60 percent of the calculations had some type of administrative or calculation component error contributing to an assistance overpayment or underpayment situation. Errors were considered if they exceeded a \$5 impact threshold on monthly assistance payment amounts. The study projected, with 95 percent confidence, annual assistance overpayments of \$1.669 billion \pm \$251 million and annual assistance underpayments of \$634 million \pm \$151 million, due to errors attributable to program administration.

Tenant Reporting of Income

In developing the estimate of assistance overpayments attributed to tenant underreporting of income, the Department used the same PD&R 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 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 Office of Housing project-based Section 8 assistance, and the other to the Office of Public and Indian Housing's voucher program. The purpose of these reviews was to determine, on a sample basis, whether HUD assistance was 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 below results for each program area are considered preliminary, pending further review and verification of cases for which all required supporting documentation for billings was not readily available to determine the amount of any actual valid assistance payment error. For Public and Indian Housing data, specifically, there is concern about the completeness of the data collected and the validity of the conclusions reached, and additional information is being sought to provide corroboration of the initial review results.

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 is in question because the required supporting documentation was not readily available for review, further review is necessary to determine how much, if any, of this estimate actually represents a valid payment error versus a program administration or record keeping deficiency.

Office of Public and Indian Housing: Assistance underpayments totaled an estimated \$120.9 million and assistance overpayments totaled an estimated \$98.7 million, for a net assistance underpayment estimate of \$22.2 million attributed to billing errors. The 95% confidence interval for these estimates was in the plus/minus \$7 million range. These estimates apply to the 76% of sampled cases with all required supporting documentation available. The extent of actual error on the remaining 24% of sampled cases cannot be substantiated due to documentation issues. These unsupported cases represent an estimated \$1,267 million of assistance. Further review is being undertaken to determine the extent to which these unsupported cases represent any valid payment error versus a valid program administration or record keeping deficiency. It is likely that any actual valid errors associated with these unsupported cases follow the pattern of cases where all documentation was available.

In addition to the discrepancies noted above, on net there appeared to be significant net underpayment to participating private landlords by HUD's program administrators. While this amounted to only about 1 percent of all documented eligible payments, the projected estimates amounted to a total of \$83 million dollars given the program's large size. HUD plans to further review, verify and appropriately address cases of apparent underbilling or underpayment.

Combined Error Impacts

The combined effect of the estimated \$1.669 billion of overpayments and \$634 million of underpayments attributed to program administrator processing errors, plus the \$978 million of overpayments attributed to tenant underreporting of income, yields a gross payment error estimate of \$3.281 billion. Offsetting the overpayment and underpayment error estimates yields a net annual subsidy overpayment estimate of \$2.013 billion, which represents approximately 10.7 percent of the \$18.883 billion in total rental subsidies paid by HUD in fiscal year 2000. Given the preliminary nature of the billing error estimates, HUD has not combined them in the total error estimate at this time. However, HUD plans to provide a single updated combined annual error estimate beginning with 2003 program activity.

Corrective Actions

HUD is taking actions to address the causes of erroneous assistance payments, and is instituting necessary controls 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. 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. This type of secondary impact is desirable, since it better targets assisted housing resources, but reduces potential savings.

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 2002 (dollars in millions):

Budget Functional Classification	Gross Cost	Earned Revenue	Net Cost
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	31,869	19	31,850
Administration of Justice	43	-	43
Miscellaneous	-	-	-
Total with the Public	<u>\$ 35,588</u>	<u>\$ 2,172</u>	<u>\$ 33,416</u>
TOTAL:			
Commerce and Housing Credit	(1,088)	4,011	\$ (5,099)
Community and Regional			
Development	5,723	4	5,719
Income Security	32,369	23	32,346
Administration of Justice	44	-	44
Miscellaneous	-	-	-
TOTAL:	<u>\$ 37,048</u>	<u>\$ 4,038</u>	<u>\$ 33,010</u>

The following shows HUD's total cost and earned revenue by budget functional classification for fiscal 2001 (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	\$ 928	\$ 2,040	\$ (1,112)
Community and Regional			
Development	70	2	68
Income Security	423	12	411
Administration of Justice	-	-	-
Miscellaneous	-	-	-
Total Intragovernmental	<u>\$ 1,421</u>	<u>\$ 2,054</u>	<u>\$ (633)</u>
With the Public:			
Commerce and Housing Credit	\$ (1,607)	\$ 1,575	\$ (3,182)
Community and Regional			
Development	5,354	5	5,349
Income Security	28,743	(130)	28,873
Administration of Justice	37	-	37
Miscellaneous	-	-	-
Total with the Public	<u>\$ 32,527</u>	<u>\$ 1,450</u>	<u>\$ 31,077</u>
TOTAL:			
Commerce and Housing Credit	(679)	3,615	\$ (4,294)
Community and Regional			
Development	5,424	7	5,417
Income Security	29,166	(118)	29,284
Administration of Justice	37	-	37
Miscellaneous	-	-	-
TOTAL:	<u>\$ 33,948</u>	<u>\$ 3,504</u>	<u>\$ 30,444</u>

NOTE 19 – PRIOR PERIOD ADJUSTMENTS

For fiscal year 2002, HUD recorded \$4.8 million in prior period adjustments for Community Planning and Development programs. This adjustment resulted from the liquidation of obligations for fiscal year 2001 expenditures used to cover Section 108(b) Loan Guarantee repayments.

NOTE 20 – APPORTIONMENT CATEGORIES OF OBLIGATIONS INCURRED

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

<u>Fiscal Year</u>	<u>Category A</u>	<u>Category B</u>	<u>Exempt From Apportionment</u>	<u>Total</u>
FY 2002	\$1,227	\$ 56,686	\$ 314	\$ 58,227
FY 2001	\$1,194	\$ 54,814	\$ 340	\$ 56,348

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

At the end of FY 2002, the Statement of Budgetary Resources for FHA reported \$3 million less for obligations incurred than the amount reported in the Budget of the U.S. Government. This difference is due to adjustments relating to claims and contingent liabilities recorded as part of HUD's year-end closing process. At the end of FY 2002, the Statement of Budgetary Resources for the Section 8 Housing Certificate Program reported \$200 million more in recoveries of prior year obligations than the amount reported in the Budget of the U.S. Government. This difference is due to audit adjustments proposed by the OIG related to their review of the Department's unexpended balances as of September 31, 2002. After analysis of the subsidiary records, OCFO reduced the balance of the Department's accounts payable for this program by \$105 million as of September 30, 2002. The one-time adjustment is reported on HUD's Statement of Budgetary Resources as an offsetting collection, but is reported as a non-cash adjustment in the Budget of the U.S. Government. Other HUD grant and loan programs also reported \$150.8 million in expired unobligated balances in the Statement of Budgetary Resources but not in the Budget of the U.S. Government.

For fiscal year 2001, there were differences between the Statement of Budgetary Resources and the Budget of the U.S. Government. These timing differences were related to audit adjustments made subsequent to the 2001 Budget of the U.S. Government submission. These adjustments were included in the 2001 Statement of Budgetary Resources. In addition, other HUD grant and loan programs reported \$144 million in expired unobligated balances in the Statement of Budgetary Resources and the Report on Budget Execution (SF-133) but not in the Budget of the U.S. Government.

**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 and FY 2001, the department reported a net increase in unfunded annual leave liability, in the consolidated Statement of Financing, of \$2.4 million and \$1.4 million, respectively. 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 MAJOR PROGRAM AREA)**

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

	Government Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Developmen t Block Grants	Community Development Home Subsidies	Operating Subsidiaries	Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other 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
Investments (Note 5)	21,346	6,996							28,342
Accounts Receivable (Net) (Note 7)									9
Other Assets (Note 8)	88		6	9	8		35	1	52
Total Intragovernmental Assets	\$31,031	\$9,505	\$1,835	\$13,208	\$4,934	\$1,686	\$9,735	\$7,308	\$10,390
Investments (Note 5)									
Accounts Receivable (Note 7)	331	31	419						1
Credit Program Receivables and Related Foreclosed Property (Note 9)	3,371						4	7,724	280
General Property Plant and Equipment (Note Other Assets (Note 8)	137	10							78
TOTAL ASSETS	\$34,870	\$9,555	\$18,804	\$13,208	\$4,934	\$1,686	\$9,739	\$15,032	\$10,754
LIABILITIES									
Intragovernmental Liabilities									
Accounts Payable	\$3,096		\$0	\$5	\$0	\$0	\$0	\$0	\$0
Debt (Note 12)	7,552					\$1,354	\$2,766	5	11,677
Other Intragovernmental Liabilities (Note 13)			\$239				4,381	253	4,674
Total Intragovernmental Liabilities	\$10,648	\$0	\$239	\$6	\$0	\$1,354	\$7,147	\$258	\$19,447
Accounts Payable	1,196	\$33	7	24	\$8	\$69	29	2	30
Loan Guarantees Liabilities (Note 9)	3,761								53
Debt Held by the Public (Note 12)							2,220		
Federal Employee and Veterans' Benefits (Note Debt Issued to Claimants (Note 12)	288								81
Loss Reserves (Note 14)		539							288
Other Governmental Liabilities (Note 13)	850	65	4	3	1	1	6	16	1,047
TOTAL LIABILITIES	\$16,743	\$637	\$250	\$33	\$9	\$70	\$3,609	\$7,165	\$523
NET POSITION									
Unexpended Appropriations	\$761		\$18,554	\$13,175	\$4,925	\$1,616	\$9,533	\$7,109	\$9,734
Cumulative Results of Operations	17,366	\$8,918					(3,403)	758	497
Total Net Position	18,127	8,918	18,554	13,175	4,925	1,616	6,130	7,867	10,231
Total Liabilities and Net Position	\$34,870	\$9,555	\$18,804	\$13,208	\$4,934	\$1,686	\$9,739	\$15,032	\$10,754

Figures may not add to totals because of rounding.

**Department of Housing and Urban Development
Consolidating Balance Sheet
As of September 2001
(Dollars in Millions)**

	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home Subsidies	Operating Subsidies	Indian Housing Loans and Grants	Public and Elderly and Disabled Grants	Housing for the Elderly and Disabled	All Other Eliminations	Consolidating
ASSETS											
Intragovernmental											
Fund Balance with Treasury (Note 3)	9,443	\$2,043	\$18,041	\$10,149	\$4,669	\$1,829	\$10,270	\$7,065	\$10,439		\$73,948
Investments (Note 5)	17,338	6,641									23,979
Accounts Receivable (Net) (Note 7)	6								8		6
Other Assets (Note 8)	79		3	5	6		11		30		(8)
Total Intragovernmental Assets	\$26,866	\$8,684	\$18,044	\$10,154	\$4,675	\$1,829	\$10,281	\$7,065	\$10,477		(\$100)
Investments (Note 5)											
Accounts Receivable (Note 7)	250	33	391						5		679
Credit Program Receivables and Related											
Foreclosed Property (Note 9)	2,773						5	7,891	280		10,949
General Property Plant and Equipment (Note		8							65		73
Other Assets (Note 8)	125	14							1		140
TOTAL ASSETS	\$30,014	\$8,739	\$18,435	\$10,154	\$4,675	\$1,829	\$10,286	\$14,956	\$10,828		(\$99)

LIABILITIES											
Intragovernmental Liabilities											
Accounts Payable	\$2,046		\$0	\$5	\$0	\$0	\$0	\$0	\$3		(\$8)
Debt (Note 12)	4,544						\$1,430	\$3,253	8		9,235
Other Intragovernmental Liabilities (Note 13)			\$510					4,406	116		(91)
Total Intragovernmental Liabilities	\$6,590		\$510	\$5	\$0	\$0	\$1,430	\$7,659	\$127		(\$99)
Accounts Payable	1,143	\$29	105	39	\$14	\$32	35	9	37		1,443
Loan Guarantees Liabilities (Note 9)	6,053								37		6,090
Debt Held by the Public (Note 12)								2,496			2,496
Federal Employee and Veterans' Benefits											86
Debt Issued to Claimants (Note 12)	224										224
Loss Reserves (Note 14)		536									536
Other Governmental Liabilities (Note 13)	889	50	7	4	1	4	6	24	180		1,165
TOTAL LIABILITIES	\$14,899	\$615	\$622	\$48	\$15	\$36	\$3,967	\$7,692	\$467		(\$99)

NET POSITION											
Unexpended Appropriations	\$2,129		\$17,813	\$10,106	\$4,660	\$1,793	\$10,068	\$6,899	\$9,837	\$0	\$63,305
Cumulative Results of Operations	12,986	\$8,124					(3,749)	365	524		18,250
Total Net Position	15,115	8,124	17,813	10,106	4,660	1,793	6,319	7,264	10,361	0	81,555
Total Liabilities and Net Position	\$30,014	\$8,739	\$18,435	\$10,154	\$4,675	\$1,829	\$10,286	\$14,956	\$10,828		(\$99)

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 2002 and 2001
(Dollars in Millions)**

	Government		Section 8 Rental Assistance	Community Development Block Grants	Home Subsidies	Operating Subsidiaries	Indian Housing Loans and Grants	Public and Housing for the Elderly and Disabled	All Other Eliminations	Consolidating
	Federal Housing Administratio	National Mortgage Association								
2002										
PROGRAM COSTS										
Intragovernmental Gross Costs	\$641		\$53	\$26	\$14	\$33	\$214	\$264	\$213	\$1,458
Less: Intragovernmental Earned Revenue	(1,461)	(\$399)						0	(7)	(1,867)
Intragovernmental Net Costs	(\$820)	(\$399)	\$53	\$26	\$14	\$33	\$214	\$264	\$206	(\$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)	0				(0)	(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	\$33,016
Total Net Costs	(\$3,935)	(\$794)	\$18,474	\$5,443	\$1,551	\$3,699	\$4,252	\$516	\$3,401	\$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	\$33,010

	Government		Section 8 Rental Assistance	Community Development Block Grants	Home Subsidies	Operating Subsidiaries	Indian Housing Loans and Grants	Public and Housing for the Elderly and Disabled	All Other Eliminations	Consolidating
	Federal Housing Administratio	National Mortgage Association								
2001										
PROGRAM COSTS										
Intragovernmental Gross Costs	\$625		\$31	\$33	\$11	\$35	\$204	\$314	\$168	\$1,421
Less: Intragovernmental Earned Revenue	(1,609)	(\$430)							(14)	(2,053)
Intragovernmental Net Costs	(\$984)	(\$430)	\$31	\$33	\$11	\$35	\$204	\$314	\$154	(\$632)
Gross Costs With the Public	(1,703)	73	16,613	4,947	1,425	\$3,112	3,851	784	3,042	32,144
Less: Earned Revenues	(456)	(448)	150					(665)	(31)	(1,450)
Net Costs With the Public	(\$2,159)	(\$375)	\$16,763	\$4,947	\$1,425	\$3,112	\$3,851	\$119	\$3,011	\$30,694
Total Net Costs	(\$3,143)	(\$605)	\$16,794	\$4,960	\$1,436	\$3,147	\$4,055	\$433	\$3,165	\$30,062
Costs Not Assigned to Programs									362	362
Net Cost of Operations	(\$3,143)	(\$605)	\$16,794	\$4,960	\$1,436	\$3,147	\$4,055	\$433	\$3,547	\$30,444

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

	Government Federal Housing Administratio	National Mortgage Association	Section 8 Rental Developmen Assistance Block	Community Development Home	Operating Subsidiaries	Public and Indian Housing Loans and Disabled	Housing for the Elderly and Disabled	All Other Eliminations	Financial Statement Eliminations	Consolidatin
Net Position-Beginning of Period			\$0	\$0	\$0	\$3,749	(\$365)	(\$524)	\$0	(\$18,250)
Prior Period Adjustments (Note 19)			5	5						5
Beginning Balances, As Adjusted			\$0	\$5	\$0	\$3,749	(\$365)	(\$524)	\$0	(\$18,245)
Budgetary Financing Sources										
Other Adjustments (Recissions, etc)										
Appropriations Used	(2,381)		(\$18,391)	(\$5,405)	(\$3,672)	(4,527)	(887)	(3,748)		(40,542)
Transfers In/Out Without Reimbursemen	839									839
Other Budgetary Financing Sources			(83)	(38)	(27)	(71)	(22)	269		8
Other Financing Sources										
Donations and Forfeitures of Property	1,102									865
Transfers In/Out Without Reimbursemen										
Imputed Financing From Costs										
Absorbed From Others	(14)									(73)
Other	9		(5)	(5)				(2)		2
Total Financing Sources	(\$445)		(\$18,474)	(\$5,448)	(\$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	3,804		33,010
Ending Balances	(\$17,366)	(\$8,918)	\$0	\$0	\$0	\$3,403	(\$758)	(\$497)	\$0	(\$24,136)

Unexpended Appropriations

	Government Federal Housing Administratio	National Mortgage Association	Section 8 Rental Developmen Assistance Block	Community Development Home	Operating Subsidiaries	Public and Indian Housing Loans and Disabled	Housing for the Elderly and Disabled	All Other Eliminations	Financial Statement Eliminations	Consolidatin
Net Position-Beginning of Period			(17,813)	(10,106)	(1,793)	(10,068)	(6,899)	(9,837)		(63,305)
Prior Period Adjustments			5	5						5
Beginning Balances, As Adjusted	(\$2,129)		(\$17,813)	(\$10,111)	(\$1,793)	(\$10,068)	(\$6,899)	(\$9,837)		(\$63,310)
Budgetary Financing Sources										
Appropriations Received										
Transfers In/Out	(2,982)		(20,746)	(7,783)	(3,495)	(3,986)	(1,097)	(3,695)		(45,630)
Other Adjustments (Recissions, etc)	1,986			(700)				(6)		1,280
Appropriations Used	(17)		1,614	14	50	56	56	3,748		1,717
Transfers In/Out	2,381		18,391	5,405	3,672	4,521	887	3,748		40,536
Total Financing Sources	\$1,368		(\$741)	(\$3,064)	(\$285)	\$177	\$535	\$103		(\$2,097)
Ending Balances	(\$761)		(\$18,554)	(\$13,175)	(\$4,925)	(\$9,533)	(\$7,109)	(\$9,734)		(\$65,407)

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 2001
 (Dollars in Millions)

Cumulative Results of Operations

2001	Government		Section 8 Rental Developmen t Block Grants	Community Development Block Grants	Home Subsidies	Operating Subsidi es	Public and Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other Eliminations	Financial Statement Consolidatin g
	Federal Housing Administra tion	National Mortgage Association								
Net Position-Beginning of Period			\$0	\$0	\$0	\$0	\$4,090	\$0	(\$494)	(\$13,869)
Prior Period Adjustments										
Beginning Balances, As Adjusted			\$0	\$0	\$0	\$0	\$4,090	\$0	(\$494)	(\$13,869)
Budgetary Financing Sources										
Appropriations Used	(1,371)		(\$16,743)	(\$4,925)	(\$1,418)	(\$3,088)	(4,338)	(772)	(3,578)	(36,233)
Transfers In/Out Without Reimbursemen	318									318
Other Budgetary Financing Sources			(51)	(55)	(18)	(59)	(58)	(26)	260	(7)
Other Financing Sources										
Transfers In/Out Without Reimbursemen	1,384								(204)	1,180
Imputed Financing From Costs										
Absorbed From Others	(15)								(56)	(70)
Other	7									7
Total Financing Sources	\$323	\$0	(\$16,794)	(\$4,980)	(\$1,436)	(\$3,147)	(\$4,396)	(\$798)	(\$3,577)	\$0
Net Cost of Operations	(3,143)	(\$805)	16,794	4,980	1,436	3,147	4,055	433	3,547	0
Ending Balances	(\$12,966)	(\$8,124)	\$0	\$0	\$0	\$0	\$3,749	(\$365)	(\$524)	(\$18,250)

Unexpended Appropriations

2001	Government		Section 8 Rental Developmen t Block Grants	Community Development Block Grants	Home Subsidies	Operating Subsidi es	Public and Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other Eliminations	Financial Statement Consolidatin g
	Federal Housing Administra tion	National Mortgage Association								
Net Position-Beginning of Period			(17,600)	(9,925)	(4,282)	(1,647)	(10,263)	(6,661)	(9,340)	(60,870)
Prior Period Adjustments										
Beginning Balances, As Adjusted	(\$1,152)		(\$17,600)	(\$9,925)	(\$4,282)	(\$1,647)	(\$10,263)	(\$6,661)	(\$9,340)	(\$60,870)
Budgetary Financing Sources										
Appropriations Received	(3,580)		(18,941)	(5,602)	(1,800)	(3,242)	(4,144)	(1,083)	(4,116)	(42,508)
Transfers In/Out	1,245								(6)	1,239
Other Adjustments (Recissions, etc)	(13)		1,965	496	4	8	1	73	47	2,601
Appropriations Used	1,371		16,743	4,925	1,418	3,088	4,338	772	3,578	36,233
Total Financing Sources	(\$977)		(\$213)	(\$181)	(\$378)	(\$146)	\$195	(\$238)	(\$497)	(\$2,435)
Ending Balances	(\$2,129)		(\$17,813)	(\$10,106)	(\$4,660)	(\$1,793)	(\$10,068)	(\$6,899)	(\$9,837)	(\$63,305)

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 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 & Subsidies	Housing for the Elderly and	All Other	2002 Budgetary Total	Federal Housing Administration Non Budgetary Program	Other Non Budgetary Credit Program	2002 Total
Budgetary Resources:												
Budget Authority	\$3,231	\$0	\$20,641	\$7,783	\$1,846	\$3,495	\$4,011	\$1,097	\$3,705	\$3,925	\$0	\$3,925
Net Transfers, Current Year Authority									6			6
Unobligated Balance-Beginning of Year	19,894	8,605	1,685	1,054	284	141	882	2,922	4,174	4,478	59	4,537
Net Transfers, Actual, Prior Year Balance				700					700			700
Spending Authority from Offsetting	7,423	931	105				72	807	943	10,223	14	10,237
Adjustments												
Recoveries of Prior Year Adjustments	25		2,634	9	3	26	42	14	942	50		50
Permanently not available												
Cancellations-Expired and No Year	(4)			(4)					(37)			(45)
Enacted Recissions			(1,588)		(50)				(320)			(1,958)
Capital Trans & Debt Redemption	(2,199)						(90)	(489)	(18)	(916)		(916)
Other Authority Withdrawn			(5,122)				(522)	(73)	(842)			(6,559)
Total Budgetary Resources	\$28,370	\$9,536	\$18,355	\$9,542	\$2,083	\$3,662	\$4,395	\$4,278	\$8,553	\$17,760	\$73	\$17,833
									\$88,774			\$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	\$14,739	\$1	\$14,740
Unobligated Balances Available	625	685	1,685	1,756	256	867	867	2,501	2,692	1,467		1,467
Unobligated Balances Not Available	23,209	9,415	1,282	30	26	26	22	42	1,899	1,554	72	1,626
Total Status of Budgetary Resources	\$28,370	\$9,536	\$18,355	\$9,542	\$2,083	\$3,662	\$4,395	\$4,278	\$8,553	\$17,760	\$73	\$17,833
									\$88,774			\$106,607

Obligated Balance, Net-Beg of Period
Obligated Balance Transferred, Net
Obligated Balance, Net - End of Period

Outlays

Disbursements	4,482	76	18,604	5,429	1,540	3,635	4,566	1,174	4,700	14,657	1	14,658
Collections	(7,535)	(931)	(105)				(72)	(807)	(960)	(10,211)	(15)	(10,226)
Subtotal	(\$3,043)	(\$855)	\$18,499	\$5,429	\$1,540	\$3,635	\$4,494	\$367	\$3,740	\$4,446	(\$14)	\$4,432
Less: Offsetting Receipts	(1,993)								(8)			(2,001)
Net Outlays	(\$5,036)	(\$855)	\$18,499	\$5,429	\$1,540	\$3,635	\$4,494	\$367	\$3,732	\$4,446	(\$14)	\$4,432
									\$31,805			\$36,237

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 2001
(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 &	Housing for the Elderly and	All Other	2001b Budgetary Total	Federal Housing Administration Non Budgetary Program	Other Non Budgetary Program	2001 Total	Total
Budgetary Resources:													
Budget Authority	\$7,734	\$0	\$18,941	\$5,602	\$1,800	\$3,242	\$4,163	\$1,083	\$4,123	\$900	\$0	\$900	\$47,594
Net Transfers, Current Year Authority									6				6
Unobligated Balance-Beginning of Year	19,004	7,839	2,958	903	189	57	1,714	2,876	4,151	4,471	32	4,503	44,194
Spending Authority from Offsetting	5,542	918	(27)	(4)	(1)	(1)	76	793	1,040	12,300	33	12,333	20,670
Adjustments													
Recoveries of Prior Year Adjustments	17		2,583	14	9	3	55	59	535	4		4	3,279
Permanently not available													
Cancellations-Expired and No Year									(42)				(56)
Enacted Recissions	(2)		(1,971)	(490)	(4)	(7)	(48)	(2)	(10)	(3,511)		(3,511)	(2,534)
Capital Trans & Debt Redemption	(1,369)						(94)	(666)	(123)				(5,763)
Other Authority Withdrawn							(584)		(1,130)				(6,863)
Total Budgetary Resources	\$30,926	\$6,757	\$17,327	\$6,024	\$1,990	\$3,293	\$5,288	\$4,143	\$8,550	\$14,164	\$65	\$14,229	\$100,527
Status of Budgetary Resources:													
Obligations Incurred (Note 20)	\$11,032	\$151	\$15,642	\$4,970	\$1,706	\$3,152	\$4,406	\$1,221	\$4,376	\$9,686	\$6	\$9,692	\$56,348
Unobligated Balances Available	1,566		739	1,027	284	138	866	2,946	2,967	2,194	1	2,195	12,628
Unobligated Balances Not Available	18,328	8,606	946	27	3	3	16	76	1,207	2,284	58	2,342	31,551
Total Status of Budgetary Resources	\$30,926	\$6,757	\$17,327	\$6,024	\$1,990	\$3,293	\$5,288	\$4,143	\$8,550	\$14,164	\$65	\$14,229	\$100,527
Obligated Balance, Net-Beg of Period	\$1,233	(963)	\$46,129	\$9,074	\$4,107	\$1,671	\$13,690	\$4,157	\$17,504	\$212	\$0	\$212	\$97,714
Obligated Balance Transferred, Net													
Obligated Balance, Net - End of Period	1,575	(39)	42,495	9,081	4,383	1,683	13,711	4,215	16,886	(98)	(21)	(119)	93,881
Outlays													
Disbursements	10,882	128	16,893	4,939	1,420	3,136	4,331	1,105	4,518	9,947	6	9,953	57,105
Collections	(5,751)	(918)	27		4	1	(77)	(793)	(1,099)	(12)		(12)	(20,873)
Subtotal	\$5,131	(\$790)	\$16,720	\$4,939	\$1,424	\$3,137	\$4,254	\$312	\$3,419	\$8,935	(\$6)	(\$2,314)	\$36,232
Less: Offsetting Receipts	(620)							(6)	(626)				(626)
Net Outlays	\$4,511	(\$790)	\$16,720	\$4,939	\$1,424	\$3,137	\$4,254	\$312	\$3,413	(\$2,308)	(\$6)	(\$2,314)	\$35,606

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 Operating Subsidies	Public and Indian Housing Loans and	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	\$1,827	\$3,636	\$1,735	\$3,963	\$0	\$58,227
Less: Spending Authority from Offsetting Collections & Recoveries	(17,721)	(931)	(2,739)	(9)	(3)	(26)	(821)	(1,889)		(24,263)
Obligations Net of Offsetting Collections	\$1,554	(\$810)	\$13,669	\$7,747	\$1,824	\$3,610	\$914	\$2,064		\$33,964
Less: Offsetting Receipts	(1,933)							(8)		(2,001)
Net Obligations	(\$439)	(\$810)	\$13,669	\$7,747	\$1,824	\$3,610	\$914	\$2,056	\$0	\$31,963
Other Resources										
Donations & Forfeitures of Property	(1,102)							237		(865)
Transfers In/Out Without Reimbursement	14							59		73
Imputed Financing from Costs Absorbed by Others	(9)	16						(1)		6
Net Other Resources Used to Finance Activities	(1,097)	16						(1)		(786)
Total Resources Used to Finance Activities	(\$1,536)	(\$794)	\$13,669	\$7,747	\$1,824	\$3,610	\$914	\$2,351	\$0	\$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	(\$154)		\$4,722	(\$2,337)	(\$293)	\$62	\$1,063	\$1,716		\$4,199
Resources That Fund Expenses from Prior Periods	(6,256)						(\$560)	(3)		(6,261)
Budgetary Offsetting Collections and Receipts	18,656						806	26		19,488
Not Affecting Net Cost of Operations	(10,355)					72		(52)		(10,335)
Resources Financing Acquisition of Assets										
Other Changes to Net Obligated Resources	357		83	33	20	27	22	(263)		4
Net Affecting Net Cost of Operations	\$2,245	\$0	\$4,805	(\$2,304)	(\$273)	\$99	\$680	\$1,424	\$0	\$7,095
Total Resources Used to Finance the Net Cost of Operations	\$710	(\$794)	\$18,474	\$5,443	\$1,551	\$3,699	\$1,162	\$3,775	\$0	\$36,272
Components of Net Cost of Operations										
Not Requiring/Generating Resources in the Current Period:										
Components Requiring or Generating Resources in Future Periods								2		
Resources in Future Periods	1,149									1,149
Increase in Annual Leave Liability (Note 22)										
Increase in Environmental/Disposal Liability										
Reestimates of Credit Subsidy Expense										
Exchange Revenue Receivable from the Public										
Other										
Total Requiring/Generating Resources in Future Periods	\$1,149	\$0	\$0	\$0	\$0	\$0	\$0	2	\$0	\$494
Components Not Requiring/Generating Resources										
Depreciation and Amortization										
Revaluation of Assets or Liabilities										
Other										
Total Components of Net Cost of Operation	(1,275)							13		(1,275)
Total Components of Net Cost of Operations	(4,519)							25		(4,494)
Total Components of Net Cost of Operation Not Requiring/Generating Resources	(\$5,794)	\$0	\$0	\$0	\$0	\$0	\$0	\$38	\$0	(\$5,756)
Total Components of Net Cost of Operations in the Current Period	(\$4,645)	\$0	\$0	\$0	\$0	\$0	(\$646)	\$29	\$0	(\$5,262)
Net Cost of Operations	(\$3,935)	(\$794)	\$18,474	\$5,443	\$1,551	\$3,699	\$4,252	\$3,804	\$0	\$33,010

Figures may not add to totals because of rounding.

**Department of Housing and Urban Development
Consolidating Statement of Financing
For the Year Ended September 2001
(Dollars in Millions)**

	Government	Federal Housing Administration	National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home Operating Subsidies	Indian Housing Loans and Grants	Public and Housing for the Elderly and Disabled	All Other	Financial Statement Eliminations	Consolidating
Resources Used to Finance Activities:											
Obligations Incurred	\$20,718	\$151	\$15,642	\$4,970	\$1,706	\$3,152	\$4,406	\$1,221	\$4,382	\$0	\$56,348
Less: Spending Authority from Offsetting Collections & Recoveries	(17,863)	(918)	(2,556)	(14)	(5)	(2)	(131)	(652)	(1,608)		(23,949)
Obligations Net of Offsetting Collections	\$2,855	(\$767)	\$13,086	\$4,956	\$1,701	\$3,150	\$4,275	\$369	\$2,774		\$32,399
Less: Offsetting Receipts	(620)								(6)		(626)
Net Obligations	\$2,235	(\$767)	\$13,086	\$4,956	\$1,701	\$3,150	\$4,275	\$369	\$2,768	\$0	\$31,773
Other Resources											
Donations & Forfeitures of Property Transfers In/Out Without Reimbursement	(1,384)										(1,180)
Imputed Financing from Costs Absorbed by Others	14										70
Other Resources	(7)	(62)	51	55	18	59	58	26	(261)		(63)
Net Other Resources Used to Finance Activities	(1,377)	(62)	51	55	18	59	58	26	(261)		(1,173)
Total Resources Used to Finance Activities	\$858	(\$829)	\$13,138	\$5,011	\$1,719	\$3,209	\$4,333	\$395	\$2,767	\$0	\$30,600
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	\$81		\$3,654	(\$36)	(\$283)	(\$62)	(\$18)	(\$75)	\$696		\$3,957
Resources That Fund Expenses from Prior Periods	(9,492)			5			6				(9,481)
Budgetary Offsetting Collections and Receipts	17,178							785	118		18,081
Net Affecting Net Cost of Operations	(8,565)						76		(61)		(8,550)
Resources Financing Acquisition of Assets											
Other Changes to Net Obligated Resources	(260)						(\$44)		1		(603)
Net Affecting Net Cost of Operations											
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	(\$1,058)			(\$31)	(\$283)	(\$62)	(\$280)	\$710	\$754	\$0	\$3,404
Total Resources Used to Finance Components of Net Cost of Operations	(\$200)	(\$829)	\$16,791	\$4,980	\$1,436	\$3,147	\$4,053	\$1,105	\$3,521	\$0	\$34,004
Hot Requiring/Generating Resources in the Current Period:											
Components Requiring or Generating Resources in Future Periods											
Increase in Annual Leave Liability (Note 22)											1
Increase in Environmental/Disposal Liability											559
Reestimates of Credit Subsidy Expense	564							(672)	(5)		(677)
Exchange Revenue Receivable from the Public											33
Other											
Total Requiring/Generating Resources in Future Periods	\$564	\$24	\$0	\$0	\$0	\$0	\$0	(\$672)	\$0	\$0	(\$84)
Components Not Requiring/Generating Resources in Future Periods											
Depreciation and Amortization											4
Revaluation of Assets or Liabilities											(1,124)
Other											(2,356)
Total Components of Net Cost of Operation Not Requiring/Generating Resources											\$0
Total Components of Net Cost of Operations in the Current Period	(\$2,943)	\$24	\$3	\$0	\$0	\$0	\$2	\$0	\$26	\$0	(\$3,560)
Net Cost of Operations	(\$3,143)	(\$805)	\$16,794	\$4,980	\$1,436	\$3,147	\$4,055	\$433	\$3,547	\$0	\$30,444

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 2002 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 2002 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 Departmental Automated Audits Management System, this appendix lists the newly developed recommendations resulting from our report on HUD'S fiscal year 2002 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 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 serve as a baseline for implementing corrective action to reduce or eliminate the erroneous payments resulting from intermediary's billings.

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.a. Develop guidance that directs the field offices to document the risk assessments and monitoring strategy plans developed to support resource allocations for conducting on-site monitoring and technical assistance visits. Also, direct that any risk assessment documentation developed be maintained in order to assist in future planning and monitoring efforts.
- 2.b. Develop guidance that directs the field offices to develop individual monitoring plans that identify: high-risk areas, monitoring goals, and objectives for the housing authorities selected for on-site monitoring or technical assistance visits. Also, direct that the field offices use the individual monitoring plans to guide their on-site monitoring efforts.
- 2.c. Develop guidance that directs the field office to maintain the public housing information center (PIC) with complete, consistent, and accurate data on a current basis.
- 2.d. Direct that PIC access protocols be evaluated to eliminate access problems and ensure users full access to PIC.
- 2.e. Develop procedures and protocols for the administrative holding period for newly created PHAS scores that ensures timely release and issuance of the scores.

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.

- 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.

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.a. Ensure that when establishing the settings, for Single Sign On, within the Active Directory, mainframe (to include Top Secret), and Lotus Notes, that the security settings require alphanumeric passwords and prevent users from using their user-ID or name as part of their password.
- 4.b. Provide adequate technical training to the HUD ADP Security group so that the Department is able to monitor contractors' activities.
- 4.c. Develop specific operation and end user procedures for the Top Secret security software.
- 4.d. Ensure system programmers verify the APF libraries' online status when there is a system change or upgrade. This verification should be performed using the CA-Examine tool.
- 4.e. Develop system implementation, installation, maintenance, backup and recovery procedures specifically customized for HUD's information technology environments and needs.

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.

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

- 6.a. Conduct a study to identify and implement the most feasible controls to ensure source/load integrity so that the source and executable versions of the application software are aligned and the correct versions placed in PVCS and production.
- 6.b. Perform a 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.
- 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.
- 6.d. Require all future releases of HUD's Consolidated Financial Statement System (HCFSS) follow the HARTS release process, which include independent testing of the software.
- 6.e. Restrict universal access to all the modules in the UNIX production server for WASS to execute and read only.

We also recommend that the **Chief Financial Officer**:

- 6.f. Ensure that the duties and responsibilities of personnel are properly segregated between the development and Integrated System Test environment under the internet component in LOCCS.

In regard to physical security, we recommend the **Chief Information Officer**:

- 7.a. Proceed with plans to implement an expiring visitor badge system. This would also include developing procedures and training personnel on how to use the product.

With respect to the reportable condition that weak personnel security management continues to pose risks of unauthorized access to the Department's critical financial systems, we recommend that the **Chief Information Officer**:

- 8.a. Enforce current policies that require users requesting above read access to HUD's mission-critical and sensitive systems to submit proper user access forms (HUD Form 22017) before they are allowed access to the systems.
- 8.b. Provide OSEP a list of users with access to HUD's critical (sensitive) systems for the purpose of reconciliation, on a periodic (at least quarterly) basis.
- 8.c. Remove greater-than read access to sensitive systems for users who have not submitted appropriate background investigation documents or who have been terminated or are no longer authorized to access information resources.

We recommend that the Office of Administration:

- 8.d. Conduct a comparison of the access security data provided by the OCIO with the data residing in the personnel security's database on a periodic (at least quarterly) basis and provide OCIO with the results.

With respect to the reportable condition that HUD needs to improve funds control over public housing operating funds, we recommend that the **Assistant Secretary for Public and Indian Housing**:

- 9.a. Maintain an automated system for monitoring operating subsidy eligibility requirements and obligations.

We further 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.

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.a. Deobligate excess unexpended funds identified.
- 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.

- 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.
- 10.d. Strengthen the accounting for the Section 236 IRP program by developing an integrated automated system.

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 Departmental Automated Audits Management System. 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 material weakness that HUD's financial systems are not compliant with Federal financial standards, we recommend that the **Deputy Secretary**:

- 1.a. 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.)

With respect to the 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 May 18, 2002.)

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.)

- 2.b. The Office of Housing should provide written policies and procedures for post payment reviews in the interim period before the automated review process is operational. Appropriate voucher selection methods, i.e. random sampling, and results tracking mechanisms, should be established.

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** in coordination with the appropriate **program offices**:

- 1.a. Review the grant systems, with special emphasis on IDIS, to determine and implement needed system modifications or manual procedures (based upon cost benefits analysis) to properly account for Federal grant transactions. (Final action target date is June 30, 2003.)

We recommend that the **Chief Financial Officer**:

- 1.c. Create the crosswalks in Hyperion to accept GNMA and FHA SGL data. (Final action target date is March 31, 2003.)
- 1.d. Include the GNMA and FHA SGL data with the HUDCAPS/Hyperion load file for automatic generation of HUD's Consolidated Financial Statements. (Final action target date is March 31, 2003.)
- 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 March 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.a. Develop the capability to provide summary reports on the performance, compliance and funding factors that result in the risk rating for the high and medium risk assessment categories in the National Risk Assessment component of the PIC. The identification of the risk factors should assist field offices in determining monitoring strategies and planning monitoring efforts in a more efficient manner. (Final action target date is July 31, 2003.)
- 2.b. Expand the utilization of PIC in management of monitoring and other efforts by developing the capability of all PIH field office staff in the use of the system, and requiring that all field staff use it in the monitoring efforts. (Final action target date is July 31, 2003.)

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.)

With respect to the reportable condition that weak personnel security management continues to pose risks of unauthorized access to the Department's critical financial systems, we recommend that the **Chief Information Officer:**

- 5.c. Provide the Office of Administration with the required quarterly listing of all individuals who have access to mission-critical systems within three working days following the end of each fiscal quarter. The information provided should include Social Security Numbers so that it can be readily reconciled with Office of Human Resource's personnel security database.(Final action target date is January 31, 2003.)

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. 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 FMFIA will report 17 non-conforming systems.

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	21	15
Chief Financial Officer	16	1
Office of Administration	2	0
Office of Public and Indian Housing	2	1
Government National Mortgage Association	3	0
Office of Community Planning and Development	3	0
Real Estate Assessment Center	<u>1</u>	<u>0</u>
	<u>48</u>	<u>17</u>

The following section outlines the Department's plan to correct specific A-127 system non-conformances.

Office of Housing

<u>System</u>	<u>Outstanding Noncompliance Issue @ 09/30/02</u>	<u>Plan @9/30/02</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 <p>Note: The F31 system will be terminated at completion of this phase</p> <p>Long Term: Integrate or replace FHA insurance systems with the FHA subsidiary ledger software to improve accounting and insurance operations</p>	10/2002 12/2004 12/2006	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
F75 Multifamily Claims System	In addition to issues above, <ul style="list-style-type: none"> • Functional requirements • Clear Documentation • Training/User Support 	Convert the system to a web-based platform Completed: Functional Requirements, Clear Documentation and training and user support	09/30/2002 04/01/2002 Actual	FY01-\$456,561 FY02-\$366,000
A56 Mortgage Insurance General Accounting	<ul style="list-style-type: none"> • Classification structure • Integrated FMS • Application of SGL • Federal Accounting Standards • Financial Reporting • Budget Reporting • Functional Requirements • Clear Documentation • Internal Controls • Training/User Support • Maintenance 	Document detailed functional requirements for the new FHA subsidiary ledger system (complete) Determine the best system solution for the new subsidiary ledger system Implement a new FHA general ledger to automate FHA headquarters' funds control processes, financial statement reporting, and updates to the departmental general ledger Terminate A-56 and replace with P013 FHA subsidiary ledger (COTS package)	04/17/00 Actual 09/01/00 Actual 10/02 04/03	FY 00 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
F87	The Office of Housing plans to re-evaluate this	Re-evaluate system deficiencies	FY 2003	To be determined

<u>System</u>	<u>Outstanding Noncompliance Issue @ 09/30/02</u>	<u>Plan @9/30/02</u>	<u>Target date to Complete all Phases</u>	<u>Resources</u>
	system in FY 2002 to identify system deficiencies			

Office of the Chief Financial Officer

<u>System</u>	<u>Outstanding Noncompliance Issue @ 09/30/02</u>	<u>Plan @9/30/02</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 	<p>Develop a statement of work to re-engineer/re-platform LAS</p> <p>Conduct Feasibility Study, Risk Analysis and Cost Benefit Analysis to analyze the options of outsourcing to an external organization, replatforming, re-engineering, or modifying LAS, or purchasing and implementing a COTS package</p> <p>Define requirements</p> <p>Implement a replacement system</p>	<p>11/01 Actual</p> <p>05/02 Actual</p> <p>12/02</p> <p>Dependent upon results from previous task</p>	<p>\$225,779</p> <p>\$220,380</p>

Office of Public and Indian Housing

<u>System</u>	<u>Outstanding Noncompliance Issue @ 09/30/02</u>	<u>Plan @09/30/02</u>	<u>Target date to Complete all Phases</u>	<u>Resources</u>
N07- Regional Operating Budget and Obligations Tracking (ROBOTS)	<ul style="list-style-type: none"> • Integrated financial management system • Functional requirements 	<ul style="list-style-type: none"> • Implement PIH Information Center (PIC) system as the integrated solution for the PIH Operation Fund. • Develop interfaces to capture the eligibility calculation in PIC for transmission to HUDCAPS as an obligation amount and balance obligation between HUDCAPS and PIC • Proposed interface solution eliminates dual data entry of the obligation amount in two systems <ul style="list-style-type: none"> A-1. Complete validation of existing software, procedures guide and training materials A-2. Complete data cleanup of the Op Sub data in the legacy system A-3. Complete analysis and development of the Functional Requirements Documents (FRD) A-4. Complete design, construction, and implementation for Ob. Sub. in PIC A-5. Develop, test, and implement the PIC to HUDCAPS/Datamart interface A-6. Complete PIC training for the PIH/FMD staff A-7. Complete the limited conversion of all data from the legacy system (ROBOTS) 	04/01/03 01/31/03 03/27/02 01/23/02 01/31/03 TBD 01/31/03	

2. Our audit disclosed reportable conditions regarding the security over financial information. Although reportable conditions, 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.¹²

<u>Responsible Office</u>	<u>Nature of the Problem</u>
Office of Housing	<p>(1) Unauthorized access to FHA systems could subject FHA to Privacy Act compliance issues,</p> <p>(2) Applications can be accessed by having physical access to computers</p> <p>(3) Processing cycles among systems are not clearly documented</p> <p>Continuity of use of system is at jeopardy due to lack of documentation</p> <p>The primary cause for these occurrences is that HUD needs to make improvements in the area of ADP system portfolio management, application security, and preparation and maintenance of systems documentation.</p>
Office of Housing	<p>The Cash Control Reporting System (CCARS) security plan does not contain accurate information on the use of system audit trails, and audit trails are not periodically reviewed for the system.</p> <p>A comprehensive risk assessment of the Computerized Homes Underwriting Management System (CHUMS) has not been performed since 1994.</p> <p>The primary cause for this is occurrence is that key database controls are not adequate to provide assurance that computer resources are protected from unauthorized access.</p>
Chief Information Officer	<p>The integrity of software tests can be negatively impacted if the incorrect version of the program is tested.</p> <p>The primary cause for this is that HUD did not require separation of duties among individuals who develop the application software, develop the Integrated System Test environment, and migrate the programs to the test environment.</p>
Chief Information Officer	<p>HUD's mission critical client/server applications continue to be exposed to the risk of unauthorized, deliberate or unintentional, software modifications, which could result in errors, loss of data, or system failure.</p>

¹⁵ The issues are discussed in greater detail in the sections of this report relating to the reportable condition "Controls over HUD's Computing Environment Can be Further Strengthened" and "Weak Personnel Security Practices Continue to Pose Risks of Unauthorized Access to the Department's Critical Financial Systems". Also, KPMG LLP's separate report on their audit of FHA's fiscal year 2002 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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The primary cause is that HUD's configuration management tool, PVCS does not address control issues to:

- ensure source/load integrity,
- remove obsolete modules from the production environment, and
- ensure all modules contained within the production environment are synchronized with those in PVCS.

Chief Information Officer	Unauthorized updates can be made to production modules.
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The primary cause is that HUD did not grant the appropriate access to the authorized users based on their job function.

Chief Information Officer	Failure to correct physical control weaknesses could result in potential temporary or permanent loss of IT system use.
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The primary cause is that HUD is lacking some internal controls over physical security at the HUD Computer Center.

Chief Information Officer	In the wake of a disaster, the continuity of critical applications is jeopardized.
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The primary cause is that major application security plans are submitted without any significant indication of contingency planning or indication of mission-critical status.

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.

Specific recommendations to correct security weaknesses are listed in Appendix B of this report and KPMG LLP's separate report on their audit of FHA's fiscal years 2002 and 2001 financial statements.

Federal Accounting Standards

KPMG LLP reported in a material weakness that FHA does not have a collection of ADP financial systems that are capable of fully monitoring and controlling budgetary resources in an integrated manner. This resulted in a need to:

- Implement 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*).

U.S. Government Standard General Ledger at the Transaction Level

HUDCAPS is the Department's official standard general ledger system. FHA provides consolidated summary level data to HUDCAPS. FHA has 19 subsidiary systems that feed transactions to its commercial general ledger system. These systems lack the capability to process transaction in the SGL format. To provide consolidated summary level data from FHA to HUDCAPS, FHA uses several manual processing steps, including the use of personal computer based software to convert the commercial accounts to government SGL, and transfer the account balances to HUDCAPS. JFMIP requires that the core financial system "...provide for automated month-and year-end closing of SGL accounts and rollover of the SGL account balances". However, as discussed above, the Department is in the process of correcting this nonconformance item with the implementation of the U.S. Standard General Ledger (SGL) and credit reform accounts in the FHA general ledger. This project has a target completion date of 12/2006.

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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>
<i>10.a.</i>			<i>\$1,100,000,000</i>

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, D.C. 20410-0100

JAN 10 2003

CHIEF FINANCIAL OFFICER

MEMORANDUM FOR: Randy McGinnis, Director, Financial Audits Division, GAF

FROM:  Angela M. Antonelli, Chief Financial Officer, F

SUBJECT: Management Comments on OIG's Draft Report on HUD's Fiscal Year 2002
Financial Statements - Internal Control and Compliance Sections

I am writing to provide the Department's official response to the subject draft report, which was provided to us for comment on January 3, 2003. HUD management generally agrees with the substance of the internal control and compliance issues raised in the Office of Inspector General's (OIG) draft report. The attached chart provides our detailed comments on requested corrections, clarifications or changes to the presentation of the OIG's draft finding issues and recommendations. Please consider all the comments in the attached chart as you complete your final audit report.

At this point in the audit process, our only areas of concern pertain to the OIG's intended final reporting on the three subjects for which audit work was not yet complete at the time the draft report was issued: (1) funding recaptures, (2) the footnote disclosure on excess rental housing assistance payments, and (3) performance measures data. We would appreciate an opportunity to review a draft of the OIG's intended final reporting on those matters before your report is completed.

Although your staff has not fully completed their audit work, we are unaware at this time of any audit issues that would preclude the issuance of an unqualified or clean audit opinion on the Department's FY 2002 consolidated financial statements. If a clean opinion is rendered, this will be the third consecutive year that HUD has received a clean opinion—a strong indicator of financial management stability at HUD. Receipt of a clean opinion is important in sustaining confidence in HUD's financial statements for Office of Management and Budget (OMB), Congressional and public users of this information. However, the need for continued progress in resolving remaining material management control weaknesses and reportable conditions associated with our underlying financial management operations is a priority for HUD management.

The directed acceleration of the preparation and audit of HUD's FY 2002 financial statements was a major challenge for the Department. On behalf of the Department, I want to thank you and your audit staff for the collaborative working relationship we experienced in

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pursuing this challenge together. I also commend you on the constructive manner in which the independent audit process was conducted to assist HUD management in validating the effectiveness of our systems of internal control and identifying areas for needed improvement. A positive working relationship between OIG and management will continue to benefit the Department as we face the shared challenge of further acceleration of the preparation and audit of HUD's financial statements in FY 2003 and 2004. I also look forward to your input to the HUD Integrated Financial Management Improvement Project (HIFMIP), particularly as it relates to resolving audit issues on the interpretation and application of financial management systems requirements in a manner that makes optimal business sense for HUD.

If you or your staff has any questions on our comments, please contact De W. Ritchie, Deputy Chief Financial Officer, on (202) 708-1946, extension 2481.

Attachment

No.	Draft Report Reference	Management Comments for OIG's Consideration
1.	Pages 3 - 8, Material Weakness on Financial Management Systems	<p>Management requests reconsideration of the broadly stated nature of this material weakness write-up and the draft report's conclusions that "the Department's financial management systems for FY 2002 remain substantially noncompliant with the Federal financial management systems requirements" and that "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."</p> <p>We agree that the FHA systems are substantially noncompliant, and will be so until FHA's commercial accounting system is replaced with a fully compliant system through the completion of the on-going FHA Subsidiary Ledger Project. However, the basis for OIG's expansion of the noncompliance issue beyond FHA is questioned in that it: 1) is reliant on an interpretation that the systems requirements preclude manual processes from an acceptable single integrated financial management system—a position with which HUD management disagrees, and 2) does not demonstrate a substantive impact in terms of a lack of information necessary to effectively manage the Department as a result of attributed systems deficiencies. With respect to the risk of material misstatements in the financial statements, FHA has received unqualified audit opinions for the past ten years, despite its systems compliance deficiencies, and the Department has received an unqualified opinion the past two years.</p> <p>Further information on management's position on this issue was previously provided to the OIG in management's response to the OIG's initial "Notice of Findings and Recommendations" on this issue, and we request reconsideration of this input.</p>
2.	Pages 4 & 5, Listing of 8 Systems Deficiency Bullets	<p>Management requests that OIG reconsider the nature and significance of each of these draft systems deficiencies and delete from the final report those issues that are process rather than systems issues, or are not substantive concerns in terms of a real impact on HUD management or the accuracy of the financial statements. Of specific concern are the following deficiency bullet points:</p> <p>Bullet No. 1 – This write-up is questioned as both misapplying criteria that allow reasonable manual processes in an acceptable integrated system, and as not demonstrating a substantive adverse impact on the management of the Department or the content of HUD's financial statements.</p> <p>Bullet No. 4 – While this was a problem, the draft indicates it has since been corrected and therefore no longer part of a valid basis for a continuing systems compliance deficiency.</p>

No.	Draft Report Reference	Management Comments for OIG's Consideration
		<p>Bullet No. 5 – Clarification is requested as to whether this is a system or a process issue.</p> <p>Bullet No. 6 - Clarification is requested as to whether this is a system or a process HUD and timing issue.</p> <p>Bullet No. 7 – Reconsideration is requested in that OIG's own finding describes this as a monitoring rather than a systems issue, in that on-site verification of support for payments is what is recommended to verify the propriety of payments.</p> <p>To the extent these are still viewed as systems deficiencies, we request further information as to the nature of the systems revisions needed to effectuate adequate corrective action.</p>
3.	Page 6, "Status of the Department's financial systems remediation plans" 1 st & 2 nd Paragraphs	<p>The first paragraph should recognize that changes in management and administration have been a contributing cause to the delay and redirection of efforts to better integrate HUD's financial management systems.</p> <p>In the second paragraph, the reference to the Deputy Chief Financial Officer should read the "former" Deputy Chief Financial Officer. Also, the statement "That vision statement has since been retracted..." would more correctly read, "That vision statement is under reconsideration by the new administration, as recommended by the OIG."</p>
4.	Page 6, 2 nd Paragraph	The current target contract award date should be revised from February 2003 to May 2003, and the planned completion date for the studies and system decision recommendation is now July 2004, versus the April 2004 date shown in the draft.
5.	Page 6, "Other financial mgmt system deficiencies identified" 1 st Bullet	The inclusion of this first bullet on noncompliance with grants management systems and accounting requirements is inconsistent with the agreed upon resolution of the OIG's initial 2001 audit recommendations on this issue, as further discussed in the middle of page 7 and the top of page 8 of the draft report. HUD continues to believe its established grant accounting practice is acceptable, and that the practice advocated by OIG would be costly to implement and an undue burden on grantees with little to no corresponding benefit to Federal program decision makers. OIG has not demonstrated that any other large grants agency requires the extra reporting from grantees based on OIG's interpretation of the JFMIP requirements. We request that this issue be deleted from the report.
6.	Page 7, 1 st Paragraph	At the end of first paragraph, the current target contract award date should be revised from February 2003 to May 2003, and the planned completion date for the studies and system decision recommendation is now July 2004, versus the April 2004 date shown in the draft report.
7.	Page 8	At the top of the page, the current target contract award date should be revised from February 2003 to May 2003, and the planned completion date for the studies

No.	Draft Report Reference	Management Comments for OIG’s Consideration										
		and system decision recommendation is now July 2004, versus the April 2004 date shown in the draft report.										
8.	Pages 10 - 27, Housing Assistance Program Delivery	Discussion in this section of the draft indicates that the Office of Multifamily Housing (MFH) has both a material weakness involving “Oversight and Monitoring of Subsidy Calculations and Intermediaries Performance” and a reportable condition on “Controls Over Project-Based Subsidy Payments.” Given the draft report’s repeated reference to the need for a “comprehensive plan” to correct all issues in this section (e.g., top of page 24), it seems logical that the reporting of the conditions would likewise recognize the interrelated nature of these issues and combine them into a single material weakness. Therefore, we request that the separate reportable condition on controls over subsidy payments be included as part of the overall material weakness on intermediary oversight and monitoring of subsidy program administration, including verification of the billing/payment cycle.										
9.	Pages 10, 22 and 23	<p>The OIG’s audit approach and discussion regarding MFH monitoring of “Housing Assistance Program Delivery” is on the basis of “project” monitoring, when it is more appropriate to view the monitoring of Housing Assistance Program (HAP) activity in terms of the coverage of “units.” Subsidies are calculated, billed and verified at the unit level and projects vary in size as to the number of units. In considering the positive impacts of the continued roll out of the PBCA program, versus MFH staff monitoring responsibilities, we request that the following information on workload distribution be considered by the OIG:</p> <table data-bbox="462 1192 1274 1690"> <tr> <td>MFH total units as tracked in REMS</td> <td>1.40 million</td> </tr> <tr> <td>MFH units that receive assistance, that are managed by State authorities under non-PBCA contracts</td> <td>.30 million</td> </tr> <tr> <td>MFH units receiving assistance that is not Section 8 HAP related</td> <td>.13 million</td> </tr> <tr> <td>MFH units where projects have been assigned to a PBCA to monitor</td> <td>.65 million</td> </tr> <tr> <td>Balance of Section 8 HAP managed by MFH</td> <td>.32 million</td> </tr> </table> <p>Of this final 0.32 million, about 8 percent of the units are from assisted projects where MFH staff has retained oversight in States that have a PBCA in place. The remaining 0.25 million units are in States where no PBCA is yet assigned. When the PBCA program is completed, and if the 8 percent retention rate continues, the units left receiving assistance that MFH staff would directly monitor would be</p>	MFH total units as tracked in REMS	1.40 million	MFH units that receive assistance, that are managed by State authorities under non-PBCA contracts	.30 million	MFH units receiving assistance that is not Section 8 HAP related	.13 million	MFH units where projects have been assigned to a PBCA to monitor	.65 million	Balance of Section 8 HAP managed by MFH	.32 million
MFH total units as tracked in REMS	1.40 million											
MFH units that receive assistance, that are managed by State authorities under non-PBCA contracts	.30 million											
MFH units receiving assistance that is not Section 8 HAP related	.13 million											
MFH units where projects have been assigned to a PBCA to monitor	.65 million											
Balance of Section 8 HAP managed by MFH	.32 million											

No.	Draft Report Reference	Management Comments for OIG's Consideration
		<p>about 10 percent of the total assisted projects. Using the PBCAs has led to a marked increase in occupancy reviews being conducted and is an annual requirement of the contract. The OIG continues to focus only on the projects that MFH oversees and did not include any reporting of the number of occupancy and management reviews conducted by the PBCAs. The data from REMS that MFH provided to the OIG at the start of this audit indicate that 8,108 management or occupancy reviews were done. Of this, over half were clearly coded as having occupancy work included. Furthermore, the geographic nature of the utilization of the PBCAs is not emphasized. Finally, emphasis on projects instead of units does not give an accurate picture of overall actual MFH oversight.</p>
10.	Page 11, 2 nd Paragraph	<p>The sixth sentence should be revised to read as follows to better reflect the required process: "...receives depend directly on its self-reported and verified income."</p>
11.	Page 12, 2 nd Paragraph, Erroneous Payment Discussion	<p>At the time OIG drafted its report, management had not yet completed its proposed financial statement footnote disclosure on the excess rental housing assistance payments to put the case level details of the initial billing error study in perspective. Now that OIG has been provided with the proposed footnote disclosure, we request that this section of the report be revised for consistency with the information in the proposed footnote, subject to completion of the audit verification. HUD is reporting this initial billing study information as preliminary, pending further verification and validation of the results, which is underway. In light of the context of the footnote disclosure, we request that the last sentence of this paragraph be revised to read as follows: "For the FY 2002 financial statements, HUD expanded its error measurement efforts to include a subsidy billing study. The preliminary estimates from this study have been reflected in HUD's FY 2002 financial statement footnote disclosure, subject to further validation. Preliminary annual billing error estimates were \$3.1 million in net overpayments for project-based assistance programs and \$48 million in net underpayments for tenant-based assistance program activity. However, there is an additional \$1,267 million of estimated payments which are still under review to determine the extent of any actual error, pending further effort to establish the availability of underlying supporting documentation. OIG should not presume that the total amount of these payments represents erroneous subsidy payments. It is likely that associated actual errors follow the pattern of cases where documentation was available. The causes of billing error are being addressed through corrective actions being taken under the Department's RHIP initiative."</p> <p>MFH has learned from the issuance of last year's audit report that MFH industry groups have been confused by the commingling or combining of reporting on the distinctly different MFH and PIH programs. To the extent OIG provides any detailed reporting of the estimated preliminary billing error information in the audit report, it should be consistent with the separate reporting of MFH and PIH program information in the footnote disclosure. HUD will provide a more detailed program-by-program breakout of error estimates in future financial</p>

No.	Draft Report Reference	Management Comments for OIG's Consideration
		statement disclosures.
12.	Page 12, 3 rd Paragraph, Last Sentence	The full title of the HHS database should be reported as the "National Directory of New Hires Database (NDNH)." The last sentence of this paragraph should be rephrased to recognize that: "HUD not only encourages HAs to verify income through computer matching with state wage agencies to detect underreported and unreported income, but HUD/PIH has initiated a program to set up cooperative matching agreements with HUD in every state to assure HAs have this tool to strengthen controls over tenant income reporting."
13.	Page 13, 1 st Paragraph, and Page 15, 2 nd Paragraph	These two sections should be revised to clarify the distinction between HUD's use of IRS/SSA data for the purpose of error measurement estimation, versus the attempted large-scale use of computer matching with this information as an internal control for verifying and correcting income reporting used in subsidy calculations. It should be recognized that HUD might have to continue to use the IRS/SSA data for error measurement purposes if it does not obtain access to a better source of comprehensive income data, such as the HHS National Directory of New Hires database. It should be further recognized that the attempted large-scale computer matching with IRS/SSA income data as a back-end error detection and recovery control process did not prove to be effective, and that this process was discontinued in favor of the pursuit of a more efficient and effective front-end income data sharing model that would eliminate error.
14.	Page 13, 3 rd Paragraph	Reported efforts under the RHIIP initiative do not seem to include the participation and efforts by MFH. For example, at the bottom of page 13 of the report is a fairly detailed discussion of PIH efforts. Please note that MFH has drafted and almost completed clearance on a new occupancy handbook, is just about to put into clearance a guide to assist contract administrators and HUD staff in conducting occupancy reviews, and has conducted training of MFH staff on occupancy issues in FY 2002 with more scheduled for FY 2003.
15.	Page 13, 3 rd Paragraph, Next to Last Sentence	Additional 2002 accomplishments should be recognized as follows: (9) provided basic income/rent training for HUD field staff and contracted resources for additional training and technical assistance for HUD field staff and POAs, (10) developed a legislative proposal for statutory authority to conduct computer matches with the HHS National Directory of New Hires, (11) initiated a nationwide state wage data-sharing project that includes the design of a data system to provide the data to PHAs, (12) developed and provided cost estimates for program simplification proposals as a possible means of reducing error, (13) issued program fact sheets to explain income and rent requirements in the various rental subsidy programs, (14) completed rent calculation pilot project for possible application, and (15) launched a technical assistance contract for HAs whose RIM reviews resulted in serious income/rent errors.
16.	Page 13, Footnote 5	The footnote should be corrected to read: "...unreported and <u>underreported...</u> " (underlining added for emphasis)

No.	Draft Report Reference	Management Comments for OIG's Consideration
	Footnote 5	(underlining added for emphasis)
17.	Page 14, 2 nd Full Paragraph	Throughout the report, references to MTCS should be changed to refer to HUD PIC Form 50058. Also, it should be noted that PIH intends to re-institute a reporting and sanctions policy to assure HA compliance with PIC Form 50058 reporting requirements.
18.	Page 15, Partial Paragraph at Top of Page	This section should be revised in accordance with our above-related comments on "Page 12, 2 nd Paragraph, Erroneous Payment Discussion."
19.	Page 15, 3 rd Paragraph	Delete the third sentence, as this is not a true statement.
20.	Page 16, 1 st Full Paragraph	The second sentence should be deleted as HUD is pursuing authority to obtain and share with intermediaries HHS NDNH data, as a more timely alternative data source to the IRS/SSA data. Any reference to billing errors in this section should be placed in the context of our footnote disclosure, in accordance with earlier comments.
21.	Page 17, 3 rd Paragraph	<p>We request that the entire paragraph be restated as follows to add clarification of the facts of the situation:</p> <p>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. Unlike last year, a manual risk assessment was to be performed because the PIH Information Center (PIC) was unavailable to perform automated assessments due to systemic programming problems. In response to a GAO audit, PIH agreed at the end of FY 2001 to revise the PIC Risk Assessment to flag all Troubled PHAs as "high risk." While the system was off-line for revision, field offices were instructed at the beginning of FY 2002 to use the latest available Risk Assessment data (fourth quarter FY 2001) to conduct a manual risk assessment and monitoring plan until the system became available, which was anticipated to occur no later than December 31, 2001. Because of funding and contracting delays, the revision was not released until May 9, 2002. Field Offices therefore maintained a manual risk assessment for the first three quarters of the fiscal year. In June 2002, field offices were trained on the new Risk Assessment system changes and instructed to begin using the PIC Risk Assessment data to finalize their monitoring plans for the remainder of the fiscal year. We found that two of four field offices tested performed manual risk assessments of 91 of the 192 HAs within their jurisdictions and only scheduled 18 of their 65 high-risk housing authorities for on-site monitoring or technical assistance. The other two field offices reported conducting a modified risk assessment but failed to document the assessment completed. These two field offices scheduled 18 of 75</p>

No.	Draft Report Reference	Management Comments for OIG's Consideration
		high-risk housing authorities for on-site monitoring or technical assistance.
22.	Page 19, 3 rd Paragraph	The second sentence should be corrected from "...1,932 resulted in a failing physical score" to correctly read "...1,841 resulted in a failing physical score."
23.	Page 21, 1 st Full Bullet	<p>The entire bullet should be replaced with the following to better describe this situation:</p> <p>PIH field operations developed a National Risk Assessment Module in PIC that allows PIH to perform quarterly risk assessments of its HAs on a national level. However, the module was not used to conduct risk assessment in FY 2002 of HAs with low-income and tenant-based Section 8 programs because of ongoing system changes. Also, the initial FY 2003 risk assessment runs will be completed without current PHAS and SEMAP data, and the field offices will have to reassess the risk as new quarterly information becomes available and adjust the overall monitoring plan accordingly. In December 2002, PIC Release 4.0 was issued and provided current PHAS and SEMAP scores that will be utilized for all subsequent quarterly assessments.</p>
24.	Pages 25-26, Risks Associated with the Subsidy Payment Process	<p>This discussion in this section relates to assigning the responsibilities of tenant data review from non-performance ACCs to the PB-ACC, and should be revised in consideration of the following:</p> <p>-The last statement on page 25 is incorrect in stating that the FMC will be responsible for the financial management aspects of the ACCs. This is not the case once we assign non-performance based contracts to the PBCAs. PBCAs will be responsible for budgets, year-end settlement statements and payments.</p> <p>-Additionally, on page 26, the narrative refers to the FMC review of vouchers which will not be the case once the Section 8 contracts are assigned to PBCAs who will then be held accountable for voucher review. This paragraph and the others that follow through page 27 specifically refer to the FMC and needs to be rephrased to accurately reflect the activities associated with PBCAs, more specifically the voucher review process of the PBCAs and the tenant file review conducted as part of the annual management review.</p>
25.	Page 26 and Recommendation #3b on Page 55	The OIG comment that authority to suspend payments on contracts that failed to meet tenant data requirements should be transferred to FMC is an issue that needs to be addressed by MFH and FMC as they continue to work together on monitoring payments. A preferable recommendation would be that Housing implements 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.
26.	Page 43, 2 nd Paragraph	Replace the last sentence with:

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	Paragraph	As a result, HUD used a proration level higher than it would have if timely management reports had been available, resulting in a cumulative funding shortfall of approximately \$250 million (\$174 million for fiscal year 2001 and \$75 million for FY 2002).
27.	Page 44, Last Paragraph	<p>Add the following relevant information after the third sentence in this section:</p> <p>HUD informed PHAs in Notice PIH 2001-32 that funds appropriated by Congress were not sufficient to fully fund estimated subsidy requirements for fiscal year 2001; therefore, HUD would fund subsidy requirements for fiscal year 2001 at 99.5 percent of eligibility.</p>
28.	Page 45, 1 st Paragraph	<p>Replace the paragraph with the following:</p> <p>HUD expected that this process would understate the actual amounts due PHAs and year-end reports showed that \$141 million of fiscal year 2001 operating subsidy funds were unobligated and would be carried forward into fiscal year 2002. HUD planned to use the carryover funds to complete the funding cycle for PHAs with fiscal years beginning in 2001 and informed Congress of this intent in its submitted Operating Plan for fiscal year 2002. HUD published Notice PIH 2002-8 in March 2002 informing PHAs that sufficient funds would be available to permit full funding of fiscal year 2002 subsidy requirements. The decision was made without the benefit of management reports showing whether the \$141 million carried over from the previous fiscal year would be sufficient to complete the fiscal year 2001 funding cycle.</p>
29.	Page 45, 2 nd Paragraph	<p>Replace the paragraph with the following:</p> <p>In April 2002, HUD informed the Field Offices that the modifications had been made to ROBOTS so that data entry of actual requirements for fiscal year 2001 could begin. By May 2002, eight months into fiscal year 2002, HUD processed the final 2001 data into ROBOTS. The first management reports were generated showing that the actual eligibility for fiscal year 2001 could be higher than the \$141 million in available funding. HUD continued to refine the revenue shortfall for fiscal year 2001 with a revised final shortfall of \$174 million.</p>
30.	Page 45, 3 rd Paragraph	<p>Replace the paragraph with the following:</p> <p>Furthermore, HUD had not entered the first half of the fiscal year's funding data for fiscal year 2002 into ROBOTS since the system could only accommodate one fiscal year's data at a time. HUD processed Letters of Notification outside the data system to fund fiscal year 2002 operating subsidy eligibility. By August 2002, actual eligibility requirements for the first half of fiscal year 2002 had been entered into ROBOTS. Management reports projected a cumulative funding shortfall of approximately \$250 million (\$174 million for fiscal year 2001 and \$75</p>

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		million for fiscal year 2002).
31.	Pages 45-46, 4 th Paragraph	<p>Replace with the attached reworded paragraph:</p> <p>HUD withheld the obligation of funds for PHAs with fiscal years beginning October 1, 2002. PHAs with fiscal years beginning in January, April, and July 2002, all received 100 percent of their operating subsidy eligibility, however, remaining available fiscal year 2002 operating subsidy funds were insufficient to fund PHAs with fiscal years beginning October 1, 2002 at a 100 percent level. Past program practice in these situations has been for HUD to provide letters-of-intent to selected PHAs at less than full eligibility and then supersede the letter in the next fiscal year at an eligibility amount tied to the same proration level received by the other PHAs. Both Congress and OMB have raised concerns over this practice. We noted in House Committee Report 107-740, dated October 10, 2002, that Congress did not include language in HUD's Appropriations Bill for FY 2003 making operating funds available for two years.</p>
32.	Page 46, HUD Needs to Improve Processes for Reviewing Obligation Balances	<p>Regarding this reportable condition, we have the following comments:</p> <ol style="list-style-type: none"> 1. The draft OIG report makes no mention of changes in Multifamily's procedures for reviewing unliquidated Section 8 balances that were revised in FY 2002 to address issues raised in previous audit reports and approved in June 2002 by the Office of Budget and the OIG. 2. The discussion in the draft report should be redone in view of revised procedures that no longer depend on availability of TRACS data to identify contracts to be reviewed or to determine the amount of recapture. The revised procedures include all contracts in the PAS accounting system (based on data provided by the CFO), assuring that there cannot be any contracts with available budget authority balances omitted from the recapture analysis. 3. The revised procedures for monitoring unliquidated project-based Section 8 balances initiated in FY 2002 address another important issue not specifically cited in previous audit reports--validation of contracts receiving payments. <ol style="list-style-type: none"> a. The prior procedures focused on contracts for which there had not been recent payments, thereby assuming that all contracts receiving payments represent valid obligations. b. In FY 2002, Housing conducted the first of what will become an annual comprehensive review by Multifamily field offices of the validity of all contracts with budget authority balances in the PAS/LOCCS accounting system. c. Actions between annual reviews of valid obligations will include follow-

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		<p>up to ensure that:</p> <ul style="list-style-type: none"> i. questionable contracts are researched and dealt with appropriately; ii. contracts which are no longer active are closed-out in a timely manner, including recapture of any budget authority balances; and iii. discrepancies between the results of the valid obligations review and data in Multifamily systems are identified.
33.	Page 47, Last Paragraph	<p>This section states: "The focus of the review was on obligations with no disbursement activity for six months, which were open as of June 5, 2002." This is not correct. Focus of review was on all obligations that exceeded a \$200,000 balance. This value was agreed to by OCFO and OIG as the value needed to meet the 95 percent threshold.</p>
34.	Page 47, Last Paragraph	<p>This section states: "We found that, as of October 11, 2002, 125 of the 1,094 transactions with obligational authority of \$38 million had not been deobligated in HUDCAPS." OIG needs to be clear that recaptures were executed on ALL obligations identified by program offices, with the exception of CPD, whose procedures require proper closeout documents prior to recapture.</p>
35.	Page 48	<p>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 (p. 48 of draft OIG report). The effort will be made to convert contracts in HUDCAPS to the PAS/LOCCS payment method in FY 2003. If successful and when completed, the conversion will:</p> <ul style="list-style-type: none"> 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. <i>Facilitate timely recapture of expired budget authority for contracts currently in HUDCAPS;</i> 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.

No.	Draft Report Reference	Management Comments for OIG's Consideration
36.	Page 48, 2 nd Paragraph	PIH does not agree with the language that HUD had not reviewed the unexpended obligations. A review was performed as of September 30, 2002 and excess balances were identified. PIH is currently in the process of recapturing the balances but feels the amount will turnout to be less than \$219 million. Additionally, the \$219 million balance identified in the report includes funding increments for projects managed by the Office of Community Planning and Development. Please change the wording accordingly.
37.	Page 55, Recommendation # 1.a.	This recommendation should be addressed to the Assistant Secretary for Public and Indian Housing in coordination with the CFO and PD&R.
38.	Page 56, Recommendation #4.e.	We request that the OIG consider that the Office of Information Technology Operations already has these procedures in place. As previously reported to the OIG, the <i>HUD Computer Center Business Resumption Plan</i> contains backup and recovery procedures for individual systems software. Appendix C contains the Critical Applications Backup and Recovery Procedures. Appendices M through S detail the steps and procedures to recover the mainframes, LAN, HINET and Notes Mail/Client Server environments. When used in conjunction with the HUD Computer Center Standard Operating Procedures (SOPs), this is sufficient to restore the entire IT infrastructure.
39.	Page 57, Recommendation #7.a.	We request that the OIG consider that the Office of Information Technology Operations ordered the badges on November 22nd. The order was shipped on November 24th and we received them before the end of the week. There was a training period to ensure the security guards understood how to use the product. The entire system, including written processes, was put in place on December 15, 2002.
40.	Page 57, Recommendation #8.d.	The Office of Administration has begun a quarterly reconciliation of access security data. The first review, to be completed in January 2003, will compare all employees and contractors with greater than read-only access to HUD's sensitive systems against the database of employees and contractors with background investigations. These reviews will continue, and be completed during the month following the end of the quarter.
41.	Page 57, Recommendation #9.b.	Regarding this recommendation, allotment holders hold the Antideficiency Act responsibility including responsibility for reviewing the validity of the need for outstanding obligations. Notwithstanding, CFO is executing a stronger oversight role in terms of assuring the allotment holder has an adequate funds control plan, and adheres to it.
42.	Pg. 57, Recommendation #10	The lead in to recommendation #10 states: "With respect to the material weakness that HUD needs to improve the process for reviewing obligation balances, ...". This should be changed to correctly reflect that the Obligation review is a Reportable Condition, per page 46, not a Material Weakness.

No.	Draft Report Reference	Management Comments for OIG's Consideration
		Reportable Condition, per page 46, not a Material Weakness.
43.	Page 57, Recommendation # 10.a.	Management concurs with recommendation 10.a. and OCFO will work with PIH and Housing to review the amounts identified by OIG as potential excess commitments or obligations in the Section 236 IRP insured program, the Mod Rehab program, the Rental Assistance and Rent Supplement programs, and the project-based Section 8 program and decommit or deobligate appropriately in FY 2003. OCFO will also work with program offices to improve the recapture process.
44.	Page 57, Recommendation #10.b. and #10.c.	<p>Recommendation 10.b. We have already begun to discuss with Housing how we might do recaptures at the end of the 2nd, 3rd and 4th quarters each year.</p> <p>Recommendation 10.c. We are working with Housing to document the process and are discussing procedures to ensure Section 236 IRP prepayments are recorded timely. We plan to work with OIG auditors this quarter to document the methodology they used to calculate commitments for the insured portfolio talking into consideration the annual reduction in the mortgage insurance premium and then apply that methodology to adjust each project's 2003 beginning balance.</p>
45.	Page 61, Recommendation #1.b.	OIG should remove this from the final report as it was closed in DAAMS subsequent to the drafting of the report based on completed final action.
46.	Page 61, Recommendation #1.c.	Our agreement with OIG is to not create Hyperion crosswalks for GNMA & FHA data for the reasons documented in previous responses, but rather to do what's called for in recommendation 1.d., which we plan to do by 3/31/03.
47.	Page 62, Recommendation #2.a. and #2.b.	OIG should revise the report to indicate the Final Action Target date for both recommendations has been extended in DAAMS to July 31, 2003.

OIG EVALUATION OF AGENCY COMMENTS

This appendix provides our comments on Attachment No. 1 to the Department's February 14, 2002 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 OCFO indicated that the OIG is misinterpreting OMB Circular A-127 requirements which allows manual processing in determining system requirements for an integrated financial system. The OIG's position has never precluded manual processes from an acceptable single integrated financial management system. Rather, our position on this issue is that implementing FFMIA and JFMIP guidance and requirements provide that interfaces must be automated unless the number of transactions is so small that it is not cost-beneficial to automate. The intent of this requirement is to ensure that the design of an integrated financial system eliminates any unnecessary duplicate transaction entries. Automated interfaces provide a more efficient and effective method for transaction processing between applications since there is one point of entry (input) and one exit (output) for transactions. Additionally, automated interfaces reduces the risk of data errors and omissions that are more likely to occur if manual transaction processing is used to process transactions between applications.</p> <p>Both the Department and the FHA rely on the exchange of financial data between FHA and Department systems to support HUD's financial management needs. However, there are no automated interfaces to accomplish these tasks. Several interfaces between HUD's core financial system (HUDCAPS) and FHA's subsidiary ledger are either not automated or require manual analyses, reprocessing and additional entries. This increases the level of manual processing needed to reconcile and monitor these processes and potentially reducing the overall reliability of the financial data. As a result, we could not be assured that HUD can provide reliable and timely financial information for managing current operations and that the risk for material misstatements in the financial statements has been reduced to a relatively low level.</p>
2	Refer to our response in the above section.
3	The report was revised to reflect the changes indicated.
4	The report was revised to reflect the changes indicated.
5	We cannot delete this first bullet from the report. The condition still exists until HUD completes the agreed upon management action targeted for June 30, 2003.
6	The report was revised to reflect the changes indicated.

Comment Number	OIG Evaluation
7	The report was revised to reflect the changes indicated.
8	The Department's comments have been noted, however no changes to the report were made. The "Oversight and Monitoring of Subsidy Calculations Intermediaries Performance" and "Controls Over Project-Based Subsidy Payments" findings identify weaknesses in two separate processes. Therefore, we presented these findings separately.
9	The Department's comments have been noted. We recognize that the percentage of occupancy reviews conducted may change if units instead of projects are measured. In the future, we will consider determining how many units in lieu of projects actually received occupancy reviews.
10	The comment was considered, but verification of income is not a factor in admission of a household to rental assistance programs.
11	The comments were considered and the report was revised accordingly.
12	The comments were considered and the report was revised accordingly, but we were not provided any information during the audit that would substantiate that HUD was attempting to establish matching agreements in every state.
13	The comments were considered and the report was revised accordingly.
14	The information in the report is based on the update provided by the CFO office regarding RHIIP efforts. The comments were considered and the report was revised accordingly.
15	The information in the report is based on the update provided by the CFO office regarding RHIIP efforts. The comments were considered and the report was revised accordingly.
16	The comment was considered and the report was revised accordingly.
17	The comment was considered and the report was revised accordingly.
18	The comments were considered and the report was revised accordingly.
19	The comment was considered and the report was revised accordingly.

Comment Number	OIG Evaluation
20	The comment was considered and the report was revised accordingly.
21	The comments were considered, but information provided during the audit did not substantiate that (1) PIC risk assessment system designates troubled HAs as high risk, (2) the system had to be off-line to make revisions, (3) funding and contracting delays prevented the release of the revisions, (4) the field offices received instructions regarding the risk assessment data, maintained a manual risk assessment, were trained on the new risk assessment system, or instructed to begin using the risk assessment data to finalize their monitoring plans. We did substantiate that the field offices did not always use the risk assessment data, or complete or maintain a manual risk assessment for the first three quarters, or use the risk assessment data to finalize their monitoring plan, but we did substantiate that the data was used to identify HAs for the rental integrity monitoring reviews.
22	The comment was considered, but the information and records provided by REAC supported that there was 1,932 inspections resulted in failing physical scores.
23	The comments were considered, but we did not substantiate that PIH was successful in changing the PIC system, nor have any support that the changes made by PIC release 4.0 provided current PHAS and SEMAP scores.
24	This section of the report is specific to the reviews conducted by the FMC for the Office of Housing. We only mention the PBCAs to show that HUD is reducing the number of HAP contracts HUD administers. It is our understanding that HUD will always administer at least some of the HAP contract portfolio and as contract administrator of those HAPs, HUD needs to improve their current review procedures.
25	The comment was considered and the report was revised accordingly.
26	The comment was considered and the report was revised accordingly.
27	The comment was considered and the report was revised accordingly.
28	The comment was considered and the report was revised accordingly.
29	The comment was considered and the report was revised accordingly.
30	The comment was considered and the report was revised accordingly.
31	The comment was considered and the report was revised accordingly.
32	Audit work in this area was still ongoing at the time our draft report was issued on January 3, 2003. Our draft for this section and the Department's comments are based on prior year

Comment Number	OIG Evaluation
	audit results. The report has been revised to reflect the results of the current year's audit.
33	The comment was considered and the report was revised accordingly.
34	The comments were noted, however no change was made to the report.
35	Audit work in this area was still ongoing at the time our draft report was issued on January 3, 2003. Our draft for this section and the Department's comments are based on prior year audit results. The report has been revised to reflect the results of the current year's audit and the Department's comments.
36	The comments were considered and the report was revised to reflect \$217 million in excess funds related to the Mod Rehab program. The report correctly explains that a review of Mod Rehab recaptures was initiated by an OIG request in December 2002.
37	The recommendation was addressed to the CFO in coordination with program offices to ensure independence and objectivity of the estimate for financial reporting purposes.
38	OIG has taken the Department's response into consideration but our recommendation remains the same. Our review of appendices C and M through S of the <i>HUD Computer Center Business Resumption Plan</i> found that they do not cover the daily operation/maintenance tasks and installation steps customized for HUD. Therefore, BRP documents can not serve as HUD's daily operation/maintenance and installation guides that cover topics such as adding/deleting I/O devices for OS/390; updating software for subsystems such as TSO, JES2, VTAM, CICS, NETVIEW, TMON, etc.; and special cases/fixes. Also, the mention of backup/recovery documentation in this recommendation is not referring to the full backup and recovery of the system. It is in reference to the procedures/steps to bring the system back to normal when there is corruption of system volumes such as spools, JES2, or IPL volumes. In addition, special or isolated incidents and fixes should be documented in the operation guide for future reference. Finally, Appendix O does not provide specific steps to restore DB2, IMS, CICS, MVS and Top-Secret.
39	We have added language to the report section "HUD's Actions Planned and Underway to Improve Controls Over Its Computing Environment" to clarify that the new badge system was implement on December 15, 2002. We will perform a follow-up review of this new system as part of the next audit.
40	We have changed the report section "HUD's Actions Planned and Underway to Correct Personnel Security Weaknesses" to reflect HUD's quarterly reconciliation of access security data.
41	We concur with your statement that HUD allotment holders hold the overall responsibility for the proper management and control of all funds allotted to them, while the Secretary along with the Chief Financial Officer have overall responsibility for establishing an effective administrative control of funds process and monitoring the overall budget formulation and execution process.
42	The report was revised to reflect the changes indicated.

Comment Number	OIG Evaluation
43	HUD's proposed actions agree with our recommendation.
44	HUD's proposed actions agree with our recommendations.
45	This recommendation has been removed.
46	This recommendation remains until the Department completes recommendation 1.d.
47	The report was revised to reflect the changes indicated.

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