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November 15, 2004
Audit Case Number
2005-FO-0002

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

Randy W. McGinnis

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

SUBJECT: Audit of the Federal Housing Administration's Financial Statements for Fiscal Years 2004 and 2003

In accordance with the Government Corporation Control Act as amended (31 U.S.C. 9105), the Office of Inspector General engaged the independent certified public accounting firm of KPMG LLP to audit the fiscal year 2004 and 2003 financial statements of the Federal Housing Administration (FHA). The contract required that the audit be performed according to generally accepted government auditing standards.

KPMG is responsible for the attached auditor's report dated November 8, 2004 and the conclusions expressed in the report. We do not express an opinion on FHA's financial statements or conclusions on FHA's internal controls or compliance with laws and regulations.

This report includes both the Independent Auditors' Report and FHA's principal financial statements. Under Federal Accounting Standards Advisory Board (FASAB) standards a general-purpose federal financial report should include as required supplementary information a section devoted to management's discussion and analysis (MD&A) of the financial statements and related information. The MD&A is not included with this report. FHA plans to separately publish an annual report for fiscal year 2004 that conforms to FASAB standards.

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

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

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KPMG
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Independent Auditors' Report

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

The Federal Housing Administration:

We have audited the accompanying consolidated balance sheets of the Federal Housing Administration (FHA) as of September 30, 2004 and 2003, and the related consolidated statements of net cost, changes in net position and financing, and the combined statements of budgetary resources (hereinafter collectively referred to as consolidated financial statements) for the years then ended. FHA is a wholly owned government corporation within the U.S. Department of Housing and Urban Development (HUD). The objective of our audits was to express an opinion on the fair presentation of these consolidated financial statements. In connection with our audits, we also considered FHA's internal control over financial reporting and tested FHA's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on its consolidated financial statements.

Summary

As stated in our opinion on the consolidated financial statements, we concluded that FHA's consolidated financial statements as of and for the years ended September 30, 2004 and 2003, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

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

- HUD/FHA's Automated Data Processing (ADP) system environment must be enhanced to more effectively support FHA's business and budget processes;
- FHA management must improve its review over the Credit Reform estimation process;
- HUD/FHA should more effectively manage controls over the FHA ADP systems portfolio; and
- FHA must continue to place more emphasis on monitoring lender underwriting, continue to improve early warning processes, and establish effective loan portfolio risk assessment tools for single family insured mortgages.

We consider the first two reportable conditions above to be material weaknesses.

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

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

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of FHA as of September 30, 2004 and 2003, and the related consolidated statements of net cost, changes in net position and financing, and the combined statements of budgetary resources for the years then ended.

In our opinion the consolidated financial statements referred to above present fairly, in all material respects, the financial position of FHA as of September 30, 2004 and 2003, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

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

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

Internal Control Over Financial Reporting

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

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

In our fiscal year 2004 audit, we noted certain matters, summarized below and more fully described in Appendix A, involving internal control over financial reporting and its operation that we consider to be reportable conditions. The full text of management's response is included as Appendix B. Our assessment of management's response is included as Appendix C and the status of prior year internal control findings is included as Appendix D.

We believe the following reportable conditions are material weaknesses:

- **HUD/FHA's ADP system environment must be enhanced to more effectively support FHA's business and budget processes.** HUD/FHA continues to conduct many day-to-day business operations with legacy-based systems, limiting FHA's ability to monitor budget execution. FHA continues to make progress with its financial systems environment. A key improvement made during fiscal year 2003 was the implementation of the FHA Subsidiary Ledger (FHASL) financial system, which automated many previously manual processes used to: (1) consolidate the accounting data received from the various FHA operational legacy systems; and (2) prepare summary entries for posting to the FHASL. During fiscal year 2004, FHA continued the project with the implementation of the Cash Contracts and Funds Control System (CCFC), which is used to provide real-time allocations of expenses to appropriations and general ledger to cash management system reconciliation tools, to facilitate month-end cash reporting. Despite these improvements, significant weaknesses still exist.

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

- **FHA management must improve its review over the Credit Reform estimation process.** During our review of the 2004 Credit Reform estimation cash flow models and related processes, we noted that management did not adequately review the underlying data supporting model assumptions or the cash flow model functionality, leaving material errors in FHA's Mark-to-Market (MTM) Loan Loss Reserve (LLR) and Liability for Loan Guarantee (LLG) claim projections and model calculations. We also noted that the MTM LLR/LLG does not reflect historical claims experience as evidenced by the actual program cash flow data.

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

- **HUD/FHA can more effectively manage controls over the FHA ADP systems portfolio.** During fiscal year 2004 we continued to identify weaknesses related to application security, system support, and the preparation and maintenance of system documentation. For example, we identified certain security and access control weaknesses in the new CCFC system. A key reason why FHA's systems continue to suffer from information security weaknesses is the need for improvement in HUD's overall information security program.
- **FHA must continue to place more emphasis on monitoring lender underwriting, continue to improve early warning processes, and establish effective loan portfolio risk assessment tools for single family insured mortgages.** Proper standards for acceptance of lenders to FHA programs and adherence to FHA underwriting standards are FHA's first line of protection against assuming undue credit risk. Over 95% of FHA's Single Family endorsements are initiated by HUD-approved Direct Endorsement lenders. FHA places significant reliance on the quality of the underwriting performed by these lenders. In an effort to manage the quality of endorsements, both headquarters and the Homeownership Centers conduct quality-assurance activities to assist in determining the adequacy of contractor and lender performance. These processes are intended to ensure that poorly performing lenders are identified and timely corrective action is taken to identify, manage, and account for the credit risk within the portfolio. However, these activities are typically focused on lenders that are already performing poorly as evidenced by their high default and claim rates usually over an eighteen-month period.

While FHA has certain detective controls to assist it in monitoring lender underwriting, we continue to believe that FHA needs to improve its early warning detective controls and risk assessment process to better identify poorly performing lenders earlier in the process and to timely mitigate unplanned risks in its portfolio.

We also noted other matters involving internal control over financial reporting and its operation that we have reported to management of FHA in a separate letter dated November 8, 2004.

Compliance and Other Matters

Our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, as described in the Responsibilities section of this report, disclosed one instance of potential noncompliance that is required to be reported herein under *Government Auditing Standard*s or OMB Bulletin No. 01-02.

The HUD Office of the Chief Financial Officer is currently investigating a potential Anti Deficiency Act violation associated with the commitment limitation for FHA's General Insurance/Special Risk Fund programs during a continuing resolution for fiscal year 2004. Accordingly, no final legal determination has been made at this time.

Responsibilities

Management's Responsibilities

The *Government Corporation Control Act* requires government corporations to submit an annual management report to Congress on its financial status and any other information needed to fairly present its financial position and results of operations.

Management is responsible for the financial statements, including:

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

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

Auditors' Responsibilities

Our responsibility is to express an opinion on the fiscal years 2004 and 2003 consolidated financial statements of FHA based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, and OMB Bulletin No. 01-02. Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit includes:

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

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

In planning and performing our fiscal year 2004 audit, we considered FHA's internal control over financial reporting by obtaining an understanding of FHA's internal control, determining whether internal controls had been placed into operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our audit was not to provide assurance on internal controls over financial reporting. Consequently, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether FHA's fiscal year 2004 consolidated financial statements are free of material misstatement, we performed tests of FHA's compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of consolidated financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 01-02. Our audit procedures were not designed to test the requirements of OMB Bulletin No. 01-02 relating to the *Federal Financial Management Improvement Act* (FFMIA) of 1996, which were not considered applicable at the FHA level. FFMIA requirements will be reviewed and reported by the HUD Office of the Inspector General (OIG) at the HUD consolidated level. We limited our tests of compliance to the provisions described above and we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to FHA. Providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our audit and, accordingly, we do not express such an opinion.

Distribution

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

KPMG LLP

November 8, 2004

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Appendix A

Material Weaknesses and Reportable Conditions

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Material Weaknesses and Reportable Conditions

Introduction

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

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

The following section describes the material weaknesses and the reportable conditions as of and for the year ended September 30, 2004, and our recommendations. FHA management's response, our assessment of that response, and the status of prior year internal control findings are presented in Appendices B, C, and D, respectively.

Material Weaknesses

We noted the following matters during our audit that we consider to be material weaknesses:

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

For many years, weaknesses in FHA's financial management system environment have been reported. A key improvement made during fiscal year 2003 was the implementation of the FHA Subsidiary Ledger (FHASL) financial system. The FHASL automated many previously manual processes used to consolidate the accounting data received from the various program area legacy operating systems. During fiscal year 2004, FHA continued the project by implementing the Cash Contracts and Funds Control System (CCFC), which is used to provide real-time allocations of expenses to appropriations and general ledger to cash management system reconciliation tools to facilitate month-end cash reporting. CCFC replaced the Cash Control Accounting and Reporting System (CCARS), and now also provides functionality that was previously provided by the Credit Subsidy Control System (CSCS). Despite these improvements, significant weaknesses still exist, most notably related to budget execution.

As discussed below, and despite recent progress, HUD/FHA continues to conduct many day-to-day business operations with legacy-based program operating systems, which limits FHA's ability to effectively monitor budget execution related to certain funds control processes.

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FHA is currently unable to efficiently integrate, monitor, and control its budgetary resources at the transaction level. Because of these system weaknesses, FHA relies on certain manual processes and reconciliations of its operational systems to:

- Assess availability of budgetary resources after the disbursement is generated by the program operating system for certification, but prior to the obligation and disbursement of funds. The funds control procedure is performed during the overall disbursement process; however, this system integration weakness limits FHA's ability to associate individual budgetary transactions with the related disbursements;
- Compile the status of budgetary resources to prepare the SF-133, *Report on Budget Execution*;
- Input budgetary entries to the FHASL; and
- Accumulate obligation amounts from the various obligating systems in order to prepare the Statement of Budgetary Resources quarterly and to periodically perform funds control.

Additional control risk is introduced into the budget execution process as a result of applying these manual procedures. The funds control check is done during the same time period when disbursements are certified for payment. Since the disbursement systems are not integrated with FHA's contracting systems, it is not possible for FHA to evaluate net available budgetary resources, including obligations incurred, at the transaction level prior to the disbursement of funds.

The Federal Financial Management Improvement Act of 1996 (FFMIA) and Office of Management and Budget (OMB) Circular A-127, *Financial Management Systems*, call for Federal agencies to conform to functional requirements set forth by the Joint Financial Management Improvement Program (JFMIP). JFMIP, in its *Core Financial System Requirements*, dated November 2001, requires agency core financial systems to support the budget administration and execution process by:

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

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

FHA is continuing to implement a long-term plan, or "blueprint," to improve its financial systems processing environment. The implementation of the FHASL was a key step in this effort. Additional

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planned steps include the replacement of existing stand-alone systems and incorporation of their functions into the FHASL, reengineering of mixed systems to separate program systems, and integrate the financial functionality into the FHASL to improve the interfaces between the FHASL and the remaining program and mixed systems.

Recommendations to address the above include:

1.a. The Deputy Assistant Secretary for Finance and Budget and the HUD OCIO should continue to ensure that the FHASL implementation follows FFMIA requirements and HUD's System Development Life Cycle Methodology.

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

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

(2) FHA Management Must Improve Its Review Over The Credit Reform Estimation Process

The potential future losses related to FHA's central business of providing mortgage insurance are reported in the financial statements as the Liability for Loan Guarantee (LLG) and the Loan Loss Reserve (LLR), as required by Statement of Federal Financial Accounting Standards (SFFAS) No. 2, *Accounting For Direct Loans and Loan Guarantees*. These liabilities are accounted for using both financing and liquidating accounts, respectively, in accordance with the Credit Reform Act of 1990. FHA management uses historical claim rates and other data to annually establish or refine assumptions about future loan performance in order to estimate future losses. These loss estimates are calculated using mathematical models that apply management's assumptions concerning future events to the existing insurance-in-force portfolio.

The Office of Evaluation, under the direction of the Office of Finance and Budget, is the FHA department responsible for developing and maintaining the loss estimation model structure, developing the assumptions used in the models, and performing the loss estimation process.

In developing the fiscal year 2004 Multifamily cash flow models, FHA management identified a project-level data application error in the claims analysis it used to project fiscal year 2003 claims for the Multifamily LLG and LLR in the Mark-To-Market (MTM) risk category. The data mis-application occurred because the claims analysis was double-counting the impact of debt service costs on the net cash flows for individual projects, thereby inappropriately projecting certain projects to go to full or partial claim. Upon further consideration of the data mis-application, FHA found other refinements were necessary in the 2003 claims analysis and cash flow model in order to estimate an appropriate reserve. As a result, the fiscal year 2003 loss reserve was determined to be appropriate, in aggregate.

Effective internal control over the loss estimate process must be present to ensure that the historical data used in the models is complete and accurate; that structural changes to the models' calculator and modifications made to key assumptions used to generate the loss estimates are properly documented; that all underlying data, programmatic changes, and structural modifications to the

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models are adequately reviewed and approved by management; and that the resulting estimates are properly recorded and reported in the financial statements. Pursuant to the Federal Financial Accounting and Auditing Technical Release 6 (TR 6), *Preparing Estimates for Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act, Amendments to Technical Release 3: Preparing and Auditing Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act*, issued January 2004, paragraph 16 states in part "Preparing reliable and timely direct loan and loan guarantee subsidy estimates must be a joint effort between the budget, CFO, and program offices at each agency. These offices should work together to ensure that the procedures and internal control…are implemented and operating as designed." TR 6 goes on to state that "Agencies must accumulate sufficient relevant and reliable data on which to base cash flow projections." Paragraph 20 of TR 6 states, "Documentation must be provided to support the assumptions used by the agency in the subsidy calculations. This documentation will not only facilitate the agency's [management's] review of the assumptions, a key internal control, but it will also facilitate the auditor's review. Documentation should be complete and stand on its own, i.e., a knowledgeable independent person could perform the same steps and replicate the same results with little or no outside explanation or assistance." The guidance requires that the agency maintain the appropriate supporting documentation for key assumptions and that management should ensure that the documentation is available.

In addition, during our review of the fiscal year 2004 LLR/LLG estimates for both the Single Family and Multifamily programs, we noted management assumptions and judgments that were not properly supported by underlying data. As a result, we proposed changes to the original estimates provided to us for our year-end audit work as follows:

- Based on our discussions with management and our independent review of historical data regarding the 2004 Single Family '601' program assumptions, we noted that management was primarily basing its assumptions related to lender participation on "informed opinion" rather than historical data. The 601 program is now in its third year of operation. Management chose to use its judgment in establishing the assumptions for future lender participation, rather than giving greater consideration to actual historical participation data from 2002 and 2003. TR 6, paragraph 18, states in part, "Informed opinion refers to the judgment of agency staff or others who make subsidy estimates based on their programmatic knowledge and/or experience without using a fully satisfactory information store..." Paragraph 18 also states, "Informed opinion may be used only as a last resort when relevant historical data and/or modeling capabilities are not available." Subsequently, FHA made changes to the assumptions in the Single Family LLG cash flow model resulting in a $288 million increase to the liability.

- In conjunction with its review of the 2003 LLR/LLG cash flow models, FHA management made changes to the 2004 MTM LLR/LLG cash flow model. As a result of these refinements, the overall MTM LLR/LLG reserve showed a decrease from 2003 amounting to $1.4 billion, although the MTM loan guarantee portfolio had not significantly changed. Our review of the 2004 cash flow models identified errors in the data and in the model calculation. In addition, during our review of the MTM LLG/LLR reserve, we noted that the 2004 model did not properly reflect the historical experience of the MTM cash flows. As a result, we were unable to rely on the LLR/LLG amounts produced by the MTM cash flow model. Due to this lack of functionality, we applied additional substantive procedures to complete our analysis of the MTM LLR/LLG, which resulted in an increase to the MTM LLR/LLG reserve in the amount of $2.214 billion.

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Recommendations to address the above include:

2.a. The Deputy Assistant Secretary for Finance and Budget should ensure that there is an effective review of the completeness and accuracy of the underlying data supporting the assumptions used in the Single Family and Multifamily cash flow models. The review should be performed in accordance with accounting principles generally accepted in the United States of America and related guidance, to ensure program area assumptions are based on the appropriate combination of actual historical data and management judgment.

2.b. The Deputy Assistant Secretary for Finance and Budget should further develop the process to review the LLR/LLG estimates each year and compare them with actual experience to determine whether projected cash flows are representative of actual cash flows. Significant variances should be investigated.

Reportable Conditions

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

(3) HUD/FHA Can More Effectively Manage Controls Over The FHA ADP Systems Portfolio

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

During fiscal year 2004, in response to prior year audit recommendations, HUD/FHA took several actions to enhance ADP controls over its systems. However, continued improvements are needed in the areas of application security controls, ADP system portfolio management, and systems documentation.

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

- The Underwriting Reporting System (URS) is used as part of an overall process by Single Family Homeownership Center (HOC) personnel and Post Endorsement Technical Review (PETR) contractors to monitor the underwriting performance of lenders with direct endorsement authority. Since fiscal year 2002, we have noted access control weaknesses with the system. Effective access controls for URS are not only critical to ensure data integrity and processing security, but also to ensure compliance with the Privacy Act of 1974. The Privacy Act requires Federal agencies to implement safeguards sufficient to ensure the security and confidentiality of individual records. URS contains sensitive information such as FHA borrower names and addresses and the results of lender reviews. Consequently, unauthorized access to URS could cause FHA to be noncompliant with the Privacy Act. FHA anticipates enhancing URS controls based on the results of a Single Family business process reengineering effort, planned for completion by fiscal year 2006.

Material Weaknesses and Reportable Conditions

- The FHA Connection (FHAC), which is an internet-based system that allows FHA-approved lenders to have real-time access to several of FHA's systems. Specifically, as noted in fiscal year 2003, FHAC password controls and the process for reviewing user accounts should be improved. Details on these weaknesses were provided to FHA management.
- The Lender Approval Subsystem (LASS) is an internet-based system that receives, collects, and scores financial, compliance, and performance-related information of FHA-approved lenders. LASS electronically collects and analyzes financial information for HUD-approved lenders and loan correspondents. During fiscal year 2004 we noted several access control weaknesses with LASS. Details on these weaknesses were provided to FHA management.
- As described earlier in this report, the FHASL is FHA's general ledger system. The FHASL has provided additional functionality to FHA in terms of financial management. However, we have noted information security weaknesses with the FHASL. For example, we noted security weaknesses with CCFC, the FHASL cash management module. Details on the weaknesses were provided to FHA management.
- The Approval, Recertification, and Review Tracking System (ARRTS) is used for tracking incoming application and recertification packages from lenders. ARRTS allows authorized individuals to input and edit information on lender applications, annual recertification and reviews of approved lenders. During fiscal year 2004 we noted information security weaknesses with ARRTS. Details on the weaknesses were provided to FHA management.

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

One of the contributing causes to these issues is that FHA systems have not been consistently incorporated into HUD's security certification and accreditation (C&A) program. This program is designed to ensure that system and application information security controls are in place and operating (certification), and that the appropriate management official has formally accepted any security risks of the system (accreditation). HUD's weaknesses in information security were also emphasized during fiscal year 2004 by the Government Accountability Office (GAO), which reported concerns over the quality and consistency of HUD's C&A program.[1]

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

[1] Information Security – Agencies need to implement consistent processes in Authorizing Systems for operation, June 2004 (GAO-04-376).

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URS is used for key aspects of Single Family lender monitoring and consists of separate databases at each of the four Single Family HOCs. URS is a key element of Single Family processes supported by FHA's Computerized Homes Underwriting Management System (CHUMS). However, URS is not documented as part of the CHUMS security plan, is not integrated with CHUMS, lacks system change control procedures, and lacks sufficient access controls. We first noted issues with URS in fiscal year 2002. FHA has taken no action since that time because URS is being assessed as part of a Single Family business reengineering effort, which will ostensibly incorporate all related systems. One of the goals of this effort is to ensure ADP systems supporting key FHA financial and business processes are adequately supported and included in the HUD OCIO's enterprise architecture and ADP systems portfolio.

Systems documentation. During fiscal year 2004, several HUD/FHA systems, including LASS and the Institution Master File (IMF), lacked system documentation supporting current operations. This documentation is important to HUD/FHA's day-to-day operation and management of systems. In addition, because many HUD/FHA personnel who are knowledgeable about the HUD/FHA systems environment are eligible for retirement in the near future, having fully documented systems is critical to system continuity.

Recommendations to address the above issues include:

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

3.b. The FHA Office of Systems and Technology, in coordination with the HUD OCIO, should ensure that application security controls are enhanced for FHAC to address the identified weaknesses.

3.c. The FHA Lender Approval and Re-certification Division, in coordination with the HUD OCIO, should ensure that application security controls are enhanced for LASS and IMF to address the identified weaknesses.

3.d. The FHASL Project Director, in conjunction with the FHA Office of Financial Analysis and Reporting and HUD OCIO, should ensure that the identified FHASL control weaknesses are addressed.

3.e. The Deputy Assistant Secretaries for Single Family Housing, Multifamily Housing, and Finance and Budget, in coordination with the HUD OCIO, should continue to ensure that as the planned Single Family and Multifamily business process reengineering efforts are performed, key FHA system functionality, such as the functionality currently provided by URS, is addressed.

3.f. The Director of FHA's Office of Systems and Technology and appropriate FHA system owners should continue to coordinate with the HUD OCIO to include all major FHA systems in the HUD C&A program.

Material Weaknesses and Reportable Conditions

(4) FHA Must Continue to Place More Emphasis on Monitoring Lender Underwriting, Continue to Improve Early Warning Processes, and Establish Effective Loan Portfolio Risk Assessment Tools for Single Family Insured Mortgages

Proper standards for acceptance of lenders to FHA programs and adherence to FHA underwriting standards are FHA’s first line of protection against assuming undue credit risk. Over 95% of FHA’s Single Family HUD-approved Direct Endorsement (DE) lenders initiate endorsements. FHA places significant reliance on the quality of the underwriting performed by these lenders. In an effort to manage the quality of endorsements, both headquarters and the HOCs conduct quality-assurance activities to assist in determining the adequacy of contractor and lender performance. These processes are intended to ensure that poorly performing lenders are identified and timely corrective action is taken to identify, manage, and account for the credit risk within the portfolio. However, these activities are typically focused on lenders that are already performing poorly as evidenced by their high default and claim rates usually over an eighteen-month period.

While FHA has certain detective controls to assist in monitoring lender underwriting, we continue to believe that FHA needs to improve its detective controls to assist in better identifying poorly performing lenders earlier in the process. For instance, FHA currently has contractors performing Post Endorsement Technical Reviews (PETR) on 5 to 10% of new endorsements underwritten by DE lenders. The PETR process rates an underwriter’s ability to properly evaluate loan applications. Factors considered by the contractors in determining the rating include the mortgagor’s credit, a valuation of the mortgaged property, and the results of a loan closing package review. Each of these factors is rated as good, fair, or poor. While the PETR process serves to identify certain documentation and processing errors created by the lender, it does not identify risk to the insurance fund as a result of underwriting errors. Therefore, we believe that a revised PETR process would better enable FHA to identify high-risk loans that have a high probability of default or claim.

FHA is currently in the process of developing a revised PETR process that would result in a rating based on the level of risk a loan represents to the portfolio. This revision will enable FHA to separate reportable compliance and documentation issues from those underwriting issues that directly affect the risk of the loan to FHA’s insurance fund. FHA expects to implement the revised PETR process in fiscal year 2005.

FHA does not have a formal process in place to analyze certain loan factors, such as borrower credit scores and qualifying ratios, which would allow it to perform a risk analysis on recently originated loans. Certain factors have been observed that correlate with loan performance, most of which relate to the credit worthiness of borrowers. By analyzing these factors, FHA can identify potentially poor performing lenders and can also use this information to assist in enhancing the predictive precision of the conditional claim rates used in the Liability for Loan Guarantee (LLG) estimation model. Historically, FHA has not had certain data such as the borrower credit scores readily available to perform a more refined risk analysis. In response to this issue, FHA has developed and implemented certain processes and policies that will allow FHA to obtain pertinent information from lenders.

In an effort to improve its early warning and risk assessment process, FHA developed the Technology Open to Approved Lenders (TOTAL) Mortgage Scorecard (the Scorecard) to evaluate the credit risk of FHA loans that are submitted to an automated underwriting system. To underwrite an FHA loan electronically, a mortgagee must process the request through an automated underwriting system that can communicate with the Scorecard. FHA’s Scorecard was deployed in

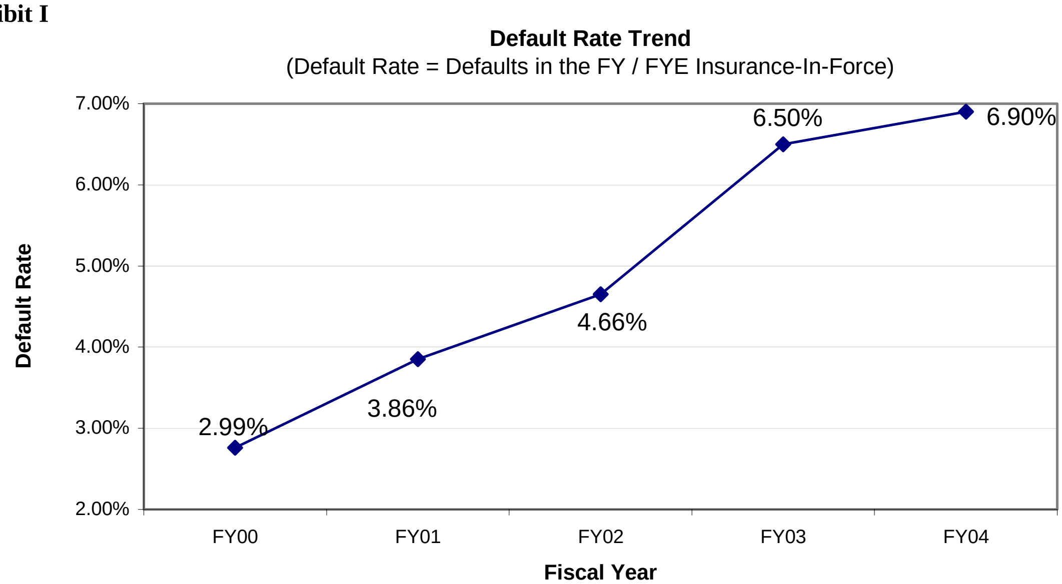
Material Weaknesses and Reportable Conditions

January 2004 and was required for new scores that are originated after May 1, 2004, and all scored loans, including rescorings, after August 1, 2004. The Scorecard captures certain data, such as credit bureau scores, which allows FHA to better evaluate the overall credit risk of mortgages entering its portfolio. This data also allows FHA to examine individual lender portfolios, various product offerings, identify high-risk mortgages, and better estimate default and claim assumptions.

FHA also issued Mortgagee Letter 2004-13, which requires that FHA lenders enter credit bureau scores into CHUMS via FHA Connection for mortgages underwritten without benefit of automated technology. This allows FHA to examine the credit quality of these mortgages with a comparable level of precision as those mortgages scored by the Scorecard. With this information, as well as those mortgages scored through the Scorecard, FHA will be better able to assess the quality of these loans and improve the prediction of default/claim trends through enhanced risk assessments.

A lack of stronger detective (upfront) controls related to early warning has contributed to an increase in the default rate over the past five years. As evidenced in Exhibit I below, FHA's default rates have steadily increased over the last five years from 2.99% in fiscal year 2000 to 6.90% in fiscal year 2004.

Exhibit I



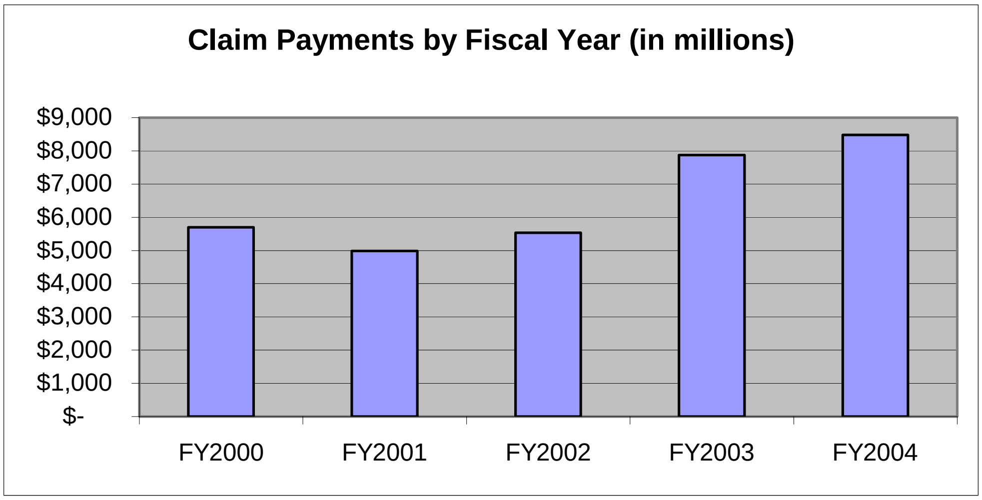
Source: Single Family Data Warehouse

We recognize that economic factors such as home purchase price appreciation and increased unemployment rates have an impact on the default rate; however, changes in underwriting policies may also contribute to the higher default rates.

Material Weaknesses and Reportable Conditions

Default rates are an early indication of potential loan losses. As the default rate has been rising, claims have also increased. Claim payments have been on the rise since fiscal year 2002 as depicted in Exhibit II. Claims increased from $5.5 billion in fiscal year 2002 to $8.5 billion in fiscal year 2004, a 54% increase while insurance-in-force decreased 13% to $430 million during the same period.

Exhibit II



FHA must improve monitoring in order to fully manage the risk in the FHA portfolio, which may serve to minimize unanticipated losses to the fund.

Recommendations to address the above include:

4.a. The Single Family Deputy Assistant Secretary (DAS) should continue to redesign the PETR process as an effective early warning control that better predicts loan performance so that the process can be used as a lender monitoring tool and also as an effective risk assessment tool.

4.b. The Single Family DAS should develop and implement a formal process to analyze certain loan data such as borrower credit scores to better identify high-risk loans and to better monitor the performance of DE lenders. The ability to identify loans with a high risk of default or claim will also assist management in evaluating the claim assumptions used in the LLG estimation model with greater precision.

Appendix B

Management's Response to FHA's Fiscal Year 2004 Audit Report

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

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

November 12, 2004

MEMORANDUM FOR: KPMG LLP

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

SUBJECT: Response to KPMG's Fiscal Year 2004 FHA Audit Report

Federal Housing Administration (FHA) management hereby presents our responses to your, November 12, 2004 audit report on the fiscal year 2004 FHA financial statements prepared in conformity with accounting principles generally accepted in the United States of America.

Report on Internal Controls – Material Weaknesses

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

FHA concurs with this finding and the associated recommendations but submits the following comments for consideration.

FHA continues to make the development of integrated financial systems a high priority. On October 1, 2002, FHA implemented a new transaction-based general ledger, which represented a significant step in addressing this material weakness and ushered in a whole new era for FHA financial systems and reporting. This step inaugurated operation of FHA's new core financial system, the FHA Subsidiary Ledger (FHASL). During FY 2004, FHA successfully integrated the cash management and contract accounting functions into the FHASL and integrated funds control for these functions. In addition, FHA implemented real time automated controls over multifamily insurance commitments and credit subsidy.

Over the next two years, using a phased approach, FHA plans to integrate its remaining 14 legacy systems, including 19 automated financial interfaces, into a single comprehensive FHA core financial system. Integrating the functions of these legacy systems within the FHASL will, among other things, enable FHA to efficiently track obligations and disbursements of funds at the individual transaction level against available budgetary resources.

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

Regarding recommendation 1.b., the Deputy Assistant Secretary for Finance and Budget will ensure that the FHASL project provides the greatest possible automation support to critical FHA financial processes that are currently performed manuallywith special emphasis on budget functions. The FHASL project will continue to implement enhancements to these critical FHA financial processes in steps, in accordance with the FHA Blueprint for Financial Management Systems, so that FHA can realize the benefits of practical improvements in each year of the FHASL project.

In FY 2004, FHA integrated into the FHASL processes for controlling mortgage insurance commitments, credit subsidy obligations, disbursements of FHA funds, and the interim Funds Control Database procedures In November 2004, FHA will integrate automated daily controls for Single Family insurance commitments and credit subsidy in the FHASL. Controls associating the availability of budgetary resources with individual budgetary transactions will be implemented as FHA's existing legacy systems are integrated into the FHASL.

Regarding recommendation 1.c., the Deputy Assistant Secretary for Finance and Budget will ensure that the FHASL project proceeds with system designs and specifications consistent with and supportive of HUD OCIO's IT enterprise architecture. The FHASL project will continue to participate in enterprise architecture as it applies to the FHASL core financial software for all financial operations of the FHA programs. The FHASL project will also continue to support OCIO's enterprise architecture program in planning HUD's application architecture and implementing HUD's future IT infrastructure.

2. FHA Management Must Improve Its Review Over the Credit Reform Estimation Process.

FHA concurs with this finding and associated recommendations with the following comments.

FHA has implemented a process that brings every change to the previous year's cash flow models to the attention of the Deputy Assistant Secretary for Finance and Budget as well as budget, accounting, and program staff. Every modeling change and every assumption used in the models are documented in memoranda and are reviewed with these officials who provide signatures attesting that they participated in the assumption setting process.

In preparing the 2004 cash flow model assumptions for the single family Accelerated Claims Disposition Demonstration program—aka the 601 program, this procedure was followed. Assumptions regarding future program activity were arrived at through a review of historical data and program officials' plans for the future. It is true, as KPMG notes, that "Management chose to use its judgment in establishing the assumptions for future lender participation, rather than giving greater consideration to actual historical participation data from 2002 and 2003." As a new program, 601 activities have increased rapidly with each new round of loan sales. Management believes that actual historical experience alone is not sufficient to predict activity levels likely to be achieved in the future. FHA continues to believe that its original assumptions are still possible with the publication of a regulation making the 601 a permanent program.

Regarding to recommendation 2.a., KPMG states that projections based on historical claims experience would have produced a more accurate estimate of the MTM reserve, but FHA believes that because the MTM program is relatively new and its level of activity has been ramping up, historical performance is unlikely to be highly predictive of future program impacts.

Instead FHA uses audited annual financial statement data on individual eligible properties to estimate the likely financial impact of lowering rents on assisted units to the market rent. Because it examines the financial condition of each property following the rent reduction necessary to reduce the contract rent to the Fair Market Rent, it is more accurate in predicting the future performance of properties under Mark-to-Market treatment than simple projection of past program performance into the future. However, FHA will analyze the results of any predictive models against actual historical performance.

Regarding recommendation 2.b., the configuration management plan establishes a process for documenting all approved changes to the single family and multifamily cash flow models. All assumptions changes or modifications to the cash flow models are documented in memos and submitted to FHA management for sign-off and approval. Only changes that have gone through the configuration management plan, have met all requirements listed in the plan, and have been approved by FHA management are used in the models.

FHA intends to continue to rely upon and to refine this review process in the future.

Report on Internal Controls - Reportable Conditions

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

FHA concurs with this finding and associated recommendations with the following comments.

Regarding recommendation 3.a., the URS is functionally under the overall CHUMS underwriting system. Single Family Housing has begun a comprehensive effort to integrate and modernize all business systems. This effort will implement Single Family Target Enterprise Architecture. Current System Development Methodology tasks underway on the Single Family Integration effort are the Requirements Analysis and Design phases. The high-level business functions for Underwriting and Acquired Assets have also completed Business Process Re-engineering (BPR). The development and integration of a system to support the underwriting business function is one of the first major phases. This phase will address both the functionality and application security controls for the functionality associated with URS.

Regarding recommendation 3.b., the functionality of FHA Connection is included in the effort by Single Family Housing to integrate and modernize all business systems. This effort will implement Single Family Target Enterprise Architecture. Current System Development Methodology tasks underway on the Single Family Integration effort are the Requirements Analysis and Design phases. The high-level business functions for Underwriting and Acquired Assets have also completed Business Process Re-engineering (BPR). The development and integration of a system to support the underwriting business function is one of the first major phases. The functionality associated with the FHA Connection is a key element of this phase. This phase will address both the functionality and application security controls for the functionality associated with URS.

Regarding recommendation 3.c., as with the preceding recommendations, the Single Family Integration effort includes the integration and modernization of all business functionality associated with the LASS and IMF systems. Implementation of appropriate, compliant security controls is part of the overall effort.

Regarding recommendation 3.d., the Deputy Assistant Secretary for Finance and Budget will ensure that the FHASL project reviews existing security procedures and practices to identify improvements necessary to comply with federal and HUD security standards. During FY2004, the FHASL project began a systematic review of security roles and access privileges for all users. During the review, the FHASL project is limiting user access to the functions needed for the business processes each user performs. The FHASL project has already reviewed and adjusted security access for system administration and security administration functions. The FHASL project expects to complete the review for all FHA business areas by June 30, 2005. The FHASL project has implemented all of the security user ID and password controls available in its COTS core financial software, and will be working with HUD's OCIO to reach complete compliance with federal standards on user ID and password security through the application of the Lightweight Directory Access Protocol (LDAP), a HUD-wide single sign-on process. In addition, the FHASL is reviewing business processes in areas requiring separation of duties, such as disbursement verification and certification to ensure adequate internal controls. These reviews will be completed, and corrective business processes will be adopted, by June 30, 2005.

Regarding recommendation 3.e., The FHASL effort is the lead Housing Enterprise Architecture effort and will fully integrate all financial activity in a single compliant environment. This effort builds on extensive Business Process Analysis and Re-engineering. A significant number of independent, and even overlapping, financial systems will be integrated with, and often completely eliminated by, FHASL.

The second major integration and re-engineering effort is Single Family Integration. The Single Family Integration and FHASL efforts are not independent. The FHASL team participates in the Single Family Integration effort. Members of each team are part of the other effort. Both of these endeavors will result in the implementation of the Target Enterprise Architecture for the affected business areas.

The Multifamily efforts represent the third major effort. Work is underway on the Multifamily Target Enterprise Architecture. Multifamily Housing also has a BPR underway for Rental Assistance Housing. This BPR is a cooperative effort including Office of Public and Indian Housing. Another business process engineering effort just starting is the Funding Model Analysis for project based Rental Assistance. Throughout fiscal year 2005, additional elements high level business processes of Multifamily Housing will be added to the review and re-engineering efforts.

The result of these efforts will be the integration and modernization of Housing systems to meet all the business needs. This covers the URS activity related to Single Family underwriting.

Regarding recommendation 3.f. The Office of the Chief Information Officer has completed Certification and Accreditation reviews for 25 active Housing systems. Reviews of the remaining systems will be completed in the first two quarters of fiscal year 2005. The lead for this effort is in the Office of the Chief Information Officer. All housing offices, the system owners and sponsors, as well as staff supporting the IT Capital planning and performance monitoring responsibilities ensure coordination and support for this effort.

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

FHA concurs with these finding and associated recommendations with the following comments.

While FHA will continue to improve its ability to evaluate and manage the risk factors of the loans it insures, it should be noted that the increase the default rate cited in the chart accompanying the audit is a direct function of the decrease in the FHA insurance-in-force as opposed to any increase in actual loans in default which actually were less at the end of FY 2004 than FY 2003.

Regarding recommendation 4.a., the manner in which loans are rated under FHA's Post Endorsement Technical Review (PETR) process and the list of underwriting reason codes will be replaced effective January 1, 2005. The new codes, which refocus the PETR process on risk of a loan to the FHA insurance fund, were developed after a year-long review and analysis by staff at the four Homeownership Centers and FHA headquarters.

The new PETR process will identify risk to the FHA insurance fund. A loan will receive a rating of "acceptable" or "unacceptable" for credit and property underwriting. A rating of "unacceptable" indicates that deficiencies are identified that would make the loan ineligible due to a credit or property issue. This rating directly relates to the risk to the FHA fund because FHA underwriting criteria manages risk for eligible loans. A rating of "acceptable" indicates that no deficiencies were identified that would result in a change to the eligibility determination of the credit or property. Deficiencies in documentation or processing errors may be cited, but such deficiencies and errors did not result in change in eligibility.

During the year-long review process, FHA staff examined 250 existing codes used to define non-compliance and condense them into 70 codes, which focus primarily on risk to the FHA insurance fund. While the review process has been completed, the new PETR process cannot be implemented until changes are programmed into FHA's systems. Systems programming will be completed and the new PETR process will be effective by January 1, 2005.

Regarding recommendation 4.b., FHA has successfully developed and implemented a formal process to analyze certain loan data to better identify high-risk loans and better monitor the performance of DE lenders. In FY 2002, FHA completed the development of a PETR algorithm to identify loans that represent a risk to the FHA fund, based on borrower and loan characteristics. This algorithm includes key qualifying factors and other high-risk indicators. FHA secured funding to program the algorithm into FHA systems, which was completed in February 2004. The final action certification was accepted by OIG and was reported under Audit Number 04FO0001, Recommendation 3A. FHA, by policy, does not use credit scores to unfairly target lenders or loans for review, as described below.

FHA's mission is to serve individuals and families that are underserved by the conventional mortgage market. Through FHA's TOTAL Scorecard, FHA utilizes borrower's credit scores (along with other borrower and loan characteristics) as a tool to help manage FHA's risk to the Mutual Mortgage Insurance (MMI) Fund. However, FHA does not solely rely on a borrower's credit score to determine a loan's risk in the underwriting process because that could lead toward discriminating against the very population that FHA intends to serve. Many lower-income, minority, and first-time home buyers have relatively low credit scores because they have had limited experience using traditional consumer credit – not necessarily because they are not credit worthy.

FHA's TOTAL scorecard recognizes that a low credit score can be partially offset by other factors such as the borrower having higher cash reserves or requesting a loan with less than the maximum loan-to-value ratio. Relying solely on credit scores to determine loan credit eligibility may push potential borrowers into subprime and predatory loans and would lead to a continuing decline in FHA market share. In addition, targeting lenders and loans for review based solely on credit scores would discourage lenders from underwriting loans to borrowers with low credit scores and discourage lenders from participating in FHA programs.

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Appendix C

Assessment of Management's Response

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Assessment of Management's Response

Our Assessment of Management's Response

We obtained written comments on this report from Federal Housing Administration (FHA) management, which is included as appendix B. The following is our assessment of management's response.

Assessment of management's response to material weakness No. 1:

We concur with management's response. FHA is in the process of implementing each of the recommendations specified.

Assessment of management's response to material weakness No. 2:

FHA management concurs with our finding and the related recommendations with reservation. In its response, FHA provided responses to our recommendations in reverse order. FHA labeled its response to our recommendation No. 2.a., with a response that appears to be associated with our recommendation 2.b., and vise versa.

With regard to our reported recommendation No. 2.b., FHA management states that it continues to believe the Multifamily Mark-To-Market (MTM) cash flow model is well structured and incorporates appropriate information to properly predict future claims associated with this risk category. In addition, FHA believes that "because the MTM program is relatively new and its level of activity has been ramping up, historical performance is unlikely to be highly predictive of future program impacts." However, management will in future periods "analyze the results of any predictive models against actual historical performance."

We continue to conclude that the MTM cash flow model does not provide a predictive claim projection result, however, we concur that management must as a final test of any cash flow model's success, analyze the results of the projection in light of the historical data.

With regard to our reported recommendation No. 2.a., FHA management states it intends to continue to use and refine its configuration management plan, in which "All assumptions changes or modifications to the cash flow models are documented in memos and submitted to FHA management for sign-off and approval. Only changes that have gone through the configuration management plan, have met all requirements listed in the plan, and have been approved by FHA management are used in the models."

We encourage FHA management to review all assumption changes or modifications made to the cash flow models, however, the errors noted in the MTM cash flow model during the fiscal year 2004 audit will not be found through management's review of assumption changes or modification alone. FHA management must develop a process to conduct an in-depth review of the cash flow models that will ensure the timely correction of all formulas errors and inaccuracies or duplication of underlying data.

Assessment of Management's Response

Assessment of management's response to reportable condition No. 3:

We concur with management's response. FHA has or is in the process of implementing each of the recommendations specified.

Assessment of management's response to reportable condition No. 4:

FHA management agrees with this finding and our recommendations.

In response to recommendation 4.a., FHA states "the manner in which loans are rated under the Post Endorsement Technical Review (PETR) process and the list of underwriting reason codes will be replaced effective January 1, 2005." FHA management believes the new codes will refocus the PETR process on risk to FHA's Mutual Mortgage Insurance Fund. We encourage the development of this new risk focused modification.

In response to our recommendation No. 4.b., FHA management believes that the implementation of the PETR algorithm in February 2004, which it states was developed to identify high-risk loans, includes key qualifying factors and other high-risk indicators to monitor Direct Endorsement (DE) lenders.

Although the algorithm may identify certain loan characteristics that imply higher risk, we do not believe FHA is successfully monitoring DE lender performance. PETR reviews are intended to identify certain documentation and processing errors created by the lender, however it does not identify risk to the insurance fund as a result of underwriting errors. Therefore, we believe the next step in the PETR process development must be to improve FHA's response to the PETR results to ensure DE lenders timely modify poor endorsement practices.

Appendix D

Status of Prior Year Internal Control Findings Reported

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Appendix D

Status of Prior Year Internal Control Findings Reported

Fiscal Year 2003 Finding	***Type***	***Fiscal Year 2004 Status***
1. HUD/FHA's ADP system environment must be enhanced to more effectively support FHA's business and budget processes.	2003 – Material Weakness 2004 – Material Weakness	**1. HUD/FHA's ADP system environment must be enhanced to more effectively support FHA's business and budget processes.** HUD/FHA continues to conduct many day-to-day business operations with legacy-based systems, limiting FHA's ability to monitor budget execution. FHA continues to make improvements with its financial systems environment. A key improvement made during fiscal year 2003 was the implementation of the FHA Subsidiary Ledger (FHASL) financial system, which automated many previously manual processes used to: (1) consolidate the accounting data received from the various FHA operational legacy systems; and (2) prepare summary entries for posting to the FHASL. During fiscal year 2004, FHA continued the project with the implementation of Cash Contracts and Funds Control System (CCFC), which is used to provide real-time allocation of expenses to appropriations and general ledger to cash management system reconciliation tools to facilitate month end cash reporting. Despite these improvements, significant weaknesses still exist. FHA plans to fully address this material weakness by performing reengineering efforts for the Single Family and Multifamily operational systems and related business processes and by building additional automated interfaces from the operational systems to the FHASL. These system enhancements will also allow FHA to better monitor its budgetary execution process. FHA plans to fully complete these efforts by fiscal year 2007.

Status of Prior Year Internal Control Findings Reported

Fiscal Year 2003 Finding	*Type*	*Fiscal Year 2004 Status*
2. HUD/FHA can more effectively manage controls over the FHA ADP systems portfolio.	2003 – Reportable Condition 2004 – Reportable Condition	**2. HUD/FHA can more effectively manage controls over the FHA ADP systems portfolio.** During fiscal year 2004 we continued to identify weaknesses related to application security, system support, and the preparation and maintenance of system documentation. A key reason why FHA's systems continue to suffer from information security weaknesses is the need for improvement in HUD's overall information security program.
3. FHA must place more emphasis on monitoring lender underwriting and continue to improve early warning and loss prevention for Single Family insured mortgages.	2003 – Reportable Condition 2004 – Reportable Condition	**3. FHA must continue to place more emphasis on monitoring lender underwriting, continue to improve early warning processes, and establish effective loan portfolio risk assessment tools for single family insured mortgages.** Proper standards for acceptance of lenders to FHA programs and adherence to FHA underwriting standards are FHA's first line of protection against assuming undue credit risk. Over 95% of FHA's Single Family endorsements are initiated by HUD-approved Direct Endorsement lenders. FHA places significant reliance on the quality of the underwriting performed by these lenders. In an effort to manage the quality of endorsements, both headquarters and the Homeownership Centers conduct quality-assurance activities to assist in determining the adequacy of contractor and lender performance. These processes are intended to ensure that poorly performing lenders are identified and timely corrective action is taken to identify, manage, and account for the credit risk within the portfolio. However, these activities are typically focused on lenders that are already performing poorly, as evidenced by their high default and claim rates usually over an eighteen-month period.

Appendix D

Status of Prior Year Internal Control Findings Reported

Fiscal Year 2003 Finding	***Type***	***Fiscal Year 2004 Status***
		While FHA has certain detective controls to assist it in monitoring lender underwriting, we continue to believe that FHA needs to improve its early warning detective controls and risk assessment process to better identify poorly performing lenders earlier in the process and to timely mitigate unplanned risks in its portfolio.

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PRINCIPAL FINANCIAL STATEMENTS

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FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED BALANCE SHEETS
As of September 30, 2004 and 2003
(Dollars in Millions)

	2004	2003
ASSETS		
Intragovernmental		
Fund Balance with U.S. Treasury (Note 3)	$ 7,898	$ 7,934
Investments (Note 4)	23,430	23,982
Other Assets (Note 7)	64	57
Total Intragovernmental	31,392	31,973
Investments (Note 4)	122	123
Accounts Receivable, Net (Note 5)	234	152
Loans Receivable and Related Foreclosed Property, Net (Note 6)	3,947	4,291
Other Assets (Note 7)	120	130
TOTAL ASSETS	**$ 35,815**	**$ 36,669**
LIABILITIES		
Intragovernmental		
Borrowings from U.S. Treasury (Note 9)	$ 7,635	$ 8,794
Other Liabilities (Note 10)	627	1,511
Total Intragovernmental	8,262	10,305
Accounts Payable (Note 8)	533	869
Loan Guarantee Liability (Note 6)	5,074	6,251
Debentures Issued to Claimants (Note 9)	187	270
Other Liabilities (Note 10)	590	739
TOTAL LIABILITIES	**14,646**	**18,434**
NET POSITION		
Unexpended Appropriations (Note 16)	699	576
Cumulative Results of Operations	20,470	17,659
TOTAL NET POSITION	**21,169**	**18,235**
TOTAL LIABILITIES AND NET POSITION	**$ 35,815**	**$ 36,669**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF NET COST
For the years ended September 30, 2004 and 2003
(Dollars in Millions)

	2004	2003
MMI/CMHI PROGRAM COSTS		
Intragovernmental Gross Costs (Note 12)	$ 631	$ 583
Less: Intragovernmental Earned Revenue (Note 13)	1,459	1,312
Intragovernmental Net Costs	(828)	(729)
Gross Costs with the Public (Note 12)	(436)	3,679
Less: Earned Revenue from the Public (Note 13)	64	445
Net Costs with the Public	(500)	3,234
NET MMI/CMHI PROGRAM COST (SURPLUS)	**$ (1,328)**	**$ 2,505**
GI/SRI PROGRAM COSTS		
Intragovernmental Gross Costs (Note 12)	$ 88	$ 131
Less: Intragovernmental Earned Revenue (Note 13)	93	106
Intragovernmental Net Costs	(5)	25
Gross Costs with the Public (Note 12)	(231)	(941)
Less: Earned Revenue from the Public (Note 13)	186	505
Net Costs with the Public	(417)	(1,446)
NET GI/SRI PROGRAM COST (SURPLUS)	**$ (422)**	**$ (1,421)**
NET COST (SURPLUS) OF OPERATIONS	**$ (1,750)**	**$ 1,084**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF CHANGES IN NET POSITION
For the years ended September 30, 2004 and 2003
(Dollars in Millions)

	2004 Cumulative Results of Operations	2004 Unexpended Appropriations	2003 Cumulative Results of Operations	2003 Unexpended Appropriations
BEGINNING BALANCES	**$ 17,659**	**$ 576**	**$ 17,366**	**$ 761**
BUDGETARY FINANCING SOURCES				
Appropriations Received (Note 16)	$ -	$ 2,023	$ -	$ 2,402
Other Adjustments (Note 16)	-	(4)	-	(10)
Appropriations Used (Note 16)	1,812	(1,812)	2,258	(2,258)
Transfers-Out (Notes 15 and 16)	(555)	(84)	(756)	(319)
OTHER FINANCING SOURCES				
Transfers-Out (Note 15)	(208)	-	(138)	-
Imputed Financing (Note 12)	14	-	16	-
Other (Note 15)	(2)	-	(3)	-
TOTAL FINANCING SOURCES	**$ 1,061**	**$ 123**	**$ 1,377**	**$ (185)**
NET (COST) SURPLUS OF OPERATIONS	**$ 1,750**	-	**$ (1,084)**	-
ENDING BALANCES	**$ 20,470**	**$ 699**	**$ 17,659**	**$ 576**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
COMBINED STATEMENTS OF BUDGETARY RESOURCES
For the years ended September 30, 2004 and 2003
(Dollars in Millions)

	2004 Budgetary	2004 Non-Budgetary	2003 Budgetary	2003 Non-Budgetary
BUDGETARY RESOURCES (Note 17)				
Budget Authority:				
Appropriations	$ 2,023	$ -	$ 2,402	$ -
Borrowing Authority	130	3,400	205	2,890
Unobligated Balance Carried Forward	27,111	1,061	23,834	3,021
Spending Authority from Offsetting Collections:				
Earned				
Collected	4,432	17,303	6,569	12,549
Receivable from Federal Sources	(29)	119	7	(158)
Unfilled Customer Orders	-	5	-	-
Recoveries of Prior Year Obligations	36	12	510	77
Permanently Not Available	(298)	(4,559)	(760)	(1,649)
TOTAL BUDGETARY RESOURCES	**$ 33,405**	**$ 17,341**	**$ 32,767**	**$ 16,730**
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred	$ 9,427	$ 12,732	$ 5,656	$ 15,669
Unobligated Balance-Apportioned	152	2,586	225	814
Unobligated Balance Not Available	23,826	2,023	26,886	247
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 33,405**	**$ 17,341**	**$ 32,767**	**$ 16,730**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS				
Obligated Balance, Net, Beginning of Period	$ 938	$ 941	$ 1,707	$ (79)
Obligated Balance, Net, End of Period:				
Accounts Receivable	(248)	(134)	(278)	(14)
Unfilled Customer Orders	-	(5)	-	-
Undelivered Orders	537	520	506	222
Accounts Payable	454	744	710	733
Outlays:				
Disbursements	9,615	12,412	5,907	14,731
Collections	(4,432)	(17,303)	(6,569)	(12,549)
Subtotal	5,183	(4,891)	(662)	2,182
Less: Offsetting Receipts	419	-	1,372	-
NET OUTLAYS	**$ 4,764**	**$ (4,891)**	**$ (2,034)**	**$ 2,182**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF FINANCING
For the years ended September 30, 2004 and 2003
(Dollars in Millions)

	2004	2003
RESOURCES USED TO FINANCE ACTIVITIES		
Obligations Incurred	$ 22,159	$ 21,325
Spending Authority from Offsetting Collections and Recoveries	(21,878)	(19,554)
Offsetting Receipts	(419)	(1,372)
Transfers Out	(208)	(138)
Imputed Financing from Costs Absorbed by Others	14	16
Other	(2)	(3)
TOTAL RESOURCES USED TO FINANCE ACTIVITIES	**$ (334)**	**$ 274**
RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST (SURPLUS) OF OPERATIONS		
Change in Budgetary Resources Obligated for Goods and Services Ordered but not yet Provided	$ (340)	$ (116)
Resources that Fund Expenses Recognized in Prior Periods	(7,546)	(3,557)
Budgetary Offsetting Collections and Receipts that Do Not Affect the Net Cost (Surplus) of Operations	20,371	19,010
Resources that Finance the Acquisition of Assets	(12,630)	(15,731)
Transfer Out to HUD without Reimbursement Related to Salary and Expense Payments	(274)	(273)
Other Resources or Adjustments that do not Affect the Net Cost (Surplus) of Operations	138	(334)
TOTAL RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST (SURPLUS) OF OPERATIONS	**$ (281)**	**$ (1,001)**
TOTAL RESOURCES USED TO FINANCE THE NET COST (SURPLUS) OF OPERATIONS	**$ (615)**	**$ (727)**
COMPONENTS OF THE NET COST (SURPLUS) OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD		
Upward Reestimate of Credit Subsidy Expense	$ 3,129	$ 7,546
Downward Reestimate of Credit Subsidy Expense	(262)	(138)
Changes in Loan Loss Reserve	(1,082)	(1,654)
Changes in Bad Debt Expenses Related to Uncollectible Pre-Credit Reform Receivables	(351)	(259)
Reduction of Credit Subsidy Expense from Endorsements and Modifications of Loan Guarantees	(2,945)	(3,853)
Gains or Losses on Sales of Credit Program Assets	605	522
Other	(229)	(353)
TOTAL COMPONENTS OF THE NET COST (SURPLUS) OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD	**$ (1,135)**	**$ 1,811**
NET COST (SURPLUS) OF OPERATIONS	**$ (1,750)**	**$ 1,084**

The accompanying notes are an integral part of these statements.

NOTES TO FINANCIAL STATEMENTS
September 30, 2004

Note 1. Significant Accounting Policies

Entity and Mission

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

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

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

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

Basis of Accounting

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

Basis of Consolidation

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

Use of Estimates

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

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

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

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

Fund Balance with U.S. Treasury

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

Credit Reform Accounting

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

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

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

In order to resolve the different requirements between the FCRA and the National Affordable Housing Act of 1990 (NAHA), OMB instructed FHA to create the capital reserve account to retain the MMI/CMHI negative subsidy and subsequent downward reestimates. Specifically, the NAHA required that FHA's MMI fund achieve a Capital Ratio of 2.0 percent by fiscal year 2000. The Capital Ratio is defined as the ratio of economic net worth (current cash plus the present value of all future net cash flows) of the MMI fund to unamortized insurance in force (the unpaid balance of insured mortgages). Therefore, to ensure that the calculated Capital Ratio reflects the actual strength of the MMI fund, the resources of the capital reserve account, which are considered FHA assets, are included in the calculation of the MMI fund's economic net worth. At the end of fiscal year 1995, FHA met and has since maintained the Capital Ratio requirement. FHA's actuary estimates the September 30, 2004 Capital Ratio at 5.53 percent. The fiscal year 2003 estimated Capital Ratio was 5.21 percent.

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

Investments

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

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

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

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

Loans Receivable and Related Foreclosed Property, Net

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

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

General Property, Plant and Equipment

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

Current HUD policy concerning SFFAS No. 10 *Accounting for Internal Use Software* indicates that HUD will either own the software or the functionality provided by the software in the case of licensed or leased software. This includes "commercial off-the-shelf" (COTS) software, contractor-developed software, and internally developed software. FHA had several procurement actions in place and had incurred expenses for software development. FHA identified and transferred those expenses to HUD to comply with departmental policy. The capitalizable software development costs identified and transferred to HUD by FHA in fiscal year 2004 and 2003 were $2 million and $3 million, respectively.

Loan Guarantee Liability

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

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

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

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

Unearned Premiums

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

Appropriations and Monies Received from Other HUD Programs

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

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

Full Cost Reporting

SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards*, requires that Federal agencies report the full cost of program outputs in the financial statements. Full cost reporting includes all direct, indirect, and inter-entity costs. For purposes of HUD's consolidated financial statements, HUD identifies each responsibility segment's share of the program costs or resources provided by other Federal agencies. As a responsibility segment of HUD, FHA's portion of these costs for fiscal years 2004 and 2003 was $14 million and $16 million, respectively and are included in FHA's financial statements as an imputed cost in the Consolidated Statements of Net Cost, and an imputed financing in the Consolidated Statements of Changes in Net Position and the Consolidated Statements of Financing.

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

Distributive Shares

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

Liabilities Covered by Budgetary Resources

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

Note 2. Non-entity Assets

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

(Dollars in millions)	2004	2003
Intragovernmental:		
Fund Balance with U.S. Treasury	$ 790	$ 1,597
Investments in U.S. Treasury Securities	4	4
Total Intragovernmental	794	1,601
Other Assets	114	123
Total Non-entity Assets	908	1,724
Total Entity Assets	34,907	34,945
Total Assets	**$ 35,815**	**$ 36,669**

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

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

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

Note 3. Fund Balance with U.S. Treasury

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

(Dollars in millions)	2004	2003
Fund Balances:		
Revolving Funds	$ 6,697	$ 3,721
Appropriated Funds	481	420
Other Funds	720	3,793
Total	**$ 7,898**	**$ 7,934**
Status of Fund Balance with U.S. Treasury:		
Unobligated Balance:		
Available	$ 2,738	$ 1,039
Unavailable	2,905	4,724
Obligated Balance not yet Disbursed	2,255	2,171
Total	**$ 7,898**	**$ 7,934**

Revolving Funds

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

Appropriated Funds

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

Other Funds

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

Status of Fund Balance with U.S. Treasury

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

Note 4. Investments

Investment in U.S. Treasury Securities

As discussed in Note 1, all FHA investments in Treasury securities are in non-marketable securities issued by the U.S. Treasury. These securities carry market-based interest rates. The market value of these securities is calculated using the bid amount of similar marketable U.S. Treasury securities as of September 30. The cost, par value, net unamortized discount, net investment, and market values of FHA's investments in U.S. Treasury securities as of September 30, 2004 were as follows:

(Dollars in millions)	Cost	Par Value	Unamortized Premium (Discount), Net	Investment, Net	Market Value
MMI/CMHI Investments	$ 23,066	$ 23,321	$ (143)	$ 23,178	$ 24,162
GI/SRI Investments	4	4	-	4	4
Subtotal	23,070	23,325	(143)	23,182	24,166
MMI/CMHI Accrued Interest	-	-	-	248	-
Total	**$ 23,070**	**$ 23,325**	**$ (143)**	**$ 23,430**	**$ 24,166**

The cost, par value, net unamortized discount, net investment, and market values as of September 30, 2003 were as follows:

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

Investments in Private-Sector Entities

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

(Dollars in millions)

	Beginning Balance	New Acquisitions	Share of Earnings or Losses	Return of Investment	Other Adjustments	Ending Balance
FY 2004	$ 123	$ 123	$ 62	$ (185)	$ (1)	$ 122
FY 2003	-	133	4	(14)	-	123

The condensed, audited financial information related to these private-sector entities as of December 30, 2003 are as follows:

(Dollars in millions)	**2004**	**2003**
Total assets, primarily mortgage loans	$ 349	$ 323
Liabilities	2	-
Partners' capital	347	323
Total liabilities and partners' capital	$ 349	$ 323
Revenues	$ 62	$ 25
Expenses	(11)	(2)
Net Income	$ 51	$ 23

Note 5. Accounts Receivable, Net

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

From the Public:

	Gross		**Allowance**		**Net**	
(Dollars in millions)	**2004**	**2003**	**2004**	**2003**	**2004**	**2003**
Receivables related to credit program assets	$ 34	$ 103	$ (4)	$ (14)	$ 30	$ 89
Premiums receivable	50	26	-	-	50	26
Miscellaneous receivables	232	115	(78)	(78)	154	37
Total	**$ 316**	**$ 244**	**$ (82)**	**$ (92)**	**$ 234**	**$ 152**

Receivables Related to Credit Program Assets

These receivables include sale proceeds receivable and rents receivable from FHA's foreclosed properties. The sale proceeds receivable should be differentiated from the PMM notes receivables, which are created by the sales of FHA's foreclosed properties on credit to qualifying non-profit organizations.

Premiums Receivable

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

Miscellaneous Receivables

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

Allowance for Loss

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

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

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

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

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

(Dollars in millions)

Direct Loan Programs		Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Direct Loans
FY 2004:	MMI/CMHI	$ 3	$ -	$ (2)	$ -	$ 1
	GI/SRI	19	2	(10)	-	11
	FY 2004 Total	**$ 22**	**$ 2**	**$ (12)**	**$ -**	**$ 12**
FY 2003:	MMI/CMHI	$ 1	$ -	$ -	$ -	$ 1
	GI/SRI	21	1	(8)	-	14
	FY 2003 Total	**$ 22**	**$ 1**	**$ (8)**	**$ -**	**$ 15**

Direct Loans Obligated After Fiscal Year 1991:

(Dollars in millions)

Direct Loan Programs		Loans Receivable, Gross	Interest Receivable	Foreclosed Property	Allowance for Subsidy Cost	Value of Assets Related to Direct Loans
FY 2004:	MMI/CMHI	$ -	$ -	$ -	$ (3)	$ (3)
	GI/SRI	-	-	-	-	-
	FY 2004 Total	**$ -**	**$ -**	**$ -**	**$ (3)**	**$ (3)**
FY 2003:	MMI/CMHI	$ -	$ -	$ -	$ (3)	$ (3)
	GI/SRI	-	-	-	-	-
	FY 2003 Total	**$ -**	**$ -**	**$ -**	**$ (3)**	**$ (3)**

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

(Dollars in millions)

Loan Guarantee Programs		Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Defaulted Guaranteed Loans Receivable, Net
FY 2004:	MMI/CMHI	$ 6	$ -	$ (1)	$ 14	$ 19
	GI/SRI	2,755	135	(905)	1	1,986
	FY 2004 Total	**$ 2,761**	**$ 135**	**$ (906)**	**$ 15**	**$ 2,005**
FY 2003:	MMI/CMHI	$ 8	$ 16	$ (4)	$ 33	$ 53
	GI/SRI	2,420	144	(878)	9	1,695
	FY 2003 Total	**$ 2,428**	**$ 160**	**$ (882)**	**$ 42**	**$ 1,748**

Defaulted Guaranteed Loans from Post-1991 Guarantees:

(Dollars in millions)

Loan Guarantee Programs		Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Foreclosed Property	Allowance for Subsidy Cost	Value of Assets Related to Defaulted Guaranteed Loans Receivable, Net
FY 2004:	MMI/CMHI	$ 340	$ 2	$ 2,095	$ (993)	$ 1,444
	GI/SRI	704	73	394	(682)	489
	FY 2004 Total	**$ 1,044**	**$ 75**	**$ 2,489**	**$ (1,675)**	**$ 1,933**
FY 2003:	MMI/CMHI	$ 232	$ -	$ 2,773	$ (841)	$ 2,164
	GI/SRI	584	48	420	(685)	367
	FY 2003 Total	**$ 816**	**$ 48**	**$ 3,193**	**$ (1,526)**	**$ 2,531**

Guaranteed Loans Outstanding:

(Dollars in millions)

Loan Guarantee Programs	Outstanding Principal of Guaranteed Loans, Face Value	Amount of Outstanding Principal Guaranteed
Guaranteed Loans Outstanding (FY 2004):		
MMI/CMHI	$ 412,404	$ 383,548
GI/SRI	94,711	85,248
Total	**$ 507,115**	**$ 468,796**
Guaranteed Loans Outstanding (FY 2003):		
MMI/CMHI	$ 434,002	$ 404,506
GI/SRI	101,197	85,619
Total	**$ 535,199**	**$ 490,125**
New Guaranteed Loans Disbursed (FY 2004):		
MMI/CMHI	$ 101,632	$ 100,625
GI/SRI	15,749	15,515
Total	**$ 117,381**	**$ 116,140**
New Guaranteed Loans Disbursed (FY 2003):		
MMI/CMHI	$ 144,227	$ 129,306
GI/SRI	19,004	17,451
Total	**$ 163,231**	**$ 146,757**

Loan Guarantee Liability, Net:

(Dollars in millions)

Loan Guarantee Programs	Liabilities for Losses on Pre -1992 Guarantees, Estimated Future Default Claims (LLR)	Liabilities for Loan Guarantees for Post-1991 Guarantees (LLG)	Total Loan Guarantee Liability, Net
FY 2004: MMI/CMHI	$ 85	$ 1,316	$ 1,401
GI/SRI	2,264	1,409	3,673
FY 2004 Total	**$ 2,349**	**$ 2,725**	**$ 5,074**
FY 2003: MMI/CMHI	$ 111	$ 2,008	$ 2,119
GI/SRI	3,324	808	4,132
FY 2003 Total	**$ 3,435**	**$ 2,816**	**$ 6,251**

Subsidy Expense for Loan Guarantees by Program and Component:

(Dollars in millions)

Subsidy Expense for New Loan Guarantees	Defaults	Fees and Other Collections	Other	Total
FY 2004: MMI/CMHI	$ 1,454	$ (4,502)	$ 388	$ (2,660)
GI/SRI	798	(1,076)	-	(278)
FY 2004 Total	**$ 2,252**	**$ (5,578)**	**$ 388**	**$ (2,938)**
FY 2003: MMI/CMHI	$ 2,003	$ (6,066)	$ 479	$ (3,584)
GI/SRI	759	(1,026)	-	(267)
FY 2003 Total	**$ 2,762**	**$ (7,092)**	**$ 479**	**$ (3,851)**

(Dollars in millions)

Subsidy Expense for Modifications and Reestimates	Total Modifications	Interest Rate Reestimates	Technical Reestimates	Total Reestimates
FY 2004: MMI/CMHI	$ -	$ -	$ 1,986	$ 1,986
GI/SRI	-	-	508	508
FY 2004 Total	**$ -**	**$ -**	**$ 2,494**	**$ 2,494**
FY 2003: MMI/CMHI	$ -	$ -	$ 5,947	$ 5,947
GI/SRI	-	-	352	352
FY 2003 Total	**$ -**	**$ -**	**$ 6,299**	**$ 6,299**

(Dollars in millions)

Total Loan Guarantee Subsidy Expense	2004	2003
MMI/CMHI	$ (674)	$ 2,363
GI/SRI	230	85
Total	**$ (444)**	**$ 2,448**

Subsidy Rates for Loan Guarantees by Program and Component:

(Percentage)

	Defaults	Fees and Other Collections	Other	Total
Budget Subsidy Rates for Loan Guarantees of FY 2004 Cohort:				
MMI/CMHI	1.35	(4.18)	0.36	(2.47)
GI/SRI	3.19	(4.27)	-	(1.08)
Budget Subsidy Rates for Loan Guarantees of FY 2003 Cohort:				
MMI/CMHI	1.55	(4.08)	-	(2.53)
GI/SRI	4.75	(5.88)	-	(1.13)

Schedule for Reconciling Loan Guarantee Liability Balances:

(Dollars in millions)	2004 LLR	2004 LLG	2003 LLR	2003 LLG
Beginning Balance of the Loan Guarantee Liability	**$ 3,435**	**$ 2,816**	**$ 5,089**	**$ (1,328)**
Add: Subsidy Expense for guaranteed loans disbursed during the reporting fiscal years by component:				
Default Costs (Net of Recoveries)	-	2,252	-	2,762
Fees and Other Collections	-	(5,578)	-	(7,092)
Other Subsidy Costs	-	388	-	479
Total of the above subsidy expense components	**-**	**(2,938)**	**-**	**(3,851)**
Adjustments:				
Fees Received	-	2,914	-	3,085
Foreclosed Property and Loans Acquired	-	6,367	-	6,527
Claim Payments to Lenders	-	(9,116)	-	(8,934)
Interest Accumulation on the Liability Balance	-	(227)	-	(326)
Other	-	43	-	235
Ending Balance before Reestimates	**3,435**	**(141)**	**5,089**	**(4,592)**
Add or Subtract Subsidy Reestimates by Component:				
Technical/Default Reestimate:				
Subsidy Expense Component		2,494		6,299
Interest Expense Component		372		1,109
Total Technical/Default Reestimate	**(1,086)**	**2,866**	**(1,654)**	**7,408**
Ending Balance of the Loan Guarantee Liability	**$ 2,349**	**$ 2,725**	**$ 3,435**	**$ 2,816**

Administrative Expense:

(Dollars in millions)	2004	2003
MMI/CMHI	$ 198	$ 219
GI/SRI	228	227
Total	**$ 426**	**$ 446**

Other Information on Foreclosed Property:

Additional information on FHA foreclosed property as of September 30 is as follows:

	2004	**2003**
Number of property in foreclosure process	47	109
Number of property held	25,307	43,064
Average holding period for property held	5 months	6 months

Pre-Credit Reform Valuation Methodology

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

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

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

A separate analysis was conducted to adjust the loan bss estimate for planned reductions in project-based Section 8 rental assistance subsidies administered by the Office of Multifamily Housing Assistance Restructuring (OMHAR). All projects that submitted annual financial statements, received Section 8 assistance and had contract rents exceeding 90 percent of fair market value were included. In the analysis, the gross rent for these projects was reduced to bring the contract rent for assisted units to fair market levels. The effects of this rent reduction on projects' financial health was assessed and the projects were grouped into the following three categories:

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

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

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

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

Credit Reform Valuation Methodology

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

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

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

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

- Conditional Termination Rates: The estimated probability of an insurance policy claim or non-claim termination in each year of the loan guarantee's term.

- Recovery Rates: The estimated percentage of a claim payment that is recovered through disposition of a mortgage note or underlying property.

- Claim Amount: The estimated amount of the claim payment relative to the unpaid principal balance at the time the claim occurs.

Additional information about loan performance assumptions is provided below:

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

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

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

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

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

Discussion of Change in the Liability for Loan Guarantees

FHA has estimated and applied credit subsidy rates to each FHA loan guarantee program since fiscal year 1992. Over this time FHA's credit subsidy rates have varied. The variance is caused by three factors: (1) additional loan performance data underlying the credit subsidy rate estimates, (2) revisions to the calculation methodology used to estimate the credit subsidy rates, and (3) revisions on expected claims and prepayments derived from the revised Actuarial Review of the MMI Fund as of FY 2004. Loan performance data, which reflect mortgage market performance and FHA policy direction, are added as they become available. Revisions to the estimation methodology result from legislative direction and technical enhancements.

FHA estimated the credit subsidy rates for the 2004 cohort in fiscal year 2002. At the time of budget submission, the rates reflected prevailing policy and loan performance assumptions based on the most recent information available. These credit subsidy rates can be compared to the credit subsidy rates estimated at the end of 2004. The two rates can be reconciled through credit subsidy reestimates, which allow FHA to adjust the LLG and subsidy expense to reflect the most current and accurate credit subsidy rate.

Described below are the programs that comprise the majority of FHA's fiscal year 2004 new business. In addition, the Hospital Insurance program is also described. These descriptions highlight the factors that contributed to changing credit subsidy rates and the credit subsidy reestimate. Overall, FHA's liability decreased by $1.2 billion from the fiscal year 2003 values.

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

Due to the magnitude of the MMI fund, program changes can significantly affect the overall LLG and subsidy expense recorded in the financial statements. During fiscal year 2004, recent data, expected claims and prepayments estimated by the *Actuarial Review of MMI Fund as of FY 2004,* and changing assumptions decreased the liability of the MMI fund. The majority of this change is due to the revised claims being predicted by the claim and prepayment rates taken from the *Actuarial Review of the MMI Fund as of FY 2004.*

GI/SRI Section 221(d)(4) **-** The Section 221(d)(4) program was established to provide mortgage insurance for the construction or substantial rehabilitation of Multifamily rental properties with five or more units. Under this program, HUD may insure up to 90 percent of the total project cost and is prohibited from insuring loans with HUD-subsidized interest rates. The Section 221(d)(4) program is the largest Multifamily program in the GI/SRI fund. The Section 221(d)(4) liability decreased in FY 2004 and was impacted by two major changes.

First, FHA revised cash flow modeling of claim recoveries. Previously, FHA assumed it did not collect income on notes in the HUD-held inventory recovered via paid in full disposition. In addition, FHA assumed it recovered 100 percent of the claim amount at the time of final payment on these notes. In FY 2004, actual historical data from FHA's Multifamily Accounting and Reporting System (MARS) and the Property Management System (PMS) was used to calculate the recovery assumptions for all disposition types, which resulted in a decrease to the 221(d)(4) liability estimate.

Second, since 1991, FHA has realized a decrease in the length of time assets are held in inventory after assignment and acquisition. In FY 2004, FHA reduced the holding period assumptions for assets recovered via paid in full disposition and property sale, with the approval of the Office of Management and Budget (OMB), which resulted in a decrease to the 221(d)(4) liability estimate.

GI/SRI Section 234(c) **-** The Section 234(c) program insures a loan for as many as 30 years to purchase a unit in a condominium building. One of the many purposes of FHA's mortgage insurance programs is to encourage lenders to make affordable mortgage credit available for non-conventional forms of ownership. Condominium ownership, in which the separate owners of the individual units jointly own the development's common areas and facilities, is one particularly popular alternative. The Section 234(c) program is FHA's largest Single Family program in the GI/SRI fund. Historically, the program generates a reduction in credit subsidy expense. The decrease in LLG for Section 234(c) for FY 2004 is attributed to the improved performance of condominium mortgages relative to the homes insured under MMI.

GI/SRI Section 203(k) **-** The section 203(k) program allows a homebuyer to finance the purchase and rehabilitation of a Single Family property with a single mortgage loan insured by FHA. In the past, this program encountered incidents of fraud and FHA explicitly accounts for these risks through its LLG estimates. Based on management's judgments on claim costs and the additional rehabilitation costs associated with these fraud cases, the LLG increased by $125 million.

FHA developed these assumptions based on data and management's judgments about future loan performance and related risk. Overall, the claim costs decreased the LLG by $91 million.

Note 7. Other Assets

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

(Dollars in millions)

		2004		2003
Intragovernmental:				
Advances to HUD for Working Capital Fund Expenses	$	64	$	53
Miscellaneous Assets		-		4
Total	**$**	**64**	**$**	**57**
With the Public:				
Escrow Monies Deposited at Minority-Owned Banks	$	114	$	123
Undistributed Charges		6		7
Total	**$**	**120**	**$**	**130**

Advances to HUD for Working Capital Fund Expenses

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

Escrow Monies Deposited at Minority-Owned Banks

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

Undistributed Charges

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

Note 8. Accounts Payable

Accounts payable as of September 30 are as follows:

With the Public:

(Dollars in millions)	2004	2003
Claims Payable	$ 231	$ 428
Premium Refunds and Distributive Shares Payable	78	121
Disbursements in Transit	64	160
Miscellaneous Payables	160	160
Total	**$ 533**	**$ 869**

Claims Payable

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

Premium Refunds and Distributive Shares Payable

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

Disbursements in Transit

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

Miscellaneous Payables

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

Note 9. Debt

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

(Dollars in millions)	2003 Beginning Balance	2003 Net Borrowing	2003 Ending Balance	2004 Net Borrowing	2004 Ending Balance
Agency Debt:					
Debentures Issued to Claimants	$ 288	$ (18)	$ 270	$ (83)	$ 187
Other Debt:					
Borrowings from U.S. Treasury	7,553	1,241	8,794	(1,159)	7,635
Total	**$ 7,841**	**$ 1,223**	**$ 9,064**	**$ (1,242)**	**$ 7,822**

	2004	**2003**
Classification of Debt:		
Intragovernmental Debt	$ 7,635	$ 8,794
Debt held by the Public	187	270
Total	**$ 7,822**	**$ 9,064**

Debentures Issued to Public

The National Housing Act authorizes FHA, in certain cases, to issue debentures in lieu of cash to settle claims. FHA-issued debentures bear interest at rates established by the U.S. Treasury. Interest rates related to the outstanding debentures ranged from 4.00 percent to 12.875 percent in fiscal year 2004 and from 4.00 percent to 13.375 percent in fiscal year 2003. FHA debentures may be redeemed by lenders prior to maturity to pay mortgage insurance premiums to FHA, or they may be called with the approval of the Secretary of the U.S. Treasury.

The par value of debentures outstanding at September 30 was $183 million in fiscal year 2004 and $265 million in fiscal year 2003. The fair values for fiscal years 2004 and 2003 were $265 and $367 million, respectively.

Borrowings from U.S. Treasury

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

During fiscal year 2004, FHA's U.S. Treasury borrowings carried interest rates ranging from 3.71 percent to 7.34 percent. In fiscal year 2003 the carried interest rates ranged from 4.76 percent to 7.36 percent. Fiscal year 2004 maturity dates occur from September 2017 – September 2023. Loans may be repaid in whole or in part without penalty at any time prior to maturity.

Note 10. Other Liabilities

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

(Dollars in millions)	Current 2004	Current 2003	Non-Current 2004	Non-Current 2003	Total 2004	Total 2003
Intragovernmental:						
Special Receipt Account Liability	$ 627	$ 1,511	$ -	$ -	$ 627	$ 1,511
Total	**$ 627**	**$ 1,511**	**$ -**	**$ -**	**$ 627**	**$ 1,511**
With the Public:						
Trust and Deposit Liabilities	$ 189	$ 240	$ -	$ -	$ 189	$ 240
Unearned Premiums	35	49	137	232	172	281
Undistributed Credits	75	98	-	-	75	98
Miscellaneous Liabilities	154	120	-	-	154	120
Total	**$ 453**	**$ 507**	**$ 137**	**$ 232**	**$ 590**	**$ 739**

Special Receipt Account Liability

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

Trust and Deposit Liabilities

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

Unearned Premiums

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

Undistributed Credits

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

Miscellaneous Liabilities

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

Note 11. Commitments and Contingencies

Litigation

FHA is party in various legal actions and claims brought by or against it. In the opinion of management and general counsel, the ultimate resolution of the majority of these legal actions and claims will not materially affect FHA's consolidated financial statements as of, and for, the fiscal years ended September 30, 2004 and 2003. There are two cases where judgment against FHA is considered reasonably possible with a potential loss estimated at $66 million.

Note 12. Gross Costs

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

(Dollars in millions)	2004		2003	
	MMI/CMHI	**GI/SRI**	**MMI/CMHI**	**GI/SRI**
Intragovernmental:				
Interest Expense	$ 604	$ 66	$ 525	101
Imputed Costs	6	8	7	9
Other Expenses	21	14	51	21
Total	**$ 631**	**$ 88**	**$ 583**	**$ 131**
With the Public:				
Salary and Administrative Expenses	$ 177	$ 214	$ 168	$ 206
Subsidy Expense	(674)	230	2,363	85
Interest Expense	63	111	1,102	163
Bad Debt Expense	(14)	(337)	(17)	(242)
Loan Loss Reserve Expense	(25)	(1,057)	(28)	(1,626)
Other Expenses	37	608	91	473
Total	**$ (436)**	**$ (231)**	**$ 3,679**	**$ (941)**

Interest Expense

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

Imputed Costs/Imputed Financing

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

FHA in its Statements of Net Cost are equal to the amounts of imputed financing in its Statements of Changes in Net Position.

Salary and Administrative Expenses

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

Subsidy Expense

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

Bad Debt Expense

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

Loan Loss Reserve Expense

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

Other Expenses

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

Note 13. Earned Revenue

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

(Dollars in millions)	2004		2003	
	MMI/CMHI	**GI/SRI**	**MMI/CMHI**	**GI/SRI**
Intragovernmental:				
Interest Revenue from Deposits at U.S. Treasury	$ 346	$ 93	$ 192	$ 106
Interest Revenue from MMI/CMHI Investments	1,113	-	1,120	-
Total	**$ 1,459**	**$ 93**	**$ 1,312**	**$ 106**
With the Public:				
Premium Revenue	$ 54	$ 67	$ 88	$ 130
Interest Revenue	8	(34)	370	82
Other Revenue	2	153	(13)	293
Total	**$ 64**	**$ 186**	**$ 445**	**$ 505**

Interest Revenue

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

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

Premium Revenue

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

Up-front Premiums

The up-front premium rates, which are set by legislation, vary according to the mortgage type and the year of origination. The pre-1992 up-front premiums in the MMI fund were recorded as unearned revenue upon collection and are recognized as revenue over the period in which losses and insurance costs are expected to occur. Other FHA funds' unearned revenue is recognized monthly as revenue on a straight-line basis.

The FHA up-front premium rates in fiscal year 2004 were:

	Premium Rate
Single Family	1.50%
Multifamily	.45%, .50%, .57%, .61%, .80%, or 1.0%

Periodic Premiums

The periodic premium rate is used to calculate monthly or annual premiums receivable. These rates, which are also legislated, vary by mortgage type and program. The FHA periodic premium rate in fiscal year 2004 for Single Family and Multifamily were:

	Mortgage Term 15 Years or Less	Mortgage Term More Than 15 Years
Single Family	.25%	.50%
Multifamily	.45%, .50%, .57%, .61%, or .80%	.45%, .50%, .57%, .61%, or .80%

For Title I, the maximum insurance premium paid for guaranteed cases endorsed in years 1992 through 2001 is equal to 0.50 percent of the loan amount multiplied by the number of years of the loan term. The annual insurance premium for a Title I Property Improvement loan is 0.50 percent of the loan amount until the maximum insurance charge is paid. The annual insurance premium of a Title I Manufactured Housing loan is calculated in tiers by loan term until the maximum insurance charge is paid. For guaranteed cases endorsed in fiscal years 2003 and 2004, the Title I annual insurance premium is 1.00 percent of the loan amount until maturity.

Other Revenue

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

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

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

Note 15. Transfers Out

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

(Dollars in millions)

	U.S. Treasury	HUD	Total
Budgetary Financing Sources	$ 365	$ 274	$ 639
Other Financing Sources	208	-	208
Other	-	2	2
FY 2004 Total	**$ 573**	**$ 276**	**$ 849**
Budgetary Financing Sources	$ 802	$ 273	$ 1,075
Other Financing Sources	138	-	138
Other	-	3	3
FY 2003 Total	**$ 940**	**$ 276**	**$ 1,216**

Transfers Out to U.S. Treasury

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

Transfers Out to HUD

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

Note 16. Unexpended Appropriations

Unexpended appropriation balances at September 30 are as follows:

(Dollars in millions)	Beginning Balance	Appropriations Received	Other Adjustments	Appropriations Used	Transfers - Out	Ending Balance
Positive Subsidy	$ 72	$ 15	$ -	$ (3)	$ -	$ 84
Administrative Expenses	394	767	(4)	(699)	-	458
Reestimates	-	517	-	(517)	-	-
GI/SRI Liquidating	110	724	-	(593)	(84)	157
FY 2004 Total	**$ 576**	**$ 2,023**	**$ (4)**	**$ (1,812)**	**$ (84)**	**$ 699**
Positive Subsidy	$ 65	$ 15	$ (6)	$ (2)	$ -	$ 72
Administrative Expenses	377	751	(4)	(730)	-	394
Reestimates	-	1,167	-	(1,167)	-	-
GI/SRI Liquidating	319	469	-	(359)	(319)	110
FY 2003 Total	**$ 761**	**$ 2,402**	**$ (10)**	**$ (2,258)**	**$ (319)**	**$ 576**

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

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

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

Note 17. Budgetary Resources

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

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

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

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

Financing sources for repayments are from premiums earned, and the maturity dates on these borrowings are generally 20 years or more. The balances of the Permanently Not Available line item in the Statements of Budgetary Resources in fiscal year 2004 and fiscal year 2003 are $4,857 million and $2,409 million respectively. In fiscal year 2004, the $4,857 million amount is composed of a repayment of $209 million for debentures, a repayment of $4,559 million for borrowing from the U.S. Treasury, a return to U.S. Treasury of $5 million for rescinded and cancelled appropriations, and a transfer to the U.S. Treasury of $84 million of unobligated balances that remained in the GI/SRI liquidating account at the end of fiscal year 2003.

The SF-133 and the Statement of Budgetary Resources for fiscal year 2003 has been reconciled to the fiscal year 2003 actual amounts included in the P&F Schedules presented in the Budget of the United States Government. There were no significant reconciling items. Information from the fiscal year 2004 Statement of Budgetary Resources will be presented in the fiscal year 2006 Budget of the U.S. Government. The Budget will be transmitted to Congress on the first Monday in February 2006 and will be available from the Government Printing Office at that time.

Required Supplementary Information

Schedule A: Intragovernmental Assets

FHA's intragovernmental assets, by federal entity, are as follows on September 30, 2004 and 2003:

(Dollars in millions)

Agency	Fund Balance with U.S. Treasury	Investments in U.S. Treasury Securities	Other Assets
U.S. Treasury	$ 7,898	$ 23,430	$ -
HUD	-	-	64
FY 2004 Total	**$ 7,898**	**$ 23,430**	**$ 64**
U.S. Treasury	$ 7,934	$ 23,982	$ -
HUD	-	-	53
Other	-	-	4
FY 2003 Total	**$ 7,934**	**$ 23,982**	**$ 57**

Schedule B: Intragovernmental Liabilities

FHA's intragovernmental liabilities, by federal entity, are as follows on September 30, 2004 and 2003:

(Dollars in millions)

Agency	Borrowings from U.S. Treasury	Other Liabilities
U.S. Treasury	$ 7,635	$ 627
FY 2004 Total	**$ 7,635**	**$ 627**
U.S. Treasury	$ 8,794	$ 1,511
FY 2003 Total	**$ 8,794**	**$ 1,511**

Required Supplementary Information

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

(Dollars in millions)	MMI/CMHI 2004	MMI/CMHI 2003	GI/SRI 2004	GI/SRI 2003	Total 2004	Total 2003
BUDGETARY RESOURCES						
Budget Authority:						
Appropriations received	$ 444	$ 434	$ 1,579	$ 1,968	$ 2,023	$ 2,402
Borrowing Authority	3,000	2,575	530	520	3,530	3,095
Unobligated Balance Carried Forward						
Beginning of period	27,116	24,722	1,056	2,133	28,172	26,855
Net Transfers						
Spending Authority from Offsetting Collections:						
Earned						
Collected	19,312	15,963	2,423	3,155	21,735	19,118
Receivable from Federal Sources	104	7	(14)	(158)	90	(151)
Unfilled Customer Orders	-	-	5	-	5	-
Recoveries of Prior Year Obligations	12	542	36	45	48	587
Permanently Not Available	(4,303)	(755)	(554)	(1,654)	(4,857)	(2,409)
TOTAL BUDGETARY RESOURCES	**$ 45,685**	**$ 43,488**	**$ 5,061**	**$ 6,009**	**$ 50,746**	**$ 49,497**
STATUS OF BUDGETARY RESOURCES						
Obligations Incurred	$ 18,643	$ 16,374	$ 3,516	$ 4,951	$ 22,159	$ 21,325
Unobligated Balance-Apportioned	2,317	438	421	601	2,738	1,039
Unobligated Balance Not Available	24,725	26,676	1,124	457	25,849	27,133
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 45,685**	**$ 43,488**	**$ 5,061**	**$ 6,009**	**$ 50,746**	**$ 49,497**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS						
Obligated Balance, Net, Beginning of Period	$ 1,083	$ 823	$ 796	$ 805	$ 1,879	$ 1,628
Obligated Balance, Net, End of Period:						
Accounts Receivable	(381)	(277)	(1)	(15)	(382)	(292)
Unfilled Customer Orders	-	-	(5)	-	(5)	-
Undelivered Orders	500	274	557	454	1,057	728
Accounts Payable	830	1,086	368	357	1,198	1,443
Outlays:						
Disbursements	18,662	15,564	3,365	5,074	22,027	20,638
Collections	(19,312)	(15,963)	(2,423)	(3,155)	(21,735)	(19,118)
Subtotal	(650)	(399)	942	1,919	292	1,520
Less: Offsetting Receipts	-	-	419	1,372	419	1,372
NET OUTLAYS	**$ (650)**	**$ (399)**	**$ 523**	**$ 547**	**$ (127)**	**$ 148**

Required Supplementary Information

Schedule D: Comparative Combining Budgetary Resources by Appropriation for the MMI/CMHI Program–Fiscal Year 2004

(Dollars in millions)

	86 0183	86x4070	86x4587 & 86x4242	86x0236	MMI/CMHI Total
BUDGETARY RESOURCES					
Budget Authority:					
Appropriations received	$ 444	$ -	$ -	$ -	$ 444
Borrowing Authority	-	-	3,000	-	3,000
Unobligated Balance Carried Forward					
Beginning of period	39	583	311	26,183	27,116
Net Transfers	7,029	(583)	-	(6,446)	-
Spending Authority from Offsetting Collections:					
Earned					
Collected	-	138	15,362	3,812	19,312
Receivable from Federal Sources	-	-	133	(29)	104
Unfilled Customer Orders	-	-	-	-	-
Recoveries of Prior Year Obligations	-	1	11	-	12
Permanently Not Available	(3)	-	(4,300)	-	(4,303)
TOTAL BUDGETARY RESOURCES	**$ 7,509**	**$ 139**	**$ 14,517**	**$ 23,520**	**$ 45,685**
STATUS OF BUDGETARY RESOURCES					
Obligations Incurred	$ 7,460	$ 127	$ 11,056	$ -	$ 18,643
Unobligated Balance-Apportioned	10	11	2,296	-	2,317
Unobligated Balance Not Available	39	1	1,165	23,520	24,725
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 7,509**	**$ 139**	**$ 14,517**	**$ 23,520**	**$ 45,685**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS					
Obligated Balance, Net, Beginning of Period	$ 72	$ 456	$ 832	$ (277)	$ 1,083
Obligated Balance, Net, End of Period:					
Accounts Receivable	-	-	(133)	(248)	(381)
Unfilled Customer Orders	-	-	-	-	-
Undelivered Orders	79	25	396	-	500
Accounts Payable	2	251	577	-	830
Outlays:					
Disbursements	7,452	306	10,904	-	18,662
Collections	-	(138)	(15,362)	(3,812)	(19,312)
Subtotal	7,452	168	(4,458)	(3,812)	(650)
Less: Offsetting Receipts	-	-	-	-	-
NET OUTLAYS	**$ 7,452**	**$ 168**	**$ (4,458)**	**$ (3,812)**	**$ (650)**

Required Supplementary Information

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

(Dollars in millions)

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

Required Supplementary Information

Schedule E: Comparative Combining Budgetary Resources by Appropriation for the GI/SRI Program–Fiscal Year 2004

(Dollars in millions)

	86 0200	86x4072	86x4077 & 86x4105	GI/SRI Total
BUDGETARY RESOURCES				
Budget Authority:				
Appropriations received	$ 855	$ 724	$ -	$ 1,579
Borrowing Authority	-	130	400	530
Unobligated Balance Carried Forward				
Beginning of period	221	84	751	1,056
Net Transfers	-	-	-	-
Spending Authority from Offsetting Collections:				
Earned				
Collected	-	483	1,940	2,423
Receivable from Federal Sources	-	-	(14)	(14)
Unfilled Customer Orders	-	-	5	5
Recoveries of Prior Year Obligations	4	31	1	36
Permanently Not Available	(2)	(293)	(259)	(554)
TOTAL BUDGETARY RESOURCES	**$ 1,078**	**$ 1,159**	**$ 2,824**	**$ 5,061**
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred	$ 818	$ 1,021	$ 1,677	$ 3,516
Unobligated Balance-Apportioned	61	70	290	421
Unobligated Balance Not Available	199	68	857	1,124
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 1,078**	**$ 1,159**	**$ 2,824**	**$ 5,061**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS				
Obligated Balance, Net, Beginning of Period	$ 88	$ 600	$ 108	$ 796
Obligated Balance, Net, End of Period:				
Accounts Receivable	-	(1)	-	(1)
Unfilled Customer Orders	-	-	(5)	(5)
Undelivered Orders	90	343	124	557
Accounts Payable	1	200	167	368
Outlays:				
Disbursements	810	1,047	1,508	3,365
Collections	-	(483)	(1,940)	(2,423)
Subtotal	810	564	(432)	942
Less: Offsetting Receipts	-	-	-	419
NET OUTLAYS	**$ 810**	**$ 564**	**$ (432)**	**$ 523**

Required Supplementary Information

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

(Dollars in millions)

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