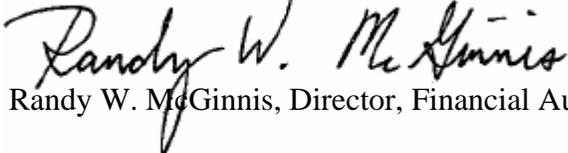




Issue Date  
November 15, 2005

Audit Case Number  
2006-FO-0003

TO: James M. Martin, Acting Deputy Chief Financial Officer, F

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

SUBJECT: **Additional Details to Supplement Our Report on the U.S. Department of Housing and Urban Development's (HUD) Fiscal Years 2005 and 2004 Financial Statements**

## **HIGHLIGHTS**

### **What We Audited and Why**

We are required to annually audit the consolidated financial statements of HUD in accordance with the Chief Financial Officers Act of 1990, as amended. This report supplements our report on the results of our audit of HUD's principal financial statements for the fiscal years ended September 30, 2005 and September 30, 2004. Also provided are assessments of HUD's internal controls and our findings with respect to HUD's compliance with applicable laws, regulations, and provisions of contracts and grant agreements<sup>1</sup>.

Our report on HUD's fiscal years 2005 and 2004 financial statements is included in HUD's Fiscal Year 2005 Performance and Accountability Report. For fiscal year 2005, OMB directed agencies to complete their Performance and Accountability Reports and submit them to the President, OMB and the Congress by November 15, 2005, thereby requiring that we complete our work by that date.

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<sup>1</sup>Additional details relating to the Federal Housing Administration, a HUD component, are not included in this report but are included in the accounting firm of Urbach, Kahn, and Werlin LLP's audit of FHA's financial statements. Their report has been published in our report entitled, "Audit of Federal Housing Administration Financial Statements for Fiscal Year 2005" (2006-FO-0002, dated November 07, 2005)

We completed an audit of the Government National Mortgage Association's (Ginnie Mae) fiscal years 2005 and 2004 financial statements. Our report on Ginnie Mae, another HUD component, included an unqualified opinion on Ginnie Mae's financial statements along with no material weaknesses or reportable conditions with its internal controls, or material instances of non-compliance. Our report is entitled, "Audit of Government National Mortgage Association Financial Statements for Fiscal Years 2005 and 2004" (2006-FO-0001, dated November 07, 2005)

## What We Found

In OIG's opinion, HUD's fiscal years 2005 and 2004 financial statements were fairly presented. Our opinion on HUD's fiscal years 2005 and 2004 financial statements was reported in HUD'S Fiscal Year 2005 Performance and Accountability Report. In our previous audit report on the fiscal year 2004 financial statements included in HUD's Fiscal Year 2004 Performance and Accountability Report, we reported that we were unable to complete sufficient audit procedures to express an opinion on the fiscal year 2004 financial statements by the OMB due date of November 15, 2004. We have subsequently completed that work and we are now able to express an opinion on the 2004 financial statements. In addition, HUD restated its fiscal year 2004 consolidated financial statements to correct accounting errors disclosed during the fiscal year 2005 audit. In conjunction with our audit of HUD's fiscal year 2005 financial statements, we also reported on two material weaknesses related to the need for HUD to:

- incorporate better risk factors and monitoring tools into FHA's single family insured mortgage program risk analysis and liability estimation process; and
- continue to improve its review over the FHA Credit Reform estimation process.

In prior years, OIG reported on weaknesses in HUD's compliance with Federal financial management system requirements, including the need to enhance FHA's management controls over its portfolio of integrated insurance and financial systems. During the past several years, HUD has made progress in implementing a new financial system at FHA and addressing most of the weaknesses that OIG identified, including initiating a vision statement for a Department-wide fully integrated financial system. These improvements enabled OIG to conclude that the weakness in financial management system requirements be reclassified from a material weakness to a reportable condition. In addition, during fiscal year 2005, HUD has made substantial progress in improving controls over the monitoring and payment process for the rental housing assistance program delivery. These improvements, combined with the progress reported in prior years, enabled OIG to reclassify the material weakness covering public housing and tenant-based Section 8 programs administered by PIH along with project-based subsidy programs administered by the Office of Housing to a reportable condition. We also reported on four other reportable conditions in internal controls related to the need to:

- further strengthen controls over HUD's computing environment;
- improve personnel security practices for access to the Department's critical financial systems;
- improve processes for reviewing obligation balances; and
- improve controls for developing estimates of budget authority required for the Section 236 Interest Reduction Program.

In addition, HUD did not substantially comply with the Federal Financial Management Improvement Act regarding system requirements. The audit also identified over \$377 million in excess obligations recorded in HUD's records, which represent funds that HUD could put to better use.

### **What We Recommend**

Most of the issues described in this report represent long-standing weaknesses. We understand that implementing sufficient change to mitigate these matters is a multiyear task due to the complexity of the issues and the impediments to change. In this and in prior year's audits of HUD's financial statements, we have made recommendations to HUD's management to address these issues. Our recommendations from the current audit, as well as those from prior years' audits that remain open, are listed in Appendix B of this report.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06 REV-3.

### **HUD's Response**

The complete text of the agency's response can be found in Appendix E. This response, along with additional informal comments, was considered in preparing the final version of this report.

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## Internal Control

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### **Reportable Condition: HUD/FHA System Environment Needs to Comply with Federal Financial Management System Requirements**

In prior years, OIG reported on weaknesses in HUD's financial management systems, which were described as a material weakness. Specifically, HUD had not adequately completed development of an adequate integrated financial management system. A primary reason was HUD's most significant system deficiency involving FHA. Since 2003, FHA has made progress in correcting the weaknesses in its overall compliance with Federal financial management system requirements through the implementation of the FHA Subsidiary Ledger. A key milestone was achieved during fiscal year 2003 with the implementation of the FHA financial system's general ledger module. In fiscal years 2004 and 2005, FHA completed the implementation of its core financial system implementation with the addition of cash management, funds control, and contract modules. These improvements, combined with progress reported in prior years, enabled OIG to conclude that the remaining issues related to information systems controls no longer constitute a material weakness, and therefore this weakness has been reclassified as a reportable condition.

In addition, HUD has not met the minimum set of automated information resource controls relating to Entity-wide Security Program Planning and Management, which is one element of required federal financial management requirements. Specifically, the Department is not compliant with Federal requirements in the areas of maintenance of adequate Security Plans and Risk Assessments, conducting annual self-assessment of security controls in information systems, the testing of Contingency Plan, and Disaster Recovery. Without having fully implemented these controls, HUD is not able to ensure its financial information is protected from unauthorized access, use, disclosure, disruption, modification, or destruction.

The Federal Financial Management Improvement Act of 1996 (FFMIA) requires, among other things, that HUD implement and maintain financial management systems that substantially comply with federal financial management system requirements. These requirements are detailed in the Federal Financial Management System Requirements series issued by the Joint Financial Management Improvement Program/Financial System Integration Office (JFMIP/FISO) and in Circular No. A-127, Financial Management Systems, issued by the Office of Management and Budget (OMB). Circular A-127 a defines single integrated financial management system as a unified set of financial systems and the financial portions of mixed systems (e.g., acquisition) encompassing the software, hardware, personnel, processes (manual and automated), procedures, controls, and data necessary to carry out financial management functions, manage the financial operations of the agency, and report on the agency's financial status.

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**FHA needs to continue progress to integrate their financial management systems.**

As previously noted, HUD's most significant system deficiency had existed in FHA, but significant progress has been made. FHA's fiscal year 2003 implementation of the FHA Subsidiary Ledger automated many previously manual processes used to (1) consolidate the accounting data received from the various FHA operational legacy systems and (2) prepare U.S. Standard General Ledger compliant summary entries for posting to the FHA Subsidiary Ledger. FHA is in the process of continuing to upgrade and integrate its various insurance and business systems in compliance with HUD's Enterprise Architecture Plan. FHA Subsidiary Ledger was a critical component of this plan and a number of applications were eliminated or integrated into other applications in connection with its implementation in recent years. FHA has a project plan to replace four insurance systems and upgrade the system interfaces for six other insurance systems in 2006 to further reduce the need for manual processing and improve financial operations. As part of this process, certain financial business processes will be migrated into the FHA Subsidiary Ledger. However, FHA and HUD have not yet developed a strategic plan or risk assessment for the future of FHA business systems that will ensure these system changes are coordinated as a "unified set of systems".

**HUD's ability to prepare financial statements and other financial information requires extensive compensating procedures.**

As reported in prior years, HUD did not have financial management systems that enabled the Department to accurately and timely generate and report the information needed to both prepare financial statements and manage operations on an ongoing basis. In order to prepare consolidated Department-wide financial statements, HUD requires FHA, Ginnie Mae, and the Office of Federal Housing Enterprise Oversight to submit financial statement line level spreadsheet templates, which are loaded into a software application. In addition, all consolidating notes and supporting schedules had to be manually posted, verified, reconciled, and traced. To overcome these systemic deficiencies with respect to preparation of its annual financial statements, HUD was compelled to rely on extensive compensating procedures that were costly, labor intensive, and not always effective.

While there have been improvements made in fiscal year 2005 to the financial reporting processes, most notably FHA and the Section 236 payment process, the underlying system issues remain. Due to functional limitations of the three applications (HUDCAPS, LOCCS and PAS) performing the core financial system function, HUD is dependent on its data mart and reporting tool to complete the accumulation and summarization of data needed for Treasury and OMB reporting. HUD's use of multiple applications to perform core financial system functions, greatly complicates financial management and increases the cost and time

expended. Great effort is required to manage and coordinate the processing of transactions to ensure the completeness and reliability of information.

**HUD has limited availability of information to assist management in effectively managing operations on an ongoing basis.**

During fiscal year 2005, HUD's financial information systems did not allow the Department to achieve its financial management goals in an effective and efficient manner. For example, in order to perform core financial system functions, HUD depends on three applications, a data warehouse, and a report-writing tool. Two of the three applications that perform core financial system functions are batch process legacy systems that require significant management oversight and manual reconciliations to ensure accurate and complete information. Additionally, HUD continues to lack an effective cost accounting system that is capable of timely tracking and reporting costs of HUD's programs to assist in managing its daily operations. This condition renders HUD unable to produce reliable cost-based performance information. HUD officials have indicated that various cost allocation studies, resource management analysis, and records contain the information necessary to enable them to determine the cost of various activities needed for mandatory financial reporting. However, this information is widely distributed among a variety of information systems, which are not linked and therefore cannot share data. This makes the accumulation of cost information time consuming, labor intensive, untimely, and ultimately makes that cost information not available for management to timely evaluate and manage HUD's programs. Budget, cost management, and performance measurement data is not integrated because HUD:

- Did not interface its budget formulation system with its core financial system;
- Lacks the data and system feeds to automate a process to accumulate, allocate, and report costs of activities on a regular basis for financial reporting needs as well as internal use in managing programs and activities;
- Does not have the capability to derive current full cost for use in the daily management of Department operations; and
- Requires an ongoing extensive data quality initiative to ensure the accuracy of its cost aspects of its performance measures as they are derived from sources outside the core financial system.

In fiscal year 2003, HUD's Office of the Chief Financial Officer launched a project known as the HUD Integrated Financial Management Improvement Project (HIFMIP). HIFMIP's intent is to modernize HUD's financial management systems in accordance with a vision consistent with administration priorities, legislation, OMB directives, modern business practices, customer service, and technology. HIFMIP will encompass all of HUD's financial systems, including those supporting FHA and Ginnie Mae. HUD will begin Phase II of HIFMIP in fiscal year 2006 where the Department will select a new core financial

system application and begin the implementation of a HUD-wide financial management system. The new system, currently called the Integrated Core Financial System, will provide the first building block to enable later integration with other desired management improvements such as integrated financial performance management.

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## **Reportable Condition: HUD Needs to Continue Improvements Made in the Oversight and Monitoring of Subsidy Calculations and Intermediaries Program Performance**

Under the provisions of the U.S. Housing Act of 1937, HUD provides housing assistance funds through various grant and subsidy programs to multifamily project owners (both nonprofits and for profit) and housing authorities. These intermediaries, acting for HUD, provide housing assistance to benefit primarily low-income families and individuals (households) that live in public housing, Section 8 and Section 202/811 assisted housing, and Native American housing. In fiscal year 2005, HUD spent about \$26 billion to provide rent and operating subsidies that benefited over 4 million households.

Since 1996, we reported on weaknesses with the monitoring of housing assistance program delivery and the verification of subsidy payments. Specifically, we focused on the impact these weaknesses had on HUD's ability to (1) ensure intermediaries are correctly calculating housing subsidies and (2) verify tenant income and billings for subsidies. During the past several years, HUD has made progress in correcting this weakness, and in 2005, HUD continued its progress, including taking steps to fully establish a comprehensive program for reducing erroneous payments. These improvements, combined with the progress reported in prior years, enabled OIG to reclassify this weakness as a reportable condition. However, HUD's continued commitment to the implementation of a comprehensive program to reduce erroneous payments will be essential to ensure HUD's intermediaries are properly carrying out their responsibility to administer assisted housing programs according to HUD requirements.

The Department has demonstrated improvements in its internal control structure to address the significant risk that HUD's intermediaries are not properly carrying out their responsibility to administer assisted housing programs according to HUD requirements. HUD's increased and improved monitoring has resulted in a continuing downward trend in improper payment estimates over the last three years. However, HUD needs to continue to place emphasis on its on-site monitoring and technical assistance to ensure acceptable levels of performance and compliance are achieved and periodically assess the accuracy of intermediaries rent determinations, tenant income verifications, and billings.

Tenant income is the primary factor affecting eligibility for, and the amount of, housing assistance a family receives and the amount of subsidy HUD pays. Generally, HUD's subsidy payment makes up the difference between 30 percent of a household's adjusted income and the housing unit's actual rent or, under the Section 8 voucher program, a payment standard. The admission of a household to these rental assistance programs and the size of the subsidy the household receives depend directly on its self-reported income. However, significant amounts of

excess subsidy payments occur because of intermediaries rent determinations, and undetected unreported or underreported income. By overpaying rent subsidies, HUD serves fewer families. Every dollar paid in excess subsidies represents funds that could have been used to subsidize other eligible families in need of assistance.

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## Verification of Subsidy Payments

The estimate of erroneous payments that HUD reports in its Performance and Accountability Report relates to HUD's inability to ensure or verify the accuracy of subsidy payments being determined and paid to assisted households. HUD has surpassed interim goals for reducing the fiscal year 2000 estimated \$2 billion in net annual rental housing assistance overpayments. HUD's interim goals were for a 15 percent reduction in fiscal year 2003, 30 percent reduction in fiscal year 2004, and 50 percent reduction in fiscal year 2005. These goals were established based on the fiscal year 2000 estimates of improper payments attributed to both housing administrator errors in subsidy determinations and tenant underreporting of income upon which benefits are based.

Although 60 percent of all subsidy determinations were found to be in error in 2000, that number declined to 41 percent in fiscal year 2003, and 34 Percent in fiscal year 2004. The baseline estimate of gross annual improper payments has been reduced from \$3.2 billion in 2000 to \$1.6 billion in 2003 and \$1.2 billion in 2004.

This year's contracted study of HUD's three major assisted housing programs estimated that the rent determination errors made by the intermediaries still resulted in substantial subsidy overpayments and underpayments. The study was based on analyses of a statistical sample of tenant files, tenant interviews, and income verification data for activity that occurred during fiscal year 2004. This study reports subsidy payment inconsistencies such that HUD incorrectly paid \$987 million in annual housing subsidies of which about \$681 million in subsidies was overpaid on behalf of households paying too little rent, and about \$306 million in subsidies underpaid on behalf of households paying too much rent based on HUD requirements. The estimate of erroneous payments is reported in HUD's Fiscal Year 2005 Performance and Accountability Report.

The estimate of erroneous payments this year also includes overpaid subsidies from underreported and unreported income and intermediaries' billings errors. HUD estimated that housing subsidy overpayments from tenants misreporting their income totaled an additional \$255 million in overpayments during calendar year 2004. However, during our test work we found an additional case resulting in a valid error. The weighted subsidy cost error for this additional case is \$11 million. Therefore, the revised subsidy overpayments estimate is \$266 million.

In addition, HUD reported an estimate of erroneous payments for its intermediary's subsidy billings errors related to Office of Housing's project-based Section 8 housing program. This estimate was reported last year, but was included this year with the estimate for the Public and Indian Housing's tenant-based Section 8 and low-income housing subsidy programs. Based on the payments errors that were identified, HUD reported an estimated \$100 million in Office of Housing's program billings errors for fiscal year 2003. In addition, HUD reported its fiscal year 2003 billings error estimate of \$6 million at the tenant level for the tenant-based Section 8 housing program and \$24 million at the project level. However, we did note during our review that the five pre-test project billing studies did not have final results and that there were eight instances in which files could not be found in the tenant-level portion of the study. Additionally, the low-income housing program estimate of \$84 million was included in this year's estimate. In the prior year, HUD did not provide an estimate for its low-income housing subsidy program because it had not previously developed such an estimate. HUD's actions to ensure that an estimate was developed demonstrates their efforts to improve the deficiencies noted in prior years concerning the rent subsidies. Therefore, adding last year's estimate of \$100 million to this year's Public and Indian Housing estimate of \$30 million for Section 8 and the \$84 million for operating subsidy makes the estimate of erroneous payments total \$214 million for billings errors.

In addition to the RHIIP-related estimates, HUD does an annual risk assessment under the Improper Payments Information Act, with statistical sampling and measurement of programs determined to be at possible high risk of improper payments. OIG was provided the results of the 2005 risk assessment effort and the results of the statistical sampling on five grant programs that started last year and carried-over for completion and reporting this year. HUD identified the gross estimate for erroneous payments from the Capital Fund Program to be \$133 million. This is above the \$10 million threshold defined by OMB M-03-13. Therefore, HUD is required to report an estimate of the annual amount of erroneous payments in this program and an action plan to reduce the error rate. Estimates for the remaining four program areas were below the \$10 million threshold.

#### HUD needs to continue initiatives to detect unreported tenant income

HUD, housing authorities, and project owners have various legal, technical and administrative obstacles that impede them from ensuring tenants report all income sources during the certification and re-certification process. In fiscal year 2004, HUD pursued statutory authority from Congress to access and use the Department of Health and Human Service's National Directory of New Hires Database to detect unreported income during the certification and re-certification process.

In fiscal year 2005, HUD began implementation of the Enterprise Income Verification System. The purpose of the system is to make integrated income data available from one source for Public Housing Authorities to use to improve

income verification during mandatory reexaminations. The Enterprise Income Verification System is able to provide new hire, wage, unemployment compensation, and Social Security benefit information through a data matching process for households covered by a HUD Form 50058. The Enterprise Income Verification System is available to Public Housing Authorities nationwide. HUD has encouraged all Public Housing Authorities to use and implement the Enterprise Income Verification System in their day-to-day operations. During the latter part of fiscal year 2005, HUD's Enterprise Income Verification System began utilizing the New Hires Database for programs administered through local Public Housing Authorities. By the end of fiscal year 2006, HUD plans to consolidate all available income matching data sources in the Enterprise Income Verification System for use by program administrators in all HUD rental assisting housing programs.

### More progress needed on the RHIIP initiatives

HUD initiated the Rental Housing Integrity Improvement Project initiatives in fiscal year 2001 in an effort to develop tools and the capability to minimize erroneous rental subsidy payments, which includes the excess rental subsidy caused by unreported and underreported tenant income. Since our last report, HUD has made progress in implementing several of these initiatives that address the problems surrounding housing authorities' rental subsidy determinations, underreported income, and assistance billings. However, HUD still needs to ensure that they fully utilize automated tools to (1) detect rent subsidy processing deficiencies, (2) identify and measure erroneous payments, and (3) have housing authorities submit all required data.

In the past, the Office of Public and Indian Housing performed rental integrity monitoring reviews to identify incorrectly paid rental subsidy that result from incorrect rental subsidy determinations made by housing authorities. Approximately 700 re-reviews were conducted in 2004 of the 490 Public Housing Authorities that receive 80 percent of HUD funding. During our review of the four field sites visited this year, we noted that of the 23 re-reviews in our sample, 19 Public Housing Authorities showed a decrease in subsidy calculation errors and four showed an increase in errors. However, during fiscal year 2005, rental integrity monitoring reviews were not performed since the Department's focus was on implementing the Enterprise Income Verification System. Consequently, according to this year's Management Plan, the Department's major goals concerning the rental integrity monitoring part of RHIIP was to follow-up on existing Corrective Action Plans to assure that they have been implemented and to verify that systemic errors have been corrected. In addition, field offices were required to follow-up on sanctions, disallowed costs, and SEMAP adjustments that resulted from the re-reviews.

The fiscal years 2003 and 2004 Rent Integrity Monitoring re-reviews resulted in 206 correction action plans. As a general guideline, the Department allows six to twelve months for a corrective action plan to be implemented. However, Field

Offices can seek approval to extend corrective action plans beyond one year if there are extenuating circumstances that prevent closure within one year. At the time our fieldwork commenced, 34 of the corrective action plans were still open and two Public Housing Authorities were sanctioned because of not implementing a corrective action plan. The Department has made great strides in assuring that 83 percent of the corrective action plans have been closed out. However, HUD must continue to assure that corrective action plans are implemented and closed out, thereby assuring that the systemic errors identified during the re-reviews were corrected.

In June 2005, HUD reinstated the sanctions policy for Public Housing Authorities with Public Housing Information Center Form 50058 reporting rates under 95 percent. The notice requires Public Housing Authorities to submit, on a timely basis, 100 percent of Form HUD-50058 records to the Public Housing Information Center system as set forth by 24 CFR Part 908 and the consolidated annual contributions contract. However, the Public Housing Information Center system information was incomplete and/or inaccurate during our testing of the four field sites. While reviewing the Public Housing Information Center system we noted that at all four sites tested, system generated numbers were not always accurate in relation to the 50058 form reporting rates. Consequently, field staffs were not always using the delinquency reports because its usefulness was limited as a management tool. HUD uses the tenant data from its Public Housing Information Center system for the income-matching program and program monitoring. To accomplish these two objectives, it is essential that the databases have complete and accurate tenant information.

Multifamily project monitoring has improved as more projects are transferred to the Performance Based Contract Administrator (PBCA)

The verification of tenant income and Section 8 subsidies is essential in ensuring rental assistance is correctly calculated and that recipients are eligible. The Office of Housing has increased its efforts to verify tenant data and the accuracy of Section 8 subsidies during Management and Occupancy Reviews as more of the project based Section 8 portfolio is transferred to the Performance Based Contract Administrator program.<sup>2</sup>

By the end of fiscal year 2005, contract administrator awards had been accomplished for each state. Under the Performance Contract Administrator Program, all housing projects covered by assistance contracts receive an annual Management and Occupancy Review, whereas the projects that are administered by HUD staff and traditional Contract Administrators do not. Due to limited resources, the selection of properties for a Management and Occupancy Review conducted by HUD staff and traditional Contract Administrators is based primarily on factors related to the risks associated with deteriorating physical conditions and with the risks associated with loan default. The scheduling of reviews does not include an assessment of factors directly associated with the risk of owner non-compliance with occupancy requirements.

At the end of fiscal year 2005, 13,628 contracts were assigned to a Performance Based Contract Administrator, whereas only 4,896 contracts (26 percent of the entire multifamily portfolio) were still administered by HUD staff or a traditional Contract Administrator. As a result, more than 74 percent of multifamily projects in this portfolio received an annual Management and Occupancy Review during fiscal year 2005. Each year, more projects within HUD's Section 8 portfolio are successfully transferred into the Performance Based Contract Administrator Program.

We are encouraged by the increased use of Performance Based Contract Administrators. We support the plans to increase the frequency of management and occupancy reviews for the assisted portfolio and suggest that similar to the approach to physical inspections, they be performed more frequently for troubled and potentially troubled projects, and that occupancy review work be emphasized.

HUD has made substantial progress in taking steps to reduce erroneous payments. However, they must continue regular on-site and remote monitoring of the Public Housing Authorities and use the results from the monitoring efforts to focus on corrective actions when needed.

We are encouraged by the on-going actions to focus on improving controls regarding income verification as well as HUD's plans regarding Corrective Action Plans, institutionalizing the rental integrity monitoring process, and the continual income and rent training for HUD, owners, management agents, and Public Housing Authority staff.

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## **Reportable Condition: Controls over HUD's Computing Environment Can be Further Strengthened**

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

We evaluated selected information systems general controls of the Department's computer systems, on which HUD's financial systems reside. Our review found information systems controls weaknesses that could negatively affect the integrity, confidentiality, and availability of computerized data. This audit report summarizes the control weakness found during the review.

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## Entity wide Security Program

HUD has made significant efforts to improve its entity wide security program, but continued progress is needed to fully comply with federal requirements. HUD has appointed a chief information security officer, revised its information security policy, and completed certification and accreditation for more than 90 percent of its applications. However, the quality of the underlying documents and the actual certification and accreditation process varied by application. While a number of vulnerabilities were closed, additional vulnerabilities, identified through oversight activities, were not corrected before accreditation.

We found HUD program officials and system owners have not fully met their responsibilities as specified in section 3544(a) of the Federal Information Security Management Act. In addition, HUD has not fully implemented an agency-wide information system security program as specified in section 3544(b). Improvements are needed in maintaining an adequate system inventory, properly categorizing security impact level for information systems, providing sufficient training to program officials and contractor staff with specialized information security responsibilities, and developing and testing contingency plans. Details can be found in a previously issued OIG memorandum.<sup>2</sup> In addition, we plan to issue a separate detailed audit report on HUD's entity-wide security program.

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## Computing Environment

We found that user access controls over HUDCAPS, PAS, Hyperion, and the Financial Data Mart application systems need strengthening. We found that these financial application systems do not have an adequate user access recertification process. Specifically,

- Twenty-five percent (271 out of 1,084) of the HUDCAPS users were not recertified during 2004. There was no user recertification completed in fiscal year 2005. According to Office of the Chief Financial Officer, recertification of HUDCAPS users is in process and completion of this task will not be completed in its entirety until after the end of the 2005 fiscal year.
- Forty-eight percent (11 out of 23) of the PAS users from the Office of the Chief Financial Officer in Headquarters were not recertified during 2004. It was not until after we began our inquiries into recertification procedures that the users were recertified on August 9, 2005.

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<sup>2</sup> Audit Memorandum No. 2006\_DP-0801, "OIG Response to Questions from the Office of Management and Budget under the Federal Information Security Management Act of 2002," dated October 4, 2005.

- There is no formal user access recertification process in place for the Hyperion application. The system administrator for the Hyperion application performed email verifications to determine whether non-Office of the Chief Financial Officer users still required access. However, this control's effectiveness is limited because the email verifications were sent to the users of the system instead of to the users' managers.
- There is no formal user access recertification process in place for the Financial Data Mart application. The Office of the Chief Financial Officer indicated that a new user access form would be sent out for Financial Data Mart users and any users who do not submit the new approved form would have their access removed.

HUD Handbook 2400.25, Section 5.1, item (e), "Identification and Authentication" requires that user access be reviewed once a year. The National Institute of Standards and Technology Special Publication 800-12<sup>4</sup>Section 10.2.2 states, "While it may initially appear that such reviews should be conducted by systems personnel, they usually are not fully effective. System personnel can verify that users only have those accesses that their managers have specified. However because access requirements may change over time, it is important to involve the application manager, who is often the only individual in a position to know current access requirements."

These conditions occurred because management does not consistently enforce policies and procedures among the various application systems. Failure to enforce policies and procedures consistently among systems leaves the Department vulnerable to oversight and errors in the maintenance of user accounts. Users may be granted access rights in excess of those needed to perform their job functions.

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### **Network Environment**

A number of weaknesses in HUD's network security were found during a vulnerability assessment performed by an OIG contractor. For example, we found that (1) HUD did not sufficiently protect connections to its network, (2) HUD's intrusion detection system did not detect or discontinue internal scans, (3) there are vulnerabilities in the configuration of Unix and Windows operating systems and networks, and (4) critical patches were not applied in a timely manner.

Those vulnerabilities were a result of inadequate patching, the use of unnecessary services, blank passwords, and default settings. Detailed results of the vulnerabilities identified were provided to HUD during a meeting on September 22, 2005 and are being disclosed in a separate limited distribution audit report. The National Institute of Standards and Technology Special Publication 800-42<sup>5</sup> indicates "security testing must fill the gap between the state of the art in system

development and actual operation of these systems. Security testing is important for understanding, calibrating, and documenting the operational security posture of an organization. Security testing is an essential component of improving the security posture of your organization. Organizations should conduct routine tests of systems and verify that systems have been configured correctly with the appropriate security mechanisms and policy. Applying patches in a timely manner can sharply reduce the vulnerability exposure of an organization. Penetration testing is an effective complement to vulnerability testing, aimed at uncovering hidden vulnerabilities.”

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### **Unisys Operating System**

We followed up on security weaknesses and vulnerabilities reported last year and found that HUD has addressed some of the previously identified deficiencies. We found that although some areas have been addressed, none of the recommendations are fully implemented and corrective actions are expected to be completed during fiscal year 2006. Nevertheless, our follow-up showed that: (1) a security plan which will address specific Unisys technical controls and document security policies and procedures is currently being developed; (2) useable security reports have been developed and audit logs have been enabled; and (3) experienced staff has been assigned to monitor, maintain and review the security reports and audit logs. However, some deficiencies still exist. Specifically, (1) security awareness and training have not been implemented; (2) adequate controls that would not allow users to have excessive privileges to functions that bypass security controls have not been implemented; and (3) although initiated, final user testing of the residue clear<sup>3</sup> system feature has been deferred until the completion of conversion to a newer technology. According to Office of the Chief Information Officer, these deficiencies are to be corrected in fiscal year 2006.

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### **Development of Contingency Plans**

We followed up on contingency planning weaknesses reported last year and found that although HUD has not developed contingency plans for all systems identified in its inventory of automated systems, HUD has made and plans to continue making progress. Specifically,

- HUD has performed tabletop<sup>7</sup> contingency plan testing for 40 out of 154 (26 percent) systems of which 23 of the 40 systems were covered by the initial contingency plan testing conducted by Electronic Data Systems

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<sup>3</sup> The residue clear system feature clears data from previously assigned storage to ensure that residual data are not available to a newly assigned user who may not be authorized to view the data. Enabling this feature would eliminate the risk that a newly assigned or unauthorized user would be able to retrieve deleted data without the owner's consent.

(EDS) on July 30, 2005. This limited testing was done at SunGard's disaster recovery sites in Pennsylvania.

- HUD provided a contingency planning strategy workshop for system owners and program officials in September 2005 and October 2005, and has scheduled additional workshops in November. HUD expects that these workshops will continue.
- EDS has developed the following contingency plans and procedures in March 2005: (1) HUD HITS Interim Data Center Disaster Recovery Plan, (2) EDS Disaster Recovery Plan for HUD Critical Production Disaster Recovery Test Procedures (Unisys, LAN, MVS), and (3) EDS Disaster Recovery Plan for HUD Unisys and MVS Load Procedures.
- HUD's OCIO plans to complete tabletop testing for all contingency plans by December 30, 2005.
- The Chief Information Security Officer indicated that more tests would be performed to test the disaster recovery capabilities at the SunGard recovery sites during fiscal year 2006.

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

For several years we have reported that HUD's personnel security over critical and sensitive systems' access has been inadequate. Although HUD continues to strive to make progress to address the reported problems, risks of unauthorized access to the Department's critical financial systems remain a major concern. We followed up on previously reported personnel security weaknesses and deficiencies and found that the Department still does not have a central repository that would account for all users with above-read (query) access to all HUD general support and application systems. Specifically,

- HUD's Online User Registration System (HOURS)<sup>4</sup> has not been fully implemented. The Office of the Chief Information Officer had proposed to initiate a plan to fully implement HOURS, which would ensure that all existing user data are tracked. Instead, OCIO now plans to replace HOURS with Alpha Five, which they plan to implement December 31, 2006.
- There are no detailed procedures to automatically identify and match background investigations in a database with user application access data. The intent of this recommendation was to develop procedures that would identify user data and include that data in the reconciliation procedures. Because no procedures were

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<sup>4</sup> HOURS is an online registration system that if fully implemented, would contain information about authorized users, including requests for access to automated resources and approvals. All systems administrators would be required to register users and their access level into this database.

developed, we cannot be assured that all users who have above read access to sensitive systems have the appropriate background investigations.

Without adequate personnel security practices, inappropriate individuals may be granted access to HUD's information and resources that could result in destruction or compromise of critical and sensitive data. We followed up on this issue and noted that OCIO plans to replace its online user registration system with Alpha five by December 31, 2006.

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

HUD needs to improve controls over the monitoring of obligation balances to determine whether they remain needed and legally valid as of the end of the fiscal year. HUD's procedures for identifying and deobligating funds that are no longer needed to meet its obligations are not always effective. This has been a long-standing weakness. Our review of the 2005 year-end obligation balances showed \$208 million in excess funds that could be recaptured. Although HUD has made some progress in implementing procedures and improving its information systems to ensure accurate data are used, further improvements in financial systems and controls are still needed. Major deficiencies include:

- Timely reviews of unexpended obligations are not being performed, and
- A lack of integration between accounting systems and the need for accurate databases has hampered HUD's ability to evaluate unexpended Section 8, Rental Assistance Payment, and Rent Supplement obligations.

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

Annually, HUD performs a review of unliquidated obligations to determine whether the obligations should be continued, reduced, or canceled. We evaluated HUD's internal controls for monitoring obligated balances.

### ***Section 8 Programs***

Section 8 budget authority is generally available until expended. As a result, HUD should periodically assess and identify excess program reserves in the Section 8 programs as an offset to future budget requirements. Excess program reserves represent budget authority originally received, which will not be needed to fund the related contracts to their expiration. While HUD had taken some action to identify and recapture excess budget authority in the Section 8 programs,

weaknesses in the review process and inadequate financial systems continue to hamper HUD's efforts. There is a lack of automated interfaces between the Office of Public and Indian Housing and the Office of Housing subsidiary records with the Department's general ledger for the control of program funds. This necessitates that HUD and its contractors make extensive use of ad hoc analyses and special projects to review Section 8 contracts for excess funds. This has hampered HUD's ability to timely identify excess funds remaining on Section 8 contracts.

The Office of Housing has been hampered in its attempts to evaluate unexpended Section 8 project-based budget authority balances. The requirement to evaluate data from two payment methods, managed by two accounting systems has hampered Housing's ability to monitor obligations and execute recaptures uniformly for contracts in both systems. In fiscal year 2005, approximately \$1 billion in unliquidated obligation balances were recaptured in the Section 8 project-based program. Our review of the Section 8 project-based contracts in HUD's Central Accounting and Program System and Program Accounting System/Line of Credit and Control System showed an additional 33 and 65 contracts respectively that had expired on or prior to September 30, 2004 with available contract/budget authority. These 98 contracts had \$40 million in excess funds potentially available for immediate recapture. This is an improvement from the prior fiscal year when we identified \$473 million in excess funds that should have been recaptured. For the \$40 million in unliquidated obligations for expired Section 8 contracts identified as excess, HUD processed an accounting adjustment to deobligate the funds.

In August 2005, the Office of Public and Indian Housing performed a recapture of expired contracts in the Moderate Rehabilitation housing program totaling \$307.5 million. Our review showed that after the recapture, HUD still possessed \$625.7 million in available contract/budget authority to cover their projected requirements totaling \$178 million. The Office of Public and Indian Housing stated that these funds were not recaptured because they were obligated on active contracts and would be considered for recapture next fiscal year.

During fiscal year 2005, the Office of Public and Indian Housing performed an analysis of budget authority for the Section 8 tenant-based program and recaptured approximately \$514.4 million of unexpended budget authority. These funds were generated primarily by reducing the reserve that housing agencies received under the Housing Choice Voucher Program from a reserve of one month to a one week reserve.

#### ***Administrative/Other Program Obligations***

Requests for obligation reviews were forwarded by the Chief Financial Officer to the program and administrative offices. The focus of the review was on program obligations that exceeded a \$265,000 balance and administrative obligations that exceeded \$28,000. Excluding the Section 8 and Section 235/236 programs, which undergo a separate review process by the program offices, the total dollar amount

of obligations identified for review totaled \$944.9 million. Of the \$944.9 million, HUD identified 3,878 transactions totaling \$69.3 million for potential deobligation. We tested the 91 obligations above the Department's review thresholds to determine whether the associated \$35.8 million balances had been deobligated in HUD's Central Accounting and Program Accounting System. We found that, as of September 30, 2005, 33 of the 91 transactions with obligational authority of \$10.7 million had not been deobligated.

### ***Rent Supplement and Rental Assistance Payments***

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

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

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

We performed a review of the Multifamily Projects unliquidated obligations accounts under the Rent Supplement and Rental Assistance programs. Our review showed \$157 million in undisbursed contract authority from prior fiscal years on 98 Multifamily Projects that should be recaptured. These projects had been terminated, converted to Section 8, or opted out from the programs and their associated funds had not been recaptured. This deficiency resulted from the lack of procedures to track and periodically review the project accounts and associated funding requirements.

For the \$157 million in excess undisbursed contract authority identified by OIG in the Rent Supplement and Rental Assistance Payment programs, HUD processed adjustments to deobligate the funds. Starting in fiscal year 2006 Rental Assistance and Rent Supplement programs will be included in HUD's Department-wide obligation review process.

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

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

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**Reportable Condition: HUD Needs to Continue Improving Controls for Developing Estimates of Required Budget Authority for the Section 236 Interest Reduction Program.**

The budget authority related to Section 236 Interest Reduction Program is included in the Statement of Budgetary Resources. This program is not considered a major program and is categorized as one of HUD's "other programs" in the various consolidating financial statements. The Section 236 Interest Reduction Program was created under the National Housing Act as amended in 1968 and new activity was ceased during the mid 1970's. The contracts entered into were typically up to 40 years in duration and over 3,100 contracts remained active. The activities carried out by this program include making interest reduction payments directly to mortgage companies on behalf of multifamily project owners. The obligations were established based upon permanent indefinite appropriation authority and HUD was obligated to fund these contracts for their duration. At the time they enter into the contract, HUD was to record an obligation for the entire amount. Because of the age of the records and the absence of sound financial practices at the time the program was active, HUD has been forced to use the best information available to compute estimated future payments to be made over the life of the loans. These estimates are the basis for HUD's currently recorded obligated balances necessary to fully fund the contracts to their expiration. HUD adjusts the recorded obligations as they proceed through the terms of the contracts to reflect better estimates of the financial commitment. Factors that can change the budgetary requirements over time include contract terminations, refinancing, and restructuring.

Deficiencies in the Section 236 Interest Reduction Program have been reported by the OIG in prior reports on the financial statements. The Offices of Housing and the Chief Financial Officer have been hampered by historically poor record keeping in their attempt to determine and account for unexpended Section 236 Interest Reduction Program budget authority balances. In response to last year's OIG report and an OMB condition to the Department's request for \$495 million in additional budget authority based on permanent indefinite appropriation, the Department initiated a contract to review the documentation supporting the 236 contract and budget authority. HUD competed a contract-by-contract accounting in August 2005 to identify individual under-reported balances as well as over-reported balances in order to meet OMB's request. While sufficient budget authority was already recorded in HUD's books to meet current requirements, based on this review, the Department estimated that the Department's recorded balances would not be sufficient to cover estimated funding requirements over the remaining durations of the contracts. Accordingly, another apportionment was

requested by the Department and approved by OMB on September 29, 2005 to provide \$757 million in additional budget authority based on permanent indefinite appropriation.

Our review showed an improvement in HUD's procedures and documentation to support the amounts recorded on the subsidiary ledgers. However, we noted that HUD still needs to continue their review of contract files to obtain needed documentation support. There are 51 projects where, due to missing documentation and problems interpreting ambiguous language used in some contracts, HUD could not yet determine if the term of the Interest Reduction Program agreement was 40 or 50 years. To be conservative, HUD assumed that these Interest Reduction Program agreements would be valid for 50 years from the date they were executed. As a result, there is a potential overstatement of the \$5 billion cumulative obligation balance ranging from \$61 million to \$352 million. In addition, we noted four contracts where HUD assumed the agreements were for 50 years and the file documentation supported contract durations of less than 50 years. HUD reduced their obligation balance for the estimated run-out costs for these contracts by \$20.6 million.

In addition, our review showed 17 Interest Reduction Program contracts with \$148 million in contract and budget authority that could be deobligated. These 17 contracts had either been terminated, prepaid, or the owners had opted-out of the program.

HUD's actions to identify and centralize documentation to support the subsidiary records of Section 236 Interest Reduction Program should enable accurate estimates of future budgetary authority. However, HUD still needs to research contracts with incomplete documentation and ensure the communication of changes to Section 236 portfolios, including projects that are refinanced, terminated, or restructured. In addition, HUD needs to obtain legal advice for clarifying ambiguous language in contracts to determine the correct amortization period. HUD and the Legal Counsel should consider when clarifying the ambiguous language that this program's purpose was intended to help project owners with the repayment of the debts based on term of mortgage notes and not assume the subsidy payments are for the maximum period of 50 years.

## Compliance with Laws and Regulations

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### HUD Did Not Substantially Comply with the Federal Financial Management Improvement Act

During fiscal year 2005, the Department continued to address its financial management deficiencies and took steps to bring the agency's financial management systems into compliance with Federal Financial Management Improvement Act. HUD has continued to obtain independent reviews of its financial management systems to verify compliance with financial system requirements, identify system and procedural weaknesses and develop the corrective actions steps to address identified weaknesses.

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

As part of a multiphase project, HUD implemented a new FHA automated general ledger in October 2002. This new system automated FHA's posting of transactions to the Standard General Ledger. In fiscal years 2004 and 2005, FHA completed the implementation of its core financial system implementation with the addition of cash management, funds control, and contract modules. With these improvements, the Department became substantially compliant with FFMIA Standard General Ledger provision and is moving in the direction of FFMIA compliance with Federal financial management systems requirements. We have included the specific nature of noncompliance issues, responsible program offices and recommended remedial actions in Appendix C of this report.

#### Federal Financial Management System Requirements

In its *Fiscal Year 2005 Accountability Report*, HUD reports that 2 of its 44 financial management systems do not comply with the requirements of the Federal Financial Management Improvement Act and OMB Circular A-127, *Financial Management Systems*. Even though 42 individual systems have been certified as compliant with Federal Financial Management Systems Requirements, collectively and in the aggregate, deficiencies still exist. In addition to deficiencies noted in HUD's Accountability Report, we report as a reportable condition that *HUD/FHA System Environment Needs to Comply with Federal Financial Systems Requirements*. This reportable condition addresses how HUD's financial management systems remain substantially noncompliant with Federal financial management requirements.

We also continue to report, as reportable conditions that *Controls over HUD's Computing Environment Can be Further Strengthened, and Weak Personnel Security Practices Continue to Pose Risks of Unauthorized Access to the Department's Financial Systems*. These reportable conditions discuss how weaknesses with general controls and certain application controls, and weak security management increase risks associated with safeguarding funds, property, and assets from waste, loss, unauthorized use or misappropriation.

Independent A-127 compliance reviews of eight systems and OIG audit reports have disclosed security over financial information was not provided in accordance with OMB Circular A-130 *Management of Federal Information Resources*, Appendix III and the Federal Information Security Management Act.

# APPENDIXES

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## Appendix A

### Objectives, Scope, and Methodology

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Management is responsible for:

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

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

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

We considered HUD's internal control over Required Supplementary Stewardship Information to be reported in HUD's *Fiscal Year 2005 Performance and Accountability Report* by obtaining an understanding of the design of HUD's internal controls, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls as required by OMB Bulletin 01-02, *Audit Requirements for Federal Financial Statements* and not to provide assurance on these internal controls. Accordingly, we do not provide assurance on such controls.

With respect to internal controls related to performance measures to be reported in the "Management's Discussion and Analysis" and HUD's *Fiscal Year 2005 Performance and Accountability Report*, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin 01-02. Our procedures were not designed to provide assurance on internal control over reported performance measures and, accordingly, we do not provide an opinion on such controls.

To fulfill these responsibilities, we:

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

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

Our consideration of the internal controls over financial reporting would not necessarily disclose all matters in the internal controls over financial reporting that might be reportable conditions. We noted certain matters in the internal control structure and its operation that we consider reportable conditions under OMB Bulletin 01-02. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect HUD's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements.

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

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

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

## Appendix B

### Recommendations

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To facilitate tracking recommendations in the Audit Resolution and Corrective Action Tracking System, this appendix lists the newly developed recommendations resulting from our report on HUD'S fiscal year 2005 financial statements. Also listed are recommendations from prior years' reports that have not been fully implemented. This appendix does not include recommendations pertaining to FHA issues because they are tracked under separate financial statement audit reports of that entity.

#### Recommendations from the Current Report

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

- 1.a. Deobligate all excess unexpended funds identified as a result of the fiscal year 2005 audit of financial statements.
- 1.b. Include the Rental Assistance Program, Rent Supplement, and Interest Reduction Programs under the Departments year-end review of open obligations.
- 1.c. Develop written procedures to ensure the communication of changes to Rental Assistance Program and Rent Supplement portfolios, including projects that are refinanced, terminated, converted to other programs, or opted out of the program.

With respect to the reportable condition that controls over HUD's computing environment can be further strengthened, we recommend that the **Chief Financial Officer**:

- 2.a. Implement additional management controls over the user recertification review process for HUDCAPS and PAS to ensure that the access levels of all system users are reviewed annually.
- 2.b. Implement user recertification policies and procedures for the Financial Data Mart and Hyperion application systems and ensure that the policies and procedures are enforced.

With respect to the reportable condition that HUD needs to continue improving controls over developing estimates of required budget authority for Section 236 Interest Reduction Program, we recommend that the **Chief Financial Officer** in conjunction with the **Office of Housing**:

3.a. Research contracts with incomplete documentation to obtain adequate support for the computation of budgetary resources required for all active Section 236 Interest Reduction Program contracts.

3.b. Deobligate all excess unexpended Section 236 funds identified as a result of the fiscal year 2005 audit of financial statements.

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## **Unimplemented Recommendations from Prior Years' Reports**

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

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

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

1.e. Redirect priorities to fully implement the Public Housing Information Center capabilities for tracking and monitoring housing quality inspection deficiencies and IA audit report recommendations. In addition, hold the field office accountable for obtaining current and complete data from the housing authorities and for maintaining current and complete data in the Public Housing Information Center in a timely manner. (Final action target date is December 31, 2006.)

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

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

2.f. Make resources available to develop a realistic method to identify tenants/owners who erroneously report income. (Final action target date is November 15, 2006.)

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

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

1.a. Conduct a review of the public housing subsidies and intermediaries' billings to determine whether the subsidies were recorded, billed and collected in accordance with HUD policies and regulations. The review should establish the amount of erroneous payments resulting from intermediaries' billings to HUD for the public housing program, and serve as a baseline for implementing corrective action to reduce or eliminate the erroneous payments resulting from intermediary's billings. (Final action target date is November 15, 2005.)

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

10.b. Strengthen procedures to annually or more frequently review Section 8 programs for unexpended funds that can be recaptured and used to offset future budget requirements. (Final action target date is November 15, 2005.)

10.c. Strengthen accounting procedures for the Section 236 IRP program to (1) record prepayments and remove inactive contracts in a timely manner, and (2) compute estimated subsidy payments using proper amortization factors. (Final action target date is October 31, 2005.)

10.d. Strengthen the accounting for the Section 236 Interest Reduction Program by developing an integrated automated system. (Final action target date is October 31, 2005.)

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## OIG Report Number 2004-FO-0003 (Fiscal Year 2003 Financial Statements)

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

1.a. Initiate corrective action to address the underlying causes for the erroneous payment resulting from billing errors, such as the intermediaries' failure to accurately report or maintain required documentation of subsidy determinations, and bookkeeping and procedural errors. (Final action target date is November 30, 2005.)

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

3.a. Initiate corrective action to address the underlying causes for the erroneous payment resulting from billing errors, such as the intermediaries' failure to accurately report or maintain required documentation of subsidy determinations, and bookkeeping and procedural errors. (Final action target date is November 30, 2005.)

accurately report or maintain required subsidy determination documentation, and bookkeeping and procedural errors. (Final action target date is November 15, 2006.)

3b. Establish controls over the HUD administered project-based Section 8 payment process at FMC to comply with Title VII of the GAO Policy and Procedures Manual for Guidance of Federal Agencies. (Final action target date is November 15, 2006.)

3.c. Establish criteria to enforce the accuracy of the data submitted through TRACS. (Final action target date is November 15, 2006.)

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### **OIG Report Number 2005-FO-0003 (Fiscal Year 2004 Financial Statements)**

With respect to the material weakness on improvements needed in oversight and monitoring of subsidy calculations and intermediaries program performance, we recommend that the **Chief Financial Officer**:

1.a. Assume overall responsibility for the erroneous payments estimate to ensure that the studies to develop the erroneous payments estimate are funded and completed so that the estimate can be developed by the end of the fiscal year. (Final action target date is October 7, 2005.)

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

2.a. Direct the field office to require housing authorities to initiate corrective action for all tenants when the rental integrity reviews identify systemic deficiencies. (Final action target date is November 30, 2005.)

2.b. Require the field offices to initiate sanctions, disallow and recapture costs or other take action when the rental integrity review indicates housing authorities continue to have significant incorrect rental subsidy determinations. (Final action target date is November 30, 2005.)

2.c. Require the field offices to conduct periodic rental integrity reviews as part of the monitoring strategy for all housing authorities. (Final action target date is November 30, 2005.)

2.d. Establish requirements to ensure that housing authorities report accurately and fully all tenant data every reporting period in which rental subsidies are expended. Final action target date is November 30, 2005.)

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

- 4.a. Deobligate all excess unexpended funds identified as a result of the fiscal year 2004 audit of financial statements. (Final action target date is December 31, 2005)

With respect to the reportable condition that HUD needs to improve the controls over developing estimates of required budget authority for Section 236 Interest Reduction Program, we recommend that the **Chief Financial Officer** in conjunction with the **Office of Housing**:

- 5.a. Develop written procedures for developing estimates for budgetary resources and communicating changes to Section 236 portfolios, including projects that are refinanced, terminated, or restructured. (Final action target date is November 30, 2005)
- 5.b. Maintain adequate documentation to support the computation of budgetary resources for all active Section 236 Interest Reduction Program contracts. (Final action target date is November 30, 2005)

## Appendix C

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

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

#### Federal Financial Management Systems Requirements

1. HUD's annual assurance statement issued pursuant to Section 4 of the Financial Manager's Integrity Act will report two non-conforming systems<sup>9</sup>

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

<u>Responsible Office</u>	<u>Number of Systems</u>	<u>Non-Conforming Systems</u>
Office of Housing	19	0
Chief Financial Officer	14	1
Office of Administration	4	1
Office of Public and Indian Housing	3	0
Government National Mortgage Association	2	0
Office of Community Planning and Development	2	0
	<u>44</u>	<u>2</u>

The following section outlines the Department's plan to correct noncompliance with OMB Circular A-127.

**Office of the Chief Financial Officer**

<b><u>System</u></b>	<b><u>Outstanding Noncompliance Issue @ 09/30/05</u></b>	<b><u>Plan @9/30/05</u></b>	<b><u>Target date to Complete all Phases</u></b>	<b><u>Resources</u></b>
A21 - Loan Accounting System	<ul style="list-style-type: none"> <li>Integrated Financial Management System</li> </ul>	Initiate Stage  Begin Procurement Effort for SDM, Define stage  Award Contract  Develop Functional Requirements  Complete Functional Requirements  COTS procurement solicitation  Implement a replacement system for LAS	Complete  Complete  Complete  Complete  Complete  12/31/2005	\$225,779

**Office of Administration**

<b><u>System</u></b>	<b><u>Outstanding Noncompliance Issue @ 09/30/05</u></b>	<b><u>Plan @9/30/05</u></b>	<b><u>Target date to Complete all Phases</u></b>	<b><u>Resources</u></b>

<p>D67A – Facilities Integrated Resource Management System</p>	<ul style="list-style-type: none"> <li>• Inadequate Internal Controls</li> <li>• Integrated Financial Management System Functional</li> </ul>	<p>Short term:</p> <ul style="list-style-type: none"> <li>• Issued memoranda and the existing standard operating procedures to each of the five HUD organizations responsible for the purchase and/or management of assets, reiterating the importance of following the policies and procedures for recording computer equipment purchases in FIRMS.</li> <li>• Conducted refresher training for inventory management staff.</li> <li>• Implement annual physical inventories of all HUD equipment. Ensure that all HUD-owned equipment has a barcode and is registered in FIRMS.</li> <li>• Interface FIRMS with HUD Procurement systems (HPS/SPS). Provide the ability to perform periodic comparisons of assets identified by HPS/SPS as being purchased by HUD and those assets residing in FIRMS.</li> <li>• Interface FIRMS with HUD General Ledger. Provide the ability to perform a periodic analysis of assets purchased by HUD and those assets residing in FIRMS.</li> <li>• Update SOPs as necessary and reissue annually to the organizations responsible for the purchase and/or management of assets.</li> <li>• Perform quarterly FIRMS/General Ledger reconciliation.</li> </ul>	<p>Complete</p> <p>Complete</p> <p>Complete</p> <p>Complete</p> <p>Complete</p> <p>01/31/2006</p> <p>12/31/2005</p>	<p></p> <p></p> <p>\$9,000</p> <p>\$11,000</p> <p></p> <p></p>
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		<p>Mid Term:</p> <ul style="list-style-type: none"> <li>Continue to perform quarterly FIRMS/General Ledger reconciliation.</li> <li>Continue to perform annual physical inventory.</li> </ul> <p>Long Term:</p> <ul style="list-style-type: none"> <li>Full automate integration of FIRMS with HUD General Ledger and Procurement Systems in accordance with the Administration Consolidated Plan (ACP). This is a three-year effort projected to begin in FY 2007.</li> </ul>	<p>Quarterly</p> <p>Annually with target of 12/31</p> <p>09/2009 Subject to availability of funding</p>	<p>\$6,000,000 over 3 years</p>
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2. Our audit disclosed reportable conditions regarding the security over financial information. Similar conditions have also been noted in HUD’s A-127 reviews and other OIG audit reports. We are including security issues as a basis for noncompliance with FFMIA because of the collective effect of the issue and noncompliance with Circular A-130, Appendix 3 and the Federal Information Security Management Act (FISMA). The responsible office, nature of the problem and primary causes are summarized below.

**Responsible Office**

**Nature of the Problem**

**Office of Administration/Chief Information Officer**

HUD program officials and system owners have not fully met their responsibilities as specified in section 3544(a) of the Federal Information Security Management Act. In addition, HUD has not fully implemented an agency-wide information system security program as specified in section 3544(b).

These conditions occurred because HUD does not maintain an adequate system inventory, properly categorize security impact level for information systems, provide sufficient training to contractor staff with specialized information security responsibilities, and develop and test the contingency plans.

**Office of Administration/Chief Information Officer**

HUD does not have an adequate user access recertification process for HUDCAPS, PAS, Hyperion, and the Financial Data Mart application systems.

These conditions occurred because management does not consistently enforce policies and procedures among the various application systems.

**Responsible Office**

**Nature of the Problem**

**Office of  
Administration/Chief  
Information Officer**

HUD's networked environment is vulnerable in that (1) HUD does not sufficiently protect connections to its network, (2) HUD's intrusion detection system does not detect or discontinue internal scans, (3) there are vulnerabilities in the configuration of Unix and Windows operating systems and networks, and (4) critical patches are not applied in a timely manner.

These conditions exist because of inadequate patching, the use of unnecessary services, blank passwords, and default settings.

**Office of  
Administration/Chief  
Information Officer**

HUD has not implemented sufficient controls over the Unisys 2200 operating system. It has not (1) implemented security awareness and training; (2) implemented adequate controls that will not allow users to have access to functions that bypass security controls; (3) completed final user testing of the residue clear system feature.

These conditions occurred because management has not addressed these issues and plans corrective actions in fiscal year 2006.

**Office of  
Administration/Chief  
Information Officer**

There is inadequate assurance that HUD would be able to recover information technology operations in a timely and orderly manner in the event of a disruption.

This occurred because HUD has not developed contingency plans for all systems identified in its inventory of automated systems.

**Office of  
Administration/Chief  
Information Officer**

The Department still does not have a central repository that would account for all users with above-read (query) access to all HUD general support and application systems.

This condition occurred because HUD has not fully implemented the HUD Online User Registration System (HOURS), but plans to replace HOURS with Alpha Five by December 31, 2006.

**Office of Housing and  
CIO**

The single family and multifamily insurance and related financial systems are not effectively managed as a "unified set of systems" resulting in control weaknesses with the FHA Subsidiary Ledger's (FHASL) disaster recovery planning, risk assessment and contingency planning process and other components of system security.

One of the contributing causes to these issues is the continuing weakness in HUD's certification and accreditation (C&A) program. The C&A program is designed to ensure that system and application information security controls are in place and operating effectively (certification), and that the appropriate management official has formally accepted any security risks of the system (accreditation).

## Appendix D

### SCHEDULE OF QUESTIONED COSTS AND FUNDS PUT TO BETTER USE

Recommendation Number	Ineligible 1/	Unsupported 2/	Unreasonable or Unnecessary 3/	Funds Put to Better Use 4/
1a				\$208,249,091
3b				\$169,344,232

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law, contract or Federal, State or local polices or regulations.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity where we cannot determine eligibility at the time of audit. Unsupported costs require a future decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of Departmental policies and procedures.

3/ Unnecessary/Unreasonable costs are those costs not generally recognized as ordinary, prudent, relevant, and or necessary within established practices. Unreasonable costs exceed the costs that would be incurred by a prudent person in conducting a competitive business.

4/ Funds Put to Better Use are quantifiable savings that are anticipated to occur if an OIG recommendation is implemented resulting in reduced expenditures in subsequent period for the activities in question. Specifically, this includes costs not incurred, de-obligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings.

# Appendix E

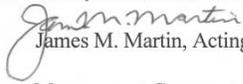
## AGENCY COMMENTS



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

OFFICE OF THE CHIEF FINANCIAL OFFICER

November 4, 2005

MEMORANDUM FOR: Randy McGinnis, Director, Financial Audits Division, GAF  
FROM:   
James M. Martin, Acting Deputy Chief Financial Officer, F  
SUBJECT: Management Comments on Draft Report on HUD's  
Fiscal Year 2005 Financial Statements – Internal Control  
and Compliance Sections

Thank you for the opportunity to comment on the subject draft report's internal control and compliance sections, as requested in your memorandum of October 31, 2005. We are pleased to see the recognition of HUD's continuing progress in strengthening its internal controls and financial systems, as evidenced by the reclassification of two longstanding material weakness issues to reportable conditions. With the exception of the draft report's conclusion on HUD's compliance with the Federal Financial Management Improvement Act of 1996 (FFMIA), we generally agree with the nature of the internal control deficiency or enhancement issues raised in the draft report, and the recommended corrective or improvement actions, but request reconsideration of the significance and presentation of some of the draft finding issues in your final report. Our formal comments are provided in the attached chart for your consideration. Additional detailed comments regarding technical corrections or considerations have been provided to you under separate cover.

As noted in your incoming request for comments, work on the audit continues and further changes to the report may be necessary. We request an opportunity to comment on any additional or significantly revised finding issues developed during the remainder of the audit.

The President's mandate for the accelerated preparation, audit and issuance of annual federal agency financial statements within 45 days after the end of the fiscal year is a significant challenge for the Department and its auditors. At this point, we anticipate meeting that goal this year and I want to thank you and your audit team for the collaborative manner in which you worked with HUD management and staff towards bringing this annual audit cycle to a successful conclusion. Working together, we continue to improve HUD's financial management operating environment as a foundation for the important mission of the Department. If you have any questions on our comments, please feel free to contact me on 708-1946, or Jerome Vaiana of our staff at 708-0614, extension 8106.

Attachment

[www.hud.gov](http://www.hud.gov) [espanol.hud.gov](http://espanol.hud.gov)

**HUD Management Comments on OIG's Draft FY 2005 Financial Statement Audit  
Internal Control and Compliance Section**

**Draft Material Weaknesses on the Need to Continue to Improve its Review over the FHA Credit Reform Estimation Process and Incorporate Better Risk Factors and Monitoring Tools Into FHA's Single Family Insured Mortgage Program Risk Analysis and Liability Estimation Process** – The draft report proposes that two internal control issues from the separate audit of the Federal Housing Administration (FHA) be brought forward and reported as material weaknesses in HUD's consolidated financial statement audit. While FHA completed its planned corrective actions to strengthen management's review of the Credit Reform estimation process in FY 2005, FHA's auditors, the accounting firm of Urbach, Kahn and Werlin LLP, disclosed the need for additional quality control in two areas. FHA also continued to strengthen controls related to the prior year reportable condition on its monitoring of lender underwriting and loan portfolio risk assessment tools for insured single family mortgages. Nevertheless, FHA's auditors have recommended future enhancements to these processes. While HUD agrees with the recommended enhancements to FHA's existing risk analysis and credit reform estimation processes, and associated quality controls, we reiterate the FHA response to their auditors that the nature of the recommended process enhancements do not warrant reporting as material internal control weaknesses in the FHA's current processes. HUD management is including these interrelated issues as a reportable condition under its Federal Managers' Financial Integrity Act (FMFIA) reporting, and plans to complete the corrective actions necessary to eliminate both of these audit issues in the next audit cycle.

**Draft Reportable Condition: HUD/FHA System Environment Needs to Comply with Federal Financial Management System Requirements** – HUD agrees with the reclassification of this longstanding material weakness issue to a reportable condition, and appreciates the OIG's recognition of the progress made in improving financial systems operations and compliance. However, we find the draft report's finding that HUD is still not substantially compliant with the Federal Financial Management Improvement Act of 1996 (FFMIA) to be inconsistent with this reclassification and recognition of improvements. OMB's "Revised Implementation Guidance for the Federal Financial Management Improvement Act" states that: "In determining whether an agency's financial management systems substantially comply with FFMIA, management and auditors need to consider whether a system's performance prevents the agency from meeting the specific requirements of FFMIA..." The OMB guidance states that FFMIA was intended to assure that agency systems "generate reliable, timely and consistent information necessary for Federal managers' responsibilities." The guidance further states that: "Agencies that can:

- Prepare financial statements and other required financial and budget reports using information generated by the financial management system(s);
- Provide reliable and timely financial information for managing current operations;
- Account for their assets reliably, so that they can be properly protected from loss, misappropriation, or destruction; and
- Do all of the above in a way that is consistent with Federal accounting standards and the Standard General Ledger are substantially compliant with FFMIA."

Now that the previous FHA financial systems deficiencies have been remediated through the FHA Subsidiary Ledger Project, HUD's position is that its core financial management system is substantially compliant with FFMIA in that the above requirements are being fulfilled. We agree that our systems processes can be more efficiently integrated, to eliminate the need for existing compensating controls, but the existing environment is substantially compliant and not representative of a material risk of misreporting. We request that OIG consider revisions to the draft report sections pertaining to HUD's compliance with FFMIA.

We further request that OIG clarify the nature of the remaining reportable condition. We suggest that the title be revised to read "HUD System Environment Enhancements Would Better Meet Federal Financial Management System Requirements." We also request reconsideration or detailed support for much of the narrative in this section of the draft report. For example, we do not agree that we are generally lacking the information/data needed to operate our programs or fulfill mandatory reporting requirements, as inferred in the draft report. While we don't have systems that do everything we would like, and at the push of a button, our data systems do support federal financial reporting requirements and provide the necessary data to inform budget, management and operational decisions.

**Draft Reportable Condition: HUD Needs to Improve Controls over Performance Measures Data Reliability** – As indicated in the draft report, OIG's audit work on this issue had not yet been concluded at the time the draft report was issued for management comment. Since the time this issue was originally established as an audit-related reportable condition in 1999, HUD has: addressed the original findings on data controls; established a data quality improvement process; and improved the reporting of data sources and limitations in its PAR. While HUD acknowledges the need to continue to improve the quality of performance data reflected in its annual Performance and Accountability Report (PAR), we believe this issue does not warrant continued reporting as a financial statement audit issue and request it be removed from OIG's final report.

**Draft Reportable Condition: HUD Needs to Continue Improvements Made in the Oversight and Monitoring of Subsidy Calculations and Intermediaries Program Performance** – HUD agrees with the reclassification of this longstanding material weakness issue to a reportable condition, and appreciates the OIG's recognition of the progress made in strengthening internal controls and reducing improper payments in HUD's largest program area. HUD's plans to implement the Enterprise Income Verification System and sustain an adequate on-site monitoring presence should remove this reportable condition in FY 2006.

**Draft Reportable Conditions: Controls Over HUD's Computing Environment Can be Further Strengthened, and Weak Personnel Security Practices Continue to Pose Risks of Unauthorized Access to the Department's Critical Financial Systems** – HUD appreciates the recognition that "HUD has made significant efforts to improve its entity wide security program" and we agree that "continued progress is needed to fully comply with federal requirements" for systems security and other controls over HUD's computing environment. We further agree that HUD has not yet completed the planned action to establish a central repository that would account for all users with above-read (query) access to all HUD general support and application systems, to

address the previously established reportable condition on personnel security weaknesses. However this action is scheduled for implementation by December 31, 2006, and we request OIG's consideration of combining this remaining action on the reportable condition on personnel security as part of a single reportable condition on Controls Over HUD's Computing Environment.

**Draft Reportable Conditions: HUD Needs to Improve Processes for Reviewing Obligation Balances, and HUD Needs to Continue Improving Controls for Developing Estimates of Required Budget Authority for the Section 236 Interest Reduction Program** – HUD made significant progress in addressing both of these reportable conditions in FY 2005, including:

- Changes to Section 8 Program funding processes and methodologies for recapturing excess program funds addressed prior Inspector General audit concerns regarding large obligation balances on expired contracts and enabled HUD to recapture over \$1.5 billion to meet enacted rescission mandates and other program needs; and
- A reconciliation and reconstruction of records for over 3,300 projects in the Section 236 Interest Reduction Program enabled HUD to establish a revised estimate of the remaining program run-out costs of over \$5 billion, with provisions for an improved integration and automation of the program business and accounting processes to maintain accurate program balances going forward.

HUD agrees with the OIG's FY 2005 findings and recommendations on the need for better controls over obligation balances in the Rental Assistance Program and Rental Supplement Program, and to clarify obligation balances on the 51 projects remaining from the FY 2005 reconciliation of the Section 236 Interest reduction Program portfolio. However, given the reduced scope and significance of these issues, we request OIG's consideration of combining the remaining issues into one reportable condition on the Need to Further Improve Processes for Reviewing Obligation Balances.

## Appendix F

### OIG EVALUATION OF AGENCY COMMENTS

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With the exception of the report's conclusion on HUD's compliance with the Federal Financial Management Improvement Act of 1996 (FFMIA), management generally agreed with our presentation of findings and recommendations subject to detail comments. HUD's management disagrees with the conclusion that HUD is still not substantially compliant with FFMIA, and finds the conclusion inconsistent with the warranted reclassification of the former material weakness on HUD's compliance with federal financial systems requirements to a reportable condition. HUD agrees that their systems processes can be more efficiently integrated to eliminate the need for existing compensating controls, but feel the existing environment is substantially compliant and not representative of a material risk of misreporting.

We disagree with HUD's conclusions. FFMIA emphasizes the need for agencies to have systems that are able to generate reliable, useful, and timely information for decision-making purposes and to ensure accountability on an ongoing basis. The deficiencies noted in HUD's financial management systems are due to the current financial system being developed prior to the issuance of current requirements. It is also technically obsolete, has inefficient multiple batch processes, and requires labor-intensive manual reconciliations. Because of these inefficiencies, HUD's management systems are unable to routinely produce reliable, useful, and timely financial information. This weakness manifests itself by limiting HUD's capacity to manage with timely and objective data, and thereby hampers its ability to effectively manage and oversee its major programs.

In addition, HUD is not fully compliant with one of the three indicators of compliance with Federal financial management requirements. HUD has material deficiencies related to security over financial management information systems in accordance with FISMA and OMB Circular A-130 Appendix III. The Department has not met the minimum set of automated information resource controls relating to Entity-wide Security Program Planning and Management. Specifically, the Department is not compliant with Federal requirements in the areas of maintenance of Security Plans and Risk Assessments, Independent Review of Technical Security Controls, and the testing of Contingency Plan and Disaster Recovery tests.