



Audit Report

**Financial Audits Division
Office of Audit**

*U.S. Department of Housing
and Urban Development
Audit of Fiscal Year 1997
Financial Statements*

*98-FO-177-0004
March 20, 1998*

U.S. Department of Housing and Urban Development
Office of Inspector General
Office of Audit, Room 8284
451 7th Street SW
Washington, D.C. 20410-4500



Audit Report

Financial Audits Division Office of Audit

Report: 98-FO-177-0004

Issued: March 20, 1998

TO: Richard F. Keevey, Chief Financial Officer, F

FROM:  James A. Heist, Director, Financial Audits Division, GAF

SUBJECT: Audit of the U.S. Department of Housing and Urban Development
Fiscal Year 1997 Financial Statements

In accordance with the Chief Financial Officers (CFO) Act of 1990, this report presents the results of our audit of HUD's principal financial statements for the year ended September 30, 1997. Also provided are assessments of HUD's internal controls and compliance with laws and regulations. HUD continues to face major challenges in its efforts to correct longstanding material internal control weaknesses. As we discuss in the report, HUD needs to overcome issues with its internal control environment, such as the need to upgrade financial systems and improve resource management, that are hindering its ability to carry out its mission and improve the management of its programs. Our report discusses the significance of HUD's financial management and control problems and HUD's actions to correct them. Our report also contains recommendations to assist the Department in its continuing efforts to correct these longstanding problems.

In performing our audit, we also identified several matters which, although not material to the financial statements, are being communicated to the Department separately. We appreciate the courtesies and cooperation extended to the OIG staff and those of our contractor.

In accordance with HUD Handbook 2000.6 REV-2, within 60 days, please submit to me, for each recommendation listed in the first section of Appendix B that is addressed to you or the Acting Deputy Secretary, a status report on: (1) the corrective action taken; (2) the proposed corrective action and target completion dates; or (3) why action is considered unnecessary. For recommendations addressed to the assistant secretaries, please coordinate their response or, at your option, request that they respond directly to me. A status report is not required for recommendations 5.a. and 5.b. as we are issuing a management decision concurrent with the issuance of this report. An additional status report is required on any recommendation without a management decision after 110 days. Also, please furnish us with copies of any correspondence or directives issued in response to the audit.

Table of Contents

OIG Transmittal Memorandum.....	i
Independent Auditor’s Report.....	1
HUD’s Internal Control Environment.....	13
Verification of Subsidy Payments.....	23
Monitoring Program Recipients.....	33
System Issues.....	47
Compliance with Laws and Regulations.....	57
<hr/>	
Financial Statements	
Consolidated Statement of Financial Position.....	59
Consolidated Statement of Operations.....	60
Consolidated Statement of Cash Flows.....	61
Notes to the Consolidated Financial Statements.....	63
Consolidating Statement of Financial Position.....	95
Consolidating Statement of Operations.....	97
Consolidating Statement of Cash Flows.....	99
<hr/>	
Appendices	
A Objectives, Scope and Methodology.....	101
B Recommendations.....	105
C FFMIA Noncompliance, Responsible Program Offices and Recommended Remedial Actions.....	115
D Agency Comments.....	123
E Report Distribution.....	129

Abbreviations:

BRP.....	business resumption plan
CARC.....	Chicago Asset Recovery Center
CDBG.....	Community Development Block Grant
CHUMS.....	Computerized Homes Underwriting Management System
CPD.....	Office of Community Planning and Development
CFO.....	Chief Financial Officer
FERA.....	Front-End Risk Assessment
FFMIA.....	Federal Financial Management Improvement Act
FFS.....	Federal Financial Systems
FHA.....	Federal Housing Administration
FMC.....	Financial Management Center (Section 8)
FMFIA.....	Federal Managers' Financial Integrity Act
GAAP.....	generally accepted accounting principles
GAO.....	General Accounting Office
HA.....	housing authority
HAP.....	housing assistance payment
HUB.....	Voucher Processing "Hub"
HUD.....	Department of Housing and Urban Development
HUDCAPS.....	HUD's Central Accounting and Program System
IA.....	independent auditor
IDIS.....	Integrated Disbursement and Information System
IP.....	improvement plan
IRS.....	Internal Revenue Service
LOCCS.....	Line of Credit and Control System
LOI.....	Letter of Interest
MTCS.....	Multifamily Tenant Characteristics System
NPR.....	National Performance Review
OIG.....	Office of Inspector General
OMB.....	Office of Management and Budget
PAS.....	Program Accounting System
PHMAP.....	Public Housing Management Assessment Program
PIH.....	Office of Public and Indian Housing
RAMS.....	Risk Assessment Management System
REAC.....	Real Estate Assessment Center
SFFAS.....	Statement of Federal Financial Accounting Standards
SHFA.....	State Housing Finance Agency
SS.....	Social Security
SSA.....	Social Security Administration
SSI.....	Supplemental Security Income
SWAT.....	Special Workout Assistance Team
TARC.....	Troubled Agency Recovery Center
TRACS.....	Tenant Rental Assistance Certification System

Independent Auditor's Report

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

In accordance with the Chief Financial Officers (CFO) Act of 1990, we have audited the accompanying consolidated statements of financial position of the Department of Housing and Urban Development (HUD) as of September 30, 1997 and 1996 and the related consolidated statements of operations and cash flows for the fiscal years then ended. HUD's financial statements as of September 30, 1997 and 1996 and for the fiscal years then ended, taken as a whole, were reliable in all material respects, except as discussed below:

- ***Qualification with respect to the fiscal year 1997 and 1996 financial statements: accounting standards were not followed for FHA's loan programs***

As reported in Note 2 to the financial statements, in reporting on the mortgage insurance programs of the Federal Housing Administration (FHA), HUD's principal financial statements were not prepared in accordance with the requirements of Statement of Federal Financial Accounting Standards (SFFAS) Number 2, *Accounting for Direct Loans and Loan Guarantees*. This requires that agencies estimate and report cash flows relating to loans and loan guarantee commitments made after September 30, 1991, and that such cash flows be accounted for on a present value basis. FHA's mortgage insurance programs are presented in accordance with private sector *generally accepted accounting principles* (GAAP) which significantly differ from the reporting requirements of SFFAS Number 2. FHA, as a government corporation, prepares separate financial statements in accordance with GAAP. However, the Office of Management and Budget (OMB) has determined that HUD's Department-wide financial statements are to conform with SFFAS No. 2. Because HUD had not prepared the data required for inclusion in its financial statements in sufficient time, we were unable to apply sufficient procedures with respect to such information and were unable to determine the nature and extent of any differences that would result by reporting FHA's programs in accordance with SFFAS Number 2.

- ***Qualification with respect to the fiscal year 1996 financial statements: excess subsidy estimate is understated and not entirely statistically valid***

In Note 14 to the financial statements, HUD estimates that under its Section 8, Low Rent Public Housing (Operating Subsidy) and Section 202/811 Programs, \$939 million and \$538 million, plus or minus \$184 million and \$161 million, in excess rental subsidies were provided to participating households during calendar years 1996 and 1995, respectively. Under these programs, a participating household's income is a major factor affecting eligibility for, and the amount of, housing assistance a family

receives, and indirectly, the amount of subsidy HUD pays. In general, 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. HUD's estimate was developed in part through a review of a representative sample of households in its tenant databases. Households' income information from this sample was computer matched against federal income tax data maintained by the Social Security Administration (SSA) and Internal Revenue Service (IRS).

As we stated in our report dated March 21, 1997, HUD's estimate of excess subsidies that was included in the fiscal year 1996 financial statements was understated and not entirely statistically valid. With respect to the estimate included in the fiscal year 1997 financial statements, HUD addressed data limitations that we reported in our audit of the fiscal year 1996 financial statements, sufficient to provide for a reasonable estimate of the extent of excess subsidy payments. Specifically, in estimating the amount of excess rental subsidies, HUD (1) increased the number of assisted households in its tenant databases used to develop the estimate, (2) evaluated sample households whose income reported in the SSA/IRS data was from \$1,000 to \$3,000 in excess of the income reported in HUD's tenant databases and (3) included unreported income from SSA's Supplemental Security Income (SSI) program.

Opinion on the Financial Statements

In our opinion, except for the effects of adjustments, if any, as might have been determined to be necessary had we been able to perform sufficient procedures to satisfy ourselves as to (1) the effects of not preparing financial data for FHA in accordance with SFFAS No. 2 and (2) the statistical validity of a portion of or any additional amounts with respect to the Department's estimates of excessive housing assistance reported in the fiscal year 1996 financial statements, the accompanying financial statements present fairly, in all material respects, the financial position of HUD as of September 30, 1997 and 1996 and the results of its operations and cash flows for the fiscal years then ended, in conformity with the hierarchy of accounting principles described in OMB Bulletin 94-01, *Form and Content of Agency Financial Statements*.

Consolidating Financial Information

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating financial information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations and cash flows of HUD's major activities. The consolidating information is not a required part of the consolidated financial statements. The consolidating information has been subjected to the auditing procedures applied in the consolidated financial statements and, in our opinion, except for the qualifications described above, is fairly stated, in all material respects, in relation to the consolidated financial statements taken as a whole.

Unaudited Supplemental Information

HUD is preparing an unaudited balance sheet, statement of operations and selected footnotes as of September 30, 1997 and for the fiscal year then ended, to present FHA's financial position and selected results of operations based on the hierarchy of accounting principles described in OMB Bulletin 94-01, *Form and Content of Agency Financial Statements*, including the requirements of SFFAS No. 2. HUD plans to present this as supplemental information in its *Fiscal Year 1997 Accountability Report*. We did not audit this supplemental information and, accordingly, we do not express an opinion on it.

Material control weaknesses affect subsidies disbursed by HUD through various programs, primarily the Section 8, Low Rent Public Housing (Operating Subsidy) and Section 202/811 Programs. As a result, HUD lacks sufficient information to ensure that federally subsidized housing units are occupied by eligible families and that those families living in such units are paying the correct rents. Existing internal controls and financial systems do not provide adequate assurance that funds provided to housing authorities (HA) and multifamily project owners are correctly calculated based on participating families' eligibility, and that the objectives for which funding is provided are achieved. To provide for disclosure in HUD's financial statements as of September 30, 1997 and 1996 and for the fiscal years then ended, HUD initiated special projects to estimate the amount of unreported and under reported income of participating families, and the effect on HUD subsidies. While these special projects served as a basis for determining necessary disclosure, primarily for financial reporting purposes, they were limited in its scope, and have not corrected the material internal control weaknesses relating to the verification of these subsidy payments as discussed later in this report.

Our audit also disclosed:

- Material weaknesses in internal controls in fiscal year 1997 related to the need to:
 - complete improvements to financial systems;
 - improve resource management;
 - ensure that subsidies are based on correct tenant income;
 - continue efforts to improve monitoring of multifamily projects;
 - address FHA staff and administrative resource issues;
 - place more emphasis on early warning and loss prevention for FHA insured mortgages; and
 - improve FHA's accounting and financial management systems.

- Reportable conditions in internal controls in fiscal year 1997 related to the need to:
 - continue efforts to improve HUD's management control program;
 - continue efforts to develop improved performance measures;
 - continue efforts to improve the Office of Housing's subsidy payment process;
 - continue efforts to improve monitoring of HAs;

- complete implementation of a strategy to oversee Community Planning and Development (CPD) program grantees;
- improve general system security and other controls;
- strengthen access controls over HUD's major payment systems, the HUD Central Accounting and Program System (HUDCAPS) and the Line of Credit and Control System (LOCCS);
- continue actions to quickly resolve FHA's Secretary-held multifamily mortgage notes and minimize additional mortgage note assignments;
- sufficiently monitor and account for FHA's single family property inventory; and
- perform a review of processing controls for FHA's computer systems and place more emphasis on computer security.

Most of these control weaknesses were reported in prior efforts to audit HUD's financial statements and represent long-standing problems. In its *Fiscal Year 1996 Accountability Report*, HUD reported that it complied with Sections 2 and 4 of the Federal Managers' Financial Integrity Act (FMFIA), with the exception of the material weaknesses and nonconformances specifically identified in that report. Section 2 of FMFIA and related guidance generally require that an agency's internal accounting and administrative controls provide reasonable assurance that obligations and costs are in compliance with applicable laws; that funds, property and assets are adequately safeguarded; and that revenues and expenditures are properly and reliably accounted for and reported. Section 4 of FMFIA requires that accounting systems conform to the accounting principles and standards mandated by the Comptroller General of the United States. We disagreed with the Department's statement of overall assurance in the *Fiscal Year 1996 Accountability Report*. It did not fully consider the magnitude of the problems HUD acknowledges in its own FMFIA process. As was the case for fiscal year 1996, with OMB's approval as part of an initiative to streamline financial reporting, HUD did not prepare a separate FMFIA report for fiscal year 1997, but will be addressing those reporting requirements in its *Fiscal Year 1997 Accountability Report*. Given the magnitude of the problems that still remain, we continue to believe that an FMFIA statement of noncompliance would be appropriate for HUD.

Our audit also disclosed the following instances of non-compliance with applicable laws and regulations:

- HUD did not substantially comply with the Federal Financial Management Improvement Act (FFMIA).
- FHA was not in full compliance with data and accounting requirements of the Credit Reform Act. Specifically, FHA's single family periodic premium collection system does not maintain case-level cash flow data required by Credit Reform. Also, FHA incorrectly paid for some contractor expenses out of financing accounts instead of using program accounts as required by Credit Reform.

Apart from the above matters, we note that approximately \$70 billion of HUD's reported net position comprises funds appropriated to HUD to provide housing and community assistance in

the future under existing commitments. As discussed in Note 3 to the financial statements, HUD entered into long-term contracts and other commitments under its various grant and subsidy programs, most significantly, the Section 8 rental assistance program. Subsequent to 1988, the Congress appropriated funds to enter into and renew multiyear contracts for the entire contract terms in the initial year of the contract, the effect of which substantially increased HUD's net position. In recent years, the terms for Section 8 contract renewals have been generally declining to the point where recent renewals have generally been for a one year term. Amounts appropriated for Section 8 contracts are based on estimated information such as household income, inflation and rent which often differ from actual information over the contract terms. To the extent that actual costs are less than amounts appropriated, reserves can accumulate. During fiscal year 1997, HUD conducted a review of the costs of the tenant-based portion of the Section 8 contract renewal program administered by PIH and estimated that as of September 30, 1997, about \$9.9 billion in reserves had accumulated that was in excess of amounts needed to fund the related Section 8 contracts to their expiration dates. Pursuant to Public Law 105-18, as of September 30, 1997, HUD recaptured about \$7.7 billion of this amount of which the Congress rescinded \$3.65 billion. The remaining amount was transferred to a Congressionally mandated "Section 8 Reserve Preservation Account" for use in extending expiring Section 8 contracts.

As further discussed in Note 3, with respect to other Section 8 programs, primarily the project-based Section 8 programs administered by the Office of Housing, a substantial number of contracts remain that were executed prior to 1988, when the Congress gave HUD the authority to enter into multiyear contracts that were not funded for their entire terms of up to 40 years. HUD then used (and continues to use) permanent indefinite appropriations to fund only the current year's portion of the multiyear contracts. Because of the duration of these contracts, substantial amounts of permanent indefinite appropriations will continue to be used in future years. Beginning in fiscal year 1988, the Congress has appropriated the funds "up-front" for the entire contract term in the initial year. HUD has determined that additional budget authority will be needed to fully fund some project-based contracts over their remaining terms because the contract authority and/or "up-front" appropriations that have been provided will not be sufficient to cover contract expenditures in a number of cases. At the time of our audit, HUD was in the process of estimating the amount of additional budget authority that will be required to fund these contracts over their remaining terms. Pursuant to Public Law 105-18, the General Accounting Office (GAO) is conducting an audit to determine whether HUD's systems for budgeting and accounting for project-based Section 8 rental assistance ensure that unexpended funds do not reach unreasonable levels and that obligations are spent in a timely manner.

In addition to the matters that are referred to in Note 11.D., HUD has resolved 18 major civil rights housing cases. In order to resolve this litigation, HUD has agreed to undertake and has undertaken various actions, some of which will necessitate the expenditure of funds in future years from various HUD appropriations. Consistent with applicable accounting principles, HUD has not recorded a liability in its financial statements because performance under the agreements will not occur until future years and most of the agreements specify that future funds are to be provided pursuant to future appropriations, in accordance with the terms of the appropriations. Moreover, HUD's ability to carry out remaining obligations is contingent on the availability of future appropriations. However, the historic source of funding for litigation related Section 8 certificates and vouchers, the Headquarters Reserve Fund [42 U.S.C., 1439 (d) (4) (A) (iii)], is

not available to satisfy litigation settlements in fiscal years 1997 and 1998. Moreover, with respect to the HOPE VI program (Revitalization of Severely Distressed Public Housing), the Congress has expressly prohibited the Department, in awarding fiscal year 1997 and 1998 funds, from directly or indirectly granting a competitive advantage to settle litigation or pay judgments. The Office of Inspector General (OIG) has objected to HUD using set-asides of program funds for litigation settlements, as well as HUD's practice of awarding bonus points to applicants for settling litigation or paying judgments, on the ground that these set-asides and bonus points are not expressly permitted by statute. In addressing this issue, which we previously raised in our audit of HUD's fiscal year 1996 financial statements, HUD management advised that HUD has remaining unfunded obligations in 4 of the 18 cases and that the settlements recognize that the Congress may not provide funding. HUD management believes that should funding not be provided, the obligations may continue indefinitely or the Court may relieve HUD of its obligation, depending on the specifics of each case. With respect to future settlements, currently the Department has ongoing settlement discussions with only one case. In light of the diminished resources available for settling civil rights housing cases HUD has advised that it does not expect to enter into any settlements in which financial resources are committed, unless there is an existing appropriation under which HUD can provide funding.

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

Issues with HUD's Internal Control Environment

Fiscal year 1997 is the seventh year that HUD has been subject to audit under the provisions of the CFO Act. Most of the material weaknesses and reportable conditions discussed in this report are the same as those included in prior years' reports. HUD has been taking various actions to address the weaknesses and, in some instances, has made progress in correcting them. For the most part, however, progress has been at a slow pace in large part because HUD needs to address issues that fundamentally impact its internal control environment. HUD's ability to address its problems will substantially improve if it is successful in completing efforts to:

- upgrade its financial management systems,
- correct resource management shortcomings,
- address weaknesses with its management control program, and
- improve performance measures for its programs.

The most critical need faced by HUD in improving its control environment is to complete development of adequate systems. While HUD's efforts have met with some measurable success, much work remains and HUD will continue to report material system nonconformances in their *Fiscal Year 1997 Accountability Report*. Deficiencies with HUD's financial systems are a major factor affecting our ability to efficiently audit HUD's consolidated financial statements and render

an unqualified opinion on them. After investing over \$120 million on system integration projects over the last 6 years, the Department still relies mainly on legacy systems for financial management and program support. A number of critical financial management systems such as the Program Accounting System (PAS), Computerized Homes Underwriting Management System (CHUMS), LOCCS and others have been operational for over 15 years and are becoming increasingly difficult and costly to maintain. As part of the Secretary's *HUD 2020 Management Reform Plan (HUD 2020)*, the Department again revised its Financial Systems Integration (FSI) strategy. The *HUD 2020* plan calls for HUD to "modernize and integrate HUD's outdated financial management systems with an efficient, state-of-the-art system." The Department needs to ensure that the lack of control over project schedules and costs which has hampered the Department's ability to develop cost effective information systems in the past will not be repeated with this project. Until HUD completes the FSI plan and we have the opportunity to evaluate it and until the Department can demonstrate its ability to control performance of the implementation contractor, we remain concerned over the team's ability to exercise proper oversight over project schedules and costs.

In addition to improving its financial management systems, HUD will need to cope with inevitable staff decreases by completing development of a comprehensive strategy to manage its resources. Resource management continues to be a material weakness and the Department will continue to report this as such in its *Fiscal Year 1997 Accountability Report*. In developing its latest management reform plan, *HUD 2020*, HUD did not identify resource needs based on a detailed analysis of program functions, processes and anticipated workloads. Many of the weaknesses discussed in this report, particularly those concerning HUD's monitoring of program recipients, are exacerbated by HUD's resource management shortcomings. While we agree that HUD must reform, and agree with some of the corrective measures in the *HUD 2020* plan, we generally remain cautious about the potential effectiveness of HUD's new organizational configuration, the Department's capacity to implement its planned reforms, and the potential effectiveness of many of its planned reforms.

Later in this report, we elaborate on the need for improved systems and resource management. In addition, we discuss the need for HUD to address weaknesses with its management control program and improve performance measures for its programs.

Verification of Subsidy Payments

HUD spent about \$18 billion in fiscal year 1997 to provide rent and operating subsidies to HAs and multifamily project owners that benefited over 4 million lower-income households through a variety of programs, including public housing and several variants of the Section 8 program. HUD's control structure that was in place during fiscal year 1997 did not provide reasonable assurance that these funds were expended by HAs and project owners in compliance with the laws and regulations authorizing these programs. As noted previously, HUD estimates that excess subsidy payments exceeded \$900 million for calendar year 1996. The admission of a household to these rental assistance programs and the size of the subsidy it receives depend directly on its self-reported income. HUD's control structure does not provide reasonable assurance that subsidies

paid under these programs are valid and correctly calculated considering tenant incomes and contract rents.

Tenant income is a major factor affecting eligibility for, and the amount of, housing assistance a family receives, and indirectly, the amount of subsidy HUD pays. In general, 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. Tenants often do not report income or under-report income from a specific source which, if not detected, causes excessive subsidy payments by HUD.

As noted above, HUD has developed nationwide estimates of the amount of excess rental subsidies paid during calendar years 1996 and 1995. As we describe later in this report, various efforts are planned and underway to build upon this and address the need to institute an ongoing quality assurance program to improve controls over these payments. This includes various pilot federal income tax data matching projects. To ensure that these projects are effective, HUD needs to take action to improve the accuracy of and enforce requirements for HAs to timely update information in its tenant databases.

Monitoring Program Recipients

HUD provides grant and subsidy funds to HAs, multifamily project owners, nonprofits, and State and local governments (recipients), which, in-turn, provide housing and community development assistance to benefit primarily low income households. Weaknesses exist in HUD's control structure such that HUD cannot be assured that its funds are expended in accordance with the laws and regulations authorizing the grant and subsidy programs.

Legislation authorizing HUD's grant and subsidy programs includes specific criteria concerning tenant eligibility and allowed activities for which the funds can be expended. HUD's structure for oversight of recipients does not provide assurance that these funds are expended only on eligible tenants and allowed activities. Moreover, legislation authorizing HUD's funds also establishes minimum performance levels to be achieved with HUD funds. For example, subsidized housing must comply with HUD's housing quality standards. Here too, HUD's oversight structure does not provide it with assurance that these minimum performance levels are achieved.

Historically, HUD's oversight included the monitoring of recipients in accordance with compliance oriented procedures and frequency of reviews that applied to all recipients. In order to deal with resource limitations, in recent years, HUD has revised its monitoring strategies for its major programs to make them more risk based and focused on performance. We generally found that the field offices we visited were developing risk based plans for overseeing their recipients. However, we also found continuing problems, most notably with HUD's efforts to monitor multifamily projects.

Because of limitations in its ability to monitor recipients, HUD relies extensively on annual audits conducted by independent auditors (IA) pursuant to the Single Audit Act. HUD had issued revised guidance for audits of HAs to address concerns that the Office of Public and Indian Housing (PIH) and we have had for a number of years with the quality of these audits. As with

our prior audit, we reviewed IA audits performed using the revised guidance and confirmed last year's results by noting some areas of improvement over audits performed under previous guidance. However, we have identified some specific areas where the guidance needs to be improved and are encouraged by other initiatives being undertaken by PIH to increase the usefulness of these audits as monitoring tools.

System Issues

Because of the large volume of financial transactions, HUD relies heavily on automated information systems. In prior years, we reported on security weaknesses both in HUD's general processing controls and in specific application controls such that HUD could not be reasonably assured that assets are adequately safeguarded against waste, loss, and unauthorized use or misappropriation. Progress in improving these controls has been slow. Later in our report, we provide a detailed discussion of the weaknesses noted in our current review which relate to the need to improve:

- general system security and other controls and
- access controls over HUD's major payment systems, HUDCAPS and LOCCS.

Problems with FHA's Internal Controls Continue

In accordance with the CFO Act, a separate audit was performed of FHA's fiscal year 1997 financial statements by the independent certified public accounting firm of KPMG Peat Marwick LLP. Their report on FHA's financial statements dated March 6, 1998¹ includes discussions of interrelated material weaknesses that were also reported in prior audits of FHA's financial statements as follows:

- ***FHA must address staff and administrative resource issues.*** FHA must review the staffing levels, personnel skills versus skill needs, and training resources required under the current initiatives to streamline work into the single family Home Ownership Centers and to reengineer multifamily operations. These resource issues are complicated by national initiatives towards a smaller Federal government and prevent FHA from: (1) placing adequate resources on multifamily loss mitigation functions; (2) properly managing troubled multifamily assets; and (3) quickly implementing new automated systems. FHA must also address the impact on resources resulting from consolidating its nationwide single family operations into four Home Ownership Centers in fiscal year 1998.
- ***FHA must place more emphasis on early warning and loss prevention for insured mortgages.*** FHA must focus more attention on reducing the frequency and loss severity of defaults on insured mortgages by improving its efforts to identify and cure

¹ KPMG Peat Marwick LLP's report on FHA was incorporated in our report entitled, "Federal Housing Administration, Audit of Fiscal Year 1997 Financial Statements" (98-FO-131-0003, dated March 9, 1998).

troubled multifamily mortgages before they become seriously delinquent and by utilizing loss mitigation tools for the single family insured portfolio before properties are foreclosed.

- ***Continued emphasis must be placed on improving accounting and financial management systems.*** Some of FHA's automated systems either do not provide needed management information or do not produce reliable information. Better information systems for strategic decision-making would make monitoring loans more productive and staff more efficient. Improvements to the information systems are hindered because of budgetary constraints and the existence of other critical system priorities at HUD.

KPMG Peat Marwick LLP also notes three reportable conditions regarding the need for FHA to: (1) continue actions to quickly resolve multifamily Secretary-held mortgage notes and minimize additional mortgage note assignments and note servicing responsibilities, (2) sufficiently monitor and account for single family property inventory and (3) perform a review of processing controls for computer systems and place more emphasis on computer security.

KPMG Peat Marwick LLP also notes that FHA was not in full compliance with data and accounting requirements of the Credit Reform Act. Specifically, FHA's single family periodic premium collection system does not maintain case-level cash flow data required by Credit Reform. Also, FHA incorrectly paid for some contractor expenses out of financing accounts instead of using program accounts as required by Credit Reform.

We consider the above issues to be material weaknesses, reportable conditions and material noncompliance at the Departmental level. A more detailed discussion of these issues is not included in our report but can be found in KPMG Peat Marwick LLP's report on FHA's fiscal year 1997 financial statements.

Additional Actions Needed

Many of the issues described in this report represent long-standing weaknesses that will be difficult to resolve. HUD's management deficiencies have received much attention in recent years. For example, in January 1994, GAO designated HUD as a high risk area, the first time such a designation was given to a cabinet level agency. In February 1997, GAO updated their assessment but concluded that HUD's programs will remain at high risk to fraud, waste, abuse and mismanagement until it completes more of its planned corrective actions. As of the date of our current audit, GAO has not reported any changes in HUD's high risk status. A stated goal of the *HUD 2020* management reform is removal of HUD from the high risk list. As we reported in last year's audit, HUD's success in meeting this goal will depend on how successful it is in (1) eliminating major internal control weaknesses, fully implementing its management control program and ensuring the proper balance between program delivery and program monitoring; (2) completing efforts to integrate its major information and financial management systems; (3) completing plans for reorganizing headquarters and field offices, including redeploying staff and consolidating program activities and similar functions; and (4) completing efforts to assess

staff skills, develop appropriate training to meet certain skill needs, and increase the number of staff receiving training. As we have stated in the past, we continue to believe that while HUD can reduce staffing, HUD cannot on its own enable this reduced staff to function effectively. Congressional involvement is essential to redefine HUD's mission and programs to manageable proportions. HUD management shares this view, noting in their response to our report that HUD's ability to meet its staffing target is contingent, among other things, on the enactment of legislation by the Congress to consolidate HUD's program structure.

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

Agency Comments and Our Evaluation

On February 20, 1997, we provided a draft of the internal control sections of our report to the CFO and appropriate assistant secretaries for review and comment, and requested that the CFO coordinate a Department-wide response. A draft of the remaining sections of the report was provided on March 13, 1998. The CFO responded in a memorandum dated March 19, 1998 which is included in its entirety as Appendix D. The CFO's response, along with additional informal comments we received, were considered in preparing the final version of this report.

The Department did not disagree with most of our conclusions and recommendations, but in commenting on the material weakness relating to resource management, disagreed with our conclusion that in developing its latest management reform plan, *HUD 2020*, HUD did not identify resource needs based on a detailed analysis of program functions, processes and anticipated workloads. HUD cites an ongoing study by a management consulting firm, along with various other efforts that have been completed or are in process as HUD moves forward with implementing its management reforms.

We acknowledge that HUD is making progress and has recognized the need to make a serious effort to resolve its resource management shortcomings. However, our conclusions are based on the lack of an ongoing system that would match staff with workload, something that was not in place when the *HUD 2020* plan was first developed and continues to be lacking. Recent efforts that we have seen have been directed at justifying the existing staffing levels rather than to determine resource allocation needs. The recent consultant study mentioned in HUD's response has not been provided to us because it was still in draft at the time we issued this report.

The remainder of HUD's formal comments related to disagreements with some of our recommendations to address system security and general control weaknesses. We will attempt to resolve these disagreements through the audit resolution process.

The following sections of this report provide additional details on our findings regarding HUD's internal control environment, verification of subsidy payments, monitoring program recipients, system issues, and non compliance with laws and regulations.

Susan Gaffney
Inspector General

March 6, 1998

HUD's Internal Control Environment

HUD's Control Environment Is Hampering Efforts to Improve

Fiscal year 1997 is the seventh year that HUD has been subject to audit under the CFO Act. Most of the material weaknesses and reportable conditions discussed in this report are the same as those included in prior years' reports. HUD has been taking actions to address the weaknesses and in some instances has made progress in correcting them. For the most part, however, progress has been at a slow pace in large part because HUD needs to address issues that fundamentally impact its internal control environment. As discussed below, HUD's ability to address its problems will substantially improve if it is successful in completing efforts to:

- upgrade its financial management systems,
- correct resource management shortcomings,
- address weaknesses with its management control program, and
- improve performance measures for its programs.

Material Weakness: HUD Needs to Complete Improvements to its Financial Management Systems

As we have reported in prior efforts to audit HUD's financial statements, the Department does not have an efficient, effective, and integrated financial management system that can be relied upon to provide timely, accurate, and relevant financial information and reports to management. Although HUD has made some progress in implementing new integrated financial management systems, concerns remain and HUD continues to report material system nonconformances in its *Fiscal Year 1997 Accountability Report*. Deficiencies with HUD's financial systems are a major factor affecting our ability to efficiently audit HUD's consolidated financial statements and render an unqualified opinion on them. Major deficiencies in HUD's financial management systems reported in prior years and which continue to some degree include:

- Inadequate assurance about the propriety of Section 8 rental assistance payments.
- Insufficient information regarding the credit quality of individual multifamily loans. This makes assessing and quantifying credit risk difficult and prevents efficient, ongoing reporting of credit risk to senior management.
- The need for enhanced general ledger and subsidiary systems for FHA to facilitate better case level reporting and compliance with Credit Reform.

- Insufficient information concerning FHA operations by program, geographical area, or other relevant components.
- Lack of integration between program and accounting systems necessitating duplicate data entry, data inconsistencies, and the inability to blend financial and program data to develop meaningful performance measures.
- Security weaknesses in both HUD's general processing controls and in specific application controls.

Responsibilities for systems development have been established but progress remains slow

To address concerns with sluggish implementation, in fiscal year 1993, HUD revised its plans, approach and schedule for upgrading its systems used to support its principal business activities. One of the key elements of the revised plan was to give the program assistant secretaries responsibility for establishing systems priorities, developing work plans and schedules, preparing budget estimates and resource requirements, establishing project teams, and coordinating systems integration activities with other program initiatives (e.g., re-engineering). This approach has achieved some success. In a number of administrative and program areas, HUD has implemented systems plans. The Federal Financial System (FFS) was implemented for Salaries and Expenses Funds in fiscal year 1995. Increasingly functional versions of the Office of Housing's Tenant Rental Assistance Certification System (TRACS) have been implemented at all field locations. HUDCAPS for PIH's Section 8 Programs has been implemented at all field offices during fiscal year 1995. Over 950 CPD grantees are now using the Integrated Disbursement Information System (IDIS) online to support consolidated planning, disbursements and reporting requirements. The rest of the grantees are scheduled to be online by the end of this year. FHA implemented an electronic data interchange system to process and pay single family insurance claims, and an Internet connection for lenders to check the status of their mortgages.

Despite these accomplishments, however, progress remains slow. After investing over \$120 million on system integration projects over the last 6 years, the Department still relies mainly on legacy systems for financial management. Critical financial management systems such as PAS, CHUMS, LOCCS and others have been operational for over 15 years and are becoming increasingly difficult and costly to maintain. Numerous changes to these systems over the years were not adequately controlled or documented.

HUD revised its integration strategy under *HUD 2020* but concerns remain

In fiscal year 1997, HUD again revised its Financial Systems Integration (FSI) strategy to conform with of the Secretary's *HUD 2020* plan. Reform 2 of the plan calls for the Department to "modernize and integrate HUD's outdated financial management systems with an efficient, state-of-the-art system." The revised FSI plan calls for consolidation of four general ledger systems into a core financial system that conforms with the government-wide standards issued by the Joint Financial Management Improvement Program and OMB Circular A-127, *Financial*

Management Systems. This integrated system is to also include an Executive Information System and Geographic Information System containing consolidated data from programmatic feeder systems and/or data warehouses.

To acquire the software for the FSI, the Department used a General Services Administration required Letter of Interest (LOI) process to determine, based on need, the best product to use to build the integrated financial management system. However, before the LOI process was completed, the Department decided, based on cost, implementation schedules and risk considerations, to continue with implementation of the FFS software and forgo the option of acquiring a new software package to integrate HUD's financial management system. The initial phase of the FSI effort is to implement FFS as FHA's general ledger and a Department-wide consolidated general ledger by September 1998. Completing the next phase, to fully implement FFS as HUD's core financial system and integrate it with the program feeder systems, is targeted for September 1999.

We cannot at this time determine the ultimate outcome of the revised integration strategy. However, we note that the FSI team expects to receive basic project management training in March 1998, has acquired a project scheduler tool to support project management, has developed a work breakdown structure and is currently developing a risk management plan and a change control board. Although an initial project plan has been developed, detailing steps necessary for full implementation of HUDCAPS, the FSI team is still working on the HUD-wide detailed project plan scheduled to be completed by the end of March 1998. Until we receive the complete FSI plan and have the opportunity to evaluate it and until the Department can demonstrate its ability to control performance of the implementation contractor, we remain concerned over the team's ability to exercise proper oversight over project schedules and costs.

In addition to the need to complete integration of accounting and financial management systems, there is a continued need to protect all sensitive and critical systems under the security software already purchased for HUD's mainframe systems. While HUD continues to make progress in this area, as discussed later in this report, its systems are still not fully protected.

Material Weakness: HUD must Improve the Management of its Resources

As with many other Federal agencies, HUD's administrative resources have decreased over the years, while its workload has increased. We have previously reported that HUD has not developed a comprehensive strategy to manage its resources. Reducing and reallocating resources further weakens controls, particularly when coupled with inadequate financial systems. Resource management continues to be a material weakness and the Department will continue to report this as such in its *Fiscal Year 1997 Accountability Report*. Actions to achieve resource management have not been fully implemented and many actions are in the planning stage or are dependent on legislation to restructure HUD programs.

HUD's staff, which numbered about 17,000 in 1980, is in the process of being downsized to 7,500 by the year 2002 under the *HUD 2020* plan. Although HUD was considerably more

involved in public and assisted housing development in the early 1980's, we are unable to account for a staff reduction of 9,500 when compared to HUD's current and projected program workload, as well as its financial risk exposure. Since 1980, the number of HUD programs has increased by over 450 percent (from 54 to over 300), while HUD's staff has and will continue to be substantially reduced. We have previously reported our concerns with HUD's downsizing efforts, most recently in a November 1997 report entitled, *Interim Review of HUD 2020 Management Reform Plan*. HUD's staff downsizing target was adopted without first performing a detailed analysis of HUD's mission and projected workload under its proposed reforms. Consequently, HUD can neither support the propriety of its staffing target nor its allocation of staff among its newly proposed organizations.

HUD 2020 is the latest effort to restructure HUD

On June 26, 1997, the Secretary announced the *HUD 2020* plan. *HUD 2020* is one of the boldest attempts to date to overhaul and improve the Department's operations, and comes after numerous attempts over the years to address HUD's shortcomings. The plan calls for major staff downsizing, modification of HUD's Field and Headquarters organizational framework, consolidation of HUD's programs and activities, and significant changes in the way HUD conducts its business.

The roots of HUD's efforts to restructure itself can be traced back to the administration's National Performance Review (NPR). In September 1993, NPR recommended that HUD eliminate its regional offices, consolidate its field office structure and reduce its workforce by 1,500 by the close of fiscal year 1999. (In 1993, HUD's staff totaled about 13,500). In response to the NPR's recommendations, the former Secretary issued his proposed streamlining plan for HUD in December 1993.

In March 1995, HUD issued its report entitled *HUD Reinvention: From Blueprint to Action*. The report stated: "Significant downsizing is anticipated, reducing HUD's current workforce of 12,000 today to fewer than 7,500 employees." The downsizing target was tied to HUD's plan to (1) consolidate 60 of its major programs into three performance-based funds: a Community Opportunity Fund, an Affordable Housing Fund, and a Housing Certificates for Families and Individuals Fund; (2) phase out the direct funding of public housing in favor of providing direct assistance to residents; and (3) bring homeownership within reach of more citizens by transforming FHA into a businesslike, government owned Federal Housing Corporation. In conjunction with these goals, HUD planned to reduce its field offices from 80 to 60.

The staffing target from the *HUD 2020* plan is a carryover from HUD's 1995 Reinvention Blueprint. Because HUD has not completed a thorough analysis of the Department's mission and projected workload, HUD management is unable to demonstrate that the proposed staffing levels will be sufficient to carry out the Department's functions and activities. Although the House Appropriations Committee supports HUD's downsizing efforts, the Committee stated in its report on HUD's fiscal year 1998 appropriations that the Department's reorganization "...should not be accomplished merely for the sake of staff reduction, but should be done after careful study and review of the importance and level of business done at each field office."

While concerns remain, HUD 2020's success is critical to resolving long standing problems

Many of the weaknesses discussed in this report, particularly those concerning HUD's monitoring of program recipients, are exacerbated by HUD's resource management shortcomings. While we agree that HUD must reform, and agree with some of the corrective measures in the *HUD 2020* plan, we generally remain cautious about the potential effectiveness of HUD's new organizational configuration, the Department's capacity to implement its planned reforms, and the potential effectiveness of many of its planned reforms. As we reported in our interim review of *HUD 2020*, we also believe that the plan could have the unintended effect of compounding many of HUD's current problems, and could even create new problems for the Department.

One area that HUD needs to address is its contracting activities. HUD relies heavily on contractors to perform a wide variety of activities necessary in the administration of its programs. In our September 1997 audit report entitled *HUD Contracting*, we reported that the Department needs to improve in the following areas: (1) needs determination, planning and periodic assessments; (2) cost consciousness; (3) contractor oversight and monitoring; (4) contracting for prohibited services; (5) coordinated data and financial systems; (6) timely closeout procedures; and (7) interagency agreements. Because HUD's reliance on contractors is expected to continue, HUD, in acknowledging weaknesses with its contracting activities, has advised that it has made procurement reform a priority in the *HUD 2020* plan.

As noted later in this report as part of our concerns with monitoring of program recipients, HUD lacks adequate information concerning the quality of the housing stock under both the Office of Housing's multifamily and PIH administered programs. We reported in our audit of HUD's fiscal year 1996 financial statements that HUD was in the process of addressing this concern through contracting for basic physical inspections of all multifamily projects and independent housing quality assessments at selected HAs. A key component of the *HUD 2020* plan is to establish a Real Estate Assessment Center and standardized inspection protocol. As planning continues on this effort, HUD's previous initiative to assess the quality of the Office of Housing's multifamily projects was discontinued. Also, HUD's efforts to date to perform quality assessments at HAs have been limited. Moreover, HUD's success in addressing this long-standing monitoring deficiency is dependent upon a concept for standardizing inspections that, at the time of our current audit work, had not been tested.

It is too soon to determine whether HUD will ultimately be successful in carrying out the reforms called for in the *HUD 2020* plan. However, we are encouraged that HUD has recognized the need to address its resource shortcomings and has put forth such an extensive effort to restructure its operations.

Reportable Condition: HUD Needs to Continue Efforts to Improve its Management Control Program

FMFIA and accompanying guidance in OMB Circular A-123, *Management Accountability and Control*, require Federal managers to take systematic and proactive measures to (1) develop and implement appropriate, cost-effective management controls for results-oriented management, (2) assess the adequacy of management controls in Federal programs and operations, (3) identify needed improvements, (4) take corresponding corrective actions; and (5) report annually on management controls. In last year's audit of HUD's financial statements, we noted concerns with aspects of the management control program relating to (1) the manner of identification and analysis of risks associated with the implementation of new programs or activities, (2) identification of deficiencies and risks and their correction for ongoing programs, and (3) monitoring and controlling the audit resolution process.

HUD has initiated efforts to assess program risks

In prior audits of HUD's financial statements we noted that an integral component of HUD's management control program was performing Front-End Risk Assessments (FERA) on new or substantially modified HUD programs and activities. However, we reported that, for the most part, program officials were neither preparing FERAs nor justifying to the CFO why they should not be performed. During fiscal year 1997, as part of the *HUD 2020* initiative, HUD began addressing the need to hold managers accountable for (a) continuously identifying systemic weaknesses in their programs and (b) implementing effective risk abatement strategies. The CFO was assigned the responsibility for leading HUD's revitalized initiative known as the Management Integrity Program. To carry out the effort, the CFO has established an Office of Risk Assessment. The program has three major components.

- Incorporate FERAs into HUD's management reforms implementation efforts.
- Perform Risk Management Reviews of existing programs and develop a risk evaluation database.
- Conduct Special Risk Management Reviews upon request from program managers.

During fiscal year 1997, the Department performed 5 FERAs and 6 Special Risk Management Reviews with about 14 planned FERAs or reviews in process at September 30, 1997. However, the CFO's Office of Risk Management did not become operational until the second quarter of fiscal year 1998. Consequently, program Financial Officers had not been formally designated and the planned risk evaluation database had not been developed to ensure that program and operational risks were fully assessed at September 30, 1997. Departmental policy covering CFO and program responsibilities under the new Management Integrity Program have been developed but need to be formalized. While we believe the Management Integrity Program has been soundly conceived, it is too soon to evaluate how effective the program will be in addressing HUD's need to assess program risks.

HUD has not demonstrated effective efforts for assessing risks in ongoing programs

Departmental management has focused on goals to reduce the number of existing material weaknesses and has not demonstrated an effective management control program in assessing risks and developing the abatement strategies to reduce them. The same situation we reported in last year's audit continues to be the case since fiscal year 1991 -- the only new material weakness to be reported by the Department in its *Fiscal Year 1997 Accountability Report* was identified through an Inspector General report. Based on an August 1996 OMB memorandum, not identifying any new material weaknesses over a span of several years is reason to question an agency's assessment efforts. In addition, we continue to note that program areas' Management Control Certification statements primarily rely on weaknesses reported by Inspector General audits, GAO reviews and other independent reviews. OMB Circular A-123 states that management has the primary responsibility for monitoring and assessing controls, and should use other sources as a supplement to, not a replacement for, its own judgment. Moreover, the CFO's management control approach, has for the past few years, relied on program offices' prerogatives to perform risk assessments, particularly in the absence of control reviews from sources outside the program area.

HUD needs to resolve audits in a more timely manner

OMB Circular A-123 includes resolution of audit findings and other deficiencies as a specific management control standard. The purpose of HUD, OIG audits is to bring about positive change in HUD programs and operations. Audit resolution is the process by which the HUD, OIG and HUD management agree on the changes to be made. Then HUD management makes the changes. As in past Semiannual Reports to the Congress, we continue to report concerns with the Department's audit resolution process. Most recently, in our September 1997 report, we noted nine examples of prolonged actions in bringing audit recommendations to closure. The examples include instances where HUD had reached a management decision (agreed to take actions), however, agreed upon actions had not been completed over a period of years after the initial agreement. We also discussed six instances where matters had to be referred to the Deputy Secretary because of disagreements with program officials. As a result of the time delays, the Department increases its risk of not recovering misused funds from program participants. In addition, uncorrected control weaknesses increase the Department's vulnerability to fraud, waste, abuse and mismanagement.

Reportable Condition: HUD Needs to Continue to Refine Performance Measures to Effectively Implement Results Management

OMB Bulletins 94-01 and 97-01, *Form and Content of Agency Financial Statements*, require agencies to report performance measures about the efficiency and effectiveness of their programs. We reported in prior years that there was a lack of performance information included in HUD's annual reports. HUD's *Accountability Report* and prior annual reports emphasized financial and non-financial operating results as input or simple output measures. For example, reporting future program budget authority or past outlays only demonstrate resource inputs. Examples of outputs were public housing units demolished or the number of beds provided for homeless persons assisted at different stages of CPD's Continuum of Care programs. The comparative cost per unit to demolish housing units or to provide homeless beds is not provided to demonstrate program efficiency or effectiveness over time.

On September 30, 1997, HUD issued its Strategic Plan for fiscal years 1998-2003. This revamped Strategic Plan met the first requirement for the Government Performance and Results Act (GPRA) of 1993. It communicated seven strategic objectives for HUD's long range plans together with eleven management objectives under the *HUD 2020* initiative. To accomplish these broad objectives, the plan included 82 performance measures or indicators. In our view, most of the measures were process outputs. Many of them were incompletely defined and without any baseline data from which to demonstrate fiscal year 1999 accomplishments. None of the measures had a cost component so that program efficiency or effectiveness could be determined. GAO, in a government-wide report dated January 30, 1998 entitled *Managing for Results: Agencies' Annual Performance Plans Can Help Address Strategic Planning Challenges*, concluded that HUD's plan could be improved to better meet the purposes of GPRA in the following areas.

- While the plan includes a listing of the program evaluations under each objective, it does not describe how the evaluations were used to develop the strategic objectives and does not include a schedule of future evaluations. Although wording was added to the plan stating that evaluation schedules are determined on an annual basis, the plan does not include a schedule, which is required by GPRA.
- HUD's discussion of its strategies does not discuss the staff, capital, and technology resources needed to achieve the Department's strategic objectives, as called for by GPRA. This issue is a critical one for HUD because of its downsizing efforts and planned organizational changes.
- The plan does not discuss the impact on the strategic plan or on HUD's programs if the legislative proposals discussed in the plan are not enacted. Additionally, some of the discussions indicate that external factors may have such a great impact on the strategic objectives that HUD may not be able to achieve its objectives.

- While HUD included additional information to aid in the assessment of the strategic objectives, it is not yet clear whether the achievement of a number of the objectives will be assessable.

According to the Executive Summary in the final fiscal year 1997 Secretary's Performance Report, HUD had set over 400 goals (measures or indicators) and an additional 29 measures to comply with agreed upon OMB Circular No. A-11 measures. For many of the reported measures, HUD still needs to determine where or how the data will be obtained.

As we stated in the our prior audit report, HUD will require more development and reporting of performance information to satisfy both OMB and Congressional requests after issuance of HUD's Strategic Plan on September 30, 1997 and the pending issuance of the HUD Annual Performance Plan required by GPRA. HUD has awarded contracts to assist program offices in the further development and reporting of their performance measures. To date, no work has been done under these contracts because of OMB and Congressional consultations and continuing changes throughout fiscal year 1997 to the draft strategic plans and in fiscal year 1998 to develop HUD's fiscal year 1999 Annual Performance Plan.

The primary purpose of GPRA is for agencies to manage for program or operational results. Planning and budgeting are important bases for a results oriented management approach. However, the primary purpose is to integrate these elements into day to day operations. At the present time neither HUD managers nor operational systems implement results management into daily operations. A significant barrier to achieving the principal purpose of GPRA at HUD, is that HUD programs rely heavily on annual self-reporting by program participants or beneficiaries, periodic program evaluations, periodic information from Bureau of Census data, use of reported performance from prior years and extrapolating current estimates based upon budget information.

In fiscal year 1996 we reported on our concerns over performance measure data reliability and the Department's plans to remedy the concern with a program requirement to submit Quality Assurance Plans to the CFO for review and approval. We are encouraged that major program areas completed and submitted their performance measure Quality Assurance Plans for fiscal year 1997 to the CFO. Each office provided assurance that the measures reported are both valid and accurate. The CFO has not had an opportunity to review the support for the assertions made by the program officials. Consequently, it is premature to judge if the quality of the performance measurement reporting provides greater assurance than we reported in prior audits.

Verification of Subsidy Payments

Greater Efforts Needed to Verify Subsidy Payments

HUD spent about \$18 billion in fiscal year 1997 to provide rent and operating subsidies benefiting over 4 million lower-income households through a variety of programs, including public housing and several variations of the Section 8 program. HUD's control structure that was in place during fiscal year 1997 did not provide reasonable assurance that these funds were expended by HAs and project owners in compliance with the laws and regulations authorizing these programs. The admission of a household to these rental assistance programs and the size of the subsidy it receives depend directly on its self-reported income. HUD's control structure does not provide reasonable assurance that subsidies paid under these programs are valid and correctly calculated considering tenant incomes and contract rents. Our specific concerns, and PIH's and the Office of Housing's initiatives to address these concerns are discussed below.

PIH provides funding for rent subsidies through its operating subsidies and tenant based Section 8 rental assistance programs. These programs are administered by HAs who are to provide housing to low income families or make assistance payments to private owners who lease their rental units to assisted families.

The Office of Housing administers a variety of assisted housing programs including parts of the Section 8 program and the Section 202/811 programs. These subsidies are called "project-based" subsidies because they are tied to particular properties, therefore tenants who move from such properties may lose their rental assistance. Unlike public housing and tenant based Section 8, most of these subsidies are provided through direct contracts with multifamily project owners; there is no HA or local government intermediary. Since there is no intermediary, HUD has more responsibility for ensuring that project owners provide support only to eligible tenants and that they comply with the contract and program laws and regulations. This is a significant responsibility because of the sizable number of project owners HUD must monitor.

Material Weakness: HUD Needs to Do More to Ensure That Subsidies Are Based on Correct Tenant Income

As reported in Note 14 to the financial statements, HUD performed computer income matching with its assisted housing universe and estimated that housing subsidy overpayments were \$939 million, an amount we consider to be substantial. Tenant income is a major factor affecting eligibility for, and the amount of, housing assistance a family receives, and indirectly, the amount of subsidy HUD pays. Generally, HUD's subsidy payment makes up the difference between 30 percent of a household's adjusted income and the housing unit's actual rent or, under the Section 8 voucher program, a payment standard. Tenants often do not report income or under-report income from a specific source which, if not detected, causes excessive subsidy payments by HUD.

Under reporting or understating of income from a specific reported source is easier to detect than unreported income. Program regulations require HAs or project owners to verify applicant and tenant income and other factors relating to eligibility and rent through third party written documentation. In the past, HUD field offices performed in-depth occupancy reviews of HAs and project owners which included file reviews that were specifically designed to ensure that adequate verifications of tenant income were performed and that the amounts of income used to determine eligibility and compute rent were consistent with the verification sources. While the Office of Housing continues to perform some occupancy reviews, PIH now essentially relies on audits performed by IAs to determine whether HAs are performing income verifications. Our concerns with HUD's reliance on IAs for monitoring HAs are discussed later in this report in the section addressing HA monitoring controls.

HUD has made progress using available income matching tools to detect unreported tenant income

With regard to unreported income, various legal, technical and administrative obstacles exist that impede HUD, HAs and project owners from ensuring that tenants report all income sources during the certification and recertification process. This causes excessive subsidy payments by HUD and possibly providing assistance to ineligible families while denying access to housing assistance to eligible families. Many HAs have large waiting lists of applicants seeking assisted housing. Unreported income is difficult to detect, particularly if the tenant is also not reporting it to the primary income source through which the HA/project owner is verifying income (e.g., the tenant is receiving public assistance and working but not reporting the employment income to either the public assistance office or the HA/project owner). In prior years, HUD encouraged HAs to computer match with State wage agencies to detect unreported income, but most HAs did not have the technical and/or administrative resources to implement this technique.

In 1993, Congress amended the Internal Revenue Code to give HUD temporary access (through September 1998) to federal income tax data with which to verify tenant income. Section 542 (b) of HUD's 1998 Appropriation Act repealed this sunset provision of the Internal Revenue Code. Congress' repeal of the sunset provision makes permanent the statutory authority for the IRS and the Social Security Administration to disclose federal tax return data to HUD.

HUD performed computer income matching with federal income tax data to determine the magnitude and effect of under reported and unreported tenant income. HUD statistically sampled 1,000 households from its automated data bases and matched their reported income with federal tax data in SSA and IRS data bases. Using the staff of the Chicago Asset Recovery Center (CARC), HUD compared the computer matching results with source documents. Based on the results of the computer income matching project, HUD statistically projected at the 95 percent confidence level that the amount of excess rental subsidies was \$752 million plus or minus \$147 million, and that 16.5 percent plus or minus 2.3 percent of households had received excess rental assistance during calendar year 1996. Because the households in HUD's databases represented only about 80 percent of the estimated 4.3 million households that received assistance during

1996, HUD extrapolated these results to the entire estimated number of assisted households, yielding an excess rental subsidy estimate of \$939 million, plus or minus \$184 million.

PIH has made progress in implementing its income matching program

PIH completed its initiative with SSA for computer matching of Social Security (SS) and Supplemental Security income (SSI) data, demonstrating the effectiveness of checking, via an automated process, the amount of tenant income reported to HAs against the amount of SS and SSI benefits paid to the tenant. The PIH/SSA computer matching process for providing SSA payment information directly to HAs has been implemented nationwide for all HAs. It is in the HAs' interest to participate with PIH in this effort since it provides an effective and comprehensive means to verify SS/SSI tenant income via an automated process with minimum effort. Currently, PIH is in the process of making an Internet facility available to all HAs to facilitate the transmission of the SSA payment matching results. As of our report date, the Internet facility had been made available to HAs in eight of HUD's ten geographic areas.

In fiscal year 1997, PIH also conducted a follow-up analysis of its fiscal year 1996 nationwide sampling project to test the effectiveness of procedures for taking administrative or legal actions concerning program abuses. HUD procedures for facilitating these actions include sending a letter to tenant(s) within a household who have unreported income requesting that the tenant(s) disclose the letter to the HA. The tenant letter contains federal tax data, including the sources and amounts of incomes received. HUD also sends a letter to the HA to inform the HA that the tenant has an income discrepancy which requires resolution. As of our report date, PIH had not completed its analysis of the resolution data the HAs provided. Nevertheless, preliminary results indicate that most tenants who intend to continue receiving rental assistance redisclosed the federal tax data to HAs. This enables HAs to identify unreported income and to pursue legal and/or administrative actions. Tenants who subsequently moved out of assisted housing usually did not disclose federal tax data to HAs. PIH plans to complete its follow up analysis and report on the results by May 1998.

Except for issuing a report on the project, PIH has completed pilot federal income tax data matching projects involving every tenant household at two selected HAs. As with the nationwide sampling project, these pilot projects consist of matching household income data from the Multifamily Tenant Characteristics System (MTCS) with Form W-2 (earned) and Form 1099 (unearned) information maintained by SSA and the IRS, respectively. These income matching projects differed from the nationwide matching project in that they identified tenant households with unreported income of \$10,000 or more. The pilot projects have been very effective in identifying unreported income and excessive housing assistance. At one HA, the project identified tenants who received about \$350,000 in excessive housing assistance by not reporting about \$1.17 million in income. Following the procedures developed for the nationwide sampling project, PIH sent letters regarding the income disparities to the tenants and the HA. The HA has reported that most tenants have come forward and disclosed the unreported income. PIH plans to issue reports on the results of these projects in fiscal year 1998.

PIH needs to improve the accuracy of its tenant database and enforce timely updates by HAs

For PIH's income matching efforts to be effective, it is essential that the MTCS data base has complete and accurate tenant information. PIH's computer matching projects and monitoring efforts have identified MTCS data quality problems which can adversely affect computer matching results and other analyses of tenant data. PIH Notice 96-20 issued April 1996 stated that only 59 percent of Section 8 family records were in MCTS and reminded all HAs with Section 8 programs of HUD's requirement to submit family data forms electronically.

PIH has initiated a number of actions to improve the quality and completeness of tenant data. HUD has developed an automated MTCS Support System for use by field office staff to monitor the accuracy and timeliness of tenant data submitted by HAs. PIH has issued a Remote Monitoring Handbook to provide field offices guidance for using MTCS to perform remote monitoring. PIH Notice 96-20 advised HAs that starting in July 1996, HUD planned to reduce payment of Section 8 administrative fees by 10 percent monthly where a HA failed to transmit at least 75 percent of its Section 8 tenant household reports. During fiscal year 1997, headquarters sent monthly delinquency reports on HAs' tenant data submissions to all PIH field offices. These reports specify by program type -- Section 8 or low income -- the number of tenant households estimated to be missing from MTCS. PIH's 1997 Field Management Plan specified that field office directors have responsibility for improving tenant data reporting.

Our testing at five field offices found that these offices identified more than 100 HAs that were not in compliance with HUD's Section 8 tenant data transmission requirement. We also found that these field offices were not imposing sanctions or initiating enforcement actions even when 50 percent or more of the HA's Section 8 tenant data forms were not in the MTCS. As of the close of our field testing, the five offices had imposed sanctions against three HAs. Field office directors were reluctant to take action against the HAs primarily because HA officials argued that MTCS transmission problems prevent the HAs from successfully entering tenant data into MTCS. Without proof that the HAs are not transmitting tenant data and until MTCS transmission problems are addressed, the directors do not believe sanctions are appropriate. Field office efforts to verify specific MTCS transmission problems were not documented.

With regard to the reliability of data the HAs have entered into MTCS, the field offices we tested had not implemented procedures to determine the accuracy of data in MTCS. The field offices advised us that due to other priorities they had not spent time attempting to verify data in MTCS. One field office said that it had not been provided with any instructions on how to monitor the accuracy of information contained in the MTCS data base.

In addition to our MTCS field testing, our review of the 1997 fiscal year end MTCS delinquency report disclosed many HAs with over 600 Section 8 or low income units with no tenant family data forms in MTCS. In one case, the MTCS data base included seven tenant data forms for a HA with over 23,000 total Section 8 and low income units. As discussed later, HUD recently

began to more aggressively follow up with HAs that were not transmitting MTCS tenant data in accordance with HUD requirements.

The Office of Housing has initiated a pilot project to follow up on income matching results

In September 1997, the Office of Housing began an income verification project with the cooperation of one management agent to test the process of implementing income verification using federal income tax data during calendar year 1995. The Office of Housing anticipates that the project will provide the ability to estimate the costs and benefits of increased compliance efforts. The project identified 62 households out of 881 that had unreported or underreported income. The Office of Housing used the threshold of \$3,000 to determine if a household's unreported income needed further analysis. The objective of the project is to have the management agent notify those households with unreported income in excess of \$3,000 and meet with them to perform retroactive recertifications from the date of the unreported income. If the household was over assisted, then the household would begin a repayment agreement with the agent on behalf of HUD. At the time of our audit, Phase I, which identified the households, had been completed. The Office of Housing had not completed Phase II, the process of notifying both agents and households of the preliminary results of its analysis. Thus it is too soon to evaluate the cost effectiveness and feasibility of the project objective.

In our prior report, we noted that the Office of Housing had planned to conduct a quality control study in 1998 which would identify and implement cost-effective corrective actions to reduce rent subsidy errors, including errors not affected by under reported and unreported household income. This study was originally to have been completed by December 1997 and was to be the initial round of an ongoing, periodic quality control process. The Department agreed to perform such studies as a result of recommendations from prior financial statement audits dating back to fiscal year 1993. In addressing the overall need to improve controls over subsidy payments, the Department recognized the need for both an income matching component as well as a quality assurance component for HAs and project owners. Income matching can identify tenant fraud in reporting income whereas quality control focuses on evaluating and improving the performance of agencies and owners. The proposed quality control studies rely on site visits and interviews with HAs, owners and tenants to identify and target corrective action. At the time of our audit, the proposed study has been designed but not funded.

HUD's Actions Planned and Underway to Verify Tenant Income

At the time of our audit, The Department had instituted an ongoing income verification project through the CARC, which will perform the function for both the Office of Housing and PIH. The first sample of 20,000 assisted tenants has been made for comparison of incomes reported to HUD as part of the eligibility certification process versus earned and unearned income reported by SSA and the IRS. Tenants with an unreported difference greater than \$10,000 (threshold) for a single year who receive excess housing assistance as result of unreported income will be pursued

for repayment of the excess assistance. As of the time of our audit work, *HUD 2020* plans had not been finalized with respect to how the Department will permanently staff an ongoing income matching program.

Other HUD plans for enhancing the subsidy payment process are to complete the installation of a data link between HUD and SSA to permit verification of a tenant's reported SSA/SSI monthly benefits as part of the initial certification process. HUD is also revising the tenant family form which collects data on assisted families. The redesigned form will allow for HA flexibility in providing certain information and will implement other changes to accommodate planned revisions to the tenant based program.

In November 1997, PIH contacted HAs with large numbers of missing tenant data forms and low reporting rates, advising them of possible penalties should they continue not reporting or reporting in an unacceptable manner. Since January 1998, MTCS reflects an increase in tenant data transmissions from a number of those HAs. PIH also implemented a newly developed MTCS Communication Plan and technical support hotline to improve and increase ways of communicating information about MTCS to HAs. In October 1997, HUD also established an Internet data transmission facility to address software and data transmission difficulties.

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

The computer matching pilot projects currently underway in both the Office of Housing and PIH should be evaluated thoroughly to assess effectiveness, with particular emphasis on the effects of the statutory restriction on redisclosing federal income tax data to HAs and project owners. If the pilot demonstrates that the matching program is workable and cost effective, HUD needs to take action that will aid in quantifying, on a larger scale, the extent of abuses and the benefits of a permanent computer matching and income verification process. This matching approach should provide more efficient and effective techniques to aid in detecting unreported and under reported income. HUD may need to seek additional legislative authorities if the prohibition against disclosing federal income tax data to HAs causes major problems.

We are also encouraged by the tentative assignment of the CARC staff to perform ongoing income matching and verification work on the assisted tenant universe. However we have not reviewed any documentation supporting this designation or the methodology and procedures that CARC will follow. Additionally, at the time of our audit, the staff had not begun the ongoing portion of the income verification work, nor had the Department made final decisions on how the ongoing program would be staffed. Thus it is too soon to assess the effectiveness of this effort.

Reportable Condition: The Office of Housing Needs to Continue Efforts to Improve Its Subsidy Payment Process

The Office of Housing administers various assisted housing programs. Although the payment processes differ, under each assisted housing program, HUD pays the difference between the

contract rent for the units and that portion of the rent the occupants can pay based on their household income. The project owners are responsible for verifying household income reported by the tenant and submitting requests for payment to HUD for amounts due under their contracts with HUD

HUD field offices are required to review a minimum of 20 percent of the Section 8 vouchers against disbursement reports from the Field Accounting Divisions and compare changes on Section 8 vouchers to the TRACS database as part of the post payment review.

In fiscal year 1996 HUD established the Voucher Processing Hub (HUB) in Kansas City as part of the Kansas/Missouri State Office of Housing. It provides a centralized processing center for the receipt and review of Section 8 vouchers and household certifications. It provides a monthly reconciliation of paid vouchers to LOCCS and a comparison of household changes noted on the voucher to the TRACS database on a sample basis. During fiscal year 1997 the voucher review workload of most field offices was transferred to the HUB. By 1997 calendar year end, all offices had transferred that workload to the HUB.

TRACS contains information on tenants, projects and subsidy contracts which are part of the assisted housing programs. TRACS records data on tenant certifications and recertifications and calculates the amount of the subsidy. The paid vouchers can be reviewed using TRACS, but that system does not provide for independently verifying the income of the assisted tenants.

In fiscal year 1994, HUD's prior auditors reported that HUD planned to use TRACS in the future for payment processing and that HUD's target was to implement the interface with the payment system in fiscal year 1996. The interface was expected to automatically verify many of the contract and eligibility elements which currently must be manually reviewed. However, in fiscal year 1995 and 1996, budget reductions did not permit payment module implementation for TRACS.

Last year we noted that TRACS, while making progress on improving control over processing of payment requests, still was only useful as part of the manual review of paid vouchers. And, due to the high volume of vouchers filed, the field offices could not always perform all the required reviews following payment of the subsidy. Because the TRACS Payment Module was not implemented in fiscal year 1997, HUD continued to rely upon the manual review of paid vouchers as a control procedure for Section 8 subsidy payments.

This year we again performed tests of the voucher reviews and the use of TRACS by Office of Housing staff at six field offices and the HUB. Each of the six offices began workload transfer at some point during the year, but each was responsible for the voucher review function for at least part of fiscal year 1997.

From our testing of the voucher review process, we noted that the HUB was performing voucher reviews on approximately 15 percent of the vouchers it received and was consistently performing a monthly reconciliation of paid vouchers to LOCCS. However, at the field offices we tested we found limited performance of voucher reviews and two offices were not able to document the voucher reviews. We found that these offices were comparing vouchers to TRACS as part of a

condition for transferring the workload to the HUB, rather than as part of an internal control procedure. However only one of six offices were performing LOCCS reconciliation's prior to the date its respective workloads was transferred to the HUB. Thus, for fiscal year 1997 the voucher review process did not provide an adequate internal control over Section 8 payments.

As a result of HUD's inability to streamline the payment process on a timely basis, HUD is still vulnerable to fraud and abuse in its processing of requests for payment from project owners. In addition, without the payment module, the current subsidy payment process will continue to require labor intensive intervention at the voucher processing HUB.

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

Each audit report on HUD's financial statements since HUD has been subject to audit under the provisions of the CFO Act has identified the lack of effective controls over the Office of Housing's Section 8 subsidy payment process. The Office of Housing does not have a process to determine the accuracy of a payment requisition from the owner of a multifamily project prior to payment. HUD has abandoned plans to fully implement a TRACS Payment Module for project based Section 8 because of decisions made as part of the Section 8 Financial Management Center (FMC) component of *HUD 2020*.

The Section 8 FMC is to be established to perform duties related to rental subsidies for all HUD assisted housing programs. Current plans are to transfer all duties related to housing assistance payment (HAP) contracts to the FMC and to make TRACS available, at least initially, to the FMC as the database for projects remaining under HAP contracts

Ultimately, HUD plans to transfer monitoring responsibilities for Section 8 projects to "contract administrators" such as State Housing Finance Agencies (SHFA) and HAs. This includes responsibility for making Section 8 payments to project owners. As this occurs, those projects are to be transferred to PIH's HUDCAPS Section 8 System. The goal is to complete the system enhancements and necessary data reconciliation by September 1998, to enable the transfer of the HAP contract workload to the Center immediately thereafter. As a result, the Department has determined that full development of TRACS payment processing is not necessary.

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

Without the TRACS Payments Module or some prepayment edit procedure in place there is little chance of overcoming the internal control reportable condition associated with the subsidy payment process. Currently, the voucher processing HUB still needs to perform manual reviews of subsidy payment requests. The review procedures that are performed only provide HUD with assurance that it has contracts with the project owners and only minimal assurance is provided that amounts being paid by HUD are proper. Because of the volume of the vouchers, the HUB has not been able to apply the level of resources that are required to perform even the limited reviews. In most cases, payments are still being made without detailed review. Because plans to fully develop the Payments Module have been discontinued, HUD will not be able to address our

concerns over the subsidy payment process until HUD is able to successfully transfer the contract administrator function to SHFAs and HAs and adequately monitor those entities' performance.

Monitoring Program Recipients

HUD provides grant and subsidy funds to HAs, multifamily project owners, nonprofits, and State and local governments (recipients), which, in-turn, provide housing and community development assistance to benefit primarily low income households. Weaknesses exist in HUD's control structure such that HUD cannot be assured that these funds are expended in accordance with the laws and regulations authorizing the grant and subsidy programs.

Legislation authorizing HUD's grant and subsidy programs includes specific criteria concerning tenant eligibility and allowed activities for which the funds can be expended. HUD's structure for oversight of recipients does not provide assurance that these funds are expended only on eligible tenants and allowed activities. Moreover, legislation authorizing HUD's programs also establishes minimum performance levels to be achieved. For example, subsidized housing must comply with HUD's housing quality standards. Here too, HUD's oversight structure does not provide it with assurance that these minimum performance levels are achieved.

Material Weakness: Improvements Needed in Multifamily Project Monitoring

In prior years, we reported that the Office of Housing needed to improve the effectiveness of multifamily project monitoring and monitoring of SHFAs that administer assisted housing contracts on HUD's behalf. This year, we again find that the monitoring of the multifamily projects is inadequate to assure that subsidies were provided only to projects that provided decent, safe and sanitary housing or on behalf of tenants that met HUD eligibility requirements. Also HUD's monitoring of Section 8 contract administration by the SHFAs has continued to be inadequate.

HUD provides assistance for about 33,000 private and non-profit owned multifamily projects. This assistance includes FHA mortgage insurance and funds provided under several subsidy programs. The principal multifamily subsidy programs are:

- The Section 8 and Section 236 programs which provide subsidies to project owners, who, in turn, provide housing units at reduced rents to low income households. Approximately \$7.1 billion in project based Section 8 subsidy funds were provided for about 1.4 million units during 1997. Approximately \$650 million in subsidies were provided for about 475,000 units under the Section 236 program.
- The Section 202 and Section 811 programs provide grants to non-profit institutions for the construction of projects providing reduced rent units to the elderly and handicapped, respectively. During fiscal year 1997 these programs awarded over \$414 million for over 6000 units and almost \$80 million for over 1150 units, respectively. Ongoing rent subsidies are also provided under these programs once units are

occupied. In fiscal year 1997, HUD awarded over \$100 million for five years of rent subsidies associated with the new units noted above.

Unlike most other HUD programs, these subsidies are provided through direct contracts with multifamily project owners; there is no HA or local government intermediary. Accordingly, HUD has more responsibility for ensuring that project owners provide support only to eligible tenants and that they comply with the contract and program laws and regulations. This is a significant responsibility because of the sizable number of projects HUD must monitor.

Troubled and potentially troubled projects are not getting sufficient attention to identify and resolve deficiencies

Overall, we found that monitoring of troubled and potentially troubled assisted projects was inadequate. We noted audited financial statements that were not submitted and physical inspections, management reviews and occupancy reviews that were not performed by the field offices. In addition, field offices were not adequately following up to resolve identified deficiencies.

We performed audit work at six HUD field offices. At five of the field offices we found project monitoring to be inadequate. We reviewed project files of 194 multifamily projects, the majority of which received rental assistance and were classified as troubled or potentially troubled. We reviewed the project files to determine if the most recent annual financial audit had been submitted and if the financial statements had been analyzed by the field office. We also reviewed the files to determine the date and results of the most recent physical inspection, management review or occupancy review and whether HUD was following up on deficiencies identified during the project audit or review.

Financial analysis and follow-up on annual financial audits needed to be improved. Of the 153 financial statements that were received from the projects we reviewed, only 42 percent were analyzed by the field office. In addition, the performance and follow-up of physical inspections, management and occupancy reviews for these projects was inadequate. We found that only 111 physical inspections were performed during fiscal year 1997 for the group of 194 properties. We noted that 66 management reviews were performed, of which only 35 received adequate follow up by the field office. Occupancy reviews were performed on 66 projects, of which only 44 received adequate follow up on by the field office. For several projects, the management review was concurrent with the occupancy review. Lack of adequate monitoring of troubled and potentially troubled projects continues to be a problem for the field offices.

Field office managers at the five offices noted above cited various reasons for not monitoring projects. Among the reasons cited by one or more managers were lack of staff, lack of travel funds, lack of time, other priorities and that the financial statement review was not a management goal. When monitoring activities are not performed or not performed in a timely manner, HUD lacks assurance that rental subsidies are being paid for decent, safe and sanitary housing or that the subsidized tenants meet the HUD established eligibility requirements. Thus, HUD lacks assurance that assistance payments are being made to properties and on behalf of tenants that are in compliance with applicable laws and regulations.

At each field office we reviewed, we inquired about how properties were analyzed and classified as to the risk they represented to HUD. While all six offices stated that an assessment was performed on its housing stock, we did not find a uniform method of risk assessment. In addition, there was little or no documentation of the assessment process at five field offices. Moreover, we were unable to determine that the assessments were performed on an annual basis. This is similar to the deficiency we identified with risk assessments following our 1996 audit. Results of such a risk assessment should be used to identify troubled and potentially troubled projects and develop a plan for asset managers to assist properties to regain financial and physical stability.

In previous years HUD relied on contractors to assist with performing physical inspections and receipt and analysis of project financial statements. This year the field offices were responsible for receipt and review of the financial statements. In early 1997, field offices were instructed to terminate existing contracts for physical inspections, pending the award of four contracts for the basic physical inspections of all properties in the HUD multifamily housing portfolio. These contracts were awarded in March 1997 then terminated in May 1997. For the majority of the year, the field office was without the services of contractors that they had come to rely on for providing monitoring activities.

Better monitoring of “contract administrators” needed

HUD provides funds to SHFAs and Housing Authorities (HA), which in turn enter into rental assistance contracts with multifamily project owners. In these instances the SHFAs and HAs assume project monitoring responsibilities similar to HUD, including ensuring that payment requests from project owners are accurate and owners maintain the projects in accordance with applicable laws and regulations. Since HUD funds pass through the SHFAs and HAs to the projects, HUD policy requires the field offices to monitor these “contract administrators.” According to HUD policy, at a minimum, a field office should conduct an annual on-site review of contract administrators in its jurisdiction whose performance has been marginally satisfactory or less. All other contract administrators should be reviewed every two years. During the review, HUD should select projects to be reviewed on-site for compliance with laws and regulations.

In last year’s report, we reported that only one field office had performed a timely review of the contract administrators within its jurisdiction. For fiscal year 1997, the field offices we visited had monitoring responsibilities for 44 contract administrators providing services to about 650 projects. This year we again found that only one field office out of six had performed the required review of the Section 8 contract administrators.

Two field office managers again cited lack of staff resources as the reason for not performing site visits of the contract administrators. Additionally, two managers believed that the local Division of Public Housing was responsible for monitoring these contracts since an HA acted as the contract administrator. One field office stated it relies on remote monitoring of contract administrators. We note there is no provision for remote monitoring of contract administrators in HUD’s policy. Thus, lack of monitoring of Section 8 contract administrators continues to be a problem for the field offices. When HUD does not monitor the projects directly or indirectly, it adversely impacts HUD’s ability to assure the propriety of Section 8 disbursements.

Field offices achieve Management Plan for troubled projects

The Office of Housing uses the *Housing Management Plan* to establish priorities and monitor the performance of the Office of Housing's field offices' activities in managing insured and assisted multifamily housing projects. For the fiscal year 1997 Plan, one of the five multifamily goals was to develop and implement action plans for troubled or potentially troubled projects and reduce the inventory of those projects.

As part of our review of monitoring of troubled and potentially troubled projects, we obtained information relating to the setting of the targets for each field office, criteria for measuring progress, methods of reporting, and verification of accomplishments reported by the field offices related to that goal. We found that each of the six field offices was able to support the reported accomplishments and that each field office reported achieving 100 percent of its goal.

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

The key initiative aimed at improving HUD's monitoring of multifamily projects is *HUD 2020*. There are several separate initiatives under this plan including a Real Estate Assessment Center (REAC), Section 8 FMC, Project Manager Training, and Real Estate Management System (REMS).

- The REAC is to assess the financial and physical condition of all multifamily properties through receipt and analysis of the annual financial audit and the periodic physical inspection, both in an electronic format, currently under development. The audit and inspection data are to be scored and the results will be used to assign the property status and future course of action to resolve identified problems. At the time of our audit, no date has been specified for the REAC to become fully operational.
- REMS is the core system that will contain the complete project profile for the approximately 33,000 projects in the multifamily inventory. It is to improve the availability and maintenance of core data critical to managing MF housing projects and contain information about the property identification, ownership, financial statements, physical condition, subsidy status, property management, occupancy, FHA contracts, and a problem statement. Once data are loaded from other systems field staff will be responsible for data entry, verification and updates. REMS is scheduled for introduction in early March 1998, with training from mid March through late May.
- Housing recognized the need for project manager transitional training to accompany other *HUD 2020* initiatives. The goal of the training is to provide introductory cross-training of traditional asset development and asset management roles and to acquaint new project managers with new portfolio management methods being introduced under *HUD 2020*. One week Project Manager training sessions began in early December 1997 and are scheduled to continue through the end of February 1998.
- The Section 8 FMC will be established to perform duties related to rental subsidies for all HUD assisted properties. A key component of the plan to establish this center is to

- end HUD's direct administration of most assistance contracts with project owners, currently numbering over 20,000. These contract administration responsibilities are to be transferred to SHFAs and HAs. Contract administrators will be responsible for activities such as prevalidation of payments to owners, monitoring of compliance with HUD's occupancy rules and Housing Quality Standards and assurance of project financial viability. Contract administrator performance is to be monitored by the Office of Housing.
- Special Workout Assistance Teams (SWAT) assistance to the field offices in resolving financial and ownership problems with troubled assisted properties is to be phased out as part of *HUD 2020*, as the SWAT activity is institutionalized at all field offices. Current plans call for the SWAT activities to be moved to all field offices, although at the time of our audit the date had not been specified. With the phase out, SWAT concepts have been incorporated into the Project Manager Training delivered in the second quarter of fiscal year 1998. Additionally, the SWAT data system, *Housing Professional*, is being used as the model for the REMS to be used by Headquarters and all field offices for information on the multifamily portfolio.

During fiscal year 1997, the *Housing Management Plan* included two related goals that pertained to our concern with how field offices were monitoring their troubled and potentially troubled insured projects. The first goal required the field offices to work with project owners and agents to develop action plans that would address the physical and financial health of the troubled and potentially troubled projects. The second goal required the field offices to complete the implementation of approved action plans for troubled and potentially troubled projects. The Office of Housing has included the two goals related to action plans for multifamily troubled and potentially troubled projects in its fiscal year 1998 *Housing Management Plan*. Also included for 1998 is a goal to reduce the number of outstanding audit recommendations.

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

In last year's report we commented on the Risk Assessment Management System (RAMS), being developed by the Office of Housing. We noted that, the Office of Housing introduced the system to identify and rank multifamily projects that are troubled or potentially troubled and that the rankings would provide the asset managers with an analytical tool to assist in prioritizing work for projects potentially at risk. In early 1997, RAMS was abandoned as a mechanism to identify and rank troubled projects before it was put into wide spread use. Although a ranking concept will be used by the Assessment Center when it becomes operational, the Office of Housing did not follow through with an opportunity to acquire a timely assessment of its portfolio prior to undergoing the reforms under *HUD 2020*.

Also in last year's report, we commented on Housing's plan to award four contracts to provide a basic physical inspection to all insured, HUD-held, Section 202 and Section 811 properties in the portfolio. The inspections were expected to take a year to complete at a cost of approximately \$7 million. These contracts would have provided physical inspection information on the portfolio at one point in time for a "pass/fail" assessment of the housing stock. After about two months, this effort was also abandoned, with less than 10 percent of the stock having been inspected. As with

RAMS, this effort will be transferred to the Assessment Center, but it represents another missed opportunity to obtain critical information prior to *HUD 2020*.

We are concerned that the REAC, central to the function of project monitoring, will rely on untested methodologies for its financial and physical inspection protocols. Further concern is that in the interim, the basic physical inspection contracts and RAMS were terminated and current data gathering and analysis have suffered. Additionally when field staff was being downsized, the responsibility for the receipt and review of financial statement was returned to the field office after two years under a contractor.

This year we are again concerned by the lack of financial analysis and follow up on the inspections and management and occupancy reviews that were performed. Without proper and timely follow up with a project owner, there is little chance of corrective action being taken..

Still another concern is the ongoing problem of monitoring Section 8 Contract Administrators. Under *HUD 2020*, the Department plans to transfer a majority of the more than 20,000 properties in its Housing portfolio to monitoring by Contract Administrators. This represents a significant increase in the number of projects to be administered by SHFAs and HAs. HUD needs to ensure that their activities are effectively monitored, something HUD has been unable to do for the past few years.

The SWAT effort begun in November 1994 was continued through fiscal year 1997. SWAT is to be phased out as a separate effort in 1998 and under *HUD 2020*, is to be integrated with multifamily field office operations. We acknowledge that SWAT has been useful in the Office of Housing's efforts to target troubled projects, provide the necessary analysis of these projects, and obtain voluntary compliance from certain project owners.

Reportable Condition: Continued Efforts Needed to Improve Housing Authority Monitoring

HUD provided over \$14 billion in fiscal year 1997 in grants and subsidies to the nation's 3,300 HAs. In prior years, we reported that HUD's control structure did not provide reasonable assurance that these funds were expended in compliance with the laws and regulations authorizing these programs. In fiscal year 1997, problems remain which we believe HUD needs to address to provide assurance that HAs provide safe, decent, and sanitary housing and protect the federal investment in their properties. Our most significant concern relates to payments made by HUD, through its operating subsidies and Section 8 rental assistance programs, to assist HAs in providing affordable housing that meets HUD's housing quality standards to house eligible low income households. Our specific concerns, and HUD's reform plan initiatives to address them, are discussed below.

Improved risk evaluation and monitoring of housing authorities needed

During fiscal year 1997, HUD continued to implement its performance oriented, risk based strategy for carrying out its HA oversight responsibilities. HUD performed on-site monitoring reviews at a limited number of HAs to provide increased oversight and technical assistance in improving operations. HUD also used the Army Corps of Engineers (Corps) to perform on-site inspections of some modernization and/or development projects. Contractors were also used to perform viability assessments of 31 distressed public housing projects at nine HAs in 1997. These assessments were limited to determining whether the distressed developments cost more than Section 8 rental assistance and could not be reasonably revitalized. The contractors did not assess the quality of the physical housing stock. As of our report date, HUD had not established a process to assess the quality of its public housing stock independent of the HAs' evaluations.

In fiscal year 1997, HUD's field offices performed risk assessments of all HAs within their jurisdictions, primarily considering performance and compliance data, and developed plans to monitor and/or provide technical assistance to those HAs determined to be in the greatest need of attention. The HAs' Public Housing Management Assessment Program (PHMAP) performance certification and IAs' compliance reviews are key components of HUD's risk based monitoring strategy. As discussed later in this report, we have concerns regarding the reliability of the performance and compliance data used by HUD's field offices to a large extent to evaluate HA operations. Additionally, HA performance evaluation factors as currently reported do not effectively address or measure the overall quality of subsidized housing. There generally is no independent program for on-site inspection of the actual condition of HAs' housing stock to assess the quality of maintenance and modernization work, other than the limited reviews the Corps perform.

PHMAP is not always a reliable indicator of housing authority performance

A key component of HUD's monitoring and technical assistance strategy for HAs is PHMAP, which is used to measure HA performance in major areas of management operations. Based on the PHMAP scores, HAs are designated as high, standard, or troubled performers. The PHMAP scores are used by HUD to allocate its limited monitoring resources and for some program funding decisions. Additionally, HUD uses PHMAP scores as one measure of field office performance. The Department's Remote Diagnostic System provides management with field operations information, much of it based on PHMAP data.

A concern we have in reviewing the PHMAP process is that HUD's controls do not assure the integrity of the scores. HUD primarily relies on the HAs to certify to the accuracy of their PHMAP data. While HUD field offices perform some confirmatory reviews to ensure the integrity of this data, resource limitations affect the number and extent of reviews actually performed. During fiscal year 1997, the five offices we tested performed at least a partial confirmatory review on 52 of their 304 HAs' PHMAP certifications. As reported in prior years, confirmatory reviews performed by PIH, OIG and independent contractors have shown in many instances that HAs' PHMAP scores are overstated or unsupported. For example, one field office we tested this year reduced the scores for three of the eight PHMAP certifications it tested. In

response to a January 1997 GAO report entitled, *HUD Should Improve the Usefulness and Accuracy of Its Management Assessment Program*, HUD's field managers attributed the lack of confirmatory reviews to inadequate administrative resources.

In our prior reviews of the PHMAP scoring process, we reported the need for more effective measures to ensure the propriety of PHMAP performance data. We are concerned that the performance data as currently reported does not effectively assess the quality of the subsidized housing stock. An independent on-site inspection of the condition of a HA's properties is needed to assess the quality of the HA's subsidized housing. GAO, in its January 1997 report, disclosed that PHMAP scores are not a generally accepted measure of good property management. HUD officials, as well as representatives of the public housing industry associations and professional property management consultants, told GAO that the PHMAP indicators do not assess all major aspects of a HA's performance. As discussed later, HUD acknowledges the need to assess the quality of its assisted housing stock and, in conjunction with establishment of the REAC, plans to establish an inspection protocol to assess the physical condition and quality of assisted housing.

Our field office testing this year also found that HUD's controls over the PHMAP process at four field offices do not assure that HAs take corrective actions to improve performance deficiencies. HUD requires that HAs submit an improvement plan (IP) for PHMAP performance indicators that are rated "F." During our field testing we found that four field offices generally did not have approved IPs on file for HAs whose PHMAP certifications reported failed performance indicators or component scores. In addition, in those cases where a HA had submitted an improvement plan, there generally was no evidence of follow up to monitor the status of planned corrective actions.

Another concern we had relative to HUD's reliance on the PHMAP process is that the indicators do not consider HA performance in managing Section 8 subsidy funds. HUD had not implemented a Section 8 performance measurement program as initially planned in fiscal year 1997. At the five field offices we tested, over 221,000 units are subsidized through the Section 8 program. Thus, not including management of these funds in the HA performance measurement process decreases its usefulness.

Reliability of Single Audits is limited

Given HUD's reduced monitoring resources and its increased focus on HA performance (as opposed to compliance issues), HUD needs to be able to place reliance on the audits of HAs conducted by IAs pursuant to the Single Audit Act. In accordance with the standards under which these audits are conducted, the IAs are required to review and test HA compliance with laws and regulations that are material to the HA's financial statements. To improve the usefulness of audit reports submitted pursuant to the Single Audit Act, HUD management issued a comprehensive compliance supplement for use by the IAs in performing audits of HAs. However, we encountered a number of issues that impeded HUD's ability to place appropriate reliance on the IA reports.

In fiscal year 1997, we reviewed 26 HA audits including the IAs' supporting working papers to determine the type and extent of testing performed. We found that nine IAs had not performed

audits in accordance with the PIH compliance supplement which resulted in compliance requirements important to HUD not being tested. Additionally, based on our evaluation of the IAs supporting work papers, we questioned whether five IAs performed sufficient testing to conclude that the HAs, as a whole, were in full compliance with HUD program requirements. This issue primarily involves how the IAs select files for testing and the number of files tested. We also found that three IAs had identified instances of HAs' noncompliance with program requirements that were not reported as findings. The instances of noncompliance were usually resolved through discussions with the HAs' executive directors without further testing or documentation.

With regard to IA testing, it should also be noted that even though the IAs may certify that HAs have documentation to support data submitted to HUD, they are not expected to verify that the HAs actually performed the activities reflected in the data. A primary example of this situation is, while the IAs verify that HAs have data indicating that they have met the PHMAP requirements for the indicator on conducting annual inspections of all their housing units and major systems, the IAs do not verify that those inspections actually took place. In effect, the IA is only confirming that an inspection document is on file.

Additionally, as reported in prior years, the IA reports are sometimes untimely. During our audit period, these reports were not required to be submitted to HUD until 12 months after the HA's year end. Even with this long time frame for submission, many reports were still not received on time. Two of the field offices we tested had not implemented a process to ensure that required HA audits were completed timely. At these field offices, a significant number of HA reports were received late or were past due. One field office's records showed that 25 of 58 HAs have overdue audit reports.

HUD's Actions Planned and Underway to Improve HA Monitoring

HUD 2020 includes provisions to significantly change HUD's monitoring of program recipients and its organization to improve the Department's oversight of its assisted housing programs. Under HUD's new public housing organizational structure and operating plans, various field entities will be responsible for oversight of different aspects of the Public Housing Program. Public housing's new field office organizational set-up will include Hub Offices and Program Centers, the REAC, and Troubled Agency Recovery Centers (TARC).

- Twenty-seven Hub Offices and sixteen Program Centers are to provide ongoing monitoring and technical assistance to standard and high performing HAs, marginal performers, and newly recovered agencies within a defined geographic area. These staffs are to remain as the primary point of contact for all assigned PHAs and provide oversight of program implementation and technical assistance to those PHAs. The only major change is that the TARCs (see below) will be primarily responsible for assisting PHAs designated as "troubled."
- The REAC is to conduct annual PHA assessments. HUD is developing protocols to measure the HA's financial performance, management practices, and physical condition to identify at-risk and troubled HAs. PIH informed us that the physical

inspection protocols are nearing completion and discussions regarding the financial indicators are underway.

- The TARCs, located in Cleveland, OH. and Memphis, TN are responsible for HA intervention and recovery functions nationwide. If the REAC's integrated score of a PHA's performance is in the "fail" range, daily oversight and technical assistance responsibility is to be transferred to one of the TARCs. The TARC is to develop a recovery strategy and work with the PHA until improved performance is evidenced by an improved score from a subsequent assessment.
- As part of its reform initiative, the Department also plans to further reform PHMAP by placing greater emphasis on independent confirmation of HAs' PHMAP certifications. The Department plans to expand the compliance supplement requirements for the Single Audits and increase the management practices under the purview of PHMAP that auditors are to verify.

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

While we agree with HUD's Reform Plan measures aimed at improving oversight of the Public Housing Program, the Department's plans to monitor and improve performance in this area are not fully developed and have changed a number of times. Until HUD finalizes its implementation plans, we cannot assess HUD's ability to fully implement its oversight strategy. Moreover, HUD's success in addressing the need to objectively assess the quality of the public housing stock is dependent upon a concept for standardizing inspections that, at the time of our current audit work, had not been tested. Nevertheless, we do believe that some of HUD's Reform Plan proposals are positive.

Specifically, we agree that HUD needs to establish a standard inspection protocol to assess the physical condition and quality of public housing. The current process for evaluating HA performance does not consider the quality and livability of its housing stock. We also agree that HUD needs to work more closely with the nonfederal audit community to place greater emphasis on independent confirmation of HAs PHMAP certifications. The current PHMAP process primarily relies on HA's to certify to the accuracy of their performance data. We also agree with HUD's proposal to focus resources on identifying troubled HAs to perform timely intervention and recovery functions.

Reportable Condition: CPD's Strategy For Overseeing Grantees Is Not Fully Implemented

HUD provides significant grant funds to State and local governments through its CPD programs. As in HUD's other program areas, CPD is in the process of shifting its compliance-oriented monitoring strategy to one focused on measuring and improving grantee performance. CPD began its transition to this performance-oriented strategy in fiscal year 1994. This transition included converting to a consolidated planning process for all CPD funds allocated to each

grantee. Review of grantee plans for using CPD funds is an important part of this new strategy. CPD personnel provided a considerable amount of technical assistance to grantees in their efforts to formulate consolidated plans.

During fiscal year 1997, HUD incurred about \$5.7 billion in grant expenses under CPD's two largest grant programs, the Community Development Block Grant (CDBG) program and HOME program. Legislation authorizing CPD programs includes numerous specific requirements such as:

- Seventy percent of all CDBG funds must be used on activities that benefit low and moderate income persons.
- Administrative expenses cannot exceed 20 percent of CDBG funds and program income.
- Grantees must apply matching funds in using HOME program funds.
- Housing constructed with HOME funds must be occupied by eligible, low-income recipients.

Important aspects of new oversight strategy not implemented

In fiscal year 1994, CPD began changing its compliance-oriented monitoring approach to a performance-oriented strategy. Under its compliance-oriented approach, CPD primarily relied on performing on-sight monitoring of grantees to ensure that funds were expended in accordance with laws and regulations. CPD's new oversight strategy includes partnering with grantees and providing assistance, when possible, in order to improve grantees' performance while simultaneously performing up-front and continuous monitoring of their activities. This new strategy resulted in a decline in on-site monitoring. In addition, HUD realigned CPD's field resources so that they report directly to the Assistant Secretary for CPD at headquarters. CPD also began implementing a new computer system, IDIS, and started training field staff and grantees on how to use it. CPD's implementation of its oversight strategy has emphasized completion of grantee consolidated plans. During fiscal year 1995, CPD field staff was tasked with assisting communities in completing these first-time consolidated plans.

For fiscal year 1996, we reported that some important steps in CPD's oversight strategy were either not completed, not adequately documented, not timely, or did not include information on all grants. During fiscal year 1997 CPD issued its "Grants Management Policy Notebook" that formalized its oversight strategy and called it the "Grants Management System." The notebook consolidates previously issued policies and contains guidance on what is required for completing the various steps in the Grants Management System. Our audit focused on the requirements of the Grants Management System set forth in CPD's policy notebook in order to determine whether the system has been implemented and is providing adequate oversight of grantees. We determined that performance of two steps in this process was inadequate. One step involved evaluating and validating performance reported by grantees and documentation of those efforts. For some of the grantees during fiscal year 1997, we could not determine if CPD validated

grantee performance or the extent of their efforts in this area. This was due to a lack of adequate documentation of this step in their process.

Another important step includes performing an annual assessment of each grantee's accomplishments to determine whether planning, performance and reporting are in accordance with statutory requirements. CPD is required to provide each grantee with a written report outlining the results of the annual assessment. We found that this assessment was not performed for some grantees during fiscal year 1997. CPD officials have stated that this occurred because of staff shortages caused by retirements resulting from HUD's downsizing during fiscal year 1997. This assessment and the resulting report are very important because they become CPD's official document to the grantee and the public regarding conclusions reached about the grantee's overall performance. Thus, during fiscal year 1997 CPD had not fully implemented its new strategy for overseeing grantees and could not ensure that all grantees were only expending funds on eligible activities and individuals.

IDIS has been designed to provide CPD field staff with the capability to assess real-time performance data and ensure grantee compliance with requirements of all entitlement programs. It also is to provide reports to support the day-to-day management, tracking and monitoring of all CPD programs. We found that CPD has still not completed the process of developing all the reports required in order for IDIS to meet their management and monitoring needs. Moreover, CPD has not issued any guidance to the field staff on how to use the reports available from IDIS for their monitoring needs. CPD's ability to effectively review grantee performance will not be fully realized until such time that all reports available from IDIS have been developed and procedures on their use have been provided to field offices.

Single Audits are of little value in monitoring grantees

State and local governments receiving CPD funds over a threshold amount are required to have audits performed by IAs pursuant to the Single Audit Act. However, CPD personnel placed little reliance on these reports. This was due to the untimely nature of IA reports. CPD personnel did not always ensure receipt of IA audit reports or follow-up on findings that were identified in the reports that were received.

CPD's Actions Planned and Underway to Improve Oversight of Grantees

CPD is shifting to a performance-based strategy for monitoring grantees. A cornerstone of this effort is the development of IDIS. In phase one of the system, grantees use IDIS to prepare and transmit to CPD their plans for use of awarded funds. In phase two, grantees, as they drawdown funds, are required to provide performance information through IDIS as to actual accomplishments to date. Once both phases are fully implemented, IDIS is intended to provide CPD with timely performance information for all grantees. CPD can then focus its monitoring resources on those grantees that are performing below standard. During fiscal year 1997, CPD continued to work with grantees to bring them on line and using IDIS to drawdown funds. CPD has now embarked on a new phase wherein they finalize the reports available from IDIS and complete their on-site training of all CPD field office staff in the use of IDIS.

CPD has set forth its process which is aimed at measuring and improving grantee performance. This strategy involves partnering with grantees to improve their performance while simultaneously monitoring grantee activities to ensure compliance with regulations and program requirements. The process also involves validating performance reported by grantees and comparing it to planned actions. CPD also assisted grantee formulation of consolidated plans which contain grantees' planned actions for all funds allocated from CPD. In addition to being a part of CPD's oversight strategy, these plans and their completed actions will be accumulated and aggregated on a national level to facilitate CPD's performance reporting requirements pursuant to the Government Performance and Results Act and specific requirements related to the CDBG and HOME programs.

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

We agree with CPD's overall plan of action to focus its resources on measuring and improving grantee performance. However, these efforts were not fully implemented at the time of our review. Therefore, we cannot determine the benefits that will result once implemented or assess CPD's ability to fully implement this strategy. Our recommendation on confirming the validity of performance information reported by grantees will remain open because CPD has not fully implemented its process. We do not have any new recommendations at this time, but stress that CPD needs to complete implementation of its strategy to focus resources on measuring and improving grantee performance.

CPD's Grants Management Policy Notebook stresses the importance of maintaining substantive documentation to demonstrate proper oversight of grantees. Under a section entitled *Performance Evaluation Documentation*, the Notebook states, "When reviewing CPD records, an independent third party should be able to clearly see the conclusions reached ..." The importance of this effort has been emphasized to field office directors by including an element in their performance evaluations entitled "Program Management/Workload Management and Monitoring" which relates to achieving the goals of the new oversight strategy.

Although CPD was not able to meet its management objective of making IDIS fully operational by the end of fiscal year 1997, it did see the majority of its grantees go on line, with the ability to drawdown funds and report on performance. Once all grantees go on line with IDIS, it will serve as the primary tool for reviewing progress of planned activities. Therefore, CPD must ensure that each field representative is provided the necessary training and written guidance to become thoroughly proficient with the system in order to properly monitor grantee performance and progress.

System Issues

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

- general system security and other controls and
- access controls over HUD's two major payment systems, HUDCAPS and LOCCS.

Reportable Condition: HUD Needs to Improve System Security and Other Controls

HUD's automated information systems are critical in supporting 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 which provided limited assurance that funds, property, and assets were adequately safeguarded from waste, loss, unauthorized use or misappropriation. During fiscal year 1997, HUD has continued to make progress in enhancing computer security.

Security has improved but additional measures are needed

We have reported for a number of years that security protection over resources established on HUD's mainframe systems was inadequate. HUD uses both Hitachi and UNISYS mainframe computers to process data for over 150 applications. As part of our current year review, we noted that the Department had prepared a plan to implement additional security measures for the Hitachi and UNISYS mainframe computers. These additional measures should significantly improve security over the mainframe computing environment.

Hitachi Environment

The Hitachi computer is an IBM compatible machine with an IBM operating system. For the Hitachi environment, a number of security improvements have been made. The security software now requires user identification and a password for access to all applications. Moreover, a number of critical programs and data files have been defined to the security software, Top Secret. These resources are now protected from accidental or intentional unauthorized use.

Even though security has improved, the following security weaknesses still exist:

- The Top Secret security software is not planned to be implemented in global “fail mode” until 1999, more than 6 years after the software was purchased. Not placing the security software in global fail mode, as prescribed by the vendor, results in vulnerabilities within the mainframe security mechanisms. For example, without global fail mode, all users, files and other mainframe resources do not have to be defined to Top Secret. As a result, undefined mainframes resources can take on sensitive default privileges.
- Critical program and data files were exposed to accidental or intentional unauthorized modifications or damage because too many designated users were granted security bypass privileges during the start of their on-line processing sessions. The Department plans to implement a control over this bypass privilege by August 1998.
- Risks of audit trail compromise existed since the systems software logging facility could be modified by operating system technicians who had no need to access the facility.
- General users were granted READ access to production and system data on the Hitachi mainframe. This access allowed users to copy sensitive information such as banking information from payroll files. Also, users could read the security file and locate the encryption key for security software, Top Secret. This means that a knowledgeable perpetrator could obtain user IDs and passwords to perform unauthorized activities with little fear of being detected.

UNISYS Environment

Security over the UNISYS mainframe also requires improvement. For example, UNISYS files are created as “Public.” This means that users operating within the same application can access all application files regardless of need, role or responsibility. As a result, users could modify files for which they are not authorized and adversely effect the system beyond its intended purpose.

Network Environment

We tested selected controls in the network environment in addition to reviewing general system controls. This testing included attempts to gain access to all levels of data on the system through selected HUD Local Area Networks (LAN) from both an insider and outsider perspective. An insider with a low level user ID and password and could attempt to gain access to computer resources beyond those available to the account. External penetration testing includes using tools that hackers might use to gain unauthorized access to HUD’s networks and applications

The results of the external penetration tests revealed no control deficiencies. However, insider penetration tests indicated a need to improve access controls over HUD’s LANs. We found that numerous user IDs existed with no passwords, including a SUPERVISOR account. We also noticed that the default user ID (GUEST) was active. An inside perpetrator could use user IDs

with no passwords and the GUEST user ID to gain unauthorized access to LAN resources. This could cause failures of the LAN and/or corruption of critical data communicated and stored on the LAN. Access control on the LAN is critical as most user of HUD's critical systems access data and programs through LANs.

Aside from a need to strengthen password administration, we noticed that a number of control settings on the LAN needed to be strengthened. These weak control settings would allow an inside hacker to perform unauthorized activities that could cause LAN failures and/or data damage.

- The system allowed passwords to be used that were easily guessed.
- The system did not encrypt passwords sent between workstations and servers, which could enable a hacker to obtain passwords of legitimate users.
- Normal users were allowed access to system directories containing powerful system wide commands on the LAN, which could be used for malicious intent.

Disaster recovery for HUD's mainframes has improved but critical tests need to be conducted

During our current review, we continued to examine HUD's business resumption plan (BRP), and the testing of the plan. We found the BRP to be complete. We also found the testing process documented the test results including lessons learned and follow-up on action items.

However, we cannot determine at this time whether the testing of the BPR will be adequate. The unscheduled testing and testing of multiple critical applications will not be conducted until the fall of 1998. Since disasters are often unforeseen, unscheduled testing and testing of multiple applications are important to determine the adequacy of the plan and the recovery team's ability to react effectively during a disaster.

Changes to application software must be controlled

We continue to report weaknesses in software change control for Hitachi and UNISYS mainframe applications. There is no consistent method of controlling changes to mainframe applications system software. Tracking of software changes is limited to piecemeal, manual procedures where documentation of approval and movement of changes between development stages varies, depending upon the stage of development and who is making the changes. This creates an unnecessary risk to the software integrity of HUD's mainframe application systems.

To prevent unauthorized, unnecessary, or conflicting changes to HUD mainframe application software, a reliable, consistent, and well-documented change control process is essential. All changes should be easily traceable from the time of the request for change until the changes are finally incorporated into the operational system. While this can be accomplished with a well designed and controlled manual system, an automated system to control software changes for

large and complex systems maintained at HUD is essential. A manual change control system would be too staff intensive, especially when the Department is undergoing staffing reductions.

Although HUD purchased a software product for change control over three years ago, only one application on the Hitachi mainframe is using this tool to control software changes. This problem was documented in a previous HUD, OIG audit report (March 1996) entitled: *Controls Over Software Maintenance Must Be Significantly Strengthened*. Consequently, critical applications continue to be exposed to unnecessary risk of unauthorized, unintentional, or malicious software modifications resulting in errors, loss of data, or system failure.

The acquisition of automated change control software for the UNISYS mainframe continues to be long overdue. There are two products offering change control software for the UNISYS, and the Department has not made a choice. As a result, there are no UNISYS applications under the control of automated change control software. This condition causes us significant concern in light of the many changes necessary for the Year 2000 conversion.

HUD's ADP Security Division must ensure security administrators attend working group meetings

HUD's ADP Security Division, within the Office of Information Technology, provides guidance and assistance to the program offices regarding regulations and policy covering all technical and procedural aspects of security issues. In an effort to carry out this objective, the ADP Security Division sponsors working group meetings. This working group is known as the Security Administrator Working Group. These meetings are used as a vehicle to provide technical guidance, legislative updates and changes in requirements. However, the attendance of the security administrators to these meetings is not mandatory.

The program offices heavily rely on the ADP Security Division to provide update guidance related to proper securing of applications. With the ADP Security Division using this vehicle as a means to update the program offices on policy changes and requirements, the attendance should not be optional. In reviewing the agenda of past meetings, we note that the security topics discussed were pertinent and relevant to HUD's security administrators. These meetings provide an atmosphere where the lines of communication are open with the program offices. They provide assistance in securing the program's office applications.

HUD's Handbook 2400.24 Rev-1, dated September 29, 1994, defines the ADP Security Division's roles and responsibilities, including providing (1) policy development, guidance and oversight conforming to existing laws and regulations; (2) support and guidance to the program office staff regarding regulations and policy covering all technical and procedural aspects of ADP Security.

The Office of Information Technology has emphasized that their role is to act in an advisory capacity. It is their position that it would be difficult to mandate the attendance of the program offices' staffs at these meetings. With the attendance to these meetings being an option, we found that the agency is not in compliance with legislative requirements. The agency's most recent OMB Circular A-130 (Risk Analysis) report, dated June 8, 1997 reflects that the eight systems

reviewed had inadequate system security plans. This places the agency's systems in a vulnerable position.

The use of Security Administrator Working Group meetings to provide guidance and discuss security related issues with the program office's security administrators can be effective. However, these meetings cannot be of value if attendance is not mandatory. We strongly encourage Office of Information Technology to take an active role to convey to the program offices the importance of these meetings and ensure that the Security administrators attend these meetings.

HUD's Actions Planned and Underway to Correct System Weaknesses

With regard to mainframe security, the Department has prepared a security enhancement plan for both the Hitachi and UNISYS mainframes. This includes planned improvements that we have cited in our reports, particularly:

- Ensuring proper access authorities for "started tasks" (i.e., commands for initializing applications) have been given only to authorized users by July/August 1998;
- Eliminating the bypass security privilege for "started tasks" of an application by defining the required resources for that application.
- Automatically protecting all facilities and undefined data sets with the mainframe global fail mode setting by 1999; and
- Enhancing UNISYS access security controls for files and applications using the Access Control Record by December 1999.

However, the plan did not address the need to eliminate universal READ access to production and system data, and access to the logging facility. Recently we noted that the Office of Information Technology has initiated action to eliminate the universal READ access.

With respect to the LAN environment, the Department is evaluating the results of the penetration test to determine the extent of any necessary corrective actions.

With respect to the BRP, the Department has scheduled dates for testing multiple critical applications and plan to conduct unscheduled testing during fiscal year 1998. In addition, the Department has updated the recovery team's rosters, test procedures and test scenarios.

Regarding software change controls, so far the Department has implemented the already purchased software for change control for only one Hitachi application. The Department has a schedule to implement software change control for the other critical Hitachi mainframe applications. However, progress has been extremely slow. Relative to the UNISYS, the Department has found that there are two qualified vendors offering change control software for UNISYS applications, but has not yet selected one.

The Department has no planned action for ensuring that security administrators attend the working group meetings.

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

We are encouraged by the Department's quick response to prepare a mainframe security enhancement plan. Tasks have been clearly defined and those scheduled to be completed are on target. We hope that the remaining tasks will also be completed in a timely manner. However, the Department must remove the unnecessary exposures in system access.

With respect to the BRP, the Department has developed a comprehensive plan. Although planned, we continue to be concerned about actual testing of multiple critical applications and unscheduled tests. Until these scenarios are tested, we will be uncertain about the Department's ability to resume operations given these disaster recovery conditions.

We remain concerned with the Department's lack of progress in using an automated tool to control the software changes for the critical applications on the Hitachi and UNISYS mainframes. After having purchased the Hitachi software change control product nearly four years ago, only one application is fully implemented. Also, an automated tool is critically needed to control software changes for the UNISYS. The Department has had UNISYS mainframes for over twenty years and still lacks an adequate change control software for application programs. Change controls become even more critical when a significant number of application program changes have to be made for the Year 2000 conversion.

Reportable Condition: Additional Efforts Needed to Strengthen Access Controls over HUD's Payment Systems

HUD maintains two major systems to process payments under major program areas and administrative activities. LOCCS processes disbursements of funds to a broad range of grant recipients that include State Governments, municipalities, independent companies, non-profit institutions, and individuals. LOCCS was developed in 1984 to provide program recipients with timely payments. In fiscal year 1997, about \$22 billion was disbursed through LOCCS. HUDCAPS has been operational for both administrative accounting and PIH Section 8 programs since fiscal year 1995. This system was developed as an enhancement to a commercial off-the-shelf package, FFS, and under current plans, is to be implemented as HUD's core accounting system for all program areas. HUDCAPS includes a security module to control and monitor access for both the Administrative Accounting users, and PIH Section 8 users. During fiscal year 1997, HUD disbursed nearly \$8 billion through HUDCAPS.

Since LOCCS and HUDCAPS are major and critical systems, they must be adequately protected in accordance with OMB Circular A-130, *Management of Federal Information Resources*, which requires agencies to protect government information commensurate with the risk and harm that could result from the loss, misuse, or unauthorized access to or modifications of such information. This policy is also incorporated in HUD's ADP Security Handbook. OMB Circular A-130 further requires that an application's system security plan must define the rules of system and public

access controls based on separation of duties enforced by access controls and individual accountability, and identify any specialized security training requirement. Also, the Privacy Act of 1974 provides certain safeguards for an individual against invasion of personal privacy, and to prevent the misuse of personal information.

OMB Circular A-127, *Financial Management Systems*, states that integrated financial management systems shall have consistent internal controls over data entry, transaction processing and reporting. In addition, these controls shall be applied consistently throughout the system to ensure the validity of information and protection of government resources. Controls should provide for an appropriate segregation of duties.

For fiscal year 1996, we reported several access control weaknesses within the HUDCAPS system. We found that (1) access controls over two critical tables within HUDCAPS needed to be restricted, (2) an inadequate segregation of duties between data entry and approval functions existed, and (3) a periodic recertification of users was needed. As part of our review, and in response to our recommendations, PIH and the Office of the CFO have taken action to correct most of the deficiencies noted. However, additional steps in controlling access are needed. Our current review disclosed (1) a critical HUDCAPS table remains unrestricted, and (2) inadequate separation of duties over data entry and approval functions still exist. For fiscal year 1997 we also reviewed access controls over LOCCS and noted that access controls over that system needed to be improved.

Access to HUDCAPS Unit Distribution Table must be restricted

The Unit Distribution Table (UDIS) is PIH's official table for maintaining unit distribution data by bedroom size. These unit data are used by PIH to calculate annual contract renewal authority for budget formulation purposes. Unrestricted access to this table could compromise the data integrity within HUDCAPS. Unintentional or malicious tampering of the information in this table could result in inaccurate budget projections.

We reported in fiscal year 1996 that HUD field office personnel were able to read, enter, and change data in the UDIS for Public Housing Authorities under the jurisdiction of other HUD field offices. Additionally, we noted that there was no secondary approval or review level required for any changes made to this table. Our current review disclosed that this condition still exists.

In their response to our fiscal year 1996 recommendation, PIH commented that access to the UDIS table is a moot point as this table would be properly controlled once the Section 8 FMC is established. Further discussions with PIH personnel indicated that the input of all unit data will be centralized at the FMC once established and operational. While we agree that this may be a moot point once the FMC is established, we are concerned that up until the FMC is operational, the UDIS table remains accessible to all PIH users. Further, although current plans call for the FMC to be operational in October 1998, this date is subject to revision and could be delayed. Therefore, PIH should either restrict access to this table as soon as possible or establish compensating controls over the unit data until such time as the FMC is operational and the input of the unit data is centralized and controlled. Failure to maintain the integrity of unit data, increases the risk of

accidental or deliberate unauthorized changes or deletions to data that are a critical component of HUD's budget formulation process.

Inadequate separation of duties existed for HUDCAPS data entry and approval

In fiscal year 1996, we reported an inadequate separation of duties between data entry and approval for users with certain security profiles. The CFO, in response to our recommendation, indicated that periodic supervisory reviews will be required of documents processed to ensure proper authorization. Further, the CFO planned to include the required supervisory reviews for both the budget and purchasing functions in the Budget Execution and Accounting Manual. This manual was originally scheduled to be issued by September 1997 but was subsequently revised to January 1998.

Our current review found, however, that the inadequate separation of duties condition still exists and that the Budget Execution and Accounting Manual was not issued by the planned date. Further, one of the security profiles related to system administration needs to be especially controlled and its functions segregated as this profile allows complete access to most HUDCAPS tables and documents including vendor entry and activation tables for payment processing.

Our review found 30 security profiles, 21 model and 9 special, that provide HUDCAPS users with both data entry and approval authority for electronic payment and budget documents. The CFO has requested certifying officers, as part of their September 30, 1997 quarterly recertification update, to segregate the entry and approval functions of their HUDCAPS users. Further, if segregation of functions could not be supported, the certifying officers were required to identify the compensating controls to be implemented. The CFO is currently reviewing the recertification responses and will make a determination as to whether the responses are adequate to ensure the proper segregation of duties or compensating controls are present.

Our review also disclosed that the System Administrator profile (SYSADMIN), used by three administrative users within the CFO's office, provides full access to most of the HUDCAPS tables and documents, including the security table (STAB), vendor entry (VEND) and activation (VACT) tables. These three tables are considered sensitive and critical tables as they are used for controlling user access and payment processing functions. We noted that the SYSADMIN profile allowed personnel the authority to change user profiles, access rights, and privileges as well as the authority to enter and approve and change most documents and tables with no secondary approval or review required. Accordingly, personnel assigned this access could create fictitious vendors and issue payments to those vendors undetected.

We were informed that access to these documents and tables, to include the STAB, VEND and VACT tables, was necessary to accomplish system maintenance and security functions. However, we believe that the proper separation of duties can be accomplished without sacrificing the need to provide HUDCAPS system maintenance and security. This can be accomplished by establishing a separate Security Administrator security profile in addition to the current System Administrator security profile. The Security Administrator profile would be used by the

HUDCAPS Security Administrator to maintain user ID's and make adjustments to document and table security setup. Additionally, the Security Administrator would have control over either the VEND or VACT table. The Systems Administrator profile would grant the Systems Administrator the authority to all HUDCAPS Administrative Accounting tables, excluding the system security tables and either the VEND or VACT table. Separating the duties of the security and the system maintenance functions as well as the vendor tables, will minimize the risk and harm that could result from the loss, misuse, or unauthorized access to or modifications of data.

Access to LOCCS by field personnel needed to be better controlled

In testing the access controls over LOCCS, we noticed two deficient access controls at the two field offices we visited. We found that six users had greater access than approved. These users were granted data entry rights which also allowed them to change banking data, even though the HUD's internal procedures require that all banking information be changed by a designated group in Headquarters. We also found nine users who had greater access than required. Eight of these users could initiate and approve payments outside of their designated geographic areas of responsibilities. Another user was given access to approve and reject payments for a program area other than the one to which she was assigned.

We attributed these weaknesses, in part, to the need to update the LOCCS security plan to reflect the elements required by February 1996 revisions to OMB Circular A-130. The system owner for LOCCS indicated that she was not aware of the revised A-130 requirements since HUD's internal policy on ADP security, Handbook 2400.24, Rev-1 (September 24, 1994), had not been updated to reflect the new requirements of OMB Circular A-130. HUD's Office of Information Technology is responsible for updating the ADP security handbook.

The CFO is in the process of consolidating the field accounting operations into one location. The updated LOCCS security plan for a consolidated operation must include adequate procedures for maintaining proper separation of duties and user accountability. Access privileges should be granted based on the lowest level possible for the function to be performed. Effective access controls minimize the risk of unauthorized modifications, disclosures, losses, or system impairments.

HUD's Actions Planned and Underway to Correct Access Control Deficiencies

As a result of the recommendations from prior financial statement audits, the Office of Public and Indian Housing (PIH) has restricted access to the ABAT table to program advisors and established their own recertification process. The CFO has removed the TECHUSER profile and added password protection to the OFFLINE profile and have made improvements to their user recertification process. The CFO has also issued user recertification letters for the quarter ended September 30, 1997 which required program office certifiers to segregate the data entry and approval duties in HUDCAPS. In response to the recertification, the certifiers indicated that either the duties had been properly segregated or that the duties could not be segregated because of staffing constraints. However, for the latter case, the certifiers would conduct periodic reviews of transaction reports to ensure that transactions were recorded properly in HUDCAPS.

Additionally, the CFO has indicated that a separate profile will be established for a Security Administrator and will contain access to the VACT table. Further, the System Administrator profile will be modified to exclude access to security tables and the VACT table. Also, a new Security Administrator for HUDCAPS will be trained, and the revised profiles will be implemented once training has been completed. Regarding the issuance of the Budget Execution and Accounting Manual, the CFO advised that a contractor has been tasked to complete the manual with an estimated completion date in the third quarter of fiscal year 1998.

HUD's Office of Information Technology is in the process of updating HUD Handbook 2400.24 which was in Departmental clearance at time of our audit. The CFO has agreed to update their system security plan to be in compliance with OMB Circular A-130. With regard to LOCCS access controls, the CFO's Office has stated they will address these areas in their *HUD 2020* transition plan.

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

Although PIH has taken action to control access to the ABAT table, the UDIS table remains accessible to all users. Action needs to be taken as soon as possible to control user access to this table. Such actions include either restricting user access to the UDIS table or provided compensating controls over the integrity of the unit data until the FMC is established and controls over the unit data are centralized. The CFO's plan or completed actions to provide compensating controls for the proper segregation of duties as part of the recertification process meets the intent of our recommendation.

The rapid pace of HUD's downsizing effort has already seen the transfer of workload from two field accounting offices. A security plan for LOCCS must be updated for the consolidated offices as soon as possible. Adequate internal controls must be maintained to avoid loss due to errors, inappropriate disclosure of data, or other illegal acts that may occur during transaction processing.

Compliance with Laws and Regulations

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

FFMIA requires auditors to report whether the agency's financial management systems substantially comply with the federal financial management systems requirements, applicable accounting standards, and the United States General Ledger at the transaction level.

We have determined that HUD is not in substantial compliance with FFMIA because HUD's financial management systems did not substantially comply with (1) Federal Financial Management Systems Requirements, (2) Federal Accounting Standards, or (3) United States Government Standards General Ledger (SGL) at the transaction level. We have included the specific nature of the noncompliance, responsible program offices and recommended remedial actions in Appendix C of this report.

Federal Financial Management Systems Requirements

In its *Fiscal Year 1997 Accountability Report*, HUD is reporting that 38 of its 92 financial management systems do not materially conform with the requirements of the Federal Managers Financial Integrity Act (FMFIA) and OMB Circular A-127. The number of reported nonconforming systems was reduced by 47 from the 85 reported in the *Fiscal Year 1996 Accountability Report*. This reduction was based largely on a Departmentwide effort to evaluate each of the nonconforming systems to determine whether they met the requirements of OMB Circular A-127. The evaluations were performed at the request of the CFO by the responsible program areas and resulted in the CFO reporting 31² of the systems being reclassified from nonconforming to conforming.

The CFO requested program offices to evaluate and document whether each of their systems complied with twelve criteria established in OMB Circular A-127. The CFO classified systems as nonconforming if any one of the twelve criteria received a "No" response. We noted that only 10 of the 31 reclassified systems had detailed assessments and justifications available as required by the CFO. The remaining 21 systems were classified as conforming systems based on the program areas submitting checklists without performing or documenting detailed assessments. We have not, nor has the CFO, had an opportunity to perform detailed reviews of revised assessments that were provided during the latter stages of our audit. However, we noted that some of the assessments did not provide detailed justification for "N/A" and "Yes" responses.

Audit procedures performed for the purpose of obtaining evidence in support of the auditor's opinion disclosed that security over financial information is not provided in accordance with Circular A-130, Appendix 3. The issue of security is further supported in individual system

² The remaining net reduction in nonconforming financial systems (16) was a result of 14 systems being discontinued, 7 systems being redesignated as nonfinancial and 5 systems being added during fiscal year 1997.

assessments performed by HUD management. Those assessments noted that 5 of the 38 nonconforming systems did not meet security requirements.

Federal Accounting Standards

An agency is considered in substantial compliance with financial accounting standards if the agency can prepare audited financial statements in accordance with applicable accounting standards. HUD's audited financial statements, with respect to FHA, are not prepared in accordance with SFFAS No. 2, Accounting for Direct Loans and Loan Guarantees. This requires that agencies estimate and report cash flows relating to loans and loan guarantee commitments made after September 30, 1991, and that such cash flows be accounted for on a present value basis. FHA's mortgage insurance programs are presented in accordance with private sector generally accepted accounting principles (GAAP) which significantly differ from the reporting requirements of SFFAS Number 2.

Compliance with the Standard General Ledger (SGL) at the transaction level

HUD currently has four general ledger systems to support its core accounting needs: Program Accounting System (PAS)/Line of Credit Control System (LOCCS), Federal Financial System (HUDCAPS), Macola Accounting System and the FHA General Accounting System. FHA's core financial system is not in conformance with the SGL.

Noncompliance issues with awards of fiscal year 1996 Public Housing Demolition, Site Revitalization, and Replacement Housing Grant funds did not occur for fiscal year 1997

In our report on our audit of HUD's fiscal year 1996 financial statements, we reported that HUD's fiscal year 1996 Public Housing Demolition, Site Revitalization, and Replacement Housing Grants (HOPE VI) funding award process did not consistently comply with the HUD Reform Act of 1989. In a subsequent report entitled *Audit of the Fiscal Year 1996 HOPE VI Grant Award Process*, issued in October 1996, we detailed our concerns with the award of fiscal year 1996 HOPE VI funds, including our overall conclusion that HUD awarded \$381 million of fiscal year 1996 HOPE VI funds to 37 ineligible applicants. In our review of the fiscal year 1997 award process, we noted that HUD drew on some of the experiences learned from problems with the fiscal year 1996 process and improved the process for fiscal year 1997. Our tests of the fiscal year 1997 process disclosed no material instances of noncompliance.

Other Matters Under Investigation

Investigations are being conducted by HUD OIG with respect to certain activities in connection with sales of HUD-held mortgage notes. These investigations could reveal other violations of laws and regulations. However, the ultimate outcome of such investigations is unknown.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
CONSOLIDATED STATEMENT OF FINANCIAL POSITION
AS OF SEPTEMBER 30, 1997 AND 1996
(Dollars in Millions)

	<u>1997</u>	<u>1996</u>
ASSETS		
Entity Assets:		
Intragovernmental Assets:		
Fund Balance with U. S. Treasury, (Note 2)		
Non-interest bearing	\$75,287	\$91,624
Interest bearing	759	1,542
Total Fund Balance with U.S. Treasury	<u>76,046</u>	<u>93,166</u>
Investments (Note 4)	18,770	12,604
Other Intragovernmental Assets	276	212
Governmental Assets:		
Foreclosed Property Held for Sale, Net (Note 5)	1,476	1,169
Mortgage Notes and Loans Receivable, Net (Note 6)	9,843	12,781
Other Governmental Assets	<u>1,456</u>	<u>794</u>
Total Entity Assets	<u>\$107,867</u>	<u>\$120,726</u>
Non-Entity Assets		
Intragovernmental Assets:		
Fund Balance with U. S. Treasury, (Note 2)	\$81	\$41
Governmental Assets:		
Other Non-Entity Assets	<u>510</u>	<u>543</u>
Total Non-Entity Assets	<u>\$591</u>	<u>\$584</u>
TOTAL ASSETS	<u>\$108,458</u>	<u>\$121,310</u>
LIABILITIES AND NET POSITION		
Liabilities Covered by Budgetary Resources:		
Intragovernmental Liabilities:		
Accounts Payable and Accrued Expenses	\$876	\$1,022
Borrowings (Note 8)	36	39
Other Intragovernmental Liabilities	195	42
Governmental Liabilities:		
Accounts Payable and Accrued Expenses	802	733
Distributive Shares and Premium Refunds Payable	180	154
Claims Payable	388	653
Loss Reserves (Note 7)	13,657	13,458
Unearned Premiums	7,221	6,931
Debentures Issued to Claimants	68	82
Other Governmental Liabilities	<u>102</u>	<u>114</u>
Total Liabilities Covered by Budgetary Resources:	<u>\$23,525</u>	<u>\$23,228</u>
Liabilities Not Covered by Budgetary Resources		
Intragovernmental Liabilities:		
Borrowings (Note 8)	\$11,374	\$11,659
Governmental Liabilities:		
Accounts Payable and Accrued Expenses	139	134
Borrowings (Note 8)	<u>3,586</u>	<u>3,861</u>
Total Liabilities Not Covered by Budgetary Resources	<u>\$15,099</u>	<u>\$15,654</u>
TOTAL LIABILITIES	<u>\$38,624</u>	<u>\$38,882</u>
Commitments and Contingencies (Notes 3, 10 and 11)		
NET POSITION (Note 9):		
Mutual Insurance Funds Equity	\$2,662	\$2,526
Invested Capital	15	10
Unexpended Appropriations Held for Commitments	70,265	84,381
Cumulative Results of Operations	(15,297)	(15,999)
Future Funding Commitments	(6,092)	(6,429)
Appropriated Capital	<u>18,281</u>	<u>17,939</u>
Total Net Position	<u>\$69,834</u>	<u>\$82,428</u>
TOTAL LIABILITIES AND NET POSITION	<u>\$108,458</u>	<u>\$121,310</u>

The accompanying notes are an integral part of these financial statements.

**DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
CONSOLIDATED STATEMENT OF OPERATIONS
FOR THE YEARS ENDED SEPTEMBER 30, 1997 and 1996
(Dollars in Millions)**

	<u>1997</u>	<u>1996</u>
REVENUES AND FINANCING SOURCES:		
Operating Revenues:		
FHA Premiums	\$2,486	\$2,142
GNMA Mortgage Backed-Securities Program Income	354	335
Interest and Penalties, Non Federal	971	1,060
Interest, Federal	1,133	1,037
Other	187	91
Financing Sources:		
Appropriated Capital Used	31,588	32,391
Imputed Financing Sources	<u>11</u>	<u> </u>
Total Revenues and Financing Sources	<u>\$36,730</u>	<u>\$37,056</u>
EXPENSES:		
Section 8 Subsidies	\$15,257	\$16,480
Community Development Block Grants	4,491	4,526
Operating Subsidies	2,812	2,777
Low Rent Public Housing Grants	3,918	3,879
HOME	1,211	1,201
Other Subsidies, Grants and Loans	3,123	2,804
Mortgage-Backed Securities Program Expenses	30	27
Increase in Loss Reserves	163	1,921
Provision for Losses on Foreclosed Properties	2,232	1,975
Provision for Losses on Mortgage Notes and Loans	461	(714)
(Gain) on Sale of Mortgage Notes	(92)	(187)
Interest		
Non Federal	5	101
Federal	924	988
Salaries and Administration	1,229	1,140
Other	<u>138</u>	<u>87</u>
Total Expenses	<u>\$35,902</u>	<u>\$37,005</u>
EXCESS OF REVENUES AND FINANCING SOURCES OVER EXPENSES	<u><u>\$828</u></u>	<u><u>\$51</u></u>

The accompanying notes are an integral part of these financial statements.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
CONSOLIDATED STATEMENT OF CASH FLOWS
FOR THE YEARS ENDED SEPTEMBER 30, 1997 and 1996
(Dollars in Millions)

	1997	1996
CASH FLOWS FROM OPERATING ACTIVITIES:		
Excess of Revenues and Financing		
Sources over Expenses	\$828	\$51
Adjustments to Reconcile Excess to		
Net Cash Used by Operating Activities:		
Appropriated Capital Used	(31,588)	(32,391)
Increase in Loss Reserves	163	1,921
Provision for Losses on Foreclosed Properties	2,232	1,975
Provision for Losses on Mortgage Notes and Loans	447	(758)
Loss (Gain) on Mortgage Notes Held for Sale	(92)	(187)
Premiums Earned	(1,205)	(1,058)
Premiums Collected	1,789	1,722
Premiums Refunded	(294)	(418)
Claims Settlement Payments	(6,131)	(5,542)
Collection of Principal on Notes Acquired in Claims Settlement	187	232
Proceeds from Disposition of Assets Acquired in Claims Settlement	5,986	6,534
Increase in Payables and Other Liabilities	(210)	96
Decrease (Increase) in Receivables and Other Assets	(685)	1,204
Other, Net	(73)	(91)
Net Cash Used by Operating Activities	(\$28,646)	(\$26,710)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of Investment Securities	(\$19,203)	(\$8,141)
Proceeds from Sale of Investment Securities	13,181	6,657
Proceeds from Disposal of Mortgages	4	4
Principal Collections on Mortgages and Loans	146	146
Acquisition of Assets	(170)	(142)
Other, Net	4	
Net Cash Provided (Used) by Investing Activities	(\$6,038)	(\$1,476)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Appropriations Received	\$18,891	\$23,959
Cash Returned to Treasury	(723)	(938)
Borrowings from U.S. Treasury	589	1,567
Issuance of Debentures to Claimants	47	65
Payment of Borrowings	(1,152)	(1,277)
Payment of Debentures	(61)	(70)
Distributive Shares Paid	(1)	(2)
Transfers from other Agencies	7	7
Other, net	8	471
Net Cash Provided by Financing Activities	\$17,605	\$23,782
Net (Decrease) Increase in Cash	(\$17,079)	(\$4,404)
Funds With U.S. Treasury, Non-interest bearing - Beginning of Year	93,207	97,611
Funds With U.S. Treasury, Non-interest bearing - End of Year	\$76,128	\$93,207

The accompanying notes are an integral part of these financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 1997 and 1996

NOTE 1 - ENTITY AND MISSION

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

HUD's major programs are as follows:

The **Federal Housing Administration (FHA)** was created as a Government corporation within HUD and administers some 40 active mortgage insurance programs which are designed primarily to serve first-time home buyers and to provide affordable multifamily housing, and include insurance of loans for property improvements, cooperatives, condominiums, housing for the elderly and persons with disabilities, land development, group practice medical facilities and nonprofit hospitals.

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

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

Operating Subsidies are provided to Public Housing Authorities (PHAs) and Indian Housing Authorities (IHAs) to assist in financing the operations and maintenance costs of their housing projects.

The **Community Development Block Grant (CDBG)** programs provide funds for metropolitan cities, urban counties, and other communities to use for neighborhood revitalization, economic development, and improved community facilities and services.

The **Low Rent Public Housing Grants** program provides grants to PHAs and IHAs for construction and rehabilitation of low-rent housing. This program is a continuation of the **Low Rent Public Housing Loan** program which pays principal and interest on long-term loans made to PHAs and IHAs for construction and rehabilitation of low-rent housing.

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

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

Other Programs not included above consist of about 40 smaller programs which provide grant, subsidy funding, and direct loans to support other HUD objectives such as fair housing and equal opportunity, energy conservation, assistance for the homeless, rehabilitation of housing units, and home ownership. These programs comprise approximately 8.5 percent of HUD's consolidated assets and 7.7 percent of HUD's consolidated revenues and financing sources for fiscal 1997, and 7.2 percent of HUD's consolidated assets and 6.8 percent of HUD's consolidated revenues and financing sources for fiscal 1996.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Consolidation

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

B. Basis of Accounting

The consolidated financial statements include the accounts and transactions of the Ginnie Mae, FHA, and HUD's Grant, Subsidy and Loan programs. These statements are different than the reports prepared to monitor and control the obligation and expenditure of budgetary resources, which are prepared from the same records.

The statements are presented in accordance with the Office of Management and Budget (OMB) Bulletin 97-01, Form and Content of Agency Financial Statements, as it applies to the fiscal 1997 financial statements, with the exception of the Statement of Federal Financial Accounting Standards Number 2 (SFFAS Number 2) requirements. HUD deviates from SFFAS Number 2 accounting and financial statements presentation requirements. Discussion of HUD's basis of accounting for post 1991 Loans and Loan Guarantees is discussed in Note 13.

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

C. Operating Revenue and Financing Sources

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

Appropriations for Grant and Subsidy Programs

HUD receives appropriations on both an annual and multiyear basis. Appropriations are recognized as revenue when related program expenses are incurred. Accordingly, for grants provided by HUD, revenue and related expenses are recognized as recipients perform under the contracts. For subsidies provided by HUD, revenue and related expenses are recognized when the underlying assistance (e.g., provision of a Section 8 rental unit by a housing owner) is provided.

FHA Premiums and Unearned Revenue

Prior to July 1991, FHA's largest activity, the insurance of single family mortgages by the Mutual Mortgage Insurance (MMI) Fund, charged a one-time premium upon initiation of insurance. On July 1, 1991, the premiums charged by FHA for this insurance were restructured to include both an up-front and a risk-based annual premium. The one-time and up-front premiums are recorded as unearned revenue upon collection and are recognized as revenue over the period in which losses and insurance costs are expected to occur. The risk-based annual premiums are recognized on a straight-line basis throughout the year. FHA's other activities, including most of those conducted through the General Insurance (GI) and Special Risk Insurance (SRI) Funds, charge periodic premiums over the mortgage insurance term. Premiums on annual installment policies are earned on a straight-line basis throughout the year.

Ginnie Mae Fees

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

D. Loss Reimbursements Financed by Credit Reform Appropriations

FHA's GI and SRI funds are not intended to be self-sustaining. As a result, the National Housing Act, as amended, provides for appropriations from Congress to cover losses in these funds. The Credit Reform Act of 1990 changed the method by which FHA receives appropriations from Congress. Beginning in fiscal 1992, appropriations to the GI and SRI Funds are made at the beginning of each fiscal year to cover estimated losses on loans to be insured during that year. The revised appropriation structure also authorizes permanent indefinite appropriation authority to finance the cash requirements of operations resulting from endorsements in years prior to fiscal 1992.

E. Future Funding Commitments

HUD is responsible for repaying borrowings incurred by certain public housing organizations from private investors and the Federal Financing Bank. However, appropriations to repay these borrowings are obtained on an annual basis. Since HUD is ultimately responsible for repaying these borrowings, they have been recorded as a liability in the Consolidated Statement of Financial Position (included in "Borrowings"), and a deficiency in HUD's net position has also been recorded and is referred to as "future funding commitments."

F. Fund Balance with the U.S. Treasury

Substantially all of HUD's receipts and disbursements are processed by the U.S. Treasury which, in effect, maintains HUD's bank accounts. HUD's fund balances with the U.S. Treasury as of September 30, 1997, were as follows (dollars in millions):

<u>Description</u>	<u>Obligated</u>	<u>Unobligated</u>		<u>Total</u>
		<u>Available</u>	<u>Restricted</u>	
Appropriated Funds	\$ 51,512	\$ 17,708	\$ 116	\$ 69,336
Revolving Funds	<u>5,465</u>	<u>1,224</u>	<u>21</u>	<u>6,710</u>
Total - Entity Fund Balance	<u>\$ 56,977</u>	<u>\$ 18,932</u>	<u>\$ 137</u>	<u>\$ 76,046</u>
Non-Entity Fund Balance with the U.S. Treasury	<u>\$ 64</u>	<u>\$ 17</u>	<u>\$ -</u>	<u>\$ 81</u>

HUD's fund balances with the U.S. Treasury as of September 30, 1996, were as follows (dollars in millions):

<u>Description</u>	<u>Obligated</u>	<u>Unobligated</u>		<u>Total</u>
		<u>Available</u>	<u>Restricted</u>	
Appropriated Funds	\$ 70,814	\$ 12,650	\$ 60	\$ 83,524
Revolving Funds	<u>8,882</u>	<u>760</u>	<u>-</u>	<u>9,642</u>
Total - Entity Fund Balance	<u>\$ 79,696</u>	<u>\$ 13,410</u>	<u>\$ 60</u>	<u>\$ 93,166</u>
Non-Entity Fund Balance with the U.S. Treasury	<u>\$ 21</u>	<u>\$ 20</u>	<u>\$ -</u>	<u>\$ 41</u>

The substantial portion of the obligated fund balance is required for payment of HUD's commitments under its various grant, subsidy, and loan programs. The majority of funds designated as "Available" above represent administrative commitments. Administrative commitments are reservations of funds for a specific project by HUD (for which a contract has not been executed) to obligate all or a part of those funds. Both commitments and reservations are discussed in greater detail in Note 3. Restricted fund balances relate to funds for which the related appropriation has expired. These funds can only be used for payment of unrecorded or under-recorded obligations relating to the expired appropriation, until the account is closed and returned to Treasury. Non-entity fund balances relate to transfer appropriations.

In accordance with the Federal Credit Reform Act of 1990 (Credit Reform), all cash generated by FHA from insurance endorsed on or after October 1, 1991, is deposited in an interest-bearing account. The account earns interest at a rate based on maturity intervals of 10 years and longer, as determined by the U.S. Treasury.

Prior to Credit Reform, cash generated from FHA insurance endorsements, and not needed for short term operating purposes was invested in non-marketable U.S. Government Securities with terms similar to Government securities that are publicly marketed.

For purposes of the Consolidated Statement of Cash Flows, HUD's funds in the U.S. Treasury (including FHA's non-interest-bearing funds) are considered cash. FHA's interest-bearing funds at the U.S. Treasury are considered an investing activity, since Credit Reform did not, in substance, change the liquidity of the funds.

G. Investments in U.S. Government Securities

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

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

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

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

H. Mortgage Notes and Loans Receivable

HUD finances mortgages and provides loans to support construction and rehabilitation of low rent housing, principally for the elderly and disabled under the Section 202 program. Prior to April 1996, mortgages were also assigned to HUD through FHA claims settlement (i.e., mortgage notes assigned, MNAs). Single family mortgages were assigned to FHA when the mortgagor defaulted due to certain "temporary hardship" conditions beyond the control of the mortgagor, and when, in management's judgment, it is likely that the mortgage could be brought current in the future. In addition, multifamily mortgages were assigned to FHA when lenders filed mortgage insurance claims for defaulted notes.

During 1996, Congress mandated that FHA discontinue the single family assignment program and develop and implement a loss mitigation program to reduce defaults and related costs. FHA, however, continues to take single family assignment on those defaulted mortgage notes that were in process at the time the assignment program was terminated. In addition, multifamily and single family performing notes insured pursuant to Section 221(g)(4) of the National Housing Act may be assigned automatically to FHA at a pre-determined point.

Mortgage notes and loans are recorded at the lower of cost or fair value. Fair value is estimated based on prevailing market interest rates at dates of mortgage assignment. When fair value is less than cost, discounts are recorded and amortized to interest income over the remaining terms of the mortgages or upon sale of the mortgages. Interest is recognized as income when earned. When full collection of principal is considered doubtful, an allowance for losses is recorded. The allowance is estimated based on historical loss rates and recovery rates resulting from asset sales and property recovery rates, net of cost of sales. Mortgages and loans are reported net of the allowance for loss and any unamortized discount.

I. Foreclosed Property Held for Sale

Foreclosed property held for sale is reported at cost (the amount of the mortgage claim paid by HUD) net of an allowance for loss, which is established to reduce the property carrying value to its fair value - the amount HUD expects to receive in cash upon sale of the property - less cost of sale. Foreclosure holding and disposition costs are charged to operations as incurred.

J. Accrued Unfunded Leave and FECA Liabilities

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

HUD also accrues the portion of the estimated liability for disability benefits assigned to the agency under the Federal Employees Compensation Act (FECA), administered and determined by the Department of Labor. The liability is based on the net present value of estimated future payments based on a study conducted by the Department of Labor and is \$57 million as of September 30, 1997. Future payments on this liability are to be funded by future appropriations. HUD offsets this unfunded liability by recording future financing sources.

K. Loss Reserves

HUD records loss reserves for its mortgage insurance programs operated through FHA and its financial guaranty programs operated by Ginnie Mae. FHA loss reserves are recorded for actual or probable defaults of FHA-insured mortgage loans. Ginnie Mae reserves are established for actual and probable defaults of issuers of Ginnie Mae-guaranteed mortgage-backed securities. Such reserves are based on management's judgment about historical claim and loss information and current economic factors.

L. Retirement Plans

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

A primary feature of FERS is that it offers a savings plan whereby HUD automatically contributes 1 percent of pay and matches any employee contribution up to an additional 4 percent of pay. Under CSRS, employees can contribute up to 5 percent of their pay to the savings plan, but there is no corresponding matching by HUD. Although HUD funds a portion of the benefits under FERS relating to its employees and makes the necessary withholdings from them, it has no liability for future payments to employees under these plans, nor does it report CSRS, FERS, or FECA assets, accumulated plan benefits, or unfunded liabilities applicable to its employees. These amounts are reported by the Office of Personnel Management (OPM) and are not allocated to the individual employers. HUD's matching contributions to these retirement plans during fiscal 1997 and 1996 were \$53 million and \$55 million, respectively.

M. Pension and Other Retirement Benefits

The Department's pension and other retirement benefit expenses totaled approximately \$100 million for fiscal 1997. This amount includes \$11.4 million to be funded by the OPM. Pursuant to the requirements of SFFAS Number 5, adopted during fiscal 1997, amounts funded by OPM are to be charged to expense with a corresponding amount considered as an imputed financing source. This imputed financing source is included as "Other Revenue and Financing Sources" in the statement of operations.

N. Reclassifications

Reclassifications were made to the FHA's fiscal 1996 financial statements to conform with the presentation used in 1997. The changes in classifications have no effect on the previously reported net income.

NOTE 3 - COMMITMENTS UNDER HUD'S GRANT, SUBSIDY, AND LOAN PROGRAMS

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

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

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

HUD's commitment balances are based on the amount of unliquidated obligations recorded in HUD's accounting records with no provision for changes in future eligibility, and thus are equal to the maximum amounts available under existing agreements and contracts. Unexpended appropriations shown in the Consolidated Statement of Financial Position comprise funds in the U.S. Treasury available to fund existing commitments that were provided through "up-front" appropriations, and also include permanent indefinite appropriations received in excess of amounts used to fund the pre-1988 subsidy contracts.

HUD's obligations and contractual commitments under its grant, subsidy, and loan programs as of September 30, 1997, and 1996 were as follows (dollars in millions):

Programs	1997			1996		
	Commitments Funded Through		Total Contracted Commitments	Commitments Funded Through		Total Contracted Commitments
	Unexpended Appropriations	Permanent Indefinite Appropriations		Unexpended Appropriations	Permanent Indefinite Appropriations	
Section 8 Rental Assistance	\$ 19,468	\$ 47,479	\$ 66,947	\$ 38,557	\$ 47,590	\$ 86,147
Community Development Block Grants	8,796	-	8,796	8,490	-	8,490
HOME Investment Partnership Program	3,506	-	3,506	3,345	-	3,345
Low Rent Public Housing Grants and Loans	8,460		8,460	9,663	-	9,663
Operating Subsidies	1,524	-	1,524	1,549	-	1,549
Section 202/811	3,210	-	3,210	2,759	-	2,759
Section 235/236	130	12,210	12,340	147	13,070	13,217
All Other	<u>5,736</u>	<u>160</u>	<u>5,896</u>	<u>5,991</u>	<u>206</u>	<u>6,197</u>
Total	<u>\$ 50,830</u>	<u>\$ 59,849</u>	<u>\$ 110,679</u>	<u>\$ 70,501</u>	<u>\$ 60,866</u>	<u>\$ 131,367</u>

With the exception of the Section 202 and Low Rent Public Housing Loan Programs, which have been converted to a grant program and Section 235/236, and a portion of "all other" programs, HUD management expects all of the above programs to continue to incur new commitments under authority granted by Congress in future years. However, estimated future commitments under such new authority are not included in the amounts above.

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

HUD's reservation balance as of September 30, 1997, and 1996, were as follows (dollars in millions):

Program	1997			1996		
	Reservations Funded Through			Reservations Funded Through		
	Unexpended Appropriations	Permanent Indefinite Appropriations	Total Reservations	Unexpended Appropriations	Permanent Indefinite Appropriations	Total Reservations
Section 8 Rental Assistance	\$ 2,656	-	\$ 2,656	\$ 3,679	-	\$ 3,679
Low Rent Public Housing Grants and Loans	1,697	-	1,697	1,662	-	1,662
Section 202/811	2,414	\$ 73	2,487	2,673	\$ 73	2,746
All Other	1,393	35	1,428	1,420	16	1,436
Total	<u>\$ 8,160</u>	<u>\$ 108</u>	<u>\$ 8,268</u>	<u>\$ 9,434</u>	<u>\$ 89</u>	<u>\$ 9,523</u>

The amount required to fund each of the Department's Section 8 contracts is based on estimated information such as the number of rental units, household income, inflation, and unit rent. This estimated information will differ from actual information over the term of the contract. Accordingly, the actual amounts to be paid over the remaining terms of each Section 8 contract may be more or less than the remaining funds available under each contract. During fiscal 1997, the Department estimated that there was approximately \$9.9 billion of excess commitments (budget authority originally received which will not be needed to fund the related contracts to their expiration) relating to the Section 8 Rental Voucher and Rental Certificate programs. Of this amount, approximately \$7.7 billion was subsequently recaptured of which \$3.65 billion was rescinded and the remaining amount was transferred to the "Section 8 Reserve Preservation Account." The fiscal 1997 Section 8 contractual commitments included in the chart above reflects the amount of the recapture and rescission.

Where HUD has estimated that the funds provided in the Section 8 contracts will not be sufficient to fully fund the contracts over their remaining terms, additional amendment funds are requested from Congress. HUD is currently in the process of estimating the amount of these amendment funds that will be needed over the remaining terms of contracts relating to project based Section 8 programs.

NOTE 4 - INVESTMENTS IN U.S. GOVERNMENT SECURITIES

The U.S. Government securities are non-marketable securities. Interest rates are established by the U.S. Treasury and during fiscal 1997 ranged from 5.2 percent to 6.1 percent annually. During fiscal 1996 interest rates ranged from 4.7 percent to 8.5 percent annually. The amortized cost and estimated market value of investments in debt securities as of September 30, 1997 and 1996, were as follows (dollars in millions):

<u>Fiscal Year</u>	<u>Cost</u>	<u>Amortized (Premium) Discount</u>	<u>Net Investments</u>	<u>Unrealized Gain</u>	<u>Unrealized Loss</u>	<u>Required Market Value Disclosure</u>
FY 1997	\$ 19,017	\$ (247)	\$ 18,770	\$ 380	\$ (33)	\$ 19,117
FY 1996	\$ 12,660	\$ (56)	\$ 12,604	\$ 240	\$ (151)	\$ 12,693

NOTE 5 - FORECLOSED PROPERTY HELD FOR SALE

Foreclosed property held by HUD is principally obtained by FHA via claims settlement. Properties may also be acquired through foreclosure on direct loans under the Section 202 Program and the Section 312 Rehabilitation Loan Program. These result from financial default or non-compliance with other terms of the loan agreements, and through foreclosures on properties out of defaulted issuer pools serviced by Ginnie Mae. Foreclosed properties consisted of the following classes of property as of September 30, 1997, (dollars in millions):

<u>Description</u>	<u>FHA</u>	<u>Ginnie Mae</u>	<u>All Other</u>	<u>Total</u>
Single Family	\$ 2,435	\$ 1	\$ 2	\$ 2,438
Multifamily	355	-	1	356
Title I	<u>-</u>	<u>4</u>	<u>-</u>	<u>4</u>
Total Property	2,790	5	3	2,798
Allowance for Losses	<u>(1,319)</u>	<u>(2)</u>	<u>(1)</u>	<u>(1,322)</u>
Property Net	<u>\$ 1,471</u>	<u>\$ 3</u>	<u>\$ 2</u>	<u>\$ 1,476</u>

Foreclosed properties consisted of the following classes of property as of September 30, 1996, (dollars in millions):

<u>Description</u>	<u>FHA</u>	<u>Ginnie Mae</u>	<u>All Other</u>	<u>Total</u>
Single Family	\$ 1,860	-	-	\$ 1,860
Multifamily	490	-	\$ 3	493
Title I	-	\$ 8	-	8
Total Property	2,350	8	3	2,361
Allowance for Losses	<u>(1,188)</u>	<u>(2)</u>	<u>(2)</u>	<u>(1,192)</u>
Property Net	<u>\$ 1,162</u>	<u>\$ 6</u>	<u>\$ 1</u>	<u>\$ 1,169</u>

The allowance for losses is recorded to reduce the property carrying value to the amount HUD expects to receive in cash when properties are sold. The allowance is necessary because historically HUD has not recovered the full cost of its foreclosed property.

NOTE 6 - MORTGAGE NOTES AND LOANS RECEIVABLE

HUD's mortgage notes and loans receivable as of September 30, 1997, were as follows (dollars in millions):

<u>Description</u>	<u>FHA</u>	<u>Ginnie Mae</u>	<u>Low Rent Loans</u>	<u>Section 202 Loans</u>	<u>All Other Loan Programs</u>	<u>Total</u>
Single Family	\$ 677	\$ 7	-	-	\$ 137	\$ 821
Title I	356	-	-	-	-	356
Multifamily	<u>2,256</u>	<u>-</u>	<u>\$ 45</u>	<u>\$ 8,228</u>	<u>914</u>	<u>\$ 11,443</u>
Total Mortgages and Loans	3,289	7	45	8,228	1,051	12,620
Unearned Discounts and Allowances for Losses	<u>(2,117)</u>	<u>(3)</u>	<u>(10)</u>	<u>(21)</u>	<u>(626)</u>	<u>(2,777)</u>
Mortgages and Loans, Net	<u>\$ 1,172</u>	<u>\$ 4</u>	<u>\$ 35</u>	<u>\$ 8,207</u>	<u>\$ 425</u>	<u>\$ 9,843</u>

HUD's mortgage notes and loans receivable as of September 30, 1996, were as follows (dollars in millions):

Description	FHA	Ginnie Mae	Low Rent Loans	Section 202 Loans	All Other Loan Programs	Total
Single Family	\$ 3,023	\$ 2	-	-	-	\$ 3,025
Title I	294	-	-	-	-	294
Multifamily	<u>3,259</u>	<u>-</u>	<u>\$ 45</u>	<u>\$ 8,307</u>	<u>\$ 1,044</u>	<u>\$ 12,655</u>
Total Mortgages and Loans	6,576	2	45	8,307	1,044	15,974
Unearned Discounts and Allowances for Losses	<u>(2,605)</u>	<u>(1)</u>	<u>(10)</u>	<u>(21)</u>	<u>(556)</u>	<u>(3,193)</u>
Mortgages and Loans, Net	<u>\$ 3,971</u>	<u>\$ 1</u>	<u>\$ 35</u>	<u>\$ 8,286</u>	<u>\$ 488</u>	<u>\$ 12,781</u>

Interest income for the year ended September 30, 1997, was \$253 million on FHA notes, \$2 million on Low Rent Public Housing loans, \$698 million on Section 202 loans and \$18 million on all other loans. For the year ended September 30, 1996, interest income was \$271 million on FHA notes, \$3 million on Low Rent Public Housing Loans, \$763 million on Section 202 loans and \$21.3 million on all other loans.

FHA mortgages and loans on which the accrual of interest has been discontinued or reduced are estimated at September 30, 1997 and 1996, to be \$1.89 billion and \$4.35 billion, respectively. If interest on those mortgages and notes had been accrued for the years ended September 30, 1997 and 1996, that interest income would have approximated \$228 million and \$491 million, respectively.

Changes in the allowance for losses and unearned discounts on mortgage notes and loans for the year ended September 30, 1997, were (dollars in millions):

Description	FHA	Ginnie Mae	Low Rent Loans	Section 202 Loans	All Other Loan Programs	Total
Balance, Beginning of Year	\$ 2,605	\$ 1	\$ 10	\$ 21	\$ 556	\$ 3,193
Provision for Losses Charged to Operations	308	2	79	-	74	463
Loans Written Off	-	-	(79)	-	(4)	(83)
Amortization of Discount	-	-	-	-	-	-
Realized Losses & Write-Offs Net of Recoveries	<u>(796)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(796)</u>
Balance, End of Year	<u>\$ 2,117</u>	<u>\$ 3</u>	<u>\$ 10</u>	<u>\$ 21</u>	<u>\$ 626</u>	<u>\$ 2,777</u>

Changes in the allowance for losses and unearned discounts on mortgage notes and loans for the year ended September 30, 1996, were (dollars in millions):

Description	FHA	Ginnie Mae	Low Rent Loans	Section 202 Loans	All Other Loan Programs	Total
Balance, Beginning of Year	\$ 4,963	-	\$ 10	\$ 19	\$ 508	\$ 5,500
Provision for Losses Charged to Operations	(819)	\$ 1	39	2	66	(711)
Loans Written Off	-	-	(39)	-	(18)	(57)
Amortization of Discount	-	-	-	-	-	-
Realized Losses & Write-Offs Net of Recoveries	<u>(1,539)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(1,539)</u>
Balance, End of Year	<u>\$ 2,605</u>	<u>\$ 1</u>	<u>\$ 10</u>	<u>\$ 21</u>	<u>\$ 556</u>	<u>\$ 3,193</u>

Where mortgage notes are acquired at interest rates below the market interest rate in the year acquired, the notes are discounted. This discount reduces the fair value of the notes such that the effective interest rate approximates the market rate in the year acquired. For fiscal 1997, the weighted average nominal interest rates were 7.2 percent on FHA notes and 8.3 percent on non-FHA loans. The effective interest rates after discounting were 9.2 percent on FHA notes and 8.4 percent on non-FHA loans. FHA mortgages and loans which were considered current but which were under forbearance agreements comprise approximately \$278 million of the entire single family portfolio. For fiscal 1996, the weighted average nominal interest rates were 8.3 percent on FHA notes and 8.2 percent on non-FHA loans. The effective interest rates after discounting were 8.8 percent on FHA notes and 8.4 percent on non-FHA loans. FHA mortgages and loans which were considered current but which were under forbearance agreements comprise approximately \$1.1 billion of the entire single family portfolio. Section 202 and Low Rent Public Housing loans are made at market rates.

NOTE 7 - FHA AND GINNIE MAE LOSS RESERVES

For fiscal 1997 loss reserves established in the consolidated financial statements amounted to approximately \$13.65 billion. These reserves relate to FHA operations -- \$13.14 billion and Ginnie Mae operations -- \$508 million. Loss reserves for fiscal 1996 amounted to approximately \$13.45 billion and consisted of \$12.98 billion relating to FHA and \$472 million relating to Ginnie Mae. All loss reserves are covered by budgetary resources.

Federal Housing Administration

FHA loss reserves for claims and loss adjustment expenses (LAE), were as follows as of September 30, 1997 and 1996, (dollars in millions):

Fund	1997			1996		
	Claims Loss Reserve	LAE Reserve	Total	Claims Loss Reserve	LAE Reserve	Total
MMI	\$ 2,452	\$ 121	\$ 2,573	\$ 2,132	\$ 103	\$ 2,235
CMHI	27	-	27	6	-	6
GI	8,222	214	8,436	9,198	228	9,426
SRI	<u>2,069</u>	<u>44</u>	<u>2,113</u>	<u>1,292</u>	<u>27</u>	<u>1,319</u>
Total	<u>\$ 12,770</u>	<u>\$ 379</u>	<u>\$ 13,149</u>	<u>\$ 12,628</u>	<u>\$ 358</u>	<u>\$ 12,986</u>

The LAE reserve is provided for estimated administrative expenses of settling anticipated claims and reported defaults. The MMI Fund records an undiscounted claims loss reserve to provide for estimated losses incurred by FHA to pay claims on insured mortgages where defaults have taken place, but where claims have not yet been filed. The reserve is estimated based on historical claim and loss experience data, adjusted for judgments concerning current economic factors.

Discounted loss reserves for claims in the GI and SRI Funds are recorded when loan defaults are considered probable but have not yet been reported as such to FHA. Special projects are conducted to assess the credit risk of FHA's insured multifamily portfolio and calculate a loss reserve. Based on these reviews, multifamily loss reserves were decreased by approximately \$306 million for fiscal 1997 and increased by approximately \$1.9 billion for fiscal 1996 through a credit to operations.

Aggregate premiums generated by the GI and SRI Funds' various programs will not be sufficient to cover the Funds' losses nor to sustain their operations. The severity of the losses in these funds and the insufficiency of their premiums leave the Funds dependent on budget appropriations to sustain their operations as originally intended under statutes. Although activity in all of the SRI Fund's major programs has decreased substantially in recent years, activity in the GI Fund continues to be significant.

Government National Mortgage Association

Ginnie Mae establishes a reserve for loss through a provision charged to operations when defaults of issuers of mortgage-backed securities become probable. The reserve is relieved as losses are realized from the disposal of the defaulted issuers' portfolios. As of September 30, 1997 and 1996, the reserves are comprised of the following (dollars in millions):

<u>Description</u>	<u>1997</u>	<u>1996</u>
Single Family	\$ 196	\$ 150
Multifamily	57	57
Title I	<u>255</u>	<u>265</u>
Total	<u>\$ 508</u>	<u>\$ 472</u>

Ginnie Mae incurs losses when Federal insurance and guarantees do not cover expenses that result from issuer defaults, including such expenses as: (1) unrecoverable losses on individual mortgage defaults because of coverage limitations on federal mortgage insurance or federal mortgage guarantees; (2) ineligible mortgages included in defaulted Ginnie Mae-pools; (3) improper use of proceeds by an issuer; and (4) nonreimbursable administrative expenses and costs incurred to service and liquidate portfolios of defaulted issuers.

NOTE 8 - BORROWINGS

Several HUD programs have the authority to borrow funds from the U.S. Treasury for program operations. Additionally, FHA in certain cases is authorized by the National Housing Act to issue debentures in lieu of cash to pay claims. Funds were also borrowed by PHAs and IHAs from the private sector and from the Federal Financing Bank (FFB) to finance construction and rehabilitation of low rent housing; these borrowings are being repaid by HUD on behalf of the PHAs and IHAs.

HUD borrowings, and borrowings by PHAs/IHAs for which HUD is responsible for repayment, were as follows as of September 30, 1997 (dollars in millions):

Liabilities Not Covered by Budgetary Resources:

<u>Description</u>	<u>Beginning Balance</u>	<u>New Borrowings</u>	<u>Repayments</u>	<u>Ending Balance</u>	<u>Current Liabilities</u>	<u>Non-Current Liabilities</u>
Agency Borrowings:						
Held by Public	\$ 3,861	\$ -	\$ (275)	\$ 3,586	\$ 281	\$ 3,305
Total Agency Borrowings	\$ 3,861	\$ -	\$ (275)	\$ 3,586	\$ 281	\$ 3,305
Other Borrowings:						
From the U.S. Treasury	\$ 10,032	\$ 677	\$ (896) *	\$ 9,813	\$ 972	\$ 8,841
From the Federal Financing Bank	1,627	-	(66)	1,561	70	1,491
Total Other Borrowings	\$ 11,659	\$ 677	\$ (962) *	\$ 11,374	\$ 1,042	\$ 10,332
Total Borrowings	\$ 15,520	\$ 677	\$ (1,237) *	\$ 14,960	\$ 1,323	\$ 13,637

Classification of Borrowings

Governmental Borrowings	3,586
Intragovernmental Borrowings	\$ 11,374
Total Borrowings	\$ 14,960

* \$85 million of this balance is forgiven borrowings

Other Liabilities Covered by Budgetary Resources:

<u>Description</u>	<u>Beginning Balance</u>	<u>New Borrowings</u>	<u>Repayments</u>	<u>Ending Balance</u>	<u>Current Liabilities</u>	<u>Non-Current Liabilities</u>
Intragovernmental Borrowings:						
From the Federal Financing Bank	39	-	(4)	36	4	32
Total Borrowings	\$ 39	\$ -	\$ (4)	\$ 36	\$ 4	\$ 32

HUD borrowings, and borrowings by PHAs/IHAs for which HUD is responsible for repayment, were as follows as of September 30, 1996 (dollars in millions):

Liabilities Not Covered by Budgetary Resources:

<u>Description</u>	<u>Beginning Balance</u>	<u>New Borrowings</u>	<u>Repayments</u>	<u>Ending Balance</u>	<u>Current Liabilities</u>	<u>Non-Current Liabilities</u>
Agency Borrowings:						
Held by Public	\$ 4,132	\$ -	\$ (271)	\$ 3,861	\$ 275	\$ 3,586
Total Agency Borrowings	\$ 4,132	\$ -	\$ (271)	\$ 3,861	\$ 275	\$ 3,586
Other Borrowings:						
From the U.S. Treasury	\$ 9,361	\$ 1,636	\$ (965) *	\$ 10,032	\$ 812	\$ 9,220
From the Federal Financing Bank	1,689	-	(62)	1,627	65	1,562
Total Other Borrowings	\$ 11,050	\$ 1,636	\$ (1,027) *	\$ 11,659	\$ 877	\$ 10,782
Total Borrowings	\$ 15,182	\$ 1,636	\$ (1,298) *	\$ 15,520	\$ 1,152	\$ 14,368

Classification of Borrowings

Governmental Borrowings	3,861
Intragovernmental Borrowings	\$ 11,659
Total Borrowings	\$ 15,520

* \$20 million of this balance is forgiven borrowings

Other Liabilities Covered by Budgetary Resources:

<u>Description</u>	<u>Beginning Balance</u>	<u>New Borrowings</u>	<u>Repayments</u>	<u>Ending Balance</u>	<u>Current Liabilities</u>	<u>Non-Current Liabilities</u>
Intragovernmental Borrowings:						
From the Federal Financing Bank	89	-	(50)	39	4	35
Total Borrowings	\$ 89	\$ -	\$ (50)	\$ 39	\$ 4	\$ 35

Total HUD projected principal payments for the next 5 years and thereafter are (dollars in millions):

	<u>Governmental</u>	<u>Intragovernmental</u>
FY 1997	\$ 281	\$ 1,046
FY 1998	\$ 285	\$ 836
FY 1999	\$ 281	\$ 889
FY 2000	\$ 274	\$ 635
FY 2001	\$ 275	\$ 637
FY 2002 and thereafter	\$ 2,190	\$ 7,367

Interest paid during the years ended September 30, 1997 and 1996, on borrowings were \$924 million and \$988 million, respectively. The purposes of these borrowings are discussed in the following paragraphs.

Borrowings from the U.S. Treasury

HUD is authorized to borrow from the U.S. Treasury to finance Section 202 loans. The Treasury borrowings typically have a 15-year term, but may be repaid prior to maturity at the discretion of HUD. However, such borrowings must be repaid in the sequence in which they were borrowed from Treasury. The interest rates on the borrowings are based on Treasury's 30-year bond yield at the time the notes are issued. Interest is payable on April 30 and October 31. Interest rates are 11 percent for fiscal 1997 and 9.0 percent for fiscal 1996.

In fiscal 1997 and 1996, FHA MMI and GI/SRI funds borrowed \$592 million and \$1.6 billion respectively from the U.S. Treasury to cover cash shortfalls.

Borrowings from the Federal Financing Bank and the Public

During the 1960s, 1970s, and 1980s, PHAs and IHAs obtained loans from the private sector and from the FFB to finance development and rehabilitation of low rent housing projects. These borrowings are being repaid by HUD on behalf of the PHAs and IHAs, through the Low Rent Public Housing program. For borrowings from the Public, interest is payable throughout the year. Interest rates range from 2.25 percent to 6 percent for both fiscal 1997 and 1996. The borrowings from the FFB have terms up to 40 years; the borrowings from the private sector have terms up to 30 years. FFB interest is payable annually on November 1. Interest rates range from 10.6 percent to 16.1 percent for both fiscal 1997 and 1996.

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

NOTE 9 - NET POSITION

A. Cumulative Results of Operations

HUD's Cumulative Results of Operations represent the cumulative deficit or surplus from HUD's revolving funds operations, excluding activity relating to FHA's mutual funds which are reported separately. Cumulative losses of FHA's GI and SRI funds and of HUD's Section 202 loan program are financed with appropriated capital. Such appropriated capital is reported as a separate component of HUD's net position.

The net position activity for fiscal 1997 and 1996 is presented below (dollars in millions):

Description	1997				
	Beginning Balance	Activity Net results	Dividends Paid to Treasury	Other	Ending Balance
FHA, GI and SRI Funds	\$ (21,043)	\$ (154)	-	-	\$ (21,197)
Ginnie Mae	4,533	601	\$ -	-	5,134
Low Rent Public Housing					
Grants and Loans	49	9	-	\$ (15)	43
Section 202 Loans	45	259	-	-	304
All other	417	1	\$ -	-	418
Total	<u>\$ (15,999)</u>	<u>\$ 716</u>	<u>\$ -</u>	<u>\$ (15)</u>	<u>\$ (15,298)</u>

Description	1996				
	Beginning Balance	Activity Net results	Dividends Paid to Treasury	Other	Ending Balance
FHA, GI and SRI Funds	\$ (19,769)	\$ (1,274)	-	-	\$ (21,043)
Ginnie Mae	4,033	515	\$ (15)	-	4,533
Low Rent Public Housing					
Grants and Loans	65	(16)	-	-	49
Section 202 Loans	(143)	153	-	\$ 35	45
All other	434	17	\$ (34)	-	417
Total	<u>\$ (15,380)</u>	<u>\$ (605)</u>	<u>\$ (49)</u>	<u>\$ 35</u>	<u>\$ (15,999)</u>

The FHA cumulative losses in its GI and SRI mortgage insurance funds exceed appropriated capital, even though the National Housing Act, as amended, and the Federal Credit Reform Act authorize appropriations to restore losses in these funds. This is because, under generally accepted accounting principles, losses are recognized when the default of insured mortgages becomes probable, while for budgetary purposes, related appropriated capital will be received as defaulted loans are liquidated.

The cumulative results of operations for Ginnie Mae are derived from collection of commitment fees, guarantee fees, and investment income in excess of expenses.

B. Unexpended Appropriations

HUD receives appropriations on both an annual and multiyear basis for all non-revolving fund activity. Unexpended appropriations are amounts not yet expended, which have not lapsed, been rescinded, or been withdrawn.

Unexpended appropriations consists of obligated, committed, reserved, and available funds as presented below (dollars in millions):

Description	1997				
	Beginning Balance	Operating Appropriations Received, Net	Appropriated Capital Used	Other	Ending Balance
Section 8 Rental Assistance	\$ 43,417	\$ 1,974	\$ (15,149)	\$ (780) *	\$ 29,462
CDBG	9,217	4,877	(4,518)	-	9,576
HOME	3,527	1,408	(1,219)	-	3,716
Operating Subsidies	1,570	2,911	(2,823)	(4)	1,654
Low Rent Public Housing Grants and Loans	12,758	3,390	(4,297)	(272)	11,579
Section 202/811	6,245	865	(845)	-	6,265
All Other	<u>7,647</u>	<u>2,868</u>	<u>(2,737)</u>	<u>235</u> *	<u>8,013</u>
Total	<u>\$ 84,381</u>	<u>\$ 18,293</u>	<u>\$ (31,588)</u>	<u>\$ (821)</u>	<u>\$ 70,265</u>

* Includes transfer between HUD programs

Description	1996				
	Beginning Balance	Operating Appropriations Received, Net	Appropriated Capital Used	Other	Ending Balance
Section 8 Rental Assistance	\$ 53,053	\$ 5,880	\$ (16,384)	\$ 868 *	\$ 43,417
CDBG	9,097	4,667	(4,547)	-	9,217
HOME	3,329	1,405	(1,207)	-	3,527
Operating Subsidies	1,559	2,822	(2,811)	-	1,570
Low Rent Public Housing Grants and Loans	14,063	3,291	(4,251)	(345)	12,758
Section 202/811	6,797	1,107	(745)	(914)	6,245
All Other	<u>6,530</u>	<u>3,051</u>	<u>(2,446)</u>	<u>512</u> *	<u>7,647</u>
Total	<u>\$ 94,428</u>	<u>\$ 22,223</u>	<u>\$ (32,391)</u>	<u>\$ 121</u>	<u>\$ 84,381</u>

* Includes transfer between HUD programs

Unexpended Obligational Authority for Budgetary Reporting

Unexpended obligational authority is a budgetary term consisting of budget authority provided which has not been obligated. Unexpended appropriations for financial statement purposes will not agree with unexpended obligational authority, for the following reasons:

- a) unlike unexpended obligational authority, unexpended appropriations do not include contractual commitments and reservations for which appropriations have not yet been received. As explained in Note 3, unfunded contractual commitments and unfunded reservations relate primarily to the Section 8 and Section 235/236 programs, resulting from contract authority provided prior to FY 1988 (contract authority is not an appropriation);
- b) unexpended obligational authority includes FHA and GNMA activity. To the extent this activity is recorded for financial statement purposes, it is included in other net position accounts;
- c) commitments to fund future interest payments relating to loans made to PHAs and IHAs for which repayment was subsequently assumed by HUD, are included in unexpended obligational authority, but are not considered commitments for financial statement purposes.

Unexpended appropriations can be reconciled to unexpended obligational authority as of September 30, 1997, as follows (dollars in millions):

Appropriations recorded in accounting and budgetary records:

Contractual commitments funded through unexpended Appropriations (Note 3)	\$50,830
Reservations Funded through unexpended appropriations (Note 3)	8,160
Appropriations received, unreserved	<u>11,275</u>
Unexpended appropriations for Financial Statement Reporting	<u>70,265</u>

Non-accounting transactions recorded in budgetary records only:

Pre-1988 contract authority reflected in Note 3 as:

Contractual commitments funded through permanent indefinite appropriations	59,849
Reservations funded through permanent indefinite appropriations	108
FHA unexpended balances, not included in unexpended appropriations	17,452
GNMA unexpended balances, not included in unexpended appropriations	5,525
Public and Indian Housing Loan future interest payments assumed by HUD, not included in unexpended appropriations	<u>1,237</u>
Non-accounting transactions	<u>84,171</u>
Unexpended Obligational Authority for Budgetary Reporting	<u>\$154,436</u>

C. Mutual Insurance Funds Equity

The mutual funds equity consists of the net results to date of the operations of the MMI and CMHI mutual mortgage insurance funds of the FHA. Operating activity relating to these mutual funds is recorded separately and is not included in cumulative results of operations as discussed in Note 9A. Mutual fund equity is either held to meet capital ratio requirements or distributed to eligible policyholders.

Under the National Affordable Housing Act of 1990 (Affordable Housing Act), the MMI Fund must attain a capital ratio of 2.0 percent by fiscal 2000. The Affordable Housing Act defines the capital ratio as the ratio of the economic net worth of the MMI Fund to unamortized insurance in force.

Unamortized insurance in force is defined by the Affordable Housing Act to be the remaining obligation on outstanding mortgages and is, therefore, the same as the MMI Fund's insurance in force. The economic net worth, as defined by the Affordable Housing Act, is the current cash available to the MMI Fund, plus the present value of all future cash inflows and outflows expected to result from the outstanding mortgages insured by the MMI Fund. The MMI Fund's economic net worth differs from the MMI Fund's equity determined in accordance with generally accepted accounting principles (GAAP), because GAAP-determined equity is not based on the net present value of future cash flows.

Since fiscal 1989, FHA has commissioned independent annual studies of the actuarial soundness of the MMI Fund. These studies may be used, in part, to estimate the economic net worth of the MMI Fund. The results of the most recent study indicate that the MMI Fund has an economic value of approximately \$11.3 billion and a capital ratio of 2.81 percent as of September 30, 1997, based on unamortized insurance in force. The results of the fiscal 1996 study indicated an economic value of approximately \$9.4 billion and a capital ratio of 2.54 percent as of September 30, 1996, based on unamortized insurance in force.

Whereas the Affordable Housing Act defines unamortized insurance in force as "the remaining obligation on outstanding mortgages", this definition is more commonly understood to be the amortized insurance in force. Use of amortized insurance in force increases the capital ratio as of September 30, 1997 and 1996 to 3.02 percent and 2.71 percent, respectively.

Changes in the FHA's Mutual Funds Equity balance during the year ended September 30, 1997 were as follows (dollars in millions):

<u>Description</u>	<u>1997</u>		
	<u>MMI Fund</u>	<u>CMHI Fund</u>	<u>Total</u>
Beginning Balance	\$ 2,508	\$ 18	\$ 2,526
FY Activity:			
Net Results	156	(19)	137
Distributive Shares Paid	-	(1)	(1)
Distributive Shares Canceled	<u>-</u>	<u>-</u>	<u>-</u>
Ending Balance	<u>\$ 2,664</u>	<u>\$ (2)</u>	<u>\$ 2,662</u>

Changes in the FHA's Mutual Funds Equity balance during the year ended September 30, 1996 were as follows (dollars in millions):

<u>Description</u>	<u>1996</u>		
	<u>MMI Fund</u>	<u>CMHI Fund</u>	<u>Total</u>
Beginning Balance	\$ 1,854	\$ 17	\$ 1,871
FY Activity:			
Net Results	654	2	656
Distributive Shares Paid	-	(2)	(2)
Distributive Shares Canceled	<u>-</u>	<u>1</u>	<u>1</u>
Ending Balance	<u>\$ 2,508</u>	<u>\$ 18</u>	<u>\$ 2,526</u>

D. **Appropriated Capital**

Appropriated Capital primarily represents the amounts Congress has appropriated as permanent operating capital for HUD's loan and loan insurance programs operated as revolving funds. The appropriations given to FHA to offset losses in its subsidized funds (GI and SRI) represent the majority of the balance. Appropriations receivable that were canceled as a result of Federal Credit Reform were charged against appropriated capital.

The appropriated capital activity for fiscal 1997 is as follows (dollars in millions):

Description	1997			
	FHA GI and SRI Funds	Section 202/811 Housing for the Elderly and Disabled	All Other	Total
Appropriated Capital, Beginning of Year	\$ 14,674	\$ 2,811	\$ 454	\$ 17,939
Credit Subsidy Appropriations Received:				
On Insured 1997 Mortgages	95	-	-	95
As a result of Asset Sales	-	-	-	-
For Administrative Expenses	207	-	-	207
Appropriations Returned to Treasury				
Relating to Negative Subsidies:				
On Insured 1997 Mortgages	(142)	-	-	(142)
As a Result of Re-estimates	(25)	-	-	(25)
As a Result of Modification	(80)	-	-	(80)
As a result of modifications due to Asset Sales	(384)	-	-	(384)
As a result of Budget Rescission	-	-	-	-
Other Appropriations	-	735	(64)	671
Appropriated Capital, End of Year	<u>\$ 14,345</u>	<u>\$ 3,546</u>	<u>\$ 390</u>	<u>\$ 18,281</u>

The appropriated capital activity for fiscal 1996 is as follows (dollars in millions):

Description	1996			
	FHA GI and SRI Funds	Section 202/811 Housing for the Elderly and Disabled	All Other	Total
Appropriated Capital, Beginning of Year	\$ 14,613	\$ 2,006	\$ 528	\$ 17,147
Credit Subsidy Appropriations Received:				
On Insured 1996 Mortgages	152	-	-	152
As a result of Asset Sales	533	-	-	533
For Administrative Expenses	202	-	-	202
Appropriations Returned to Treasury				
Relating to Negative Subsidies:				
On Insured 1996 Mortgages	(142)	-	-	(142)
As a Result of Re-estimates	(110)	-	-	(110)
As a Result of Modification	(40)	-	-	(40)
As a result of modifications due to Asset Sales	(533)	-	-	(533)
As a result of Budget Rescission	(1)	-	-	(1)
Other Appropriations	-	805	(74)	731
Appropriated Capital, End of Year	<u>\$ 14,674</u>	<u>\$ 2,811</u>	<u>\$ 454</u>	<u>\$ 17,939</u>

E. Invested Capital

Invested capital represents the book value, net of amortization and depreciation, of HUD resources invested in property and equipment. HUD had a balance of \$15.1 million in Invested Capital as of September 30, 1997 and \$10.1 million as of September 30, 1996.

F. Future Funding Commitments

Future funding commitments are appropriations anticipated in future years to cover expenses incurred as of September 30, 1997 and 1996, for which HUD has not yet received appropriations. As of September 30, 1997 and 1996, future funding commitments consist of the following (dollars in millions):

	<u>1997</u>	<u>1996</u>
Low Rent Public Housing Loans	\$ (5,147)	\$ (5,488)
Section 202 Loans	(807)	(807)
Annual Leave and FECA	<u>(138)</u>	<u>(134)</u>
Total	<u>\$ (6,092)</u>	<u>\$ (6,429)</u>

The future funding commitments for the Low Rent Public Housing Loan program are to offset the liabilities assumed by HUD in repaying borrowings on behalf of PHAs and IHAs. HUD receives an annual appropriation covering yearly payment of principal and interest. A future funding commitment is recorded in the amount of the outstanding principal on these borrowings as of year end.

The Section 202 program was revised by the Housing and Community Development Act of 1987. This Act provided for a transfer of funds from the loan to the new capital grant program. A portion of these funds were borrowed from the U.S. Treasury. The repayment of these borrowings will be from future years' appropriations. A future funding commitment was recorded in the amount of \$806 million and \$807 million for September 30, 1997 and 1996.

NOTE 10 - FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

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

A. FHA Mortgage Insurance

Unamortized insurance in force outstanding for FHA's mortgage insurance programs as of September 30, 1997, and 1996 were as follows (dollars in millions):

<u>Fund</u>	<u>1997</u>	<u>1996</u>
MMI	\$ 360,289	\$ 337,449
CMHI	247	271
GI	84,205	78,753
SRI	<u>8,860</u>	<u>9,560</u>
Total	<u>\$ 453,601</u>	<u>\$ 426,033</u>

FHA's mortgage insurance covers losses that result when borrowers default on their mortgage payments. FHA mortgage insurance covers only default risk, and thus FHA is not exposed to losses resulting from interest rate fluctuations, except in the case of mortgages insured pursuant to Section 221(g)(4) of the National Affordable Housing Act. In most cases FHA insures 100 percent of the mortgage principal. However, when FHA pays claims resulting from mortgage defaults, a portion of the claim can normally be recovered through foreclosure and subsequent sale of the mortgaged property. In recent years, FHA has also recovered a portion of claims paid through public sale of the mortgage notes received at claim settlement.

FHA's MMI Fund provides mortgage insurance principally for 30-year fixed rate home mortgages. By law the MMI Fund must be operated in accordance with "sound actuarial and accounting practice." Borrowers should be charged a premium that will cover default losses and administrative expenses, and provide equity. Like all FHA activities, the MMI Fund suffers losses when premium income is insufficient to cover default losses and administrative costs. The magnitude of these losses is greater when there is either an increase in the number of mortgage defaults or a decrease in amounts recovered from the sale of foreclosed properties or mortgage notes sold. Since the MMI Fund primarily insures low down-payment mortgages, it is more susceptible to losses resulting from economic downturns. Such downturns may increase the number of defaults and result in lower claim recoveries when foreclosed properties are sold. Either situation could result in the MMI Fund experiencing greater losses than have been provided for in the accompanying consolidated financial statements.

The GI Fund provides mortgage insurance for loans involving cooperatives, condominiums, nursing homes, hospitals, and for low and moderate income multifamily loans involving construction, rehabilitation and refinancing. While the GI Fund's insurance in force is much less than that of the MMI Fund, its exposure to loss may be much greater. Unlike the MMI Fund, the GI Fund has no statutory requirement to be actuarially sound. In carrying out its mission, the GI Fund assumes levels of default risk not generally borne by commercial insurers or lenders. Furthermore, the GI Fund is susceptible to losses resulting from weaknesses in commercial and residential real estate markets at both the regional and national levels. Aggregate premiums charged by the GI Fund have not been sufficient to cover default losses and administrative costs. As a result, the GI Fund is dependent on appropriations to sustain its operations.

Activity for FHA's other two funds, SRI and Cooperative Management Housing Insurance (CMHI), has been minimal in recent years. Since these funds have very little activity, FHA's exposure to additional loss from these funds is comparatively small.

The significant geographical concentrations of both FHA's single and multifamily insurance risk are as follows. The significant geographic concentration for the single family unpaid principal insurance balance at September 30, 1997 is located in California (14 percent), Texas (8 percent), and Florida (6 percent). No other state equals 5 percent or more of the unpaid single family insurance principle balance. The concentration of risk is geographically dispersed for multifamily, except for the Hospital Program. The insurance in force for the Hospital Program is located primarily in the Northeast, with over 92 percent of the \$4.8 billion unpaid principal balance of the insurance in force attributed to the New York/New Jersey HUD Regions. New York state constitutes over 88 percent of the insurance in force for hospitals. The highest geographic concentration of risk for the remaining multifamily programs is in New York (13 percent), California (9 percent), Maryland (6 percent), Illinois (5 percent), and Ohio (5 percent). No other state equals 5 percent or more of the unpaid multifamily insurance principal balance.

B. Ginnie Mae Mortgage-Backed Securities

Ginnie Mae financial instruments with off-balance sheet risk include guarantees of Mortgage Backed Securities (MBS) and commitments to guaranty MBS. The securities are backed by pools of FHA-insured, RHS-insured, and VA-guaranteed mortgage loans. Ginnie Mae is exposed to credit loss in the event of non-performance by other parties to the financial instruments. The total amount of Ginnie Mae guaranteed securities outstanding at September 30, 1997, and 1996 was approximately \$531 billion and \$497 billion, respectively. However, Ginnie Mae's potential loss is considerably less because the FHA and RHS insurance and VA guaranty serve to indemnify Ginnie Mae for most losses. Also, as a result of the structure of the security, Ginnie Mae bears no interest rate or liquidity risk.

During the mortgage closing period and prior to granting its guaranty, Ginnie Mae enters into commitments to guarantee MBS. The commitment ends when the mortgage-backed securities are issued or when the commitment period expires. Ginnie Mae's risks related to outstanding commitments is much less than for outstanding securities due, in part, to GNMA's ability to limit commitment authority granted to individual issuers of MBS. Outstanding commitments as of September 30, 1997 and 1996, were \$31 billion and \$33 billion, respectively.

Generally, Ginnie Mae's MBS pools are diversified among issuers and geographic areas. No significant geographic concentrations of credit risk exist; however, to a limited extent, securities are concentrated among issuers.

During fiscal 1997, Ginnie Mae acquired four single family issuer portfolios with a remaining principle balance of \$351 million.

In fiscal 1997, Ginnie Mae issued a total of \$28 billion in its multiclass securities program.. The outstanding balance at September 30, 1997 was \$52 billion. These guaranteed securities do not subject Ginnie Mae to additional credit risk beyond that assumed under the MBS program.

C. Section 108 Loan Guarantees

Under HUD's Section 108 Loan Guarantee program, recipients of CDBG Entitlement Grant program funds may pledge future grant funds as collateral for loans guaranteed by HUD (these loans were provided from private lenders since July 1, 1986). This Loan Guarantee Program provides entitlement communities with a source of financing for projects which are too large to be financed from annual grants. The amount of loan guarantees outstanding as of September 30, 1997 and 1996 was \$1.16 billion and \$1.03 billion, respectively. In prior years the amount of loans guaranteed under this program were presented as of six months prior to the end of the fiscal year, since that was the most current information available. HUD is now able to provide this information as of the end of the fiscal year, and fiscal 1996 information has been restated to reflect this information. HUD management believes its exposure in providing these loan guarantees is limited, since loan repayments can be offset from future CDBG Entitlement Program Funds and, if

necessary, other funds provided to the recipient by HUD. HUD has never had a loss under this program since its inception in 1974.

NOTE 11 - CONTINGENCIES

A. Section 221(g)(4) Contingent Liability

Prior to the passage of the Cranston-Gonzalez National Affordable Housing Act of 1990, single family and multifamily mortgages insured under Section 221 of the National Housing Act that were neither delinquent nor in default could be assigned to FHA pursuant to Section 221(g)(4) by lenders in exchange for FHA debentures bearing current interest rates. Eligible mortgagees could elect to assign their current mortgages to FHA during the year following the twentieth anniversary after final endorsement of the mortgage. The assignment of these mortgages resulted in an additional cost to FHA to the extent that Treasury debenture rates exceeded the mortgage interest rates.

However, under the National Affordable Housing Act, FHA was required to arrange for the sale of the beneficial interest in the multifamily mortgage in lieu of accepting assignment after the 20th anniversary. The sales price to be paid to the lenders was to be equal to the outstanding principal balance at the time of the sale plus accrued interest. To ensure this price was realized, FHA was required to make subsidy interest payments. The Affordable Housing Act, as amended, only provided for the auction of multifamily mortgages assigned through September 30, 1996. Proposed legislation is in process to extend the auction authority through December 31, 2005, the natural sunset of the assignment program based on the November 30, 1983 congressionally mandated termination date. It is unclear if and when this legislation will be approved.

However, until an approval is received, FHA will issue debentures to those eligible Section 221(g)(4) mortgagees. FHA estimates that a maximum of 3,715 mortgages with an unpaid principle balance of \$8.3 billion could be assigned through 2005.

B. Termination of the Single Family Assignment Program

Historically, FHA has taken assignment of a significant number of insured single family mortgage notes which are in default rather than settle the claims through foreclosure or other alternatives. Legislation was enacted in April 1996 to eliminate the single family mortgage note assignment program. It authorized FHA to implement new loss mitigation tools and expand existing alternatives to foreclosure

C. Section 8 Subsidies

At September 30, 1997, the Department estimates that approximately 8,400 projects (with an insured mortgage value of \$17 billion) were receiving rental subsidies from a variety of non-FHA Section 8 subsidy programs.

Previously, the 1997 Budget set limits on Section 8 contract terms to one year and made changes to limit the level of rental subsidies paid under new Section 8 contract renewals and amendments. Various proposals to further reduce future subsidy payments made directly to project owners either were advanced as part of the formal fiscal 1998 budget process and related legislative submissions to Congress or are expected as part of the Congressional debate about the future of public and subsidized housing in the country.

H.R. 2158 - The VA, HUD & Independent Agencies Apportionment Act for fiscal year 1998, Subtitle A - FHA-Insured Multifamily Housing Mortgage and Housing Assistance Restructuring provides for a "mark to market" program to reduce the costs of over-subsidized Section 8 multifamily housing properties insured by FHA.

Under the “mark to market” program, FHA-insured Section 8 housing properties with above market rents are eligible for debt restructuring to reduce rent levels to those of comparable market rate properties or to the minimum level necessary to support proper operations and maintenance. In response to limitations with HUD capacity, the legislation shifts the administration and management of this portfolio from HUD to entities (termed participating administrative entities), charged with protecting the affordable housing stock in a fiscally responsible manner. Additionally, the legislation terminates the Government’s relationship with owners who fail to comply with Federal requirements and ends the practice of subsidizing properties that are not economically viable.

While the act includes extensive guidance on the selection of participating administrative entities development and submission of portfolio restructuring agreements covering the insured and subsidized mortgages, and determination, from a number of alternatives, of the best methods to restructure the project mortgage and subsidies, the Secretary is charged to develop additional regulations, rules, and procedures to implement the program.

The impact of these proposals would vary from project to project depending on such factors as the then current financial and physical condition, size and timing of subsidy changes, and local market conditions. In addition, final costs to FHA of these additional claims would depend upon the methods used to restructure project mortgages or to minimize the actual transfer of the mortgages or properties to FHA ownership, and the methods used to dispose of any mortgages or properties assumed in a timely fashion. The claims which would result almost all relate to insurance issued prior to 1991. FHA has available a permanent indefinite appropriation authority to pay these claims.

FHA estimates that approximately \$ 5.3 billion of loss reserves on subsidized projects have already been accrued, for financial reporting purposes, but not for budget purposes, as part of its estimation of potential losses on the entire insured portfolio at September 30, 1997. Loss reserves accrued for subsidized projects at September 30, 1996, were \$6.2 billion. These reserves include the estimated overall financial impacts on FHA of the changes to the present rent subsidy structure. HUD believes these reserves adequately provide for estimated losses on subsidized projects.

D. Lawsuits and Other

HUD is party in various legal actions and claims brought against it. In the opinion of management and General Counsel, the ultimate resolution of these legal actions and claims will not materially affect HUD’s financial position or results of operations for the fiscal year ended September 30, 1997 and 1996. Payments made out of the Claims, Judgments and Relief Acts Fund in settlement of the legal proceedings are subject to the Department of Justice’s approval.

A case was filed by owners of 42 multifamily projects regarding the Emergency Low-Income Housing Preservation Act of 1987 (ELIHPA) and the Low-Income Housing Preservation and Resident Homeownership Act of 1990 (LIHPRHA). The Court of Federal Claims has ruled that the project owners’ mortgage contracts had been breached by implementation of ELIHPA and LIHPRHA, and a trial was held in November 1996 to determine damages, if any, with respect to that claim as regards four model properties. The court awarded \$3,061,107 in damages to the Plaintiff owners of the four model properties. An appeal has been taken by the United States from the judgment entered in this case and is presently under consideration by the United States Court of Appeals for the Federal Circuit. The ruling by the Federal Circuit on this appeal will very likely affect the outcome of all the other pending actions unless further review is done by the United States Supreme Court, in which event, the Supreme Court’s decision will be determinative. To date, there are 20 other lawsuits involving approximately 656 multi-family projects, all of which allege the same cause of action as stated above. HUD intends to defend these matters vigorously. HUD is unable at this time to form a judgment about the likelihood of an unfavorable outcome, or to make an estimate of the amount or range of potential loss if the plaintiffs should prevail. Any adverse judgment would be paid out of the Claims, Judgments, and Relief Acts Fund administered by the Department of Justice.

NOTE 12 - INTRAGOVERNMENTAL FINANCIAL ACTIVITIES

HUD's financial activities interact with and are dependent upon those of the Federal government as a whole. Specifically, HUD is subject to financial decisions and management controls of the Office of Management and Budget (OMB). As a result of its relationship with other Federal government entities and OMB, HUD's operations may not be conducted, nor its financial position reported, as they would if HUD were a separate and unrelated entity.

HUD's consolidated financial statements are not intended to report the Department's proportionate share of the total federal deficit or of public borrowings by the Treasury, including interest thereon.

A. Claims, Judgments, and Relief Acts Fund

Most legal actions that affect HUD and involve an amount in excess of \$2,500, with the exception of on-the-job injury claims as discussed in Note 2 and legal actions pertaining to the FHA and Ginnie Mae programs, are paid from the Claims, Judgments, and Relief Acts Fund maintained by the Department of the Treasury and administered by the General Accounting Office and the Department of Justice. HUD is not required to reimburse this fund for payments made on its behalf. During fiscal 1997 and 1996, no material amounts were paid to settle actions against HUD.

B. Other Interagency Transactions

HUD maintains various agreements with other federal agencies under the Economy and Efficiency Act. The revenues, expenses, receivables and payables for these agreements for fiscal 1997 and 1996 are not material. HUD's two largest federal transactions are with the General Services Administration (GSA) for the use and upkeep of HUD facilities, and the Department of Agriculture's National Finance Center, for the processing of payroll and related benefits.

HUD also manages transfer appropriations from GSA, the Appalachian Regional Commission (ARC), and the Department of Energy (DOE). The GSA funding is used to pay certain building occupancy costs for HUD's Headquarters building. The ARC funding is used to facilitate joint Federal and State efforts to provide basic facilities essential to economic growth in Appalachia. The DOE funding is used to fund loans and grants related to solar energy conservation improvements. These funds are included in the "All other" category in the consolidated financial statements.

NOTE 13 - CREDIT REFORM

HUD's activities are subject to the Federal Credit Reform Act of 1990 ("Credit Reform"), which became effective on October 1, 1991. Credit Reform's effect on HUD relates primarily to how losses and costs associated with loans insured through FHA's GI and SRI funds are financed. A primary purpose of Credit Reform is to more accurately measure the "subsidy" costs of Federal credit programs. Subsidy costs generally comprise the present value of estimated disbursements for costs associated with mortgage defaults, net of the present value of estimated collections for insurance premiums and claims recoveries.

For mortgages insured on or after October 1, 1991, up-front appropriations are required to finance credit subsidy costs. Appropriations to finance subsidy costs in the GI and SRI Funds were \$95 million and \$152 million in fiscal 1997 and 1996, respectively. FHA's MMI Fund has not received credit subsidy appropriations because the premiums charged are estimated to exceed associated costs.

For mortgages insured prior to October 1, 1991, the effective date of Credit Reform, permanent indefinite appropriations are available to finance costs associated with such mortgages to the extent premiums, recoveries, and

financing are insufficient to do so. No appropriations were drawn for pre-Credit Reform mortgages for fiscal 1997 and 1996.

In fiscal year 1997, FHA's MMI and GI/SRI Funds borrowed \$592 million from the Treasury to cover re-estimates of prior years insurance and expected gains from new MMI insurance activity as required by the Credit Reform Act.

FHA also receives appropriations to finance credit-related administrative expenses of the GI/SRI funds. These annual appropriations are separate from subsidy appropriations, and are not determined on a present value basis. The GI/SRI Funds, administrative costs were \$207 million and \$202 million for fiscal 1997 and 1996, respectively. The MMI Fund administrative expenses are not covered by appropriations and are funded by operating revenues. For fiscal 1997 and 1996, the MMI Fund incurred administrative expenses of \$351 million and \$342 million, respectively.

During fiscal 1997, mortgage notes sales generated additional cash flows of \$449 million and \$384 million for the MMI and GI/SRI Funds, respectively. In fiscal 1996, additional cash flows of \$265 million and \$533 million were generated from mortgage note sales for the MMI and GI/SRI Funds, respectively. In 1996, Congress provided standing authorization to use the proceeds to help fund program operations.

Periodic subsidy re-estimates are required by Credit Reform to assure that the amount of monies necessary for credit subsidies is sufficient to cover estimated costs. Downward adjustments result from having received more subsidy than is believed needed, and the excess is deposited to a special receipt account at the Treasury. Upward adjustments result in additional monies due, which are financed by standing legislation and do not require additional Congressional action, although approval to receive and utilize the monies must be made by the OMB.

Ginnie Mae's credit activities have historically operated at a profit. Ginnie Mae has not incurred borrowings or received appropriations to finance its credit operations, nor does it anticipate the need to receive such funding. As of September 30, 1997, Ginnie Mae had an Investment in the U.S. Government balance of \$5.1 billion after establishing reserves for potential losses on its credit activities. Pursuant to the statutory provisions under which Ginnie Mae operates, its net earnings are used to build sound reserves. In the opinion of management, Ginnie Mae is in compliance with OMB implementation requirements for the Federal Credit Reform Act.

NOTE 14 - EXCESS RENTAL SUBSIDIES

During fiscal 1997 and 1996, HUD developed statistical estimates of the extent of unreported income and excess rental subsidies based on an analysis of a sample of assisted households nationwide that received rental assistance during calendar year 1996 (the most recent year for which data is available for computer matching purposes) and 1995.

Under HUD's Section 8 and Low Rent Public Housing programs, tenants generally are required to pay 30 percent of their income towards rent, with HUD providing the balance of the rental payment. New applicants and existing tenants are to provide income information which is used in determining the amount of rent they are to pay. Tenants are also required to recertify their income on an annual basis, and in certain other circumstances, i.e., when there is a significant increase in household income. The applicants' or tenants' failure to disclose all of their income, or the housing agencies', owners', or agents' failure to timely recertify the tenants for rental assistance, may result in the Department paying a greater rental subsidy than would be required. This additional subsidy is referred to as excess rental subsidy.

During fiscal 1997 and 1996, the Department selected a sample of households from its automated databases containing tenant data, and computer matched household income shown in those databases to Social Security Administration (SSA)/Internal Revenue Service (IRS) data. HUD staff examined source documents for each case where differences in income from computer matching sources and tenant reported sources exceeded a predetermined threshold. These source documents were obtained from housing agencies, owners, and agents to determine if the income differences

contributed to excess rental subsidies or were caused by other reasons that would not contribute to excess subsidies. For example, the computer matching would not identify excess subsidies if erroneous income information had been entered into the databases or SSA/IRS and tenant-reported income information were reported for different time periods.

The threshold used to determine computer matching differences was \$1,000 for calendar 1996 and \$3,000 for calendar 1995 data. Use of a threshold was necessary to provide a reasonable and cost effective basis for developing estimates of unreported income. The \$1,000 threshold was selected to provide a more accurate estimate of the amount of excess subsidies than obtained in the prior year using the larger threshold. However, to facilitate comparability between calendar 1996 and 1995 results, the Department also compiled calendar 1996 results using the prior year \$3,000 threshold.

The results of the statistical sample of computer matching results were as follows:

	Calendar 1996		Calendar 1995
	<u>(\$1,000 threshold)</u>	<u>(\$3,000 threshold)</u>	<u>(\$3,000 threshold)</u>
Excess rental subsidies for all households included in databases, based on statistical sampling, with a 95% confidence level.	\$752 million, ±\$147 million	\$644 million, ±\$146 million	\$409 million, ±\$122 million
Number of households in databases	3.47 million	3.47 million	3.24 million
Extrapolating this information to the universe of all households would yield the following results:			
Excess rental subsidies for all households included in databases extrapolated to universe of all households	\$939 million, ±\$184 million	\$804 million, ±\$182 million	\$538 million, ±\$161 million
Universe of all households receiving subsidy	4.33 million	4.33 million	4.27 million

The above extrapolation of the database information to the entire universe of households is based on the assumption that the characteristics of the households included in the databases from which the sample was selected are similar to those households not included in the databases.

The phrase “excess rental subsidies” does not necessarily equate to budgetary reductions that are realizable by eliminating the excess rental assistance. HUD’s budgetary needs are affected by many variables not recognized in the above estimates.

The Department plans on conducting a similar estimate of the amount of excess subsidies on an annual basis.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
CONSOLIDATING STATEMENT OF FINANCIAL POSITION
AS OF SEPTEMBER 30, 1987
(Dollars in Millions)

	FEDERAL HOUSING ADMINISTRATION	GOVERNMENT NATIONAL MORTGAGE ASSOCIATION	SECTION 8 RENTAL ASSISTANCE	COMMUNITY DEVELOPMENT BLOCK GRANT	HOME	PUBLIC and INDIAN HOUSING GRANTS & LOANS	OPERATING SUBSIDIES	SECTION 202 HOUSING for ELDERLY and HANDICAPPED	ALL OTHER	ELIMINATIONS	CONSOLIDATED
ASSETS											
Entity Assets:											
Intragovernmental Assets:											
Fund Balance with U. S. Treasury, (Note 2)	\$3,423	\$156	\$29,220	\$9,576	\$3,722	\$11,867	\$1,716	\$7,300	\$8,307	0	\$75,287
Non-interest bearing	759										759
Interest bearing	4,182	156	29,220	9,576	3,722	11,867	1,716	7,300	8,307	0	76,046
Investments (Note 4)	13,220	5,382	0						168	0	18,770
Other Intragovernmental Assets	193	36							47	0	276
Governmental Assets:											
Foreclosed Property Held for Sale, Net (Note 5)	1,471	3				35	0	1	425		1,476
Mortgage Notes and Loans Receivable, Net (Note 6)	1,172	4	494	19	0	5	0	8,207	425		9,843
Other Governmental Assets	525	102						81	230		1,456
Total Entity Assets	\$20,763	\$5,683	\$29,714	\$9,595	\$3,722	\$11,907	\$1,716	\$15,589	\$9,178	\$0	\$107,867
Non-Entity Assets											
Intragovernmental Assets:											
Fund Balance with U. S. Treasury, (Note 2)	\$72	\$0	\$64	\$0	\$0	\$0	\$0	\$0	\$17	\$0	\$81
Governmental Assets:											
Other Non-Entity Assets	\$72	\$0	\$502	\$0	\$0	\$0	\$0	\$0	\$17	\$0	\$591
Total Non-Entity Assets	\$20,835	\$5,683	\$30,216	\$9,595	\$3,722	\$11,907	\$1,716	\$15,589	\$9,195	\$0	\$108,458
TOTAL ASSETS											
LIABILITIES AND NET POSITION											
Liabilities Covered by Budgetary Resources:											
Intragovernmental Liabilities:											
Accounts Payable and Accrued Expenses	\$3		\$572			\$207		\$90	\$4		\$876
Borrowings (Note 8)	0							0	36		36
Other Intragovernmental Liabilities	11	\$21	0			0		0	163	\$0	195
Governmental Liabilities:											
Accounts Payable and Accrued Expenses	366		179	\$19	\$6	70	\$62	8	92		802
Distributive Shares and Premium Refunds Payable	180										180
Claims Payable	388										388
Loss Reserves (Note 7)	13,149	508									13,657
Unearned Premiums	7,221										7,221
Debentures Issued to Claimants	68										68
Other Governmental Liabilities	19		3	\$19	\$6	8	\$62	9	63	0	102
Total Liabilities Covered by Budgetary Resources:	\$21,986	\$548	\$754	\$19	\$6	\$285	\$62	\$107	\$358	\$0	\$23,525
Liabilities Not Covered by Budgetary Resources											
Intragovernmental Liabilities:											
Borrowings (Note 8)	\$3,639	\$0	\$0	\$0	\$0	\$1,561	\$0	\$6,174	139	\$0	\$11,374
Governmental Liabilities:											
Accounts Payable and Accrued Expenses	\$3,639	\$0	\$0	\$0	\$0	3,586	\$0	\$6,174	3,586	\$0	\$15,099
Borrowings (Note 8)						\$5,147	\$0		\$139	\$0	\$5,286
Total Liabilities Not Covered by Budgetary Resources	\$25,025	\$548	\$754	\$19	\$6	\$5,432	\$62	\$6,281	\$497	\$0	\$38,624
TOTAL LIABILITIES											
Commitments and Contingencies (Notes 3, 10 and 11)											
Mutual Insurance Funds Equity	2,662										2,662
Invested Capital											15
Unexpended Appropriations Held for Commitments	(21,197)	5,135	29,462	9,576	3,716	11,579	1,654	6,265	8,013		70,265
Cumulative Results of Operations						43		304	418		(15,287)
Future Funding Commitments	14,345					(5,147)		(807)	(138)		(6,092)
Appropriated Capital	(4,190)	5,135	29,462	9,576	3,716	6,475	1,654	3,546	390		18,281
Total Net Position	20,835	5,683	30,216	9,595	3,722	11,907	1,716	15,589	9,195	0	108,458
TOTAL LIABILITIES AND NET POSITION											

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
CONSOLIDATING STATEMENT OF FINANCIAL POSITION
AS OF SEPTEMBER 30, 1996
(Dollars in Millions)

	FEDERAL HOUSING ADMINISTRATION	GOVERNMENT NATIONAL MORTGAGE ASSOCIATION	SECTION 8 RENTAL ASSISTANCE	COMMUNITY DEVELOPMENT BLOCK GRANT	HOME	PUBLIC and INDIAN HOUSING GRANTS & LOANS	OPERATING SUBSIDIES	SECTION 202 HOUSING for ELDERLY and HANDICAPPED	ALL OTHER	ELIMINATIONS	CONSOLIDATED
ASSETS											
Entity Assets:											
Intragovernmental Assets:											
Fund Balance with U. S. Treasury, (Note 2)	\$5,608	\$131	\$43,371	\$9,243	\$3,533	\$13,082	\$1,634	\$7,102	\$7,920	0	\$91,624
Non-interest bearing	1,542										1,542
Interest bearing	7,150	131	43,371	9,243	3,533	13,082	1,634	7,102	7,920	0	83,166
Investments (Note 4)	7,661	4,785						158	158		12,604
Other Intragovernmental Assets	109	35	20			5		37	49	(43)	212
Governmental Assets:											
Foreclosed Property Held for Sale, Net (Note 5)	1,162	6				35		1	488		1,169
Mortgage Notes and Loans Receivable, Net (Note 6)	3,971	1						8,286			12,781
Other Governmental Assets	401	84	130			1		93			794
Total Entity Assets	\$20,454	\$5,042	\$43,521	\$9,243	\$3,533	\$13,123	\$1,634	\$15,511	\$8,708	(\$43)	\$120,726
Non-Entity Assets											
Intragovernmental Assets:											
Fund Balance with U. S. Treasury, (Note 2)	\$67		\$21						\$20		\$41
Governmental Assets:											
Other Non-Entity Assets	\$67	\$0	476	\$0	\$0	\$0	\$0	\$0	\$20	\$0	543
Total Non-Entity Assets	\$67	\$0	\$497	\$0	\$0	\$0	\$0	\$0	\$20	\$0	\$564
TOTAL ASSETS	\$20,521	\$5,042	\$44,018	\$9,243	\$3,533	\$13,123	\$1,634	\$15,511	\$8,728	(\$43)	\$121,310
LIABILITIES AND NET POSITION											
Liabilities Covered by Budgetary Resources:											
Intragovernmental Liabilities:											
Accounts Payable and Accrued Expenses	\$5		\$499			\$216		\$295	\$7		\$1,022
Borrowings (Note 8)									39		39
Other Intragovernmental Liabilities	11	\$16	43			93	\$64		15	(43)	42
Governmental Liabilities:											
Accounts Payable and Accrued Expenses	419		36		\$6			13	76		733
Distributive Shares and Premium Refunds Payable	154										154
Claims Payable	653										653
Loss Reserves (Note 7)											13,458
Unearned Premiums	12,986	472									6,931
Debentures Issued to Claimants	6,931										6,931
Other Governmental Liabilities	82										82
Total Liabilities Covered by Budgetary Resources:	\$21,241	\$509	\$601	\$26	\$6	\$316	\$64	\$308	\$200	(\$43)	\$23,228
Liabilities Not Covered by Budgetary Resources											
Intragovernmental Liabilities:											
Borrowings (Note 8)	\$3,123					\$1,627		\$6,909	\$134		\$11,659
Governmental Liabilities:											
Accounts Payable and Accrued Expenses											134
Borrowings (Note 8)											3,961
Total Liabilities Not Covered by Budgetary Resources	\$3,123	\$0	\$0	\$0	\$0	\$5,488	\$0	\$6,909	\$134	\$0	\$15,654
TOTAL LIABILITIES	\$24,364	\$509	\$601	\$26	\$6	\$5,804	\$64	\$7,217	\$334	(\$43)	\$38,882
Commitments and Contingencies (Notes 3, 10 and 11)											
NET POSITION (Note 9):											
Mutual Insurance Funds Equity	\$2,526										\$2,526
Invested Capital											10
Unexpended Appropriations Held for Commitments	(21,043)	\$4,533	\$43,417	\$9,217	\$3,527	\$12,758	\$1,570	\$6,245	7,647		84,361
Cumulative Results of Operations						49		45	417		(15,999)
Future Funding Commitments						(5,488)		(807)	(134)		(6,429)
Appropriated Capital	14,674							2,811	454		17,939
Total Net Position	(\$3,843)	\$4,533	\$43,417	\$9,217	\$3,527	\$7,319	\$1,570	\$8,294	\$9,394	\$0	\$82,428
TOTAL LIABILITIES AND NET POSITION	\$20,521	\$5,042	\$44,018	\$9,243	\$3,533	\$13,123	\$1,634	\$15,511	\$8,728	(\$43)	\$121,310

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
 CONSOLIDATING STATEMENT OF OPERATIONS
 FOR THE YEAR ENDED SEPTEMBER 30, 1997
 (Dollars in Millions)

	FEDERAL HOUSING ADMINISTRATION	GOVERNMENT NATIONAL MORTGAGE ASSOCIATION	SECTION 8 RENTAL ASSISTANCE	COMMUNITY DEVELOPMENT BLOCK GRANT	HOME	PUBLIC and INDIAN HOUSING GRANTS & LOANS	OPERATING SUBSIDIES	SECTION 202 HOUSING for ELDERLY and HANDICAPPED	ALL OTHER	ELIMINATIONS	CONSOLIDATED
REVENUES AND FINANCING SOURCES:											
Operating Revenues:											
FHA Premiums	\$2,486										\$2,486
GNMA Mortgage Backed-Securities Program Income		\$354									354
Interest and Penalties, Non Federal	253					\$2		\$698	\$18		971
Interest, Federal	805	318							10		1,133
Other	115	15							56		187
Financing Sources:											
Appropriated Capital Used			\$15,149	\$4,518	\$1,219	4,297	\$2,823	845	2,737		31,588
Imputed Financing Sources			\$15,149	\$4,518	\$1,219	\$4,299	\$2,823	\$1,544	11		\$36,730
Total Revenues and Financing Sources	\$3,659	\$687	\$15,149	\$4,518	\$1,219	\$4,299	\$2,823	\$1,544	\$2,832	\$0	\$36,730
EXPENSES:											
Section 8 Subsidies			\$15,115	\$4,491		\$22			\$120		\$15,257
Community Development Block Grants							\$2,812				4,491
Operating Subsidies						3,918					2,812
Low Rent Public Housing Grants					\$1,211						3,918
HOME											1,211
Other Subsidies, Grants and Loans								\$819	2,304		3,123
Mortgage-Backed Securities Program Expenses	\$163	\$30									30
Increase in Loss Reserves	2,232										163
Provision for Losses on Foreclosed Properties	308								0		2,232
Provision for Losses on Mortgage Notes and Loans	(92)					79		0	74		461
(Gain) on Sale of Mortgage Notes											(92)
Interest:											
Non Federal	5					0					5
Federal	250		34	27	8	235		436	3		924
Salaries and Administration	723	9				36	11	26	355		1,229
Other	87	47						4	0		138
Total Expenses	\$3,676	\$86	\$15,149	\$4,518	\$1,219	\$4,290	\$2,823	\$1,285	\$2,856	\$0	\$35,902
EXCESS (DEFICIENCY) OF REVENUES AND FINANCING SOURCES OVER EXPENSES	(\$17)	\$601	\$0	\$0	\$0	\$9	\$0	\$259	(\$24)	\$0	\$828

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
CONSOLIDATING STATEMENT OF OPERATIONS
FOR THE YEAR ENDED SEPTEMBER 30, 1996
(Dollars in Millions)

	FEDERAL HOUSING ADMINISTRATION	GOVERNMENT NATIONAL MORTGAGE ASSOCIATION	SECTION 8 RENTAL ASSISTANCE	COMMUNITY DEVELOPMENT BLOCK GRANT	HOME	PUBLIC and INDIAN HOUSING GRANTS & LOANS	OPERATING SUBSIDIES	SECTION 202 HOUSING for ELDERLY and HANDICAPPED	ALL OTHER	ELIMINATIONS	CONSOLIDATED
REVENUES AND FINANCING SOURCES:											
Operating Revenues:											
FHA Premiums	\$2,142										\$2,142
GNMA Mortgage Backed-Securities Program Income		\$335									335
Interest and Penalties, Non Federal	273					\$3		\$763	\$21		1,060
Interest, Federal	705								58		1,037
Other	70								9		91
Financing Sources:											
Appropriated Capital Used	\$3,190	\$621	\$16,384	\$4,547	\$1,207	4,251	2,811	745	2,446		32,291
Total Revenues and Financing Sources	\$3,190	\$621	\$16,384	\$4,547	\$1,207	\$4,254	\$2,811	\$1,508	\$2,534	\$0	\$37,056
EXPENSES:											
Section 8 Subsidies			\$16,350			\$28			\$102		\$16,480
Community Development Block Grants				\$4,526			\$2,777				4,526
Operating Subsidies						3,879					2,777
Low Rent Public Housing Grants					\$1,201						3,879
HOME											1,201
Other Subsidies, Grants and Loans								\$726	2,078		2,804
Mortgage-Backed Securities Program Expenses		\$27									27
Increase in Loss Reserves	\$1,921										1,921
Provision for Losses on Foreclosed Properties	1,975										1,975
(Gain) on Sale of Mortgage Notes and Loans	(819)								64		(714)
Interest	(187)					39					(187)
Non Federal	18										101
Federal	198										888
Salaries and Administration	683								1		683
Other	19					25			305		1,140
Total Expenses	\$3,808	\$105	\$16,385	\$4,548	\$1,207	\$4,271	\$2,812	\$1,321	\$2,548	\$0	\$37,005
EXCESS (DEFICIENCY) OF REVENUES AND FINANCING SOURCES OVER EXPENSES	(\$618)	\$516	(\$1)	(\$1)	\$0	(\$17)	(\$1)	\$187	(\$14)	\$0	\$51

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
 CONSOLIDATING STATEMENT OF CASH FLOWS
 FOR THE YEAR ENDED SEPTEMBER 30, 1997
 (Dollars in Millions)

	FEDERAL HOUSING ADMINISTRATION	GOVERNMENT NATIONAL MORTGAGE ASSOCIATION	SECTION 8 RENTAL ASSISTANCE	COMMUNITY DEVELOPMENT BLOCK GRANT	HOME	PUBLIC and INDIAN HOUSING GRANTS & LOANS	OPERATING SUBSIDIES	SECTION 202 HOUSING for ELDERLY and HANDICAPPED	ALL OTHER	ELIMINATIONS	CONSOLIDATED
CASH FLOWS FROM OPERATING ACTIVITIES:											
Excess (Deficiency) of Revenues and Financing Sources over Expenses	(\$17)	\$601	\$0	\$0	\$0	\$9	\$0	\$259	(\$24)	\$0	\$828
Adjustments to Reconcile Excess (Deficiency) to Net Cash Provided (Used) by Operating Activities:											
Appropriated Capital Used		(14)	(15,150)	(4,518)	(1,219)	(4,297)	(2,823)	(845)	(2,737)		(31,589)
Increase (Decrease) in Loss Reserves	163										149
Provision for Losses on Foreclosed Properties	2,232										2,232
Provision for Losses on Mortgage Notes and Loans	308					79		0	74		461
Loss (Gain) on Mortgage Notes Held for Sale	(92)										(92)
Premiums Earned	(1,205)										(1,205)
Premiums Collected	1,789										1,789
Premiums Refunded	(294)										(294)
Claims Settlement Payments	187										187
Collection of Principal on Notes Acquired in Claims Settlement	5,986										5,986
Proceeds from Disposition of Assets Acquired in Claims Settlement	(294)	4	224	(7)	0	24	(2)	(201)	42		(210)
Increase (Decrease) in Payables and Other Liabilities	(213)	(16)	(428)	(19)	0	0	0	3	(12)		(665)
(Increase) Decrease in Receivables and Other Assets	(144)	47	0	0	0	0	0	0	24		(73)
Net Cash Provided (Used) by Operating Activities	\$2,275	\$622	(\$15,354)	(\$4,544)	(\$1,219)	(\$4,185)	(\$2,825)	(\$784)	(\$2,633)	\$0	(\$28,647)
CASH FLOWS FROM INVESTING ACTIVITIES:											
Purchase of Investments Securities	(\$18,596)										(19,203)
Proceeds from Sale of Investment Securities	13,181										13,181
Proceeds from Disposal of Mortgages								\$83	4		4
Principal Collections on Mortgages and Loans						\$3		(6)	60		146
Acquisition of Assets						(81)			(83)		(170)
Other, Net								2	2		4
Net Cash Provided (Used) by Investing Activities	(\$5,415)	(\$597)	\$0	\$0	\$0	(\$78)	\$0	\$79	(\$27)	\$0	(\$6,038)
CASH FLOW FROM FINANCING ACTIVITIES:											
Appropriations Received	\$302		\$1,974	\$4,877	\$1,408	\$2,821	\$2,911	\$1,600	\$2,998		\$18,891
Cash Returned to Treasury	(631)	\$0		(4)		(15)	(7)		(66)		(723)
Borrowings from U.S. Treasury	592								(3)		589
Issuance of Debentures to Claimants	47										47
Payment of Borrowings	(76)										(1,152)
Payment of Debentures	(61)										(61)
Distributive Shares Paid	(1)										(1)
Transfers to(-) or from(+) other HUD Programs						563		38	103		0
Transfers from other Agencies									7		7
Other, Net									5		8
Net Cash Provided by Financing Activities	\$172	\$0	\$1,246	\$4,877	\$1,408	\$3,048	\$2,907	\$903	\$3,044	\$0	\$17,605
Net Increase (Decrease) in Cash	(\$2,968)	\$25	(\$14,108)	\$333	\$189	(\$1,215)	\$62	\$198	\$384	\$0	(\$17,080)
Funds With U.S. Treasury, Non-interest bearing, Beginning of Year	7,150	131	43,392	9,243	3,533	13,082	1,634	7,102	7,940	0	93,207
Funds With U.S. Treasury, Non-interest bearing, End of Year	\$4,182	\$156	\$29,284	\$9,576	\$3,722	\$11,867	\$1,716	\$7,300	\$8,324	\$0	\$76,127

CASH FLOWS FROM OPERATING ACTIVITIES:
 Excess (Deficiency) of Revenues and Financing Sources over Expenses
 Adjustments to Reconcile Excess (Deficiency) to Net Cash Provided (Used) by Operating Activities:
 Appropriated Capital Used
 Increase (Decrease) in Loss Reserves
 Provision for Losses on Foreclosed Properties
 Provision for Losses on Mortgage Notes and Loans
 Loss (Gain) on Mortgage Notes Held for Sale
 Premiums Earned
 Premiums Collected
 Premiums Refunded
 Claims Settlement Payments
 Collection of Principal on Notes Acquired in Claims Settlement
 Proceeds from Disposition of Assets Acquired in Claims Settlement
 Increase (Decrease) in Payables and Other Liabilities
 (Increase) Decrease in Receivables and Other Assets
 Other, Net
 Net Cash Provided (Used) by Operating Activities

CASH FLOWS FROM INVESTING ACTIVITIES:
 Purchase of Investments Securities
 Proceeds from Sale of Investment Securities
 Proceeds from Disposal of Mortgages
 Principal Collections on Mortgages and Loans
 Acquisition of Assets
 Other, Net
 Net Cash Provided (Used) by Investing Activities

CASH FLOW FROM FINANCING ACTIVITIES:
 Appropriations Received
 Cash Returned to Treasury
 Borrowings from U.S. Treasury
 Issuance of Debentures to Claimants
 Payment of Borrowings
 Payment of Debentures
 Distributive Shares Paid
 Transfers to(-) or from(+) other HUD Programs
 Transfers from other Agencies
 Other, Net
 Net Cash Provided by Financing Activities

Net Increase (Decrease) in Cash
 Funds With U.S. Treasury, Non-interest bearing, Beginning of Year
 Funds With U.S. Treasury, Non-interest bearing, End of Year

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
CONSOLIDATING STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED SEPTEMBER 30, 1996
(Dollars in Millions)

	FEDERAL HOUSING ADMINISTRATION	GOVERNMENT NATIONAL MORTGAGE ASSOCIATION	SECTION 8 RENTAL ASSISTANCE	COMMUNITY DEVELOPMENT BLOCK GRANT	HOME	PUBLIC and INDIAN HOUSING GRANTS & LOANS	OPERATING SUBSIDIES	SECTION 202 HOUSING for ELDERLY and HANDICAPPED	ALL OTHER	ELIMINATIONS	CONSOLIDATED
CASH FLOWS FROM OPERATING ACTIVITIES:											
Excess (Deficiency) of Revenues and Financing Sources over Expenses	(\$618)	\$516	(\$1)	(\$1)	\$0	(\$17)	(\$1)	\$187	(\$14)		\$51
Adjustments to Reconcile Excess (Deficiency) to Net Cash Provided (Used) by Operating Activities:		(46)	(16,384)	(4,547)	(1,207)	(4,251)	(2,811)	(745)	(2,446)	\$0	
Appropriated Capital Used	1,921					39		2	66		(32,391)
Increase (Decrease) in Loss Reserves	1,975										1,875
Provision for Losses on Foreclosed Properties	(819)										1,975
Provision for Losses on Mortgage Notes and Loans (Gain) on sale of Mortgage Notes	(187)										(712)
Premiums Earned	(1,058)										(187)
Premiums Collected	1,722										(1,058)
Premiums Refunded	(418)										1,722
Claims Settlement Payments	(5,542)										(418)
Collection of Principal on Notes Acquired in Claims Settlement	232										(5,542)
Proceeds from Disposition of Assets Acquired in Claims Settlement	6,534										232
Increase (Decrease) in Payables and Other Liabilities	93	(2)	63	(39)	(11)	(31)	42	(57)	38		6,534
(Increase) Decrease in Receivables and Other Assets	(33)	53	1,070	21	7	28	48	34	(24)		96
Other, Net	(57)	69	1	1		(105)	1	2	(3)		1,204
Net Cash Provided (Used) by Operating Activities	\$3,745	\$590	(\$15,251)	(\$4,565)	(\$1,211)	(\$4,337)	(\$2,721)	(\$577)	(\$2,383)	\$0	(\$26,710)
CASH FLOWS FROM INVESTING ACTIVITIES:											
Purchase of Investments Securities	(\$7,655)	(\$537)							\$51		(8,141)
Proceeds from Sale of Investment Securities	6,657								4		6,657
Proceeds from Disposal of Mortgages	(140)							\$23	103		146
Principal Collections on Mortgages and Loans								(2)	(100)		(142)
Acquisition of Assets											0
Other, Net											0
Net Cash Provided (Used) by Investing Activities	(\$988)	(\$537)	\$0	\$0	\$0	(\$20)	\$0	\$21	\$58	\$0	(\$1,476)
CASH FLOW FROM FINANCING ACTIVITIES:											
Appropriations Received	\$887		\$5,880	\$4,671	\$1,406	\$3,311	\$2,834	\$1,912	\$3,058		\$23,959
Cash Returned to Treasury	(826)	(\$15)	0	(4)			(12)		(81)		(938)
Borrowings from U.S. Treasury	1,616								(49)		1,567
Issuance of Debentures to Claimants	65										65
Payment of Borrowings	(140)										(1,277)
Payment of Debentures	(70)										(70)
Distributive Shares Paid	(2)										(2)
Transfers to(-) or from(+) other HUD Programs						38			(3)		0
Transfers from other Agencies									7		7
Other, Net	1		460						10		471
Net Cash Provided by Financing Activities	\$1,531	(\$15)	\$7,306	\$4,667	\$1,406	\$3,017	\$2,822	\$106	\$2,942	\$0	\$23,782
Net Increase (Decrease) in Cash	\$4,278	\$38	(\$7,945)	\$102	\$195	(\$1,340)	\$101	(\$450)	\$617	\$0	(\$4,404)
Funds With U.S. Treasury, Non-interest bearing, Beginning of Year	2,872	93	51,337	9,141	3,338	14,422	1,533	7,552	7,323	0	97,611
Funds With U.S. Treasury, Non-interest bearing, End of Year	\$7,150	\$131	\$43,392	\$9,243	\$3,533	\$13,082	\$1,634	\$7,102	\$7,940	\$0	\$93,207

Appendix A

Objectives, Scope and Methodology

Management is responsible for:

- preparing the principal financial statements in conformity with the hierarchy of accounting principles described in OMB Bulletin 94-01, *Form and Content of Agency Financial Statements*, a hierarchy which constitutes a comprehensive basis of accounting other than GAAP;
- establishing, maintaining and evaluating internal controls and systems to provide reasonable assurance that the broad objectives of FMFIA are met; and
- complying with applicable laws and regulations.

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

In planning our audit of HUD's consolidated financial statements, we considered the internal control structure in order to determine auditing procedures for the purpose of expressing an opinion on the consolidated financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion. We also tested compliance with selected provisions of applicable laws and regulations that may materially affect the consolidated financial statements. Providing an opinion on compliance with selected provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion. We also obtained an understanding of internal controls over the reliability of performance data reported in HUD's *Fiscal Year 1997 Accountability Report* and assessed whether information contained therein was materially consistent with the information in the principal financial statements. We do not express an opinion on this information.

To fulfill these responsibilities, we:

- examined, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements;
- assessed the accounting principles used and the significant estimates made by management;
- evaluated the overall presentation of the consolidated financial statements;

- obtained an understanding of the internal control structure 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 compliance with selected provisions of the following laws and regulations that may materially affect the consolidated financial statements;
 - National Housing Act (12 USC 1701)
 - Housing and Community Development Act of 1974
 - HUD Reform Act of 1989
 - National Affordable Housing Act of 1990
 - Multifamily Property Disposition Act of 1994
 - Chief Financial Officers Act of 1990
 - Federal Managers' Financial Integrity Act of 1982
 - Antideficiency Act
 - Budget and Accounting Procedures Act of 1950
 - Prompt Payment Act
 - Single Audit Act of 1984
 - Federal Financial Management Improvement Act of 1996
- considered compliance with the process required by FMFIA for evaluating and reporting on internal control and accounting systems;
- performed tests of compliance using the implementation guidance for FFMIA issued by OMB on September 9, 1997 as to whether HUD's financial management systems substantially comply with the federal financial management systems requirements, applicable accounting standards, and the United States Standard General Ledger at the transaction level; and
- performed other procedures as we considered necessary in the circumstances.

We did not evaluate the internal controls relevant to operating objectives as broadly defined by FMFIA. We limited our internal control testing to those controls that are material in relation to the consolidated financial statements. Because of inherent limitations in any internal control structure, errors or irregularities 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.

We noted certain matters in the internal control structure and its operation that we consider to be reportable conditions under OMB Bulletin 93-06, *Audit Requirements for Federal Financial Statements*. Reportable conditions involve matters coming to our attention that, in our judgment, should be communicated because they represent significant deficiencies in the design or operation

of the internal control structure, which could adversely affect the organization's ability to meet the following objectives:

- transactions are properly recorded and accounted for to permit the preparation of reliable financial statements and to maintain accountability over assets;
- funds, property and other assets are safeguarded against loss from unauthorized use or disposition;
- transactions, including those related to obligations and costs, are executed in compliance with: (a) laws and regulations that could have a direct and material effect on the principal financial statements, and (b) any other laws and regulations that OMB, entity management, or the Inspectors General have identified as being significant for which compliance can be objectively measured and evaluated; and
- data that support reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information.

Certain of the reportable conditions were also considered to be material weaknesses. A material weakness in the internal control structure is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited or material to a performance measure or aggregation of related performance measures may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. *Government Auditing Standards* provide the following examples of matters that may be reportable conditions:

- absence of appropriate segregation of duties consistent with appropriate control objectives;
- absence of appropriate reviews and approvals of transactions, accounting entries, or systems output;
- inadequate provisions for the safeguarding of assets;
- evidence of failure to safeguard assets from loss, damage, or misappropriation;
- evidence that a system fails to provide complete and accurate output consistent with the auditee's control objectives because of the misapplication of control procedures;
- evidence of intentional override of internal controls by those in authority to the detriment of the overall objectives of the system;
- evidence of failure to perform tasks that are part of internal controls, such as reconciliations not prepared or not timely prepared;
- absence of a sufficient level of control consciousness within the organization;

- significant deficiencies in the design or operation of internal controls that could result in violations of laws and regulations having a direct and material effect on the financial statements; and
- failure to follow up and correct previously identified deficiencies in internal controls.

Except for the limitations on the scope of our work described in this report, our work was performed in accordance with *Government Auditing Standards* and OMB Bulletin 93-06, *Audit Requirements for Federal Financial Statements*, as amended.

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

Appendix B

Recommendations

To facilitate tracking recommendations in the Departmental Automated Audits Management System (DAAMS), this appendix lists the newly developed recommendations resulting from our audit of HUD's fiscal year 1997 financial statements. Also listed are recommendations from prior years' reports that have not been fully implemented. This appendix does not include recommendations pertaining to FHA issues because they are tracked under separate financial statement audit reports of that entity.

Recommendations from the Current Report

With respect to the material weakness that HUD needs to complete improvements to its financial management systems, we recommend that the **FSI project manager**:

- 1.a. Develop a comprehensive project plan to include:
 - The scope of the project defined as a work breakdown structure;
 - A process for dealing with changes to the original plan;
 - List of all project milestones (goals);
 - Baseline schedule of all tasks by work breakdown structure;
 - Baseline costs by work breakdown structure;
 - A timeline for the project covering all activities;
 - Schedule of all resources, personnel and material, required to carry out the tasks;
 - An analysis of the risks affecting the successful completion of the project;
 - A process for monitoring the performance of the implementation contractor;
 - A process for quality control over all elements of the plan; and
 - A procedure for the testing and acceptance of all changes and final products.

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

- 1.b. Monitor progress against the comprehensive project plan developed under Recommendation 1.a., using earned value techniques.

With respect to the material weakness that HUD needs to do more to ensure that subsidies are based on the correct tenant income, we recommend that the **Deputy Secretary or the appropriate responsible official**:

- 2.a. In conjunction with development of the *HUD 2020* plan, determine the staffing requirements and organizational placement of activities necessary to carry out an ongoing income matching program.

We further recommend that the **Assistant Secretary for Public and Indian Housing**:

- 2.b. Develop and carry out a plan with appropriate milestones to complete actions to sanction HAs, under both the Section 8 and public housing programs, that do not meet requirements for the timely and complete transmission of MTCS data to HUD.

With respect to the reportable condition that HUD needs to improve system security and other controls, we recommend that the **Assistant Secretary for Administration**:

- 3.a. Remove READ access to system software libraries and production data and programs, especially TOP Secret files on the Hitachi mainframe.
- 3.b. Control access to the software logging facility of the Hitachi mainframe.
- 3.c. Remove default user IDs and IDs without passwords on the LANs.
- 3.d. Develop an implementation plan for placing all of the critical applications on the Hitachi mainframe under the control of the already purchased automated configuration management software.
- 3.e. Adopt a configuration management tool for the UNISYS mainframe.
- 3.f. Coordinate with the program offices to ensure that security administrators attend the working group meetings.
- 3.g. Improve control settings on the LAN by implementing the following controls:
 - Revise HUD's standards to require passwords to be alphanumeric rather than easily guessed words.
 - Encrypt passwords sent between workstations and servers to prevent a hacker from obtaining passwords of legitimate users.
 - Restrict access to system directories containing powerful system wide commands on the LAN.

With respect to the reportable condition that additional efforts are needed to strengthen access controls over HUD's payment systems, we recommend that the **Assistant Secretary for Public and Indian Housing**:

- 4.a. Restrict access to the UDIS table based on appropriate privileges granted under the individual security profiles or provide compensating controls over the integrity of the unit data.

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

- 4.b. Establish a separate Security Administrator security profile within HUDCAPS and segregate access to the VEND and VACT tables between the Security and System Administrators.
- 4.c. Update the LOCCS security plan to reflect the requirements of OMB Circulars A-130 and A-123, emphasizing that:
- rules of access be defined so that sensitive information such as banking data are not exposed to unauthorized access;
 - access is granted at the lowest possible level commensurate with job functions, with special emphasis on access controls; and
 - the security plan is based on consolidated operations.

With respect to the noncompliance issue relating to FFMIA, we recommend that the **Chief Financial Officer**:

- 5.a. In accordance with FFMIA, within 120 days of the issuance of this audit report, prepare the required compliance determination from the Secretary that HUD's financial management systems do not comply with FFMIA and submit the required remediation plan to OMB in accordance with OMB's September 9, 1997 FFMIA implementation guidance.
- 5.b. In developing the remediation plan described in recommendation 5.a., ensure that all assessments for systems determined to be in compliance with OMB Circular A-127 are adequately documented and develop corrective actions for systems determined to be non-conforming.

In commenting on our draft report, HUD agreed with our recommendations and will report in their *Fiscal year 1997 Accountability Report* that in developing the required remediation plan, the CFO will ensure that all assessments performed by the program offices are adequately documented and will develop corrective actions for systems determined to be non-conforming. The remediation plan is to be submitted to OMB by September 1998 as part of the CFO Five-Year Plan to be included in HUD's budget submission to OMB. Therefore, concurrent with the issuance of this report, we are recording a management decision in DAAMS with a final action target date of September 30, 1998 for recommendations 5.a. and 5.b.

Unimplemented Recommendations from Prior Year's Reports

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

OIG Report Number 92-TS-179-0011 (Fiscal Year 1991 Financial Statements)

With respect to the resource management material weakness, the following three recommendations have been reopened because corrective actions have not been fully implemented and deficiencies still exist. Responsibility has been reassigned from the Assistant Secretary for Administration to the Deputy Secretary. We recommend that the **Deputy Secretary**:

- 2.a. Establish a more systematic approach to determining staffing requirements.
- 2.b. Hold field offices and headquarters accountable for work accomplishments in line with available resources and established standards.
- 2.c. Ensure that once greater efficiencies are implemented, staffing standards are realigned to be consistent with the revised workload.

With respect to the material weaknesses in the areas of Grants, Subsidies and Direct Loans Program Issues, we recommend that HUD (primary responsibility - **Office of Housing**):

- 3.a. Pending CFS/TRACS implementation, standardize the existing manual HAP payment review process and develop a reporting mechanism in the regional offices and headquarters such that the success of pursuing and collecting overpayments can be properly managed. (Final action target date is September 30, 1994.)

OIG Report Number 93-FO-177-0004 (Fiscal Year 1992 Financial Statements)

With respect to the material weakness on resource shortages at HUD, we recommend that HUD consider the following, if additional resources cannot be obtained (primary responsibility - **Office of the Chief Financial Officer**):

- 1.a. Consolidate accounting and other administrative functions which currently exist in each of HUD's ten regional offices. (Final action target date is September 30, 1996.)

OIG Report Number 94-FO-177-0003 (Fiscal Year 1993 Financial Statements)

With respect to the material weakness on the need for more effective monitoring of housing authorities and multifamily project owners, we recommend that the CFO assume a lead role to (primary responsibility - **Office of the Chief Financial Officer**):

- 2.b. Based on any studies conducted pursuant to Recommendation 2.a., develop a formal Departmentwide plan to ensure that tenant income verifications are performed, either by HUD or its intermediaries. The plan should take into account the differing requirements under programs administered by the Offices of Housing and Public and Indian Housing and should consider a system which facilitates verification of income at the time eligibility is being evaluated and rents established. To the extent that a pre-verification system is not practicable, the plan should clearly set forth the reasons why and steps to be taken to mitigate the risks associated with not verifying income at the time eligibility is being evaluated. (Final action target date is October 31, 1997.)

OIG Report Number 95-FO-177-0004 (Fiscal Year 1994 Financial Statements)

With respect to the material weakness on the effectiveness of Housing Authority monitoring, we recommend that HUD (primary responsibility - **Office of Public and Indian Housing**):

- 5.c. Establish an automated system to provide a centralized data base to track Housing Authority monitoring activities and results. (Final action target date is September 30, 1997.)
- 5.d. Develop a system similar to PHMAP or develop an alternative performance measurement process for measuring Housing Authority performance in managing Section 8 program subsidy funds. (Final action target date is November 15, 1996.)

With respect to the reportable condition on Community Planning and Development's oversight of grantees, we have reopened the following recommendation because corrective actions have not been fully implemented. We recommend that HUD (Primary responsibility - **Office of Community Planning and Development**):

- 6.a. Implement a process to confirm the validity of performance information reported by grantees.

OIG Report Number 96-FO-177-0003 (Fiscal Year 1995 Financial Statements)

With respect to the need to prepare HUD's principal financial statements, as they relate to the mortgage insurance programs of FHA, in accordance with SFFAS Number 2, we recommend that the **Chief Financial Officer**, in consultation with the Assistant Secretary for Housing-Federal Housing Commissioner:

- 1.a. Develop and implement a plan to prepare the FHA data needed to meet SFFAS Number 2 requirements for inclusion in HUD's fiscal year 1996 principal financial statements, in a timely manner to enable that data to be subjected to auditing procedures. (Final action target date is June 30, 1999.)

With respect to the material weakness regarding excess subsidy payments and HUD's ability to adequately address the problem in a cost-effective way, we recommend that the **Deputy Secretary**, in consultation with the CFO and the Assistant Secretaries for Public and Indian Housing, Housing-Federal Housing Commissioner, and Policy Development and Research:

- 2.a. Establish a quality assurance program to periodically obtain empirical evidence about the type and extent of under reported and unreported tenant income and determine its effect on how well HUD delivers rent subsidies to eligible tenants. HUD should consider developing a program patterned after quality control programs administered by other Federal agencies with needs-based programs such as Aid to Families with Dependent Children, Food Stamps, Supplemental Security Income and Medicaid. (Final action target date is December 31, 1997.)

With respect to the material weakness on improvements needed in multifamily project monitoring, we recommend that the **Assistant Secretary for Housing-Federal Housing Commissioner:**

- 4.a. For the annual financial statement review contract, assure that the contractor delivers the report review packages to the respective field offices according to the delivery schedule specified in the contract terms. (Final action target date is October 1, 1997.)
- 4.c. Award a contract for specialized asset management services to selected properties, enabling the field offices to select the property and the necessary services for contractor assistance, based on risk to HUD and type and number of identified deficiencies. (Final action target date is April 30, 1997.)
- 4.d. For the working group that sets goals for the Housing Management Plan, consider adding goals pertaining to:
- SHFA monitoring, with targets that represent adherence to the policy in HUD handbooks as to the frequency and timing of such reviews.
 - The timely analysis of annual financial statements by the field offices, with a target based on the timeliness of the analysis after the receipt of the statements.

(Final action target date is October 31, 1997.)

With respect to the reportable condition that HUD needs to improve system security, disaster recovery, operating system documentation and change control, we recommend that the **Assistant Secretary for Administration:**

- 7.a. Conduct compliance reviews and oversight activities to ensure agency-wide implementation and enforcement of prescribed security policies. This should include advice to responsible program offices and decentralized security officers on the risks of granting inappropriate access privileges. (Final action target date is March 31, 1998.)

OIG Report Number 97-FO-177-0003 (Fiscal Year 1996 Financial Statements)

With respect to the material weakness that HUD needs to complete improvements to its financial management systems we recommend that the **Deputy Secretary:**

- 1.a. Take over direction of the Department's financial system integration development efforts to address the slow progress and provide the needed management oversight of projects and contracts. This should include action to:
- implement the measurement requirements of the Information Technology Management Reform Act and the earned value requirements of OMB Circular A-11, Part 3;
 - define policies, procedures and standards for project management and ensure project managers receive adequate training;
 - provide the necessary tools and expert assistance to individual projects; and
 - report on the progress of the system development efforts to assist the heads of each program area in holding project managers accountable for their projects.

(Final action target date is February 28, 1998.)

We recommend that the **Assistant Secretary for Housing-Federal Housing Commissioner:**

- 1.c. Prioritize Housing/FHA's projects so that they address the most critical needs first, rather than trying to address 35 projects simultaneously. As mentioned in the body of this report, FHA/Housing will be hard pressed to manage all of the planned projects under FHAMIS. Efforts to replace aging information systems with new technology must be assigned a high priority. (Final action target date is December 31, 1998.)

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

- 2.a. Assess the readiness of HUD to meet Statement of Federal Financial Accounting Standards (SFFAS) No. 4, Managerial Cost Accounting Concepts and Standards, in fiscal year 1997 and to recommend a coordinated plan of action for HUD's major operating components that accomplish the GPRA and SFFAS objectives. (Final action target date is September 30, 1998.)

With respect to the reportable condition that HUD needs to be more proactive in implementing its management control program, we recommend that the **Deputy Secretary:**

- 3.a. Establish practices for and hold program managers accountable for systematically identifying systemic weakness in their ongoing programs, initiating risk abatement strategies, identifying corrective actions and completing those actions in a timely fashion. Program managers should periodically report on their program risk assessment results and planning throughout the year. (Final action target date is March 31, 1998.)

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

- 3.b. Strengthen HUD's Management Control Program by increasing accountability for conducting Front End Risk Assessments of new or substantially modified programs by:

- Implementing a process for timely identification of programs where FERAs apply.
- Notifying the appropriate program staff that the program is a candidate for a FERA.
- Requiring program managers to certify, giving reasons to justify exemption, if a FERA is not planned or performed.

(Final action target date is March 31, 1998.)

With respect to the material weakness regarding excess subsidy payments and HUD's commitment to perform an annual statistical sampling project to estimate the amount of subsidy overpayments, we recommend that the **Chief Financial Officer**, in consultation with the Office Public and Indian Housing and the Office of Housing:

- 4.a. Refine the statistical sampling approach for future annual estimates to address the data limitation relating to income differences of under \$3,000 and consider stratifying the sample universe with the goal of increasing the precision of the estimate. In addition to increasing the precision of the estimate, stratification may facilitate addressing income differences of under \$3,000. (Final action target date is April 30, 1998.)
- 4.b. Use the results of the separate SSA payment data matching initiative to include the effect of unreported income from SSA's SSI program in future annual estimates. (Final action target date is January 15, 1998.)

With respect to the reportable condition that HUD needs to continue efforts to improve housing authority monitoring, we recommend that the **Assistant Secretary for Public and Indian Housing**:

- 6.a. Issue guidance to clarify field office responsibility with regard to performing annual on-site reviews of HOPE VI program grants pursuant to PIH's management plan and Notice 95-10 requirements, as extended. (Final action target date is December 31, 1997.)
- 6.b. Develop procedures for incorporating the results of the independent housing quality assessments into PIH's risk based monitoring strategy. (Final action target date is October 31, 1998.)

With respect to the reportable condition that HUD needs to improve system security, testing of business recovery plan, and software change control, we recommend that the **Assistant Secretary for Administration**:

- 7.b. Formulate and execute a plan that will expedite disaster recovery testing of multiple critical applications and unscheduled tests. This plan must substantially reduce the current BRP testing time-table and include, but not be limited to:
 - Determine what applications will be merged, replaced or deleted prior to disaster recovery testing of multiple critical applications. Any systems that are found to be in this category will not have to be part of the testing.

- Review with program representatives the criticality of BRP systems. It may be possible to eliminate some applications from the BRP.

(Final action target date is September 30, 1998.)

We recommend that the **Chief Financial Officer** and the **Assistant Secretary for Public and Indian Housing**, with agreement from the Office of Information Technology:

- 7.c. Implement the already purchased change management software (Endevor) for HUDCAPS. (Final action target date is April 30, 1998.)

With respect to the reportable condition that further efforts are needed to strengthen HUDCAPS access controls, we recommend the **Chief Financial Officer**, as the system owner of HUDCAPS:

- 8.a. Evaluate staffing needs for maintaining separation of duties between data entry and approval functions. Implement this segregation of duties control wherever possible. (Final action target date is December 31, 1997.)
- 8.b. Establish policies and procedures for the periodic review of all security profiles to ensure data entry and approval functions are adequately segregated wherever possible. (Final action target date is January 31, 1998.)

With respect to the reportable condition that the personnel security program needs strengthening, we recommend that the **Assistant Secretary for Administration**:

- 9.a. Require that security administrators and application program managers receive appropriate background investigations and request that the security administrators, in consultation with the Office of Information Technology, identify all individuals performing sensitive and/or critical system functions and require those individuals to receive appropriate background investigations. (Final action target date is October 15, 1997.)
- 9.b. Incorporate review of position sensitivity designations in future A-130 reviews. (Final action target date is March 31, 1998.)
- 9.c. Initiate action to ensure the Personnel Security Tracking System contains complete data and is updated in a timely manner. (Final action target date is August 1, 1998.)

With respect to the reportable condition that HUD needs to determine the amount of unexpended commitments under the PIH low rent loan program, we recommend that the **Assistant Secretary for Public and Indian Housing**:

- 10.a. Devise and implement a workplan to collect and process the actual development cost certificates and inform the CFO which projects should be closed out and/or deleted from the Department's subsidiary records. (Final action target date is March 31, 1998.)

Appendix C

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

This Appendix provides details required under FFMIA reporting requirements. To meet those requirements, we performed tests of compliance using the implementation guidance for FFMIA issued by OMB on September 9, 1997. 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 remedial actions are included in the following sections.

Federal Financial Management Systems Requirements

1. HUD's annual assurance statement issued pursuant to the Section 4 of FMFIA reports 2 areas of material non-conformance. These two areas include Departmental Financial Management Systems and FHA Multifamily Systems. HUD assessed its systems based on factors listed in paragraph 7 of OMB Circular No. A-127. HUD assessed a system as non-conforming if any one of the twelve elements was considered non-conforming. Thirty eight of HUD's ninety two systems were assessed as non-conforming systems. The organizations responsible for these systems that were found not to comply with the requirements of OMB Circular A-127 are as follows:

<u>Responsible Office</u>	<u>Number of Systems</u>	<u>Non-Conforming Systems</u>
Office of Housing	36	28
Chief Financial Officer	21	5
Office of Administration	10	3
Office of Public and Indian Housing	7	1
Office of Fair Housing and Equal Opportunity	2	1
Government National Mortgage Association	8	0
Office of Community Planning and Development	<u>8</u>	<u>0</u>
	<u>92</u>	<u>38</u>

The primary reason for the existence non-conforming systems is that HUD continues to rely on legacy systems that have not been replaced or enhanced. To correct the problem, HUD, for the most part, plans to replace non-conforming systems with new systems or incorporate the functions of nonconforming systems into conforming systems. The following sections outline the Department's plan to correct specific system non-conformances.

Office of Housing

• **Develop FHA Accounting System - A80A**

<u>Interim Milestone</u>	<u>Target Date</u>
Refine new GL Chart of Accounts	Jan 98
Begin working with AMS	Feb 98
Finalize Chart of Accounts & transactions	Apr 98
Implement FHA warehouse	Jun 98
Program FFS and interfaces	May-Jul 98
Test software/Load Sep 97 bal. & 98 transactions	Aug-Sep 98
Correct problems & load year-end transactions.	Sep-Dec 98
Complete final adjustment of FY 98 data & test FY 99 transactions	Jan-Mar 99

• **Replace Nonconforming System with A80A**

<u>System Code</u>	<u>System Name</u>	<u>Target Date</u>
A56	Mortgage Insurance General Accounting	Mar 99

• **Assess Needs for Nonconforming systems to conform after A80A is implemented**

<u>System Code</u>	<u>System Name</u>	<u>Target Date</u>
A43	Single Family Insurance System	Mar 99
A43C	Single Family Insurance Claims Subsystem	Mar 99
A80D	Distributive Shares and Refund Subsystem	Mar 99
A80G	Multifamily Mortgage Auction	Mar 99
A80S	Single Family Acquired Asset Management	Mar 99
A80N	Single Family Mortgage Notes Servicing	Mar 99
F12	Home Equity Conversion Mortgages	Mar 99
F31	Cash, Control, Acct., Reporting System (CCARS)	Mar 99
F71	Title I Notes servicing	Mar 99
F72	Title I Insurance and Claims	Mar 99
F75	Multifamily Claims System	Mar 99
R25	FHA Contract Tracking System	Mar 99

• **Develop Single Family Premium Collection System - A80R-P**

<u>Interim milestone</u>	<u>Target Date</u>
Complete Requirements Definition	Aug 97
Design, Develop, Unit test	Oct 97
Complete Systems Test	Feb 98
Complete User Acceptance Test	Jul 98
Implement	Jul 98

- **Replace Nonconforming System with new A-80R-P Single Family Premium Collection System**

A31	Single Family Premium Collection	Jul 99
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- **Develop Multifamily Asset Development and Management System - F24**

<u>Interim Milestone</u>	<u>Target Date</u>
Complete Cost Module	Aug 97
Complete Tracking Module	Sep 97
Complete Valuation Module	Sep 97
Complete Mortgage Credit Module	Sep 97
Complete Application Definition Module	Sep 97
Complete Computer System Test	Nov 97
Complete Pilot Test	Feb 98
Implement	May 98

- **Replace Nonconforming System with new Multifamily Asset Development and Management System -F24**

<u>System Code</u>	<u>System Name</u>	<u>Target Date</u>
F07	Computerized Underwriting Processing System	May 98

- **Plan and Design Real Estate Management System (REMS/F24R) and Replace Nonconforming System**

<u>System Code</u>	<u>System Title</u>	<u>Milestones</u>
F52	Multifamily Information Processing System.	No schedule provided
F90	Multifamily Insured and Direct Loan Information System	No schedule provided

- **Replace functionality of nonconforming system with Multifamily Property Management Services Contract**

<u>System Code</u>	<u>System Title</u>	<u>Milestones</u>
F46	Multifamily Property Management System	Contract to be awarded by Feb 98. Implementation by Apr 98
F49	Multifamily Accounting Reporting and Servicing	Contract to be awarded by Feb 98. Implementation by Apr 98

- **Complete Year 2000 Requirements and Other Pending Requirements**

F17	Computerized Home Underwriting Management System	Complete user manual and Yr. 2000 requirements by Sep 98
F51	Institution Master File	To be in conformance Re: System. Documents by Sep 98.

- **Complete Assessments and/or Determine how systems will conform with requirements and establish target dates**

A80Y	Hospital Mortgage Insurance Management Information System	Complete Assessment
A80ZZ	SF Property Disposition Monitoring System	Work on A80ZZ is on hold. No funds requested .
D64A	SF Housing Enterprise Data Warehouse	Complete Assessment
F05	Section 8 Management Information system	Need to determine needs based on Management Reform Decision.
F37A	Staff Profile Information/Resource Utility Tracking (SPIRUT)	Need to provide assessment
F45	Multifamily Data Warehouse	Need to provide assessment
F87	Tenant Rental Assistance Certification System	Need to determine needs based on Management Reform decision.
F92A	SF/MF Asset Sales System	Need to develop schedule and plan for developing system

Office of the Chief Financial Officer

- **Replace nonconforming systems with existing conforming system**

<u>System Code</u>	<u>System Title</u>	<u>Replacement System</u>	<u>Target Date</u>
A16	SF-224 Transaction Reconciliation System	A75/HUDCAPS.	Sep 99
A65A	Section 235 Automated Validation and Editing	A75/HUDCAPS	Sep 99
ATLAS	Advanced Technology Ledger Accounting System	A75/HUDCAPS	Sep 99
A77	Flexible Subsidy System	A21/Loan Accounting System	Sep 98

- **Close-out nonconforming system**

<u>System Code</u>	<u>System Title</u>	<u>Target Date</u>
A65	Section 235 Accounting System	Sep 97

Office of Administration

- **Replace nonconforming systems with new systems**

<u>System Code</u>	<u>System Title</u>	<u>Target Date</u>
A63	Furniture and Equipment Management Information System	Sep 99
A76	Funds Accounting and Status Tracking	Sep 98
D17	Project and Resource Management System	Sep 98

Office of Public and Indian Housing

- **Assess system needs based on Public Housing reform legislation**

<u>System Code</u>	<u>System Name</u>	<u>Target Date</u>
N07	Regional Operating Budget and Obligations Transactions	Sep 99

Office of Fair Housing and Equal Opportunity

- **Incorporate nonconforming system functionality with existing conforming system - Grants Evaluation Management System (GEMS) - E20**

<u>System Code</u>	<u>System Name</u>	<u>Interim Milestone</u>	<u>Target Date</u>
E11	Funding and Contracting Tracking System	Phase I - incorporate Fair Housing Initiative Program	FY 1997
		Phase II - incorporate Fair Housing Assistance Program	Sep 98

2. Audit procedures performed for the purpose of obtaining evidence in support of the auditor's opinion disclosed a material weakness regarding deficiencies in HUD's financial management systems and reportable conditions regarding the security over financial information. Although a reportable condition, 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. The responsible office, nature of the problem and primary causes are summarized below.³

Responsible Office **Nature of the Problem**

Office of the CFO Financial Systems Integration progress remains slow. Time frames for fully implementing FFS as HUD's core financial systems and integrating this system with program feeder systems have not been determined.

The primary cause for this occurrence is the absence of a comprehensive approach for project planning and management, baseline goals, schedules, and costs have not been developed and quality control processes have not been identified.

Office of Housing Some of FHA's automated systems either do not provide needed management information or do not provide reliable information.

The primary cause for FHA's system weaknesses, as cited by KPMG Peat Marwick, LLP, was that resources needed to develop state-of-the-art systems are lacking due to budgetary constraints or other critical HUD system priorities.

Office of Information Technology Existing security measures over the Hitachi, Unisys and Network environment do not effectively prevent accidental or unauthorized modifications or damage, or detect unauthorized use.

In the Hitachi environment, the primary cause of these occurrences are that the Top Secret Security software was not set up to define all users, files and other mainframe resources to the security package. In addition, too many designated users were granted security bypass privileges during the start of on-line processing sessions.

In the UNISYS environment all files have PUBLIC access.

In the Network environment, access controls were not completely effective.

Offices of Housing and Information Technology In prior year and current reviews, control weaknesses have been noted in FHA's EDP processing environment with respect to overall and application level security that affects the assurance that assets were adequately safeguarded.

The primary reason for security weaknesses is that the current security program management does not assure that a consistent, centrally administered security program is in place.

³ The issues are discussed in greater detail in the sections of this report relating to the material weakness on the need to complete improvements to financial systems and the reportable condition on the need to improve general system security and other controls, and KPMG Peat Marwick LLP's separate report on their audit of FHA's fiscal year 1997 financial statements.

Inadequacies include the lack of an up-to-date Security Program Plan, deficiencies in the background investigation process, and the lack of policies governing mandatory vacations or job rotations.

Corrective Actions

HUD is in the process of enhancing many existing systems as part of its current information strategy plan. As these actions are taking place, we understand that improvements in security and access controls will be undertaken. To correct security weaknesses, see the recommended actions listed in Appendix B of this report and KPMG Peat Marwick LLP's separate report on their audit of FHA's fiscal year 1997 financial statements.

Federal Accounting Standards

HUD's financial statements, with respect to FHA, are not prepared in accordance with SFFAS No. 2. FHA's mortgage insurance programs are presented in accordance with private sector GAAP which significantly differ from the reporting requirements of SFFAS No. 2. FHA, as a government corporation, prepares separate financial statements in accordance with GAAP.

This condition is primarily attributable to the inability of FHA's systems to provide the information needed to present financial statements in accordance with SFFAS No. 2. HUD has developed a corrective action plan to change FHAMIS for credit reform compliance. These corrective actions and target dates are included in the **Federal Financial Management Systems Requirements** section above for the A80, FHA Accounting System.

In addition, HUD has been working with OMB to develop an approach for preparing auditable financial statements that comply with SFFAS No. 2. This effort had not progressed to the point where it was possible to prepare financial statements for fiscal year 1997 and subject them to audit. HUD is including an unaudited balance sheet, statement of operations and selected footnotes its *Fiscal Year 1997 Accountability Report*. We are continuing to work with the Department to audit the fiscal year 1997 ending balances as we proceed with plans to audit HUD's financial statements for fiscal year 1998.

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

FHA's core financial system, FHA General Accounting System is not in compliance with the Standard General Ledger requirements. In prior years, it has been noted that resources needed to develop state-of-the-art systems are lacking because of department-wide budgetary constraints or the existence of other critical system priorities at HUD. As a result, FHA's past systems plans centered on enhancing existing systems, and actual implementation of the plans was often delayed.

During fiscal year 1997, HUD targets selecting a standard general ledger for early 1998 with implementation effective in the first quarter of 1999. HUD plans to have a fully integrated financial management system installed for the 1999 fiscal year.

Specifically, the Department plans to implement the FHA Accounting System to implement Standard General Ledger requirements. The target implementation date is March 1999. Detailed plans for implementing the system are included in the **Federal Financial Management Systems Requirements** section above for the A80, FHA Accounting System.

Appendix D

Agency Comments



U. S. Department of Housing and Urban Development
Washington, D.C. 20410-0100

MAR 19 1998

OFFICE OF THE CHIEF FINANCIAL OFFICER

MEMORANDUM FOR: Susan Gaffney, Inspector General, G

FROM: Richard F. Keevey, Chief Financial Officer, *RFK*

SUBJECT: Comments on Fiscal Year (FY) 1997 Consolidated
Final Draft Audit Report (March 13, 1998)

The purpose of this memorandum is to provide you with the attached comments on the subject report. These comments are limited to those which the program offices and the CFO consider to be the most significant and are in two categories: resource management and system security. Other submitted comments, which were considered less significant, have already been communicated to your staff.

I want to take this opportunity to thank you and your staff for the level of professionalism and cooperation shown during the conduct of this audit engagement. This approach allowed many issues to be discussed and mutually resolved at the staff level. Consequently, the final audit report will be issued shortly and will allow the Department to issue the FY 1997 Accountability Report this month. This achievement is a tribute to those individuals involved in this process and is a significant accomplishment for the Department.

Thanks for your consideration.

Attachment

Comments on Office of Inspector General Draft FY 1997 Audit Report

Material Weakness: HUD Must Improve the Management of its Resources

Your report reflects that HUD did not identify resource needs based on a detailed analysis of program functions, processes and anticipated workloads. Consequently, HUD can not support the propriety of its staffing target nor workloads, or allocation of staff among its newly proposed organizations.

This conclusion is not accurate because in fact, HUD has undertaken extensive workload analysis. Exhaustive workload analyses was performed for FHA/Housing, PIH, Fair Housing, the Real Estate Assessment Center, and the Enforcement Center. These workload analyses – along with the reengineering of numerous processes – have formed the foundation for staffing size and allocation decisions. HUD will also soon be releasing the results of a comprehensive review of its staffing and workload analyses conducted by the private management consulting firm of Booz-Allen. Booz-Allen was hired to review HUD's underlying staffing and workload analyses and make recommendations to HUD for allocating unplaced staff for priority transitional activities.

The OIG assessment focuses solely on quantitative analyses, which is too narrow a focus, and misses the range of analytical methods underlying HUD's reforms. We have used a number of other approaches to develop and refine our management reform strategies to include:

- Review of Critical Reports – We reviewed reports, hearings and analyses by GAO, NAPA, OIG and Congressional Committees that extensively documented HUD's management deficiencies. Many of the recommended solutions from these reports have been incorporated into our plans.
- Pilot Program Experience – HUD is shifting from a retail approach in 81 field offices to a wholesale operation where single family mortgage applications are to be processed in four Homeownership Centers. This consolidation follows on the proven track record in productivity improvements made at the Denver Homeownership Processing Center during the past three years. Using fewer staff and state-of-the-art technology, mortgage processing times have been reduced from four to six weeks to less than three days. These changes are the

linchpins to HUD's larger reform efforts because of the tremendous staffing reductions that are achieved through this significant consolidation.

- Change Agent Teams – Senior HUD managers and employees were formed into teams to review existing program and organizational structure, delivery systems, financial management systems and internal controls with the charge to develop recommendations for reform. This is a proven technique used in both private - and public - sector restructuring efforts.
- Consultation with Outside Experts – We consulted with management experts in both the public and private sector for their insights and recommendations. Their consensus was for HUD to undertake bold rather than incremental reforms and to continue to refine the plan as implementation proceeded.
- Consultation with Affected Constituent Group and Congress – Exhaustive consultations with affected constituent groups and with Congress provided feedback that resulted in substantial refinements of the original plan.

HUD has detailed plans to achieve its downsizing goals of 7,500 full-time employees by 2002 in two phases. In Phase I, HUD has reduced staff to approximately 9,000 employees. These 9,000 employees are better deployed to address the critical program needs than ever before because of the reallocation of the existing workforce to match critical workload priorities. The central underlying premise is that the consolidation of FHA Single Family processing into just four Homeownership Centers allows HUD to both substantially reduce Single Family staff and to reallocate this staff to higher priority needs, including Multifamily oversight, Public and Indian Housing, and the new Assessment and Enforcement Centers.

HUD will move to Phase II staffing of 7,500 by 2002, if and only if, two critical assumptions are met by that time:

- The enactment of legislation by the Congress to consolidate HUD's program structure; and
- There has been a substantial reduction in the number of troubled multifamily assisted properties and troubled PHAs.

Furthermore, the Department embarked upon its 2020 Management Reform Plan because there was a compelling need for HUD to develop and implement a plan to reform agency management in a timely fashion. This plan answers many of the management deficiencies identified by GAO, OIG, and NAPA and has the following principal thrusts:

- Establishment of Department-wide capacities for real estate assessment and enforcement;

- Improved internal controls;
- Improved systems;
- Increased staffing for monitoring and oversight of multifamily properties and Public Housing Authorities; and
- Delivery of enhanced customer service.

HUD's 2020 Management Reform Plan and its implementation is a vindication of various OIG and GAO reports on the agency and is the blueprint to implement many of our critics' proposed reforms. Unlike previous reform efforts, this plan has already moved from the drawing board into full-scale implementation. It is already yielding improvements in HUD's internal management capacities and in the delivery of HUD programs to individuals and communities across the country, as well as changing the future of the agency.

Reportable Condition: HUD Needs to Improve System Security and Other Controls

Recommendation 3: With respect to the reportable condition that HUD needs to improve system security and other controls, we recommend that the Assistant Secretary for Administration:

c. Remove default user IDs and IDs without passwords on the LANs.

RESPONSE: The LAN Branch constantly reviews all the Novell file servers for conformance to the security standards as specified in the LAN Administrator's Guide. In addition, security reports are run monthly. User ID's not used in 60 days are automatically deleted and purged from the system. User ID's with NO passwords have NO rights to the server operating system files or application system(s) files. Supervisory equivalent accounts are strictly controlled on PRODUCTION file servers and are reserved for LAN Branch LAN administrators. Test servers are strictly reserved for testing new software, have no production systems or vital information stored on them, and are not as restrictive as noted above. Accounts on test servers with supervisory equivalent rights, with or without passwords, are used for test purposes only. There are NO supervisory equivalent accounts on the PRODUCTION file server without passwords.

The user account "GUEST" is restricted to print services ONLY. The account "GUEST" has NO rights to the file server.

Based on the information above, we request that this recommendation be deleted from the report.

g. **Improve control settings on the LAN by implementing the following controls:**

- **Require passwords to be alphanumeric rather than easily guessed words.**

RESPONSE: The user password parameters are set in accordance with HUD standards. The Novell 3.x operating system does not have an option to enforce the use of alphanumeric passwords. We request that this recommendation be deleted from the report.

- **Encrypt passwords sent between workstations and servers to prevent a hacker from obtaining passwords of legitimate users.**

RESPONSE: The Office of IT needs to evaluate the effect that this change will have on network performance before a final decision is made on implementing this recommendation. In addition, the Office of IT will have to assess the impact that this change may have on HUD's program applications (especially those that are LAN and client server applications). The Office of IT will complete its evaluation of this recommendation and develop an implementation plan, if appropriate, by June 30, 1998.

- **Restrict access to system directories containing powerful system wide commands on the LAN.**

RESPONSE: Normal users on PRODUCTION file servers do NOT have access to operating system directories and only have "rights" other than read and file scan to their personal working directory or specified shared working directory areas. We request that this recommendation be deleted from the report.

Appendix E

Report Distribution

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