

**STATEMENT OF
SUSAN GAFFNEY, INSPECTOR GENERAL
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT**

**BEFORE THE HOUSE OF REPRESENTATIVES
COMMITTEE ON GOVERNMENT REFORM
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
INFORMATION AND TECHNOLOGY
MARCH 22, 2000**

**STATUS OF FINANCIAL MANAGEMENT AT THE
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT**

Chairman Horn, Ranking Member Turner, and Members of the Subcommittee, I appreciate the opportunity to appear before you today to give you my perspectives on the status of financial management at the Department of Housing and Urban Development (HUD). I am accompanied by Kathryn Kuhl-Inclan, Assistant Inspector General for Audit; James Heist, Director of the Financial Audits Division; and Benjamin Hsiao, Director of the Information Systems Audit Division. As the subcommittee is aware, the Office of Inspector General (OIG) reported on March 1, 2000 on our efforts to audit HUD's fiscal year 1999 consolidated financial statements and issued a disclaimer of opinion. OIG also issued reports on audits of the Government National Mortgage Association (GNMA) and the Federal Housing Administration (FHA), on February 24 and 29, 2000, respectively. Those audits were performed by the independent accounting firm of KPMG LLP, under contract with the OIG. KPMG LLP's reports included unqualified opinions on GNMA's and FHA's fiscal year 1999 financial statements.

Before I address issues at HUD, I'd first like to take a moment to discuss the broad purposes of the Chief Financial Officers (CFO) Act and our perspectives on the emphasis being placed on agencies' success in having auditors express unqualified opinions on their financial statements. In passing the CFO Act nearly 10 years ago, the Congress laid out three broad purposes:

1. Bring more effective general and financial management practices to the Federal Government through statutory provisions which would establish in the Office of Management and Budget a Deputy Director for Management, establish an Office of Federal Financial Management headed by a Controller, and designate a Chief Financial Officer in each executive department and in each major executive agency in the Federal Government.
2. Provide for improvement, in each agency of the Federal Government, of systems of accounting, financial management, and internal controls to assure the issuance of reliable financial information and to deter fraud, waste, and abuse of Government resources.

3. Provide for the production of complete, reliable, timely, and consistent financial information for use by the executive branch of the Government and the Congress in the financing, management, and evaluation of Federal programs.

Nowhere in these broad purposes does the CFO Act list obtaining an unqualified opinion, yet this has become the one measure that is pointed to frequently as a measure of success in improving agencies' financial management. Indeed, the President's fiscal year 2001 budget put forth a performance goal for 18 of the 24 CFO Act agencies to receive unqualified opinions on their fiscal year 1999 financial statements. While we understand that goals are important, what is missing here is a set of goals that speak more directly to the purposes of the CFO Act.

We believe that HUD's success in addressing the material weaknesses and reportable conditions in our Report on Internal Controls, which is an integral part of the financial statement audit, would be a more meaningful CFO Act performance measure than receipt of an unqualified opinion. As we pointed out in our March 1, 2000 report, HUD's ability to obtain an opinion for fiscal year 1998, while noteworthy, required extensive contractor support along with ad hoc analyses and special projects to develop account balances and necessary disclosures. This was due to continued weaknesses in HUD's internal controls and financial management systems. For fiscal year 1999, we reported a total of 17 reportable conditions, 5 of which we also classified as material weaknesses. We describe in our fiscal year 1999 report the deterioration of the internal controls relating to HUD's core financial management systems that resulted from the implementation of a new Departmental general ledger and ultimately led to our decision to disclaim an opinion on the fiscal year 1999 financial statements.

HUD continues to rely on extensive contractor support to overcome limitations in the preparation of financial statements that are brought about by poor internal controls. These efforts are in large part directed at obtaining unqualified opinions, and not correcting the systems that continue to adversely impact our ability to audit HUD's financial statements in a timely and efficient manner.

In the following paragraphs, we (i) explain the reasons for our disclaimer of opinion, (ii) summarize the Report on Internal Controls, and (iii) summarize the Report on Compliance with Laws and Regulations. The latter two reports are integral parts of the financial statement audit.

DISCLAIMER OF OPINION:

We were unable to issue an opinion on HUD's financial statements for fiscal year 1999, and as a result, we issued a disclaimer of opinion. Our decision to issue a disclaimer considered the CFO Act statutory date of March 1 to complete the audit. Both the Congress and OMB had emphasized the importance of meeting the March 1 date this year. Indeed, we understand that only four OIGs missed the deadline compared to ten last year. We considered this in reaching our decision to stop the audit. That decision also considered the prospects of our being able to complete the audit in a reasonable period of time after the deadline. We assessed the amount of work that, first of all, needed to be completed by the Department to reconcile their "fund Balance with Treasury" accounts (analogous to cash in a bank account) and finish the financial statement preparation process. Secondly, we considered the effort required for us to finish our audit work. It was clear to us that, optimistically, the

best we could hope for would be to complete the audit sometime in April 2000 and this was not acceptable. We were one of the agencies that missed the deadline last year. However, last year the audit process had not been as significantly delayed by the systems conversion effort as was the case this year. Moreover, at March 1 last year, we could reasonably anticipate being able to complete the audit and issue our opinion before the end of the month and, indeed, we were able to so.

HUD criticized our decision to stop the fiscal year 1999 audit and has alleged that we did not follow professional standards by not notifying them of our decision to disclaim an opinion in time for them to take corrective action. We disagree that we violated any standards relating to timely communication. We made it clear throughout the audit process that we intended to issue our report in time to meet the March 1, 2000 statutory due date and that our inability to complete the audit could affect the opinion. We would also point out that the conclusions with respect to HUD's internal control weaknesses, which led to the restriction of our audit scope, were formally communicated to the Department on February 9, 2000. It was only after we informed HUD officials on February 23, 2000 that those same issues were causing us to disclaim an opinion, that HUD initiated a concerted effort to accelerate the completion of the fund balance with Treasury reconciliations. This effort included contractor support to perform a basic accounting function that should have been completed by HUD staff months earlier. We can only conclude that HUD was motivated to take this action primarily because of a desire to obtain an opinion, rather than acting immediately to address the material weakness with HUD's core financial management system that was included in our draft report on internal controls. We began the fiscal year 1999 consolidated audit in June 1999 and spent nearly 20 staff years performing the audit.

For the fiscal year 1999 audit, the limitation in our audit scope was caused by the following factors:

- the undetermined effects of the conversion problems during the fiscal year of the general ledger from the Program Accounting System (PAS) to HUD's Central Accounting and Program System (HUDCAPS),
- the inadequate state of HUD's reconciliation efforts and their documentation for the general ledger accounts for the fund balance with Treasury, and
- the late manual posting of numerous and significant adjustments (some as late as February 25, 2000) directly to the financial statements, for which we lacked sufficient time to test their legitimacy.

HUD implemented a major change to its accounting system in fiscal year 1999, including a new Department-wide general ledger system using HUDCAPS. The attached "FY 1999" chart illustrates the major accounting systems used to account for the vast majority of HUD funds, and how those systems relate to one another and ultimately provide information needed to prepare the financial statements. The "FY 1998" chart illustrates the system relationships before the conversion of the general ledger to HUDCAPS. Prior to that conversion, PAS, one of HUD's "legacy" mainframe systems, served as HUD's general ledger for HUD's grant, subsidy and loan programs. Systems

maintained for the Federal Housing Administration (FHA) and the Government National Mortgage Association (GNMA) were separate and those entities maintained and continue to maintain separate general ledgers.

As illustrated in the “FY 1999” chart, the Department decided to implement HUDCAPS as its Department-wide general ledger. While we agree that the Department needs to integrate its general ledger systems, the implementation was problematic in three areas.

- HUD had to develop an interface and needed to convert existing data from PAS. The general ledger system was migrated from PAS to HUDCAPS during fiscal year 1999; however, as we note in our report, the transition was a significant undertaking and is still not complete. The interface filter and the general ledger posting models resulted in numerous rejected or incorrectly posted transactions that had to be manually researched and corrected. In addition, the migration was done without development of an automated program to help reconcile the general ledger cash accounts to Treasury’s figures.
- Summary level data from the separate FHA and GNMA general ledger systems were to be periodically transferred to HUDCAPS. This should occur at least monthly. However, as we note in our report, the transfer of fiscal year 1999 FHA data was done once after year end and required inefficient manual processes.
- HUD used a financial statement report consolidation software called Hyperion Enterprise to prepare the financial statements. Reconciliation processes to identify discrepancies with Treasury fell behind schedule, and HUD had to make numerous adjustments to the general ledger fund balance with Treasury balances to make them agree with Treasury records. These adjustments were not made via the normal general ledger posting process. Rather, they were made directly to Hyperion Enterprise. At the time we discontinued our audit work, a total of 42 adjustments totaling about \$17.6 billion had been processed in this manner to adjust fiscal year 1998 ending balances. An additional 242 adjustments totaling about \$59.6 billion, were made to adjust fiscal year 1999 activity.

REPORT ON INTERNAL CONTROLS

In reporting our findings on HUD’s systems of internal controls, our report distinguishes between material weaknesses and reportable conditions. Reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect HUD’s ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Certain of the reportable conditions were also considered to be material weaknesses. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. The following paragraphs summarize the material weaknesses in our report on our attempt to audit HUD’s fiscal year 1999

consolidated financial statements and KPMG LLP's audit of FHA's fiscal year 1999 financial statements. We also provide a listing of the additional reportable conditions not categorized as material weaknesses.

Material Weakness: Information Systems

The most critical need faced by HUD in improving its internal controls is to complete development of adequate systems. To correct financial management deficiencies in a Department-wide manner, HUD initiated a project to design and implement an integrated financial system consisting of both financial and mixed systems. The objective of the Financial Systems Integration (FSI) Plan is to correct Department-wide financial management deficiencies while simultaneously providing the information necessary to carry out the financial and programmatic missions of the Department. A major component of the FSI plan was to implement HUDCAPS, as the core financial system for the Department. As implemented, the HUDCAPS core financial system does not fully comply with federal financial system requirements. In addition, other HUD financial system weaknesses remain uncorrected and financial system integration delays continue. The Department's failure to correct long standing financial system weaknesses in its feeder systems is a contributing factor to non-compliance with financial system standards at the core financial system level. The following financial management system deficiencies, most of which were reported in prior years, were present during fiscal year 1999:

- Insufficient information regarding individual multifamily loans, including the inability to financially monitor the insured portfolio. This makes assessing and quantifying credit risk difficult and adversely impacts efficient, ongoing reporting of credit risk to senior management and effective monitoring of multifamily projects.
- Deficient FHA general ledger and subsidiary systems.
- Inadequate assurance about the propriety of Section 8 rental assistance payments.
- Lack of integration between program and accounting systems necessitating duplicate data entry.
- Inability to support adequate funds control for FHA.
- Inability to fully support the timely identification of unneeded excess funds remaining on expired project-based Section 8 contracts.

In addition, the Department's financial systems continue to have security weaknesses in general and specific application controls.

The bulk of our information system work for the fiscal year 1999 audit focused on HUDCAPS since it became the core financial system and general ledger for the Department. We have reported the following specific deficiencies related to HUDCAPS.

Departmental General Ledger

The Department-wide general ledger in HUDCAPS is not fully compliant with federal financial system requirements. Due to uncorrected weaknesses in FHA's financial management system, FHA's separate financial data are not updated each month in the HUDCAPS Departmental general ledger as required. The current approach for interfacing FHA financial systems with HUDCAPS requires the performance of a series of cumbersome manual conversions of financial data prior to submission to HUDCAPS. First, financial information from feeder systems is converted to a commercial accounting based general ledger. A second manual process translates the commercial accounts and balances to the equivalent Standard General Ledger (SGL) in HUDCAPS. These data are then used to generate standard financial reports and summary SGL entries. Because of this complex process, updated FHA general ledger financial information was transmitted to HUDCAPS only once and after year-end.

The Joint Financial Management Improvement Program (JFMIP) requires that the core financial system "...provide for automated month-and year-end closing of SGL accounts and rollover of the SGL account balances." In addition, OMB Circular A-127, *Financial Management Systems*, requires that "...Integrated Financial Management Systems...shall be designed to provide for effective and efficient interrelationships between software, hardware, personnel, procedures, controls, and data contained within the systems...Wherever appropriate, data needed by the systems to support financial functions shall be entered only once and other parts of the system shall be updated through electronic means consistent with the timing requirements of normal business/transaction cycles."

The process to enter FHA SGL transactions into the Department-wide general ledger is neither timely nor efficient. As a result, there is no assurance that information on Departmental activities can be disseminated in a timely manner to support internal or external users. In addition, the continued reliance upon manual processes to convert FHA financial transactions into a usable format is inefficient and requires duplicate entry of data.

System Interfaces

JFMIP Core Financial System requirements state that "easy and timely reconciliations between systems, where interface linkages are appropriate, must be maintained to ensure accuracy of the data." The general ledger system was migrated from the legacy PAS to HUDCAPS during the fiscal year; however the transition has not been completed at the time of our report. The interface filter and the general ledger posting models have resulted in numerous rejected or incorrectly posted transactions that have to be manually researched and corrected. In addition, the migration was done without development of an automated program to help reconcile the general ledger cash accounts to independent Treasury figures. As a result, the reconciliation processes to identify discrepancies have fallen behind schedule, and HUD had to make numerous adjustments to the general ledger cash balances to make them agree with Treasury records. These adjustments were made directly through posting to the financial statement report consolidation program called Hyperion Enterprise and bypassed the normal general ledger

posting process. The noted problems delayed the closing of the general ledger for fiscal year 1999 until January 24, 2000, and the preparation of the financial statements.

“Fund Balance with Treasury” (Cash) Reconciliations

Treasury requires that agencies reconcile their fund balance with Treasury accounts monthly. The reconciling process is analogous to individuals reconciling their checking accounts to their monthly bank statements. It is an essential internal control to ensure the integrity of U.S. Government financial reporting and provide for reliable measurement of budget results. Due to delays and the magnitude of the FSI implementation, the HUDCAPS general ledgers were not available to support the reconciliation process until November 1999. As a result, the CFO staff relied on the PAS subsidiary ledger balances to verify the Department’s fund balance with Treasury. Reconciliations did not start taking place until late July 1999 for all but four funds. For the remaining four funds, reconciliations were not completed until after fiscal year end because subsidiary records for those funds were maintained in both HUDCAPS and PAS. As of the date of our report, HUD had not reconciled the differences between HUDCAPS, PAS and Treasury reported balances. We tried to obtain documented procedures on how HUD completed the cash reconciliation using HUDCAPS; however, none were available. In addition, we tried to obtain explanations for the differences between the fund balance shown in HUDCAPS versus the Treasury reported balances. These explanations could not be readily provided by the CFO staff preparing the reconciliations because they were still waiting for the necessary information from HUDCAPS to facilitate the reconciliation process. Untimely cash reconciliations resulted in questionable accuracy and reliability of amounts reported in the fund balance with Treasury accounts.

Data Integrity

HUD uses a powerful system utility to resolve data discrepancies by directly altering the data in the HUDCAPS financial tables. Because of this ability to directly change data, the use of this utility must be strictly controlled to prevent unauthorized access and/or unintentional errors from occurring. There were an excessive number of users with access to the utility, including users from four different contractor firms as well as HUD program offices. We questioned the need for the high number of users and the database administrator agreed not all the users on the list require access to perform their jobs. Allowing uncontrolled use of such a utility exposes HUD’s financial data to damage and fraudulent activities.

Another problem was the lack of audit trails. Although some processing documentation exists, it is not complete. In some instances, we were unable to locate corresponding problem initiation records, change approval documents, and system output reflecting changes made to the tables. This condition occurred because there are no formal policies or procedures to control the use of this utility. There are no standard procedures for reporting and documenting problems. Also, change requests were being approved by various program offices as opposed by the system owner, the CFO. Further, the input parameters and output files are maintained in numerous private libraries instead of a centralized system library. A central library is necessary to provide

a standardized audit trail and ensure proper file maintenance during staff turnover. As a result, errors and omissions made to the financial records could occur and remain undetected.

Material Weakness: Verification of Subsidy Payments

HUD provides rent and operating subsidies to housing authorities and multifamily project owners that benefited over 4 million lower-income households through a variety of programs, including public housing and Section 8. HUD's control structure that was in place during fiscal year 1999 did not provide reasonable assurance that these funds were expended by housing authorities and project owners in compliance with the laws and regulations authorizing these programs. HUD estimates that excess subsidy payments totaled about \$935 million for calendar year 1998. 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. When tenants do not report income or under-report income from a specific source and the non-reporting remains undetected, HUD makes excessive subsidy payments.

HUD developed the \$935 million nationwide estimate of the amount of excess rental subsidies paid during calendar year 1998, in order to provide for disclosure of the magnitude of improper payments. 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 a large scale income tax data matching project. To ensure that these projects are effective, HUD has taken action to improve the accuracy of and enforce requirements for housing authorities to timely update information in its tenant databases.

Material Weakness: Monitoring Multifamily Projects

HUD needs to continue efforts to improve the effectiveness of multifamily project monitoring to assure that subsidies are provided only to projects that provided decent, safe and sanitary housing or on behalf of tenants that meet HUD eligibility requirements. Also, HUD's monitoring of project based Section 8 contract administration by state housing finance agencies and housing authorities has continued to be inadequate. Plans to rely on contract administrators to assume HUD's role in project monitoring have not yet been implemented. HUD provides rental assistance to about 21,000 multifamily projects on behalf of eligible tenants residing in those 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.
- The Section 202 and Section 811 programs, which provide grants to non-profit institutions for the construction of projects providing reduced rent units to the elderly and disabled, respectively. Ongoing rent subsidies are also provided under these programs once the units are occupied.

Most of these subsidies and grants are provided through direct contracts with multifamily project owners; there is no housing authority 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.

The Real Estate Assessment Center (REAC) has made some progress in providing for assessing the overall physical condition of HUD's housing portfolio, and reports completing 28,835 physical inspections of multifamily and housing authority properties during fiscal year 1999. However, at fiscal year end, the REAC had not completed financial assessments of multifamily projects due to delays in the rollout of its Financial Assessment Subsystem. In addition, HUD's plans to outsource the workload associated with housing assistance contracts have been delayed from the original plan of September 1998 to where HUD now expects to begin transferring these functions in June 2000. HUD field offices are not sufficiently staffed to adequately review project and housing authority financial statements without REAC's assistance, nor have they been able to perform sufficient on-site monitoring. Until these initiatives have been sufficiently implemented, HUD will continue to be hampered in its ability to effectively monitor multifamily projects.

Material Weakness: Controls over FHA Budgetary Funds and Funds Control:

FHA must perform analyses and reconciliations of all of its obligation systems, to ensure that all obligated amounts are properly recorded and that funds control is maintained and implemented in all systems. This process directly relates to ensuring that budgetary status and accounting information is complete, accurate, and available to management for decision-making purposes. KPMG LLP noted the following weaknesses in FHA's budgetary and accounting processes:

- Budgetary reporting of appropriation symbol 86X4077 was misstated by approximately \$64 million. The SF-133, *Report on Budget Execution*, dated November 19, 1999, submitted to OMB by HUD's CFO Office did not include an automatic apportionment of authority with respect to the interest payment to U.S. Treasury which occurred at fiscal year end. This reporting error occurred because correct and timely information was not available due to the lack of integrated and reconciled budgetary and accounting systems and processes.
- Obligations needed to be reviewed and reconciled. Although FHA fully reconciled obligation activity during the fiscal year, they did not fully reconcile the ending balance of commitments and obligations resulting from underwriting activity during fiscal year 1999 and prior years.

- FHA's general ledger budgetary obligation accounts were not fully supported. During fiscal year 1999, FHA analyzed its general ledger and developed a documented crosswalk to the SGL to prepare both the financial statements and the SF-133s, *Report on Budget Execution*. FHA also implemented the budgetary-related SGL accounts in its general ledger. However, the subsidiary systems that contain the transaction detail activity supporting the SGL did not provide reports which were properly reconciled to the general ledger. In addition, detailed reports supporting the aggregate amounts recorded to the general ledger and SF-133s were not maintained.

Material Weakness: FHA's Information Technology Systems:

For a number of years, weaknesses have been reported in FHA's financial management system environment. FHA's and HUD's inability to acquire more modern information technology has continued to deter FHA's efforts to be a more efficient and effective housing credit provider. Until a comprehensive new integrated information technology environment is implemented and available throughout HUD, FHA will continue to be forced to collect data and report information in less efficient ways.

FHA and HUD are conducting day-to-day business with legacy based systems, several of which directly impact FHA's financial activity and necessitate financial transactions to be processed through non-integrated systems, requiring manual analysis and summary entries to be posted to FHA's general ledger. In addition, key FHA systems do not provide the functionality required to sufficiently manage and account for system transactions in accordance with OMB Circular A-127, *Financial Management Systems*, and OMB Circular A-130, *Management of Federal Information Systems*. Finally, HUD continues to report material system non-conformances under the Federal Managers' Financial Integrity Act, several of which relate to FHA systems. FHA's and HUD's inability to implement modern information technology adversely affects the internal controls related to accounting and reporting FHA financial activities.

Other Reportable Conditions:

Other reportable conditions are discussed at length in our report. They represent significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect HUD's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. The reportable conditions relate to the need to:

- refine performance measures to effectively implement results management;
- improve controls over project-based subsidy payments;
- improve monitoring of housing authorities;
- improve controls over HUD's computing environment;
- overhaul personnel security for systems' access;
- strengthen access and data integrity controls over HUDCAPS;
- improve processes for reviewing obligation balances;
- continue to place more emphasis on early warning and loss prevention for FHA insured mortgages;
- continue actions to safeguard and quickly resolve Secretary-held FHA Single Family mortgage notes;
- sufficiently monitor and account for FHA Single Family property inventory;

- improve the review process for estimating reserves for the FHA insured portfolio; and
- enhance the design/operation of controls over FHA's information systems security and application data integrity.

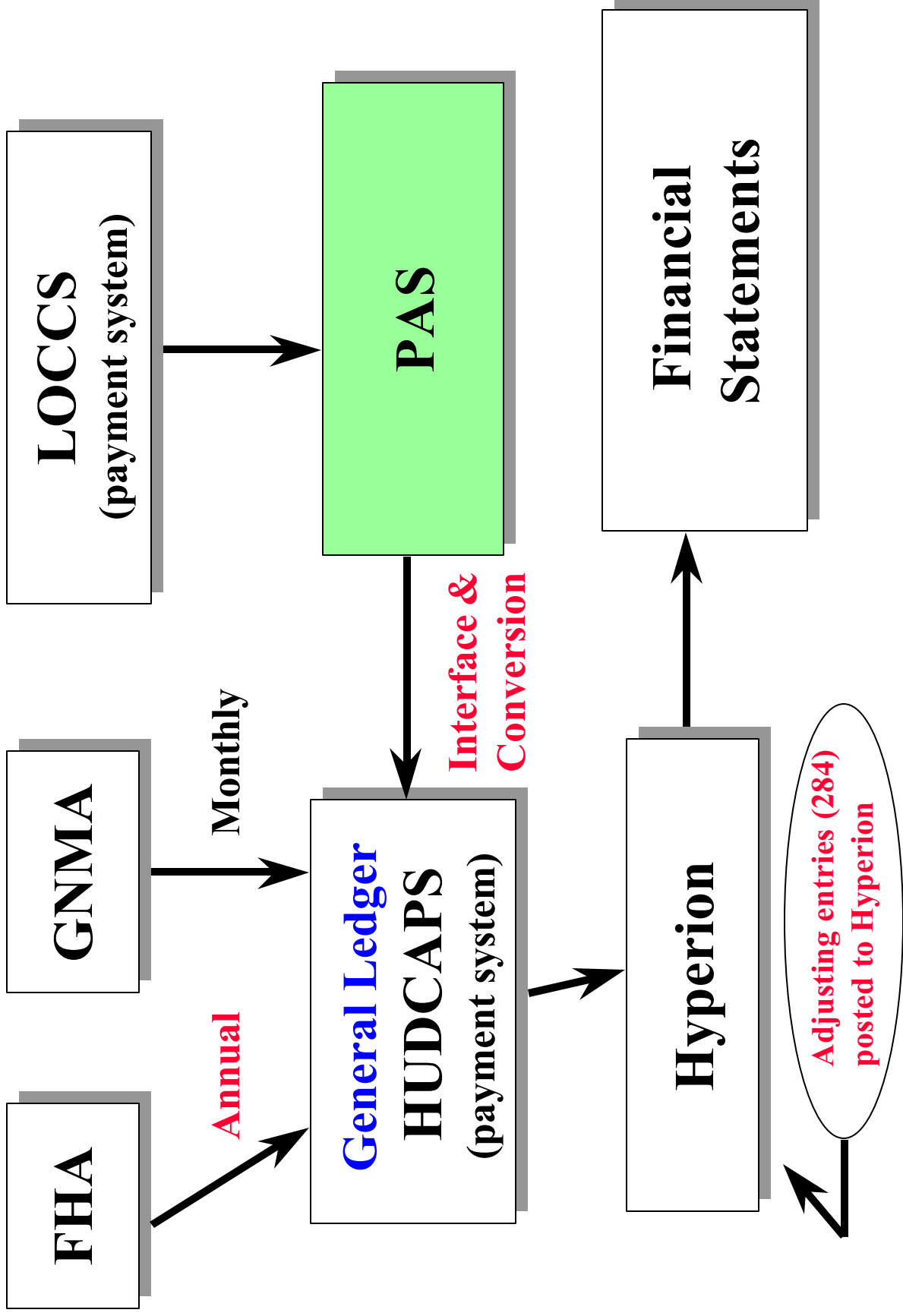
REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS:

Our findings also included the following instances of non-compliance with applicable laws and regulations:

- HUD did not substantially comply with the Federal Financial Management Improvement Act. In this regard, HUD's financial management systems did not substantially comply with (1) Federal Financial Management Systems Requirements, (2) Federal Accounting Standards, or (3) the SGL at the transaction level.
- HUD did not comply with the United States Housing Act of 1937, as amended by the Quality Housing and Work Responsibility Act of 1998. Specifically, HUD is not timely or properly enforcing the act's requirements for the timely expenditure and obligation by housing authorities of public housing modernization funds. HUD disagreed with our conclusion.

Mr. Chairman, that concludes my testimony, I appreciate the opportunity you have afforded me to appear here today.

FY 1999



FY 1998

