AUDIT REPORT

FEDERAL HOUSING ADMINISTRATION
AUDIT OF FINANCIAL STATEMENTS
FISCAL YEARS 2001 AND 2000

2002-FO-0002

February 22, 2002

OFFICE OF AUDIT
FINANCIAL AUDITS DIVISION
WASHINGTON, DC

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

//signed//

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

SUBJECT: Audit of the Federal Housing Administration's Financial Statements for Fiscal Years 2001 and 2000

This report presents the results of KPMG LLP's (KPMG) audit of the Federal Housing Administration's (FHA) financial statements for the years ended September 30, 2001 and 2000. In KPMG's opinion, the financial statements present fairly, in all material respects, the financial position of FHA as of September 30, 2001 and 2000, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations, for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

FHA is headed by HUD's Assistant Secretary for Housing-Federal Housing Commissioner, who reports to the Secretary of the Department of Housing and Urban Development (HUD). FHA is organized into four major mortgage insurance fund activities, with the Mutual Mortgage Insurance Fund, which provides single family insurance, as the largest activity. The Assistant Secretary for Housing is also responsible for administering significant non-FHA programs, such as the Section 8 Rental Assistance, Section 202 Supportive Housing for the Elderly and Section 811 Supportive Housing for Persons with Disabilities programs. Activities relating to these other programs are not included in FHA's financial statements, but are included in HUD's agency-wide financial statements.

This report includes both the Independent Auditors' Report and FHA's principal financial statements. FHA plans to separately publish an annual report for fiscal year 2001 that conforms to Federal Accounting Standards Advisory Board (FASAB) standards. As required by FASAB Statement of Federal Financial Accounting Standards (SFFAS) No. 15, a general purpose federal financial report should include as required supplementary information a section devoted to management's discussion and analysis (MD&A) of the financial statements and related information. Although the Scope and OMB Requirements section which follows indicates that KPMG has been asked to review FHA's MD&A, the MD&A is not included with this report, but will be a part of FHA's planned annual report designed to meet the CFO Act requirements applicable to HUD on or before March 31, 2002.

Audit Scope and OMB Audit Requirements

This audit was conducted in accordance with *Government Auditing Standards* and was performed according to the requirements of the Chief Financial Officers (CFO) Act and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. To complete this audit, we contracted with the independent certified public accounting firm of KPMG. We approved the scope of the audit work, monitored its progress at key points, reviewed KPMG's working papers, and performed other procedures we deemed necessary. OMB's audit requirements in Bulletin No. 01-02 exceed *Government Auditing Standards*, primarily in three areas. These relate to:

- expanding the review of FHA's internal controls,
- reviewing FHA's performance measures, and
- reporting under the Federal Financial Management Improvement Act (FFMIA) of 1996.

To address the first two additional OMB requirements, we engaged KPMG to expand their review of FHA's internal controls and performance measures including those to be reported at the HUD consolidated level. The section discussing internal controls presents the results of this work. With respect to FFMIA, the reporting requirements do not apply to the FHA audit, but will be reported at the HUD consolidated level.

Results of KPMG's Audit

In KPMG's *Independent Auditors' Report*, they expressed an unqualified opinion on FHA's financial statements. The report identifies two material weaknesses and four reportable conditions on internal controls. Appendix A discusses each of these conditions in detail, provides an assessment of actions taken by FHA to mitigate them, and makes recommendations for corrective actions. During the course of the audit, KPMG also identified several matters that are not material to the financial statements and are being communicated to FHA management and us separately from this report.

OIG Discussion of the Audit Results

Management disagreed with KPMG's determination described in Material Weakness No. 2, *Controls Over Budget Execution and Funds Control Must be Improved.* They believe the deficiencies described can primarily be resolved through the enhancements to the ADP systems environment discussed under the first material weakness and by implementing some compensating controls. KPMG's assessment was to recognize the establishment of compensating controls. However, KPMG noted the lack of functionality in the Funds Control Database greatly increases the risk of noncompliance or financial statement misstatement.

Management's Response agrees that the findings are significant, however, we believe that the response does not recognize the important distinction between detective control or compensating control reconciliation and using preventive controls in the Funds Control Database. Moreover, management suggests that the solution to the deficiency is limited to the long-term ADP system enhancements discussed in the first material weakness. This does not fully consider the need to

(a) prioritize funds control interim application system fixes, (b) establish business decision rules for allocating multiple-fund administrative contract costs, and (c) establish business decision rules for contracts processed through the property disposition program. Because of the lack of these preventive and other key manual controls, FHA will continue to have difficulties fully monitoring and controlling budgetary resources. In addition, FHA will continue to run the risk of violating the Anti-Deficiency Act and the requirements of OMB Circular No. A-34, *Instructions on Budget Execution*, until such future time when the proposed system enhancements are to be implemented.

Recommendations and Follow-up on Prior Audits

In audit reports on FHA's prior years' financial statements, various recommendations were made to address FHA's internal control weaknesses. While FHA has taken certain actions to address these recommendations, corrective actions were incomplete. In accordance with the Department's Automated Audits Management System (DAAMS), we will continue to track the resolution of these prior years' audit recommendations. KPMG's recommendations from their fiscal year 2001 audit cover several of the same issues described in prior audits. FHA's management should review all outstanding recommendations and determine a correct course of action that responds to the current status of all open findings.

To the extent that these recommendations do not substantially repeat recommendations issued under prior audits of FHA's financial statements, we will issue a separate memorandum restating and numbering these recommendations to facilitate their tracking in the DAAMS.

Comments of FHA Officials

On January 24, 2002 we provided a draft of KPMG's report to FHA officials for their review and comment. KPMG has summarized FHA's response under each applicable material weakness and reportable condition with FHA's full response included as Appendix B of KPMG's report.

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

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KPMG
2001 M Street, NW
Washington, DC 20036

INDEPENDENT AUDITORS' REPORT

To the Inspector General,
U.S. Department of Housing and Urban Development:

We have audited the accompanying consolidated balance sheets of the Federal Housing Administration (FHA) as of September 30, 2001 and 2000, and the related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources and financing, (hereinafter collectively referred to as "consolidated financial statements") for the years then ended. FHA is a wholly owned government corporation within the U.S. Department of Housing and Urban Development (HUD). The objective of our audits was to express an opinion on the fair presentation of these consolidated financial statements. In connection with our audits, we also considered FHA's internal control over financial reporting and tested FHA's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its financial statements.

SUMMARY

As stated in our opinion on the consolidated financial statements, we concluded that FHA's consolidated financial statements as of and for the years ended September 30, 2001 and 2000 are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

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

- HUD/FHA's Automated Data Processing (ADP) system environment must be enhanced to more effectively support FHA's business processes;
- Controls over budget execution and funds control must be improved;
- HUD/FHA can more effectively manage controls over the FHA ADP systems portfolio;
- FHA must place more emphasis on monitoring lender underwriting and continue to improve early warning and loss prevention for Single Family insured mortgages;
- FHA must sufficiently monitor its Single Family property inventory; and
- FHA must continue to improve its process for preparing timely estimates and properly reporting credit subsidy adjustments.

We consider the first and second reportable conditions, above, to be material weaknesses.

The results of our tests of compliance with the laws and regulations disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards* or Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

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

OPINION ON THE CONSOLIDATED FINANCIAL STATEMENTS

We have audited the accompanying consolidated balance sheets of FHA as of September 30, 2001 and 2000, and the related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources and financing, for the years then ended.

In our opinion, the consolidated financial statements referred to above, present fairly, in all material respects, the financial position of FHA as of September 30, 2001 and 2000, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations, for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The supplementary information included in Schedules A to E is presented for purposes of additional analysis and is not a required part of the financial statements. Such information has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

INTERNAL CONTROL OVER FINANCIAL REPORTING

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

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

We noted certain matters, summarized below that are more fully described in appendix A involving internal control over financial reporting and its operation that we consider to be reportable conditions. The full text of management's response is included as appendix B.

We identified two material weaknesses:

- **HUD/FHA's ADP system environment must be enhanced to more effectively support FHA's business processes.** HUD/FHA continues to conduct day-to-day business with legacy based systems. Several of these systems directly impact FHA's financial activity and result in financial transactions being processed through non-integrated systems that require manual analysis to prepare summary entries for posting to FHA's general ledger. In addition, HUD/FHA's inability to significantly update its ADP system environment adversely affects the internal controls related to accounting and reporting financial activities. For example, FHA uses nineteen automated systems to process accounting data, which is then consolidated into the FHA general ledger not only through certain system interfaces, but also through many manual data transfers and manual entry of journal vouchers. This issue has been reported for several years, and FHA is in the process of implementing corrective actions to address this situation.

- **Controls over budget execution and funds control must be improved.** FHA does not have a collection of ADP financial systems that are capable of fully monitoring and controlling budgetary resources in an integrated manner. Lack of efficient integration between these systems requires the use of manual analysis and reconciliation and use of additional databases to collect and summarize funds control information, which subjects the process to risk of error resulting from reliance on manual processes. For example, FHA must manually compile the status of budgetary resources to prepare the SF–133 *Report on Budget Execution*, based on data in at least eight systems. In addition, there is a significant number of manual budgetary entries input in to the general ledger.

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

- **HUD/FHA can more effectively manage controls over the FHA ADP systems portfolio.** During fiscal year 2001, FHA has taken steps to enhance its ADP systems control environment, including enhancing segregation of duties for the Multifamily Insurance system and reducing contractor access to sensitive Single Family reports. However, improvements are still needed in the area of ADP system portfolio management, application security, application data integrity, and preparation and maintenance of systems documentation.

- **FHA must place more emphasis on monitoring lender underwriting and continue to improve early warning and loss prevention for Single Family insured mortgages.** FHA needs to continue their efforts to reduce the frequency and loss severity of defaults on Single Family insured mortgages by continuing its use of loss mitigation tools and improving the effectiveness of monitoring processes for the Single Family insured portfolio.

- **FHA must sufficiently monitor its Single Family property inventory.** FHA continues to improve Single Family property acquisition, management, and disposition; however, certain corrective actions remain to be completed.

- **FHA must continue to improve its process for preparing timely estimates and properly reporting credit subsidy adjustments.** During fiscal year 2001, FHA experienced a two-week delay in completing the Single Family Liability for Loan Guarantees (LLG) estimate. In addition, due to OMB's rejection of certain assumptions related to the fiscal year 1999 Single Family LLG credit subsidy re-estimate, FHA incorrectly initially reported a prior period adjustment to recognize the reduction of future credit subsidy. FHA subsequently corrected this issue for financial statement reporting purposes.

We also noted other matters involving internal control over financial reporting and its operation that we have reported to management of FHA in a separate letter dated January 31, 2002.

COMPLIANCE WITH LAWS AND REGULATIONS

The results of our tests of compliance with the laws and regulations described in the Responsibilities section of this report disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements.*

There are matters currently under investigation or which have been reported by the Office of the Inspector General or the General Accounting Office. Such matters include fraudulent activities, which have been perpetrated against FHA as disclosed in note 5 to the consolidated financial statements. However, the ultimate resolution of these matters cannot presently be determined.

RESPONSIBILITIES

Management's Responsibilities

The Government Management Reform Act (GMRA) of 1994 requires each federal agency to report annually to Congress on its financial status and any other information needed to fairly present its financial position and results of operations. To meet the GMRA reporting requirements, FHA prepares annual consolidated financial statements.

Management is responsible for:

- Preparing the financial statements in conformity with accounting principles generally accepted in the United States of America;
- Establishing and maintaining internal controls over financial reporting and performance measures; and
- Complying with laws and regulations.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies.

Auditors' Responsibilities

Our responsibility is to express an opinion on the fiscal year 2001 and 2000 consolidated financial statements of FHA based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and OMB Bulletin No. 01-02. Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit includes:

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

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

In planning and performing our fiscal year 2001 audit, we considered FHA's internal control over financial reporting by obtaining an understanding of FHA's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982. The objective of our audit was not to provide assurance on internal controls over financial reporting. Consequently, we do not provide an opinion on internal control over financial reporting.

As part of obtaining reasonable assurance about whether FHA's fiscal year 2001 consolidated financial statements are free of material misstatement, we performed tests of FHA's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 01-02. Additionally, our audit procedures were not designed to test the requirements of OMB Bulletin No. 01-02 relating to the Federal Financial Management Improvement Act (FFMIA) of 1996, which were not considered applicable at the FHA level. FFMIA requirements will be reviewed and reported at the HUD consolidated level. We limited our tests of compliance to the provisions described above, and we did not test compliance with all laws and regulations applicable to FHA. Providing an opinion on compliance with laws and regulations was not an objective of our audit, and, accordingly, we do not express such an opinion.

DISTRIBUTION

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

KPMG LLP

January 31, 2002

INTRODUCTION

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

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

The following section describes the material weaknesses and reportable conditions as of and for the year ended September 30, 2001, our recommendations, FHA management's response, and our assessment of that response. The full text of management's response is included as appendix B.

MATERIAL WEAKNESSES

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

1. HUD/FHA'S ADP SYSTEM ENVIRONMENT MUST BE ENHANCED TO MORE EFFECTIVELY SUPPORT FHA'S BUSINESS PROCESSES

For many years, weaknesses in FHA's financial management system environment have been reported. HUD/FHA'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 the existing ADP systems are updated, especially those related to financial processing, FHA would continue to collect and report data less efficiently. For example, FHA uses nineteen automated systems to process accounting data, which is then consolidated into the FHA general ledger system not only through certain system interfaces, but also through many manual data transfers and manual entry of journal vouchers. In addition, FHA's general ledger system has significant system control weaknesses that result in the system being in non-compliance with the Federal Financial Management Improvement Act of 1996 (FFMIA). FFMIA requires federal financial management systems and processes to comply with various federal system requirements, federal accounting standards, and the capability of the system to post transactions using the Standard General Ledger (SGL).

FHA plans to improve its financial systems processing environment by implementing a new subsidiary ledger system that will be FFMIA compliant. This new system has been planned for several years, but FHA has faced difficulties in its implementation. For example, during fiscal year 2001, due to contracting issues, FHA was required to re-compete the system implementation contract, resulting in a one-year delay in beginning the implementation. Initial implementation efforts, including the completion of the new general ledger posting models, are scheduled for completion during fiscal year 2003, and the system is scheduled for full implementation during fiscal year 2007.

Because the new FHA subsidiary ledger has not been implemented, FHA is still conducting day-to-day business with legacy-based systems, several of which directly impact FHA's financial activity and require financial transactions to be processed through non-integrated systems, necessitating significant manual analysis. For example, within Single Family operations, there are key systems, including the Single Family Mortgage Notes System, the Single Family Premium Collection System – Periodic (SFPCS-P), and the Single Family Acquired Asset Management System (SAMS), that are currently maintained in local databases that are not efficiently integrated with the FHA financial management process, thus elevating the level of manual processing needed to monitor this process and potentially reducing the overall reliability of data and efficiency of FHA personnel.

Similarly, within Multifamily operations there are various databases used to account for properties. These databases are not interfaced, elevating the potential for processing errors. For example, the Multifamily Insurance System (MFIS) and the Multifamily Insurance Claims System (MFIC) are not interfaced, which results in active properties remaining in the MFIS after a claim is filed. Delinquency reports are generated manually and therefore are subject to human error.

Because of the lack of integration between FHA systems, key FHA systems such as the Single Family Insurance System (SFIS), SFPCS-P, SFPCS-Up front (SFPCS-U), SAMS, the Single Family Mortgage Notes System, MFIS, MFIC, and the Cash Control Accounting and Reporting System (CCARS) do not provide the functionality required to sufficiently manage and account for financial transactions in accordance with FFMIA.

Recommendations to address the above continue to include:

1.a. The Deputy Assistant Secretary for Budget and Finance and the HUD OCIO should continue to consider the subsidiary ledger system project a high priority during its implementation and ensure that the implementation follows FFMIA requirements and HUD's System Development Life Cycle Methodology.

1.b. The Deputy Assistant Secretary for Budget and Finance should ensure that as part of the planned FHA subsidiary ledger project, all critical manual FHA financial processes are addressed during the gathering of user requirements.

1.c. The HUD OCIO should ensure that as the FHA subsidiary ledger project proceeds, the project system design and specifications are consistent with and reflected in the planned HUD IT enterprise architecture.

Management's Response

Management agrees with this finding and the associated recommendations. Further discussion, including the progress of planned initiatives, is included in management's response in appendix B.

KPMG's Assessment of Management's Response

We concur with management's response.

2. CONTROLS OVER BUDGET EXECUTION AND FUNDS CONTROL MUST BE IMPROVED

In prior years we noted that FHA has faced significant internal control issues in managing budgetary funds control. In fiscal year 2001 FHA determined that it had violated the Anti-Deficiency Act due to inappropriate funding allocations made in fiscal year 2000. This violation, coupled with the continuing existence of significant funds control system deficiencies, has renewed our consideration of this issue and its overall impact on the financial statements.

As described in *Building the Public Trust: A Report to Congress on FHA Management Reform*, dated January 2001, FHA noted that system and manual processes were placed into operation during fiscal year 2000 that improved the process for managing budgetary funds. For example, FHA performed a reconciliation of the Multifamily Insurance System and the Credit Subsidy Control System (CSCS), FHA's Multifamily insurance in force system and credit subsidy and related obligations system, respectively. FHA developed a Funds Control Database to compare certain expenditures to remaining budgetary authorities prior to disbursement. FHA also embarked on a project to design and document procedures related to funds control titled *FHA Funds Control Project Interim Process Report*, dated August 27, 2001.

Despite these improvements, during fiscal year 2001 we noted significant internal control issues that still need to be addressed. For example, FHA still does not have ADP financial systems and processes that are capable of fully monitoring and controlling budgetary resources. Manual processes in place include:

- FHA must manually compile the status of budgetary resources to prepare the SF-133, *Report on Budget Execution*, based on data in at least eight systems. For example, there is a significant amount of manual budgetary entries input into the general ledger system. The process of transferring financial data from CCARS into the general ledger system requires FHA accountants to extract data from CCARS, sort appropriation data in a PC spreadsheet, and then total the amounts and prepare journal entries for entry into the general ledger system. This process is also followed for other data systems used by HUD/FHA including those depicted below.

- FHA relies on manual reconciliation processes of non-integrated systems to assess whether there is available budgetary authority prior to obligating funds. For example, to determine remaining available budgetary authority, FHA must aggregate expended amounts from certain systems including the general ledger system, SAMS, and others.

- For these systems, KPMG noted that FHA performed only quarterly reconciliations of obligations incurred and apportionments to identify obligations. Cash disbursements from these systems are subject to varying levels of documented authorization. In addition, funds control functionality is lacking as follows:

System	***Approximate Funds Disbursed (in millions) in Fiscal Year 2001***	***Funds Control Edits Exist in ADP System***
CCARS	$317	Yes
SAMS	$247	No
CSCS / F47	$99	Yes
HUDCAPS	$97	Yes
PAS/LOCCS	$32	Yes

Also, the *FHA Funds Control Project Interim Process Report* procedures related to administrative contracts do not address the methodology and documentation to support the allocation of contract obligations among funds.

In accordance with OMB Circular A-34, Section 50.2, the purpose of funds control is to:

- Restrict both obligations and expenditures from each appropriation or fund account to the lower of the amount apportioned by OMB or the amount available for obligation and/or expenditure in the appropriation or fund account.

- Enable FHA's management to identify the person responsible for any obligation or expenditure exceeding the amount available in the appropriation or fund account, the OMB apportionment or reapportionment, the allotments of sub-allotments made by FHA, and statutory limitations, and any other administrative sub-division of funds made by FHA.

In addition, the Joint Financial Management Improvement Program (JFMIP) *Core Financial System Requirements*, dated February 1999, require agency core financial systems to support the budget execution process by:

- Providing the capability to compare actual amounts (e.g., commitments and obligations) against the original and revised budgeted amounts consistent with each financial planning level.

- Providing the ability to manage and control prior year funds in the current year, including the capability to identify prior year and current year de-obligations separately.

Therefore, an agency must have funds control to monitor and control the entire process. Such control mechanisms must account for all apportionments for each fund as well as the related allotments, obligations and disbursements.

As noted above, in fiscal year 2001, FHA determined that the potential anti-deficiency reported in fiscal year 2000 did occur, resulting in an Anti-Deficiency Act violation in the amount of $7.3 million, including interest, requiring a supplemental appropriation from Congress to cover the shortfall, as disclosed in the notes to the fiscal year 2001 financial statements. This issue would likely have been avoided if FHA had clear and formal policies related to the proper allocation of contracts to appropriate funding sources.

Lack of efficient integration among funds control systems requires the use of manual analysis and reconciliation and use of additional databases to collect and summarize funds control information, which subjects the process to control risk.

FHA is planning to implement a new JFMIP compliant FHA subsidiary ledger system that is intended to redesign the funds control processes. The first phase of implementation is scheduled to be completed during fiscal year 2003, at which time the new subsidiary ledger will post transactions at the SGL level and interface automatically with the HUD Departmental general ledger. Full implementation is targeted for fiscal year 2007, at which time the new subsidiary ledger is expected to interface directly with FHA operational systems.

Recommendation to address the above continue to include:

2.a. The Deputy Assistant Secretary for Finance and Budget should continue with plans to enhance budgetary and funds control processes through the implementation of the planned FHA subsidiary ledger system.

In addition, we recommend that:

2.b. The Deputy Assistant Secretary for Finance and Budget should consider implementing the functionality to account for obligational activity in the Funds Control Database as described in the Draft *FHA Control Database (FCD) User Guide,* dated August 29, 2000.

2.c. The Deputy Assistant Secretary for Finance and Budget should establish, document, and disseminate the allocation methodology used to obligate administrative contracts and the appropriate individuals authorization.

Management's Response

In its response, management does not agree with KPMG's determination that this matter should be reported separately from the first material weakness. Management believes that this material weakness is simply the result of the matters identified in the first material weakness. Further, while management recognizes that certain vulnerabilities continue to exist in FHA's funds control system; it has established compensating controls to adequately monitor funds control. Further discussion is included in management's response in appendix B.

KPMG's Assessment of Management's Response

We recognize that management has established compensating controls to address system vulnerabilities that exist, however, due to the lack of functionality in the Funds Control Database, FHA is currently not able to track material obligations as disbursements are made. This lack of functionality greatly increases FHA's risk of noncompliance or financial statement misstatement.

REPORTABLE CONDITIONS

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

3. HUD/FHA CAN MORE EFFECTIVELY MANAGE CONTROLS OVER THE FHA ADP SYSTEMS PORTFOLIO

In prior years, this reportable condition has been titled "FHA/HUD Must Enhance The Design And Operation Of Controls Over Information Systems Security And Application Integrity". Given the issues identified during the fiscal year 2001 financial statement audit, we have re-titled this matter to be more descriptive of the weaknesses noted.

HUD/FHA relies heavily on a complex ADP systems portfolio to process its large volumes of data. These systems not only process accounting data for functions including loan origination, servicing, and asset disposition, but also for sensitive cash receipt and disbursement transactions. Therefore, it is essential that FHA ensure that systems are adequately accounted for, properly controlled to prevent unauthorized access, and maintained in such a manner to help reduce data integrity and system continuity issues.

During fiscal year 2001, in response to prior year audit issues, HUD/FHA enhanced segregation of duties for MFIS, and reduced contractor access to sensitive SAMS reports. However, improvements are still needed in the areas of application security controls, application data integrity, ADP system portfolio management, and systems documentation.

Application security controls. Certain information security controls need improvement to provide HUD/FHA with a more secure ADP systems environment. These include continued enhancement of segregation of duties for key data processing functions, implementation of stronger access controls, and ensuring that security risk assessments are performed for key applications. Detailed examples of identified control weaknesses include:

- As reported in prior years, FHA Connection, an extremely sensitive Internet-based interface that allows lending institution employees to access mission critical HUD/FHA systems, has several areas where the information security controls should be improved. The system lacks a security risk assessment, as required by OMB Circular A-130, *Management of Federal Information Resources*. Such a risk assessment is important to ensure that all risks associated with the system are identified. HUD/FHA has had plans for several years to develop an FHA Connection risk assessment, but it has not been completed. We understand that risk assessment for FHA Connection is planned to be completed during fiscal year 2002.

Another area where FHA Connection controls can be enhanced relates to lender access. Currently, there is no requirement that users at lender sites change their passwords periodically, and there is no limit on the number of log in attempts a user can attempt before his or her FHA Connection account is disabled. These issues elevate the risk that unauthorized access attempts may not be identified, and could ultimately be successful. We understand that HUD/FHA plans to address these information security weaknesses during fiscal year 2002.

- As reported in prior years, the Real Estate Management System (REMS), a key FHA Multifamily application, lacks sufficient segregation of duties between key operational functions, such as data entry and transaction approval. FHA has been planning to enhance the controls in this area for several years, but has not done so. During fiscal year 2002, we understand that the Office of Multifamily Housing Programs is planning to enhance controls to assure that segregation of duties is improved for REMS.

- In addition, we noted the following FHA systems with information security weaknesses:

  - CCARS, for which we noted that the security plan does not contain accurate information on the use of system audit trails, and audit trails are not periodically reviewed. In addition, the FHA Cash Management Branch does not periodically review user access privileges to determine if the level of system access is appropriate. These issues are significant because there are 106 CCARS users, and because CCARS is used to manage the collection and disbursement of FHA funds.

  - Computerized Homes Underwriting Management System (CHUMS) has been declared a critical and sensitive application for FHA, because it supports FHA staff in the processing of Single Family insurance applications from initial receipt through endorsement. We noted that a comprehensive risk assessment of CHUMS has not been performed since 1994. As a result, there is substantial impact to FHA if CHUMS ADP security risks are not periodically reviewed, and any identified risks are not either corrected or mitigated through compensating controls.

  - Underwriting Reports System (URS), which is a vital system used by Single Family Homeownership Center (HOC) personnel and Post Endorsement Technical Review (PETR) contractors as a quality control to monitor the underwriting performance of lenders with direct endorsement authority. We noted that passwords are optional for URS, and when passwords are used, they only consist of user initials. Effective access controls for URS are not only critical from the perspective of ensuring data integrity and processing security, but also from the perspective of complying with the Privacy Act of 1974, which requires agencies to implement sufficient safeguards to ensure the security and confidentiality of individual records. URS contains sensitive information, such as FHA borrower names and addresses, and results of lender reviews, so unauthorized access to URS could subject FHA to Privacy Act compliance issues.

- CSCS, which is used to control the reservation and obligation of positive credit subsidies for Single Family and Multifamily mortgages, has information security weaknesses. For example, CSCS is maintained on one computer in FHA's Funds Control Division (FCD), and all six employees within FCD know the password to CSCS. In addition, CSCS lacks several key information security related documents, including a system security plan and a management accreditation statement.

Establishing and maintaining effective information security controls is not only good business practice, but also mandated by the Government Information Security Reform Act of 1999 (GISRA), FFMIA, and several OMB policies (Circulars A-127, *Financial Management Systems*, and A-130). Collectively, these regulations and policies require that federal agencies develop and implement effective information security policies, procedures, and control techniques. Although many FHA systems operate on HUD platforms, and therefore are subject to HUD managed information security controls, the FHA systems identified above do not operate on HUD systems. Consequently, the identified information security control weaknesses should be addressed by FHA. However, HUD's state of information security controls does contribute to overall HUD/FHA security weaknesses. For example, key FHA systems, such as CHUMS, operate on HUD controlled mainframes, and as noted by the HUD Office of Inspector General (OIG) during fiscal year 2001, HUD's mainframe security controls are not adequate to provide assurance that computer resources are protected from unauthorized access.[1] HUD management has stated that correcting such vulnerabilities is a high priority.[2]

Application data integrity. Application data integrity controls should be improved to ensure that financial data being relied upon by HUD/FHA management is complete and accurate. The various non-integrated manual processes used to process FHA financial and operational data increase the opportunity for poor data quality. HUD/FHA recognizes that it has data integrity weaknesses, and has taken steps to address the issue. During fiscal year 2000, HUD/FHA launched an enterprise-wide data cleanup initiative, the Data Quality Improvement Program (DQIP). Two priorities for this effort were to develop and implement plans to improve data integrity for several FHA systems, including SAMS and REMS. Although DQIP

[1] Audit Memorandum - Annual Evaluation of HUD's Security Program and Practices, September 6, 2001 (01-DP-0802)

[2] HUD's Government Information Security Reform Act Annual Review Report for the Department of Housing and Urban Development, September 18, 2001

helped make improvements during fiscal year 2001, data integrity weaknesses continue to exist. For example:

- SAMS - During fiscal year 2001, HUD/FHA's data quality review of SAMS noted several system data integrity weaknesses, many of which related to the lack of sufficient system edit and validation routines.

- REMS - During fiscal year 2001, the HUD OIG reported that despite HUD/FHA's DQIP efforts, REMS data integrity efforts could still be enhanced.[3] Issues identified by the OIG included several significant data elements where REMS data did not meet designed business rules. REMS data integrity is critical for FHA, as the system is used to account for multifamily housing projects, and significantly affects management decision making and reporting.

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

- URS, which is used for key aspects of Single Family lender monitoring, consists of separate databases at each of the four Single Family HOCs. FHA management considers URS a part of the CHUMS processing cycle, but URS is not documented as part of the CHUMS security plan, is not integrated with CHUMS, lacks system change procedures and controls, and lacks sufficient access controls, as noted earlier in this report.

- CSCS, which is used to control the reservation and obligation of positive credit subsidies for Single Family and Multifamily mortgages, is in operation but no longer supported by either FHA or the HUD OCIO. CSCS also has information security weaknesses that can be attributed to the lack of sufficient support for the system. In addition, CSCS lacks several key information security related documents, including a system security plan and a management accreditation statement.

- MFIC sub-system (identified as F75A), which is used to create journal entries for the FHA general ledger, was created because the existing multifamily insurance claims system environment did not offer the functionality needed to prepare journal entries. Despite this apparent necessary functionality, the sub-system is no longer supported by the HUD OCIO because it is hosted on a FoxPro database platform.

Systems documentation. Several FHA systems, including SAMS, CSCS, CCARS, and MFIC lack system documentation supporting current operations. This is important for HUD/FHA, not only to assist in the day to day operation and management of systems, but also because HUD out-sources many ADP functions, and

[3] Audit Report of the Real Estate Management System (REMS), September 28, 2001 (2001-DP-0003)

with planned system enhancements in the areas of financial processing (e.g., FHA subsidiary ledger), detailed documentation supporting current system processing will be critical. In addition, many HUD/FHA personnel knowledgeable about the HUD/FHA systems environment could be eligible for retirement in the near future; so having well documented systems is a critical aspect of system continuity.

The issues identified above also raise concerns about HUD/FHA's ability to comply with the Clinger Cohen Act of 1996, OMB Circular A-130 policies, and HUD's Information Technology Capital Planning Guidelines. In addition, addressing the above systems control weaknesses is critical for HUD/FHA's existing systems portfolio, and to control processes for FHA's future systems portfolio. For example, HUD's February 2001, *Electronic Government Strategic Plan* includes an eHUD strategic initiative to implement paperless FHA insurance processing. Such initiatives cannot be effectively implemented without well-controlled ADP management processes.

We recognize that information security controls for FHA operations cannot be implemented solely by FHA, as FHA applications in many cases are hosted on HUD mainframe systems. However, the information security weaknesses we discuss here relate to application security, which is managed by system owners, such as FHA, as opposed to mainframe platform security, which is managed by the HUD OCIO. For example, CHUMS operates on a HUD mainframe, and security is controlled by HUD. However, URS, which is an application considered a part of CHUMS, is operated at the HOCs by FHA system owners, so information security for URS would be the responsibility of FHA.

Recommendation to address the above include:

3.a. The Deputy Assistant Secretary for Budget and Finance should ensure that application security controls are enhanced to provide assurance that segregation of duties are improved for REMS, and that information security access controls are enhanced for CCARS, FHA Connection, CSCS, and URS.

In addition, we recommend that:

3.b. The HUD OCIO should ensure that as part of the Department's overall information security program, risk assessments are conducted for CHUMS and FHA Connection.

3.c. The HUD OCIO should continue managing the Department's data quality improvement program, to include the issuance of data management guidelines and standards that are consistent with the planned IT enterprise architecture.

3.d. As data quality standards are defined and issued by the HUD OCIO, the Deputy Assistant Secretary for Budget and Finance should continue coordinating with the HUD OCIO on the data quality improvement program for FHA systems. This will help ensure that FHA data integrity issues are addressed as a coordinated effort rather than on an application-by-application basis.

3.e. The Deputy Assistant Secretary for Budget and Finance and the HUD OCIO should coordinate to ensure that as FHA systems are developed (e.g. URS), or as existing FHA systems are no longer supported, adequate system controls are still given sufficient priority. Examples of systems that this is applicable for include URS, CSCS, and the MFIC sub-system.

3.f. The Deputy Assistant Secretary for Budget and Finance and the HUD OCIO should coordinate to ensure that systems documentation be completed for key FHA systems that have outdated or incomplete documentation. In addition, as new systems are implemented, completion of systems documentation should be a priority. Specifically:

- The Deputy Assistant Secretary for Budget and Finance should ensure that documentation related to FHA system user requirements and business processes are developed and maintained; and

- The HUD OCIO should ensure that documentation related to technical system specifications and interfaces is completed and maintained, and consistent with the planned department enterprise architecture.

Management's Response

Management agrees with this finding and the associated recommendations. Further discussion, including the progress of planned initiatives, is included in management's response in appendix B.

KPMG's Assessment of Management's Response

We concur with management's response.

4. FHA MUST PLACE MORE EMPHASIS ON MONITORING LENDER UNDERWRITING AND CONTINUE TO IMPROVE EARLY WARNING AND LOSS PREVENTION FOR SINGLE FAMILY INSURED MORTGAGES

During fiscal year 2001, FHA continued to make progress in improving its ability to monitor its insured portfolio. However, the economic downturn is increasing the credit risks in the existing portfolio and in new endorsements. To control these risks and minimize losses, FHA needs to ensure that it is not insuring poorly underwritten loans and is promptly identifying and taking action on delinquent loans.

FHA needs to further increase its use of automation in underwriting, processing endorsements, and loss mitigation. The mortgage industry is developing automated tools in all aspects of the mortgage lifecycle at an increasing pace. These automated tools can ease the burden of creating and handling the numerous paper documents that characterize the traditional mortgage origination and servicing processes. With less paper to process and the better analytical functions that are being built into the new automated tools, management and staff are able to better control their processes and focus their attention on important risks.

Proper underwriting standards and the diligent application of those standards are FHA's first line of protection against undue credit risk. Over 95% of FHA's Single Family endorsements are initiated by HUD-approved Direct Endorsement lenders. FHA relies on the quality of the underwriting performed by these Direct Endorsement lenders. To test the quality of the underwriting, contractors perform post-endorsement technical reviews (PETRs) on 10% of the endorsements and the Homeownership Centers (HOCs) perform quality assurance reviews (QARs) on 5-10% of the PETRs. We found that the effectiveness of these controls over loan underwriting could be improved as evidenced by:

- The contracts for the PETRs require the contractors to be 90% accurate in their underwriting assessments, but our testing of the QAR results in three of the four HOCs showed disagreement with the contractors' ranging from 17% to 53%.

- Based on our review of the PETR process, we noted that there were no formal procedures in place regarding the communication of PETR results to the lenders, except for quarterly reports sent to the lenders from Headquarters for informational purposes only. This has led to inconsistencies among the HOCs application of this control process. For example, each HOC has developed its own procedures ranging from sending deficiency letters to lenders on a discretionary basis to issuing letters to underwriters with nine or more "poors" during a quarter and sending a copy of the letter to the lender.

The lack of control effectiveness noted above is reflected in the percentage of loans rated as poor by the PETR process. Our review of the PETR results shows that for all HOCs the percentage of poorly rated loans ranged from 10% to 44% related to the adequacy of the underlying appraisal and 19% to 86% related to the borrowers' credit worthiness. It appears that the HOCs do not fully rely on the PETR reviews and results as they are not sending the Direct Endorsement lenders the specific and timely underwriting feedback that the PETR reviews could provide. OIG audit reports dating back to 1993, as well as our previous reports, have included concerns about the PETR process.

The next line of defense against undue credit risk is the timely identification of lenders with underwriting problems and poorly performing loans. Above average early default rates are a key element in this effort. Potential problem loans and lenders must be identified before FHA can institute loss mitigation techniques and lender enforcement measures to reduce claims and losses.

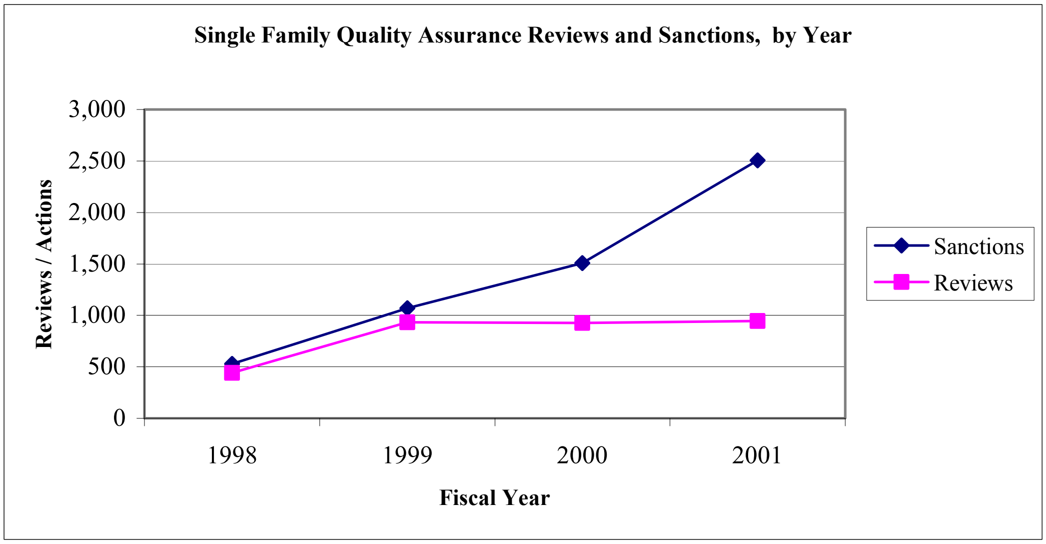
The Office of Single Family Housing continues to improve its early warning and loss prevention processes. These improvements include the following:

- **Appraisal reform.** In fiscal year 2001, HUD's Real Estate Assessment Center (REAC) implemented its Single Family Appraisal Subsystem (SASS), which uses specified indicators to statistically identify appraisals for review. As of January 2002, plans were underway to revise SASS's approach for identifying field reviews. While the current approach focuses on the appraisals, the new approach will be more risk-based in an effort to target appraisers. No additional field reviews will be performed until the new approach is implemented. FHA also increased its enforcement authority against poorly performing appraisers by employing the Single Family Appraiser Roster Removal Procedures and Appraisal Quality Assessment (AQA) system for appraisal field reviews.

- **Neighborhood Watch and Credit Watch fully implemented.** Through Neighborhood Watch and Credit Watch, every three months, FHA systematically reviews every participating lender branch's early default and claims rates, and suspends the most inferior and advises the marginal to improve. The Neighborhood Watch system was made public during fiscal year 2000. As of December 2001, additional components have been added to the public view such as Credit Watch Termination Status and effective dates, case status, and loan details.

- **Single Family enforcement actions increased.** During fiscal year 2001, the four HOCs performed 946 lender monitoring reviews, nearly three times more than three years ago. HUD has a variety of enforcement actions it can take with regard to lender violations. These include "Letters of Reprimand," "Settlement and Indemnification Agreements," and the "Suspension" or "Withdrawal of Mortgagee Approval." As shown in exhibit 1, the total number of quality assurance sanctions has steadily increased in recent years. These quality assurance reviews resulted in approximately 2,500 corrective actions against lenders, including indemnifications and referrals to the Mortgagee Review Board, the Office of Inspector General, and the Departmental Enforcement Center for further investigation or administrative sanctions.

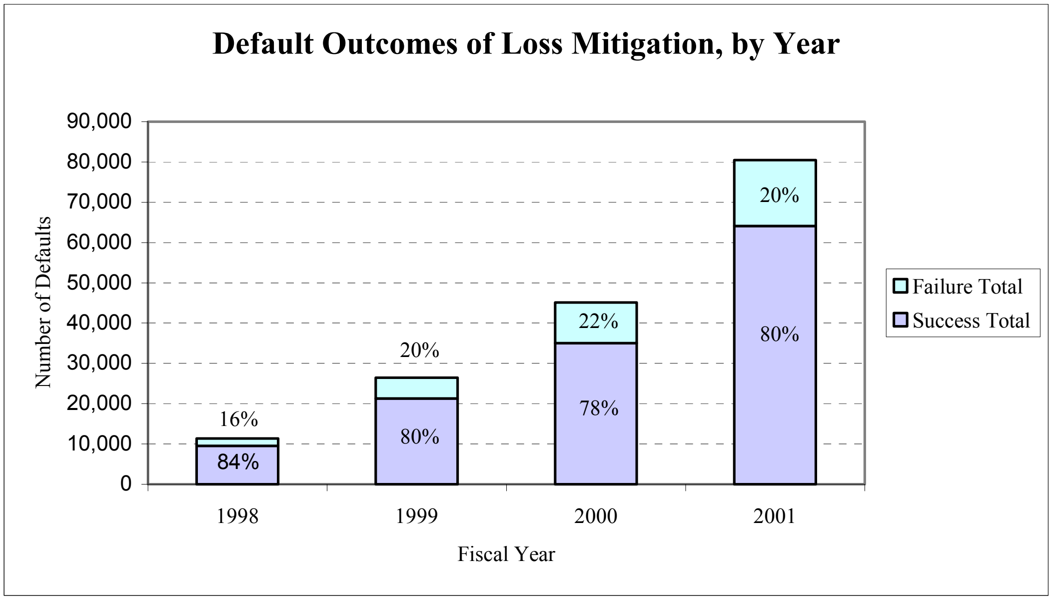
Exhibit 1



Source: Single Family Quality Assurance Fiscal Year 2001 Activity Reported, as of September 30, 2001 (Quality Assurance Division)

- **Use of loss mitigation continues to expand.** As depicted in exhibit 2, the performance of the loss mitigation program has increased substantially in the past four fiscal years. In fiscal year 2001, through use of loss mitigation tools available to lenders, FHA has provided more than 50,000 borrowers an alternative to foreclosure. A lender training program combined with increased monitoring of lender participation are the key drivers in the program's acceptance. In addition, FHA is currently in the process of developing an Accelerated Claims Disposition Program under Title VI, Section 601, of the Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriations Act, 1999 for the purpose of expediting the claims disposition process.

Exhibit 2



Source: Single Family Default Monitoring System

- **Perform post-claim reviews.** On September 29, 2001, FHA awarded a new contract for conducting post-claim reviews. The contractor is required to examine loss mitigation claims as well as full claims during its on-site reviews of mortgagees. In addition, broad oversight of lenders' compliance with loss mitigation requirements is mandatory under the servicing review contract. These reviews provide significant feedback to the lenders regarding their adherence to program requirements. During the period from May 2000 to April 2001, over 200 reviews were conducted that resulted in a receivable of over $5 million.

- **Development and implementation of REAC's Lender Assessment Subsystem (LASS).** During fiscal year 2001, FHA continued it's development of LASS, and in October 2001, LASS became available for lenders to use on a voluntary basis. LASS is a subsystem of the REAC that will automate and improve the process of capturing annual, audited financial and program compliance data for FHA-approved non-supervised lenders. Through this analysis, FHA will be able to identify potential problem lenders, and take actions to ensure that these lenders do not cause increased losses to the insurance fund. A proposed Rule making use of the sub-system mandatory for all FHA-approved lenders was issued on November 30, 2001 with a sixty-day comment period.

- **Implement triple claim legislation.** To discourage lenders from failing to consider the use of loss mitigation for defaulted loans, a penalty provision, calculated as three times the amount paid on the mortgagee's insurance claim, was enacted as Section 601(f) of the 1999 Appropriations Act. In December 2000, HUD/FHA issued Treble Damages for Failure to Engage in Loss Mitigation; Advance Notice of Proposed Rulemaking to solicit public comment on the implementation of the triple claim legislation. As a result of this notice, in fiscal year 2001, FHA modified the approach and is now preparing to issue a proposed rule.

All of these improvements put FHA in a better position to limit the losses on the defaulting insured loans. However, with delinquency rates at high levels and expected to rise in the current economic environment, FHA will need to better ensure the quality of the loans it insures. Increased emphasis on underwriting controls could also reduce the fraud and "flipping" risks that FHA and OIG have reported in several programs including the Section 203(k) rehabilitation loan program, Officer and Teacher Next Door program and nonprofit organizations' participation in Single Family programs.

Recommendations to address the above continue to include:

4.a. The Deputy Assistant Secretary for Single Family Housing should implement better analytical tools to identify problem loans and sub-standard lenders. For example, collect 30 and 60-day delinquency information on Single Family insured mortgages and use post-origination loan scoring, like Freddie Mac's "Early Indicator", to predict problem loans so that loss mitigation can begin earlier.

4.b. Continue with plans to implement LASS to automate and improve the process of capturing annual audited financial and program compliant data for FHA approved non-supervised lenders.

In addition, we recommend that:

4.c. The Deputy Assistant Secretary for Single Family Housing should implement more automated processes in the underwriting, endorsement processing and loss mitigation areas. Automated underwriting and property valuation systems speed the origination process, reduce the need for paper documentation, and reduce fraud risk by using independent information sources like credit bureaus. They also provide the opportunity to use workflow management to improve efficiency.

4.d. The Deputy Assistant Secretary for Single Family Housing should improve the performance of PETR contractors and provide more timely feedback to the lenders on the results of the PETR reviews. The HOCs should increase their QAR reviews and use the results of those reviews to provide specific feedback to the PETR contractors on their performance. The objective of the QAR reviews should be to ensure that the PETR contractors are performing their reviews at the same level of quality as the HOCs' own underwriters. Once the quality of the PETR reviews has reached this standard, the PETR review results could be sent directly to the lenders as well as to the HOCs.

Management's Response

Management agrees with this finding and the associated recommendations. Further discussion, including the progress of planned initiatives, is included in management's response in appendix B.

KPMG's Assessment of Management's Response

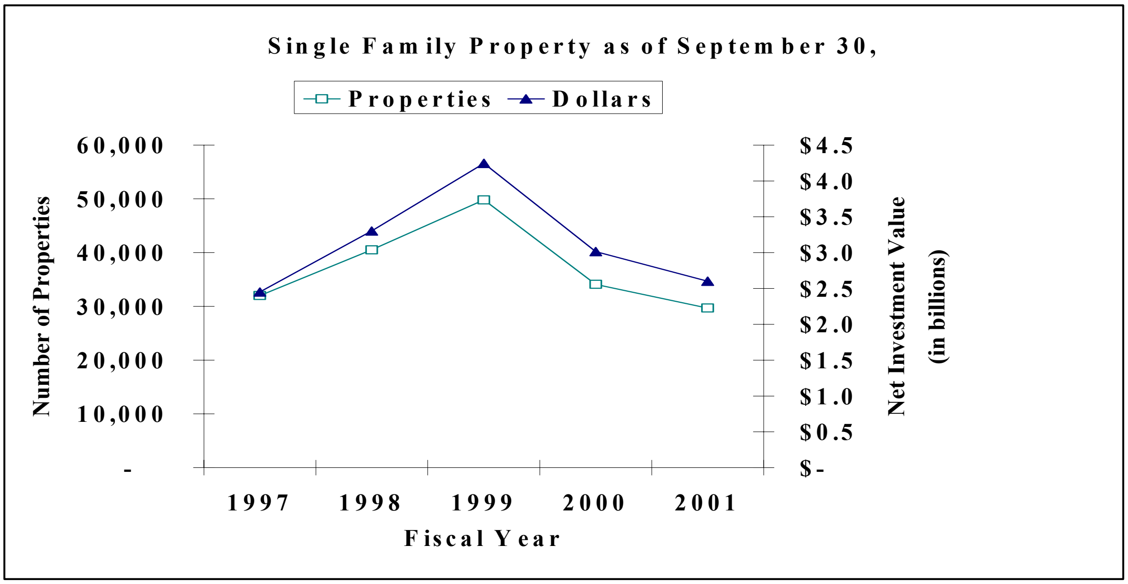
We concur with management's response.

5. FHA MUST SUFFICIENTLY MONITOR ITS SINGLE FAMILY PROPERTY INVENTORY

During fiscal year 2001, we continued to observe conditions relating to the Single Family property portfolio that need to be improved to maximize the return to FHA while preserving and protecting these properties. FHA has realized successes from its Management and Marketing Contracts (M&M) including:

- FHA's Single Family property inventory decreased from 36,000 in fiscal year 2000 to 29,000 properties in fiscal year 2001, a decrease of 20 %.
- The total net investment value was $2.6 billion at September 30, 2001, a decrease of $.4 billion as compared to September 30, 2000, as shown in exhibit 3.
- Aged inventory over 180 days decreased from 10,300 properties in fiscal year 2000 to 7,000 properties in fiscal year 2001, a decrease of 32 %, although the sales of aged inventory resulted in decreasing returns as a percent of appraised value.

Exhibit 3



Source: Single Family Acquired Asset Management System

Despite these improvements, we found that the monitoring and performance of the M&M contractors tasked with managing and selling properties continues to need improvement.

The responsibilities associated with daily Single Family Secretary-owned property operations are performed by M&M contractors. The M&M contractors are responsible for the management, operations, repairs, maintenance, rental, and sale of Single Family properties.

Oversight of M&M contractors is performed both at the HOCs and at Headquarters. Each month, contract Government Technical Representatives (GTR) prepare an assessment report for each M&M contractor in each contract area. This performance assessment summarizes results of case file reviews by third-party contractors, Special Property Inspector (SPI) physical inspections, and HOC staff on-site observations.

We reviewed a sample of the monthly assessment reports and noted that follow up related to deficiencies reported in the M&M contractor monthly assessment report could be improved. The review of a sample of monthly assessment reports indicates that in 60 % of the performance reports reviewed there was no evidence of follow up on deficiencies that were identified in the report. In addition, FHA's quality control review of the contractors tasked with reviewing the M&M contractors was inconsistent. Some HOCs were performing less than the required 10% of quality control reviews while others were not performing their quality control reviews at all. Without adequate monitoring of their M&M contractors, FHA increases its risk of losses related to the REO properties, which results in lower recovery rates.

HUD's OIG also issued a report during fiscal year 2001 that identified the need for one of the HOCs to strengthen its M&M contractor monitoring and follow-up procedures. These procedures need to be strengthened to ensure that significant and recurring M&M contractor performance deficiencies (i.e., poor inspection, maintenance, and repair of REO properties) identified in prior audits and by third party contract monitors are reported and more closely monitored and tracked.[4]

Recommendations to address the above continue to include:

5.a. The Deputy Assistant Secretary for Single Family Housing should enhance, as appropriate, comprehensive oversight tools used and management reports issued by the HOCs to facilitate effective monitoring of the M&M contractors, while improving the timelines of complete feedback to both the M&M and quality assurance review contractors.

5.b. The Deputy Assistant Secretary for Single Family Housing should continue with plans to use risk-based sampling to select case files for review as part of the oversight process.

5.c. While these reports and tools should be utilized to identify M&M contractor performance issues, the Deputy Assistant Secretary for Single Family Housing should also continue to implement incentives and disincentives to the contractors. Such a mechanism will effectively communicate the importance of adhering to HUD guidelines.

Management's Response

Management agrees with this finding and the associated recommendations. Further discussion, including the progress of planned initiatives, is included in management's response in appendix B.

KPMG's Assessment of Management's Response

We concur with management's response.

6. FHA MUST CONTINUE TO IMPROVE ITS PROCESS FOR PREPARING TIMELY ESTIMATES AND PROPERLY REPORTING CREDIT SUBSIDY ADJUSTMENTS

[4] Philadelphia Homeownership Center's (HOC) Single Family Disposition Activities, June 14, 2001 (Audit Memorandum No. 2001-PH-0803).

The potential future losses related to FHA's central business of providing mortgage insurance are accounted for in the financial statements in the Liability for Loan Guarantee (LLG) and Loan Loss Reserve (LLR) as required by Statement of Federal Financial Accounting Standards (SFFAS) No.2, *Accounting for Direct Loans and Loan Guarantees*. This liability is comprised of both liquidating and financing accounts. Since fiscal year 1998, FHA has made significant progress in developing documentation and refining the processes for estimating and accounting for the LLG.

However, during fiscal year 2001, in an effort to reduce any discrepancies between the assumptions used for the LLG and those used for credit subsidy estimation, FHA experienced a two week delay in completing the LLG estimate for the Single Family program. The delay was due primarily to differences in judgment between OMB and FHA management concerning certain assumptions FHA was using to calculate the LLG estimates. Although these differences in judgment were resolved for the Single Family LLG assumptions, FHA and OMB did not resolve all assumption issues for the Multifamily LLG. Because differences continue to exist between FHA and OMB related to certain assumptions included in the Multifamily LLG, a difference results between the estimated liability reported in the financial statements and the related credit subsidy estimate ultimately approved by OMB and reflected in the President's budget. This difference is further described in the notes to FHA's fiscal year 2001 financial statements.

In addition, OMB differed with certain Single Family LLG credit subsidy re-estimate assumptions FHA management used in fiscal year 1999. FHA incorrectly originally reported the effect of this difference as a prior period adjustment in the fiscal year 2001 financial statements, to recognize the reduced credit subsidy to be received. Under current accounting guidance regarding accounting changes, the subsequent reduction of credit subsidy due to OMB's rejection of the credit subsidy estimate does not constitute an error and should not be reflected in the financial statements as a prior period adjustment. FHA subsequently corrected this issue for financial statement reporting purposes.

We recognize that OMB's judgment regarding the credit subsidy estimate assumptions is not within the control of FHA's management and that there is no specific accounting guidance available to federal agencies on how to account for and disclose these differences, particularly when OMB has rejected the entity's LLG estimate. However, as a significant part of the financial reporting internal control process, timely completion and review of these liability estimates is critical if FHA is to prevent material errors from occurring in the financial statements.

Recommendations to address the above include:

6.a. The Deputy Assistant Secretary for Finance and Budget should implement a process to complete resolution of the LLG liability estimation process within 60 days after year end.

6.b. As an interim measure, the Deputy Assistant Secretary for Finance and Budget should develop and adopt an accounting and reporting policy relating to differences that exist between the budget estimates approved by OMB and the amounts reported in the financial statements.

6.c. Since OMB's approval process and potential rejection of credit subsidy estimates is an issue affecting not only FHA, but all federal agencies, the Deputy Assistant Secretary for Finance and Budget should consider presenting this issue to the Federal Accounting Standards Advisory Board (FASAB) with the purpose of establishing formal guidelines regarding the appropriate accounting treatment and disclosure of differences between financial statement amounts and budget estimates arising under these circumstances.

Management's Response

In its response, management does not agree with KPMG's assessment on FHA's process for preparing timely estimates and properly reporting credit subsidy adjustments. It recognizes KPMG's concerns about the re-estimate process and the timeliness of those estimates; however, management does not believe that the lack of timeliness and FHA's initial incorrect accounting treatment related to OMB's credit subsidy adjustment qualifies as a reportable condition. Management cites that it has no control over timelines set by OMB or OMB's judgment regarding the credit subsidy assumptions. Management also believes that the accounting treatment applied to reflect OMB's rejection of certain assumptions related to the 1999 credit subsidy re-estimate was a matter of professional judgment. Further discussion is included in management's response in appendix B.

KPMG's Assessment of Management's Response

We understand that the issues surrounding the OMB credit subsidy re-estimate process affect all federal credit agencies, however, the LLG estimation process and the credit subsidy re-estimate process are the most critical processes affecting FHA's ability to accurately and timely report financial information. We believe that FHA must develop specific accounting policies based on clear accounting guidance specifically related to this issue. Without this guidance, FHA and all other federal credit agencies run the risk of inconsistently applying accounting principles in this area.

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

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

MEMORANDUM FOR: KPMG LLP

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

SUBJECT: Response to KPMG's Fiscal Year 2001 FHA Audit Report

I am pleased to present FHA's responses to your January 31, 2002, audit report on the fiscal year 2001 FHA financial statements prepared under generally accepted accounting principles.

General Comments

We are pleased that KPMG has noted progress in many areas; however, we believe the extent of these improvements has not been adequately reflected in the internal control report. FHA recognizes that certain control weaknesses exist in its structure, mostly due to the inadequacy of its outdated financial management systems; however, FHA is taking aggressive action to correct these weaknesses in the long term as well as the short term.

The new material weakness identified in your audit report addresses the need for FHA to improve controls over budget execution and funds control. FHA has made many improvements in this area over the past year. We agree that funds control at FHA can and must be improved. FHA is addressing this issue through the financial systems enhancements we are implementing to address the material weakness you previously identified on the need for improvements in FHA's ADP environment to more effectively support FHA's business processes. The new material weakness identified in your current report is simply the result of the problems identified in the ADP weakness. We do not believe that KPMG has presented adequate support for a new and separate material weakness on funds control. Both material weaknesses require implementation of the FHA core financial system as their ultimate corrective action and we are working diligently to make sure this is accomplished as quickly as possible.

The new reportable condition on improving FHA's process for preparing timely estimates of credit subsidy is unrealistic for FHA to achieve on its own. Although FHA recognizes the problems associated with timely delivery of audited financial statements and the timing of the credit subsidy re-estimates for the President's budget, this is a government-wide problem and FHA should not be held solely responsible. FHA has done and will continue to do everything within its means to meet the requirements of its auditors, GAO, and OMB.

During this past fiscal year, FHA continued to focus its efforts on addressing management deficiencies and improving its overall business operations. While this report cites two material weaknesses and four reportable conditions, FHA has made major strides in addressing management deficiencies and has demonstrated its ability to function effectively. Addressing these challenges will continue to receive priority attention as FHA strives to achieve its goal of becoming a high performing, results oriented organization that delivers quality products and services that meet family and community needs.

Report on Internal Controls – Material Weaknesses

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

FHA agrees with this finding and the associated recommendations.

New FHA Core Financial System

We acknowledge the need for modernization of FHA's financial systems and operations and have developed plans for a new core financial system. FHA's *Blueprint for Financial Management Systems* defines our program to implement JFMIP-compliant commercial-off-the-shelf software that will support our core financial management functions. The program will integrate and consolidate FHA insurance systems with the new core financial system. We have organized the program in phases with intermediate milestones over a five-year period in order to control scope and limit risk.

Key objectives of the *Blueprint for Financial Management Systems* include:

- Implement U.S. Standard General Ledger (SGL) and credit reform accounts in the FHA general ledger;
- Implement automated funds control processes using the FHA general ledger;
- Automate FHA's interface with HUD's departmental general ledger;
- Produce FHA financial statements and regulatory reports directly from the FHA general ledger;
- Enhance FHA cash accounting and Treasury reconciliation with automated support from the integrated financial management system;
- Enhance FHA contract accounting with automated support from the integrated financial management system; and
- Eliminate manual accounting processes and improve integration of FHA financial and program systems.

When we achieve these objectives, we will have brought FHA into compliance with the requirements of FFMIA and other laws and regulations affecting financial systems.

During fiscal year 2001, FHA created a project team and worked to acquire contractor support to continue and complete the project. The project team updated project plans and other documents required for the Initiate Phase of HUD's System Development Methodology, which the Office of the Chief Information Officer (OCIO) reviewed and approved. The project team also coordinated plans with OCIO to include FHA's new core financial system in HUD's enterprise architecture. We also completed the Define Phase of HUD's System Development Methodology for implementation of the general ledger module, planned for October 2002. FHA will continue to follow relevant OMB guidance, HUD's Systems Development Methodology and HUD's enterprise architecture plan throughout the program.

In preparing the Define Phase documents for the new general ledger, we reviewed all of the critical business processes required to support FHA's accounting functions and identified the automated and manual processes that the new system will require. During fiscal year 2002, we plan to complete the system specifications and detailed user procedures necessary to implement these processes with the general ledger module. FHA will continue to address all critical manual FHA financial processes throughout the program.

2. Controls Over Budget Execution and Funds Control Must Be Improved

FHA does not agree with this finding and associated recommendations. Although FHA recognizes that certain vulnerabilities exist in its funds control system, FHA has established compensating controls to adequately monitor funds control. The vulnerabilities that exist can only be resolved with the implementation of the new general ledger software package; however these vulnerabilities can be mitigated through compensating controls. FHA has implemented such controls in the past and continues to enhance these interim measures as experience dictates. In the interim, FHA has developed, and will continue to enhance, compensating controls to address funds control. FHA believes that both of the material weaknesses are interrelated and should not be separate.

We agree funds control at FHA can and must be improved, but that is why we need the system actions recommended in the first material weakness. The second material weakness is simply the result of the first weakness and not a separate weakness as KPMG has presented it. Therefore, neither material weakness can be corrected until implementation of the new FHA core financial system.

The first recommendation requests FHA to consider implementing the functionality to account for "obligational activity" in the Funds Control Database. FHA concurs, in principle, with the recommendation to add functionality to the funds control database. The funds control database does account for most activity on an obligation basis, in that the majority of FHA's disbursements (claims, property disposition) are obligated and disbursed at the same time. However, to account for all obligations and be able to match disbursements against obligations would be difficult. Given current operating processes at FHA and database constraints, the recommended modification would require extensive changes in the operating processes and costly system enhancements for the short run. Given the efforts and resources directed towards implementation of the general ledger software package, these enhancements would not be cost effective. FHA will explore additional options to improve funds control in the short term. FHA will begin preparing monthly reports for management that reconcile obligations incurred with apportionment line items. These reports, which are currently prepared quarterly, will be used as a compensating control to the funds control database. By increasing the frequency of the reports, FHA will be able to ascertain spending patterns and will be better prepared to request re-apportionments.

FHA is already in the process of documenting the current allocation methodology used to obligate administrative contract funds. FHA proposes issuing a memo at the beginning of each fiscal year informing Housing personnel involved in the procurement process of the most appropriate allocation methodology for the coming year. This will show the distribution of funding sources among the various FHA activities: Housing-FHA contracts, FHA property disposition, Salaries & Expenses, and program funds. Additionally, a form which establishes the source of funds for each procurement action will be included in each procurement package.

In summary, FHA continued to keep funds control as a priority during fiscal year 2001. FHA remains committed to implementing its new financial management system that will facilitate increased funds control. FHA will also implement additional compensating controls in fiscal year 2002. Further, FHA will continue managing interim controls and processes that include the following:

- Maintain the Funds Control Database
- Continue routine credit subsidy reconciliations
- Confirm and review the ending balance of undelivered orders
- Enhance staff budgetary accounting exposure and knowledge

Reportable Conditions

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

FHA concurs with this finding and associated recommendations.

With regards to the first recommendation (3.a.) FHA concurs and has the following additional comments:

> **REMS**: For the REMS System, a memorandum will be issued to field offices in fiscal year 2002 requiring the segregation of duties for the system.
>
> **FHA Connection**: FHA implemented a major enhancement to the FHA Connection. This enhancement improved our ability to deliver timely customer service to lenders by providing them with on-line access to case detail via the Internet. The enhancement provided several new reports, as well as, an on-line help module. For the FHA Connection, a risk assessment is underway and is expected to be completed in the 2nd quarter of fiscal year 2002.

FHA will ensure that data integrity issues are addressed under the Data Quality Improvement Program as suggested in the second recommendation.

> **SAMS**: OCIO is working with Housing to tighten up the business rules and confirm that the revised rules will result in zero or minimal errors. SAMS will be tested and certified in fiscal year 2002. Actions are complete for the SAMS System.
>
> **REMS**: FHA will review the items identified in the OIG report and make necessary changes.

With regards to the third recommendation, all Housing systems are included in the IT capital planning process. URS is a reporting function within CHUMS, which is covered by the IT capital planning process. The item referred to, as the "MFIC sub-system" is a desktop utility using the HUD Enterprise Architecture standard Office Automation tools to replace a previously manual process performed with paper and a calculator. The CSCS is also a utility using the HUD Enterprise Architecture standard Office Automation tools.

As part of the Business Process Improvement (BPI) efforts, Housing will evaluate appropriate integration of such utilities into the related business systems. The planning for the FHA Subsidiary Ledger includes assessment of the funds control functionality of CSCS.

FHA concurs with the fourth recommendation (3.d.). As an overall effort, Housing is performing a review of documentation for all major Housing systems, including legacy systems. The review covers 34 systems and addresses the appropriate documentation requirements of OMB circulars A-127 and A-130. The report will be completed in February 2002. An initiative will then be started to procure support services to address weaknesses identified in the report.

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

FHA concurs with this finding and associated recommendations.

With regards to the first recommendation, FHA's Office of Single Family already has efforts currently underway to incorporate better analytical tools to identify problem loans. For example, Single Family contracted with a consulting firm in September 2001 to develop an algorithm/statistical model for post-endorsement technical reviews. The scoring model will utilize data from CHUMS, AUS, and other available data based upon risk characteristics, including default and underwriting risks. This scoring model will perform a 100 percent statistical review of all loans endorsed under the program areas outlined below.

The purpose of this review is to determine which cases would more likely have a high probability of default and consequently be targeted for post-endorsement technical reviews and other early intervention actions by the Department.

The algorithm will evaluate the following program areas:

203(b), fixed rate mortgage
251, adjustable rate mortgage
203(k), fixed rate mortgage
203(k)/251, adjustable rate mortgage
234(c), fixed rate mortgage
234(c)/251, adjustable rate mortgage

With respect to the second recommendation, 4.b., FHA wishes to point out that LASS was, in fact, implemented (placed into production) effective October 1, 2001 after user acceptance testing by HUD staff, private Certified Public Accountants, and several lenders. A Proposed Rule making use of LASS by lenders mandatory was issued November 30, 2001. HUD expects to issue a Final Rule in fiscal year 2002.

The Deputy Assistant Secretary for Single Family has already engaged a consultant to assist FHA in implementing additional and enhanced automated processes for underwriting, fraud detection, appraisal selection, and paperwork reduction as the third recommendation (4.c.) suggests. This contract has been in place since September 2001. In fact, FHA's Business Process Reengineering (BPR) efforts are designed to result in exactly what the auditor is recommending.

FHA has begun the final stages of deploying its mortgage scorecard that will allow FHA to assess the risk of default on individual loans, individual lenders, mortgage products, and will also permit FHA to concentrate its post-endorsement review resources on those loans and lenders deemed most risky.

FHA has also received a cost-benefit analysis regarding a process that would allow for mortgage endorsements without the need for the lender to submit the actual case binder to FHA for review. Available only on low-risk streamline refinance loans, it will improve workflow management by allowing staff and contractor resources to be more judiciously deployed.

FHA's BPR includes the following subtasks, all of which are germane to the independent auditor's recommendations:

Fraud prevention, identity verification, and automated valuation models that should be incorporated into FHA's overall electronic government efforts, and in what manner

The contractor shall identify and assess proprietary tools that will permit the lender, FHA or both to prevent fraud, preclude identity theft, and better determine the value of the collateral on FHA mortgages to, in part, preclude property flipping. In addition, the contractor will determine how these tools can be incorporated within existing ADP and automated underwriting systems, the costs/benefits of doing so, and examine possible linkage with these tools to a lender's ability to avail itself of E-Endorsement and E-MIC functions.

How business partners' access to the TOTAL mortgage scorecard, as well as the overall use of automated underwriting systems, will fit into FHA's overall business strategy including E-Endorsement and E-MIC efforts

The contractor shall identify how business partners' access to the FHA TOTAL Mortgage Scorecard and its attendant data capturing will augment implementation of the E-Endorsement and E-MIC processes. This modification requires that the contractor explore the optimal manner of using the scorecard deployment within a revised business process. The contractor will explore and document opportunities and hindrances to expanding access to the FHA Connection to proprietary loan origination systems (LOS).

Optimal method for retention of FHA's case binders, including scanning, smart documents, and other media

The contractor shall answer the question of whether or not the creation of case binders remains a necessary business process and if so what are the policy and procedures for mortgage document retention. Specifically, the contractor shall identify and document the optimal manner for retention of mortgage insurance case binders recognizing that participants under the E-Endorsement program will not be required to submit paper case binders except on a limited sampling of cases. The contractor must explore whether FHA should itself scan or require lenders to submit scanned documents, how FHA may use smart documents, whether it should employ document/data vaults and the levels of access for reviewing said documents among HUD staff.

Quality control (QC) and monitoring policies and procedures to include pre- and post-technical reviews

The contractor shall create a monitoring program for the origination and endorsement of FHA loans including reverse equity mortgages (HECM). This monitoring program shall include the review of loan documentation including appraisals. In addition, the capture of electronic appraisals and reviews should be incorporated into the workflow of the BPR. The contractor shall review existing fraud software for appraisals. The contractor must explore and recommend the most effective means for monitoring FHA loan quality and production. This deliverable will reengineer the pre- and post-technical review process. The level of detail for this deliverable will include 1) how loans will be selected for pre- and post - technical review; 2) % of loans to be sampled; 3) evaluation of industry tools; and 4) internal and external workflow considerations.

Finally, the contractor is also responsible for developing a process and algorithm to select those appraisals that should be chosen for field reviews as well as in-house technical reviews. The contractor will also describe the optimal manner in which appraisal data is to be received by FHA, whether via lender entry into CHUMS via the FHA Connection or through electronic transmission of the entire appraisal.

The Contractor will ensure that the algorithm can be installed in existing databases and will advise the Department of any proprietary software or processes that can also be adopted to support appraisal selection/fraud detection.

To address the fourth recommendation, Single Family's Home Ownership Centers have already taken steps to improve the performance of the PETR contractors. In fiscal year 2001, all of the HOCs began to administer standardized contracts for PETR reviews that have led to greater consistency in work product and performance. In addition in December 2001, the HOCs implemented a matrix of the "M" codes, which are underwriting rating codes that are being utilized and are a part of the HOC reference guide (found on the HUD website). These "M" codes provide a consistent rating tool and the contractors and HUD staff in all four HOCs use the matrix in order to provide more consistency relative to underwriting ratings.

The HOCs also have a system in place to ensure that the contractors are performing reviews at the same level as the HOCs. The HOCs use an internal system, the Underwriting Reporting System (URS) to capture detailed analysis of underwriter ratings. Contractors enter rating data into the URS that is also used to record the results of Quality Control reviews of contractor performance by HUD staff. The HOCs provide feedback to the contractors regarding the QC reviews completed. In addition, with implementation of the standardized contracts (varying effective dates per HOC) and the Matrix, this will ensure that the contractors are performing reviews at the same level of quality as HOC staff.

FHA's Office of Single Family also provides information to lenders on the results of the PETR reviews in a variety of ways and in a timely fashion. Quarterly reports are sent to the CEO/President of lenders summarizing the underwriting ratings. Mortgagee Letter 95-36, dated August 2, 1995, eliminated the issuance of individual ratings (report cards) to mortgagees. In addition, lenders have access to Neighborhood Watch, which now reports the overall underwriter ratings on specific cases. This provides lenders a tool to monitor themselves on a monthly basis.

Finally, on an as needed basis, HUD staff provides lenders with reports from the URS of their underwriter ratings. By providing lenders with all PETR reports, we would be generating an influx of appeals from underwriters on poor ratings. HOC staffing would not be able to support the anticipated volume of appeals that would be generated.

5. FHA Must Monitor its Single Family Property Inventory

FHA concurs with this finding and associated recommendations.

The report states that conditions need to be "improved to maximize the return to FHA while preserving and protecting these properties". FHA notes that while property conditions of foreclosed properties are often inherently poor, controls established in recent years have been continually enhanced, leading to significant improvements in control over this inherent risk. FHA has substantively addressed long-standing issues while ensuring the highest level of return on its properties in its history. The loss per claim has dropped from 46.6% in fiscal year 1996 to 31.8% by the end of fiscal year 2001. In addition, FHA's inventory of single-family Real Estate

Owned (REO) has steadily declined in the course of 2001 from over 36,000 at the beginning of the fiscal year to under 30,000 at the end of the fiscal year.

To address the first recommendation, FHA has contracted with Deliotte & Touche to review a sample of the property files maintained by the M&M contractors, as a primary compliance control check over property disposition services. To enhance its ability to communicate performance issues to the contractors and to ensure corrective action in a timely manner, Single Family has released on-line access to the results of every file review conducted over the past year. This on-line facility provides for means to sort and select results based on compliance concerns. Access to the file is currently restricted to HUD personnel. The Office of Single Family Asset Management will provide access to and training on this automated facility to all M&M contractors by September 2002. This Office will also determine the feasibility of integrating property inspection data with file review results.

With regards to the second recommendation, a risk-based sampling methodology is expected to be fully employed for property case file reviews by July 2002.

FHA has made limited progress in modifying existing M&M contracts regarding the third recommendation (3.c.). While these contracts do contain performance-based aspects, the ability to imbed incentives and disincentives in existing contracts has proven cumbersome and costly. The Office of Single Family Housing will work in conjunction with the Office of Procurement and Contracts to consider other options, including re-procurement of the M&M services. This assessment will be completed by April 2002.

6. FHA Must Continue to Improve Its Process for Preparing Timely Estimates and Properly Reporting Credit Subsidy Adjustments

FHA does not agree with this finding and associated recommendations. FHA lacks the authority to implement the first recommendation. FHA understands KPMG's concerns about the re-estimate process and timelines. However, we do not believe the circumstances surrounding the models or adjustment merit a reportable condition for FHA.

As stated in the reportable condition, the problems associated with the credit subsidy re-estimate process affect all Federal credit agencies. There are no precedents on how to resolve differences between the financial statements and President's budget, and there is a disconnect in the timetables of these processes. Thus, an agency such as FHA can only attempt to minimize differences while meeting timeframes for completion of the audit.

FHA acknowledges the two-week delay in the delivery of the LLG for single-family programs. Given GAO's guidance on the importance of using identical assumptions for the LLG and credit subsidy rates, FHA chose to work out the differences in opinion over model assumptions with OMB prior to audit delivery. FHA successfully completed the negotiations with OMB on December 13th. For the first time, FHA delivered an OMB-approved single-family model using the same assumptions for the budget and financial statements to the auditors. FHA is proud to have achieved this long-standing goal with no noteworthy errors.

FHA is aware of the plans to accelerate deadlines for financial reporting. Consequently, FHA streamlined the models during fiscal year 2001 in order to reduce the amount of time required to prepare and audit the models. For single-family programs, FHA consolidated five distinct models for each of the risk categories into one cash flow model. FHA also reduced the number of worksheets used in the models. Previously, FHA used one cash flow worksheet for each cohort. This would have resulted in over 40 cash flow worksheets for the auditors to review in fiscal year 2001. As a result of FHA's modeling changes, the auditors only needed to review one cash flow worksheet for single family's MMI and GI/SRI programs. FHA made similar advancements to the multifamily models. FHA reduced the number of multifamily assumptions worksheets from 22, one for each risk category, to 2 worksheets. Furthermore, FHA addressed the auditor's fiscal year 2000 modeling recommendations. Given the amount of progress made during this fiscal year, FHA believes that a reportable condition is not merited.

FHA recognizes that a fixed deadline for resolution of assumptions and methodology with OMB would be beneficial, but does not agree that such a restrictive timeline is possible, given that FHA has no control over timelines set by OMB. Given FHA's position, FHA will do everything within its control to implement a process to complete resolution of the LLG liability estimation process within 60 days after year-end.

FHA already relies on a process to ensure completion of its modeling processes and initiates discussions with OMB as soon after fiscal year end as possible. This helps ensure that the liability estimation is completed in a timely manner, and that the liability estimates use the same assumptions that are used for credit subsidy estimates. Due to the differences in the timelines associated with the President's Budget and the financial statement audit, however, FHA may not be able to complete discussions with OMB within the timeframe suggested by KPMG. As noted by KPMG, "OMB's judgment regarding the credit subsidy assumptions is not within the control of FHA's management."

In addition, as the due dates for agencies' audited financial statements accelerate over the next three years, a fixed deadline of 60 days after year-end will place the completion of the liability estimation after the financial statements are due. Furthermore, OMB may adjust an agency's budget and credit subsidy estimates well into the month of January. This situation will continue to cause differences between agencies' financial statements and their credit subsidy estimates presented in the President's Budget.

The second recommendation suggests FHA develop and adopt a policy for handling future differences between the amounts reported on the financial statements and the budget estimates approved by OMB. FHA management did develop a method for handling the fiscal year 2001 differences based on the review of guidance and circumstances.

After OMB notified FHA that it disagreed with certain assumptions FHA management used in a prior year, FHA considered how to present the adjustment in its fiscal year 2001 financial statements. Current Federal accounting guidance does not address this type of adjustment; therefore, FHA management reviewed the various alternatives for the financial statement presentation and determined that the adjustment should be reflected as a prior period adjustment. In the absence of specific accounting guidance, management must use its best judgment with the facts known at the time.

KPMG asserted that OMB's decision constituted a change in accounting estimates, and should be part of the current year net cost. FHA agreed to make this change, noting that the applicable guidance states: "*Distinguishing between a change in accounting estimate and the correction of an error may be difficult and may require significant professional judgment. The difference comes down to the timing of the availability of the information upon which the change or correction is made.*" FHA will develop and document a policy for handling future differences between the amounts reported on the financial statements and the budget estimates approved by OMB.

Finally, FHA agrees with the third recommendation (6.c.). In fact, FHA had already brought this issue up to the Accounting and Auditing Policy Committee (AAPC), a committee of the FASAB, when we commented on the Revised Draft of Technical Release 3. FHA requested that the Technical Release address procedures for reconciling the differences between the budget and financial statements as well as how to handle differences between the re-estimates accepted by the auditors and the re-estimates calculated by OMB. Therefore, FHA had implemented this recommendation at the time KPMG made their recommendation; however, we will continue to pursue this issue with FASAB.

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PRINCIPAL
FINANCIAL
STATEMENTS

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FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED BALANCE SHEETS
As of September 30, 2001 and 2000
(Dollars in Millions)

	2001	2000
ASSETS		
Intragovernmental		
Fund Balances with the U.S. Treasury (Note 2)	$ 8,822	$ 7,915
Investments in U.S. Government Securities (Note 3)	17,105	17,052
Interest Receivable from U.S. Government Securities	226	260
Accounts Receivable, Net (Note 4)	9	19
Other Assets (Note 6)	86	49
Total Intragovernmental	26,248	25,295
Credit Program Receivables and Related Foreclosed Property, Net (Note 5)	2,685	2,721
Accounts Receivable, Net (Note 4)	334	176
Other Assets (Note 6)	125	90
TOTAL ASSETS	**$29,392**	**$28,282**
LIABILITIES		
Intragovernmental		
Borrowings from U.S. Treasury (Note 7)	$ 4,544	$ 7,155
Payable to Special Receipt Account for Subsidy Re-estimate	1,396	517
Other Liabilities (Note 8)	30	7
Total Intragovernmental	5,970	7,679
Accounts Payable	653	506
Unearned Premiums	555	682
Liabilities for Loan Guarantees (Note 5)	6,053	7,522
Debentures Issued to Claimants (Note 7)	221	218
Premium Refunds and Distributive Shares Payable	354	174
Other Liabilities (Note 8)	472	443
TOTAL LIABILITIES	**$14,278**	**$17,224**
NET POSITION		
Unexpended Appropriations (Note 9)	$ 2,129	$ 1,151
Cumulative Results of Operations	12,985	9,907
TOTAL NET POSITION	**$15,114**	**$11,058**
TOTAL LIABILITIES AND NET POSITION	**$29,392**	**$28,282**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF NET COST
For the years ended September 30, 2001 and 2000
(Dollars in Millions)

	2001	2000
Unsubsidized Program Costs		
Intragovernmental	$ 431	$ 477
With the Public	(576)	2,290
Total Unsubsidized Program Costs	(145)	2,767
Less: Earned Revenues (Note 10)	2,383	2,644
Net Unsubsidized Program Costs (Surplus)	**($ 2,528)**	**$ 123**
Subsidized Program Costs		
Intragovernmental	$95	$111
With the Public	580	312
Total Subsidized Program Costs	675	423
Less: Earned Revenues (Note 10)	871	500
Net Subsidized Program Costs (Surplus)	**($ 196)**	**($ 77)**
NET COST (SURPLUS) OF OPERATIONS	**($2,724)**	**$ 46**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF CHANGES IN NET POSITION
For the years ended September 30, 2001 and 2000
(Dollars in Millions)

	2001	**2000**
Net Cost (Surplus) of Operations	**($ 2,724)**	**$ 46**
Financing Sources:		
Appropriations Used	(1,370)	(1,124)
Imputed Financing	(14)	(11)
Transfers-out:		
HUD	203	233
US Treasury	1,079	202
Public	2	1
Other	7	-
Total Financing Sources	(93)	(699)
Net Results of Operations	**(2,817)**	**(653)**
Prior Period Adjustments (Note 16)	(261)	(8)
Net Change in Cumulative Results of Operations	**(3,078)**	**(661)**
Change in Unexpended Appropriations	(978)	(837)
Change in Net Position	**(4,056)**	**(1,498)**
Net Position-Beginning of Period	(11,058)	(9,560)
Net Position - End of Period	**($15,114)**	**($11,058)**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
COMBINED STATEMENTS OF BUDGETARY RESOURCES
For the years ended September 30, 2001 and 2000
(Dollars in Millions)

	2001	**2000**
Budgetary Resources: (Note 13)		
Budget Authority		
Appropriations	$ 7,606	$ 1,947
Borrowing Authority	1,028	815
Unobligated Balances Carried Forward	23,476	19,953
Spending Authority from Offsetting Collections	17,842	14,139
Adjustments		
Recoveries of Prior Year Obligations	20	171
Enacted rescissions	(2)	-
Capital Transfers and Redemption of Debt	(4,880)	(1,545)
NET BUDGETARY RESOURCES	**$ 45,090**	**$ 35,480**
Status of Budgetary Resources:		
Obligations Incurred	$ 20,718	$ 12,004
Unobligated Balances - Available	3,760	4,907
Unobligated Balances - Not Available	20,612	18,569
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 45,090**	**$ 35,480**
Outlays:		
Obligations Incurred	$ 20,718	$ 12,004
Less: Spending Authority from Offsetting Collections and Recoveries	17,862	14,310
Obligated Balance, Net - Beginning of Period	1,445	1,468
Less: Obligated Balance, Net - End of Period	1,477	1,445
TOTAL NET OUTLAYS	**$ 2,824**	**($ 2,283)**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
COMBINED STATEMENTS OF FINANCING
For the years ended September 30, 2001 and 2000
(Dollars in Millions)

	2001	2000
Resources Used to Finance Activities		
Obligations Incurred	$20,718	$12,004
Spending Authority from Offsetting Collections and Recoveries	(17,862)	(14,310)
Financing Imputed for Cost Subsidies	14	11
Other	(7)	-
Total Resources Used to Finance Activities	$2,863	($ 2,295)
Less: Resources Used to Finance Items not Part of the Net Cost of Operations		
Costs Capitalized on the Balance Sheet	($5,498)	($1,907)
Financing Sources that Fund Costs of Prior Periods	8,298	-
Transfer Out to HUD without Reimbursement as related to the S&E Expenses	203	233
Other Resources that do not fund the Net Cost of Operations	61	(289)
Total Resources Used to Finance Items not Part of the Net Cost of Operations	$ 3,064	($1,963)
Components of the Net Cost of Operations that Will Not Require or Generate Resources in the Current Period		
Gains on Sales of Credit Program Assets, Net	$ 697	$ 728
Bad Debts Related to Uncollectible Non-Credit Reform Receivables	(327)	78
Reduction of Subsidy Expense from Endorsements and Modifications of Negative Subsidy Cases	(2,389)	(1,926)
Changes in Loan Loss Reserve Expense	(831)	(1,127)
Reduction of Subsidy Expense due to Adjustments related to Credit Subsidy Downward Re-estimate	(989)	(868)
Increase in Interest Income in MMI Liquidating Account due to Fiscal Year Credit Subsidy Downward Re-estimate	(481)	(46)
Other Expenses or Revenue that do not Require or Generate Resources	(176)	(405)
Total Components of the Net Cost of Operations that Will Not Require or Generate Resources in the Current Period	($4,496)	($3,566)
Financing Sources Yet to be Provided		
Fiscal Year Credit Subsidy Upward Re-estimate	$ 1,973	$ 3,944
Total Financing Sources Yet to be Provided (Note 14)	$ 1,973	$ 3,944
Net Cost (Surplus) of Operations	($2,724)	$ 46

The accompanying notes are an integral part of these statements.

NOTES TO FINANCIAL STATEMENTS
September 30, 2001

Note 1. Significant Accounting Policies

Entity and Mission

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

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

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

FHA's major programs are classified as unsubsidized and subsidized. These programs are composed of four major Funds. The unsubsidized program is comprised of (1) the Mutual Mortgage Insurance Fund (MMI), FHA's largest Fund, which provides basic Single Family mortgage insurance and is a mutual insurance fund, whereby mortgagors, upon non-claim termination of their mortgages, share surplus premiums paid into the MMI Fund that are not required for operating expenses and losses or to build equity; and (2) the Cooperative Management Housing Insurance Fund (CMHI), which also is a mutual fund, that provides mortgage insurance for management-type cooperatives. The subsidized program is comprised of (3) the General Insurance Fund (GI) which provides for a large number of specialized mortgage insurance activities, including insurance of loans for property improvements, cooperatives, condominiums, housing for the elderly, land development, group practice medical facilities and nonprofit hospitals; and (4) the Special Risk Insurance Fund (SRI) which provides mortgage insurance on behalf of mortgagors eligible for interest reduction payments who otherwise would not be eligible for mortgage insurance.

The MMI and CMHI Funds are required to charge borrowers a premium that is designed to cover default losses and administrative expenses, and to provide equity. These Funds are designed to not be dependent upon appropriations to sustain operations. The GI and SRI Funds, however, are not designed to be self-sustaining, and as a result, are dependent on appropriations from Congress.

Basis of Accounting

The principal financial statements are presented in conformity with generally accepted accounting principles (GAAP) applicable to Federal agencies, and the financial statement formats presented in Office of Management and Budget (OMB) Bulletin 97-01, "Form and Content of Agency Financial Statements," as amended. The principal financial statements include all Treasury funds under FHA control, which consist of two general fund appropriations, six revolving funds and one special fund receipt account.

Recognition and measurement of budgetary resources, for purposes of preparing the Combining Statement of Budgetary Resources, is based on budget concepts and definitions provided by OMB Circular A-11, section "Federal Credit Data" and by Circular A-34, "Instructions on Budget Execution."

Basis of Consolidation

The accompanying principal financial statements include all Treasury account fund symbols for which FHA is responsible. All accounts receivable, accounts payable, transfers in and transfers out within FHA have been eliminated to prepare the consolidated balance sheets, statements of net cost and statements of changes in net position. The statements of budgetary resources and statements of financing are prepared on a combining basis as allowed by OMB Bulletin 97-01.

Use of Estimates

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

Amounts reported for credit program receivables and related foreclosed property, unearned premiums, the liabilities for loan guarantees, and the payable to the U.S. Treasury receipt account for subsidy re-estimates, represents FHA's best estimates based on pertinent information available.

To estimate the liabilities for loan guarantees, FHA used cash flow model assumptions associated with loans subject to the Federal Credit Reform Act of 1990, as described in Note 5, to estimate the cash flows associated with future loan performance. To make reasonable projections of future loan performance, FHA developed assumptions, as described in Note 5, based on historical data and current and forecasted program and economic assumptions.

Certain programs have higher risks due to increased chances of fraudulent activities perpetrated against FHA. FHA accounts for these risks through the assumptions used in the liabilities for loan guarantee estimates. FHA develops the assumptions based on historical performance and management's judgments about future loan performance. As a result, the ordinary risks associated with potential fraudulent activities perpetrated against FHA are incorporated into these assumptions.

Fund Balances with the U.S. Treasury

Fund balances with the U.S. Treasury consist of amounts collected and available to fund payments for expenses and for escrow payments for mortgages, and of amounts collected but unavailable until authorizing legislation is enacted (see Note 2). Amounts included in the fund balance with the U.S. Treasury are received and paid through accounts defined by law and included in the Federal budget.

Credit Reform Accounting

Credit Reform establishes the use of the program, financing, and special fund receipt account for loan guarantee commitments and direct loans obligated after September 30, 1991. It also establishes the liquidating account for activity relating to any loan guarantee commitments and direct loans obligated before October 1, 1991 (pre-Credit Reform). The program account is a budget account that receives and obligates appropriations to cover the subsidy cost of a direct loan or loan guarantee and disburses the subsidy cost to the financing account. The program account also receives appropriations for administrative expenses. The financing account is a non-budgetary account that records all of the cash flows resulting from Credit Reform direct loans or loan guarantees.

It disburses loans, collects repayments and fees, makes claim payments, holds balances, borrows from U.S. Treasury, earns or pays interest, and receives the subsidy cost payment from the program account.

The special fund receipt account is a budget account used for the receipt of amounts paid from the financing account when there is a negative subsidy from the original estimate or a downward re-estimate. In most federal entities, the special fund receipt account is a General Fund account that belongs to the U.S. Treasury. However, per an agreement with OMB, in order to resolve the different requirements between Credit Reform and the National Affordable Housing Act of 1990 (NAHA), the special fund receipt account of the MMI Fund (miscellaneous receipt account) remains a FHA account. Specifically, the NAHA required that FHA's MMI Fund achieve a Capital Ratio of 2.0 percent by fiscal year 2000. The Capital Ratio is defined as the ratio of economic net worth (current cash plus the present value of all future net cash flows) of the MMI Fund to unamortized insurance in force (the unpaid balance of insured mortgages). Therefore, FHA transfers negative subsidy and downward subsidy re-estimates from the MMI financing account to the MMI liquidating account, which includes the miscellaneous receipt account, and retains ownership of funds in the miscellaneous receipt account to strengthen the financial position of the MMI fund and meet the Capital Ratio requirement. At the end of fiscal year 1998, FHA met and has since maintained the Capital Ratio requirement. FHA's actuary estimates the Capital Ratio at September 30, 2001 at 3.75 percent.

Prior to fiscal year 2000, as required by FHA's annual appropriation, the MMI financing account transferred a portion of the negative subsidy to the program account to reimburse HUD for Office of Housing salaries and expenses. Starting in fiscal year 2000, salary and administrative expenses allocated to FHA were funded by annual appropriations received in both the MMI and the GI and SRI program accounts.

The liquidating account is a budget account that records all cash flows to and from FHA resulting from pre-Credit Reform direct loan obligations or loan guarantee commitments. Liquidating account collections in any year are available only for obligations incurred during that year or to repay debt. Unobligated balances of FHA's GI and SRI Fund liquidating accounts at the end of the fiscal year that are not needed for future operations are transferred to the U.S. Treasury's General Fund. Credit Reform also provides permanent indefinite authority to cover obligations and commitments in the event that funds in the liquidating accounts are otherwise insufficient.

Investments in U.S. Government Securities

Under current legislation, FHA may invest available funds in excess of current needs in non-marketable market-based U.S. Treasury securities for the MMI/CMHI liquidating account. These U.S. Treasury securities may not be sold on public securities exchanges, but do reflect prices and interest rates of similar marketable U.S. Treasury securities. The valuation of these investments is at acquisition cost net of unamortized premium or discount. Monthly, amortization of the premium or discount is calculated on a straight-line basis (see Note 3).

Credit Program Receivables and Related Foreclosed Property

Credit program receivables arise from two sources. Prior to April 1996, under certain conditions prescribed by law, FHA would take assignment of insured Single Family loans that were in default for direct collection rather than acquire the related properties through foreclosure. Single Family loans were assigned to FHA when the mortgagor defaulted due to certain "temporary hardship" conditions beyond the control of the mortgagor and when, in FHA management's judgment, the loan could be brought current in the future. During fiscal year 2001, FHA continued to take Single Family assignments on those defaulted notes that were in process at the time the assignment program was terminated, April 1996.

Secondly, Multifamily and Title I loans are assigned when lenders file mortgage insurance claims to FHA for defaulted notes. 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.

Credit program receivables for direct loan programs and defaulted guaranteed loans assigned for direct collection are valued differently if guaranteed prior to or after October 1, 1991, in accordance with Credit Reform and Statement of Federal Financial Accounting Standards (SFFAS) No. 2, "Accounting for Direct Loans and Loan Guarantees" (see Note 5). Direct loans obligated and loan guarantees committed on or after October 1, 1991 (post-Credit Reform) are valued at the net present value of expected cash flows from the related receivables.

Pre-Credit Reform program receivables are recorded at the lower of cost or fair value (net realizable value). Fair value is estimated based on the prevailing market interest rates at the date of mortgage assignment. When fair value is less than cost, discounts are recorded and amortized to interest income over the remaining terms of the mortgage or upon sale of the mortgages. Pre-Credit Reform loans are reported net of the allowance for loss and any unamortized discount. The estimate for the allowance on pre-Credit Reform program receivables is based on historical loss rates and recovery rates resulting from asset sales and property recovery rates, net of the cost of sales.

Foreclosed property acquired as a result of defaults of loans obligated or loan guarantees committed on or after October 1, 1991, is valued at the net present value of the projected cash flows associated with the property. Foreclosed property acquired as a result of defaults of loans obligated or loan guarantees committed prior to October 1, 1991, is valued at net realizable value (see Note 5). The estimate for the allowance for loss related to the net realizable value of pre-Credit Reform foreclosed property, is based on historical loss rates and recovery rates resulting from property sales, net of the cost of sales.

General Property, Plant and Equipment

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

In fiscal year 2001, HUD developed a department-wide policy to implement SFFAS No. 10 *"Accounting for Internal Use Software."* Although previous standards had addressed the treatment of accounting for property, plant and equipment, the new standard required agencies to specifically address the accounting for expenditures to purchase, develop, and implement software for internal use.

The policy indicates that HUD will either own the software or the functionality provided by the software in the case of licensed or leased software. This includes "commercial off-the-shelf" (COTS) software, contractor-developed software, and internally-developed software. During fiscal year 2001, FHA had several procurement actions in place and had incurred expenses for software development. FHA identified and reclassified those expenditures to comply with HUD's policy. For fiscal year 2001, FHA identified approximately $13 million of capitalizable software development costs and transferred that amount to HUD.

Liabilities for Loan Guarantees

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

The pre-Credit Reform LLG is computed using the net realizable value method. The LLG for pre-Credit Reform Single Family mortgage insurance includes estimates for defaults that have taken place, but where claims have not yet been filed with FHA. In addition, the LLG for pre-Credit Reform Multifamily insured mortgages includes estimates for defaults, which are considered probable but have not been reported to FHA (see Note 5).

Unearned Premiums

Unearned premiums are recognized for pre-Credit Reform loan guarantee premiums collected but not yet earned in the liquidating account. Premiums charged by FHA for Single Family mortgage insurance provided by its MMI/CMHI Fund include up-front and annual risk-based premiums. Up-front risk-based premiums are recorded as unearned revenue upon collection and are recognized as revenue over the period in which losses and insurance costs are expected to occur. Annual risk-based premiums are recognized as revenue on a straight-line basis throughout the year. FHA's other activities charge periodic insurance premiums over the mortgage insurance term. Premiums on annual installment policies are recognized for the liquidating accounts on a straight-line basis throughout the year.

Premiums associated with Credit Reform loan guarantees are included in the calculation of the LLG and are not included in the unearned premium amount reported on the Consolidated Balance Sheets, since the LLG represents the net present value of all future cash flows associated with those insurance portfolios.

Appropriations and Monies Received from Other HUD Programs

The GI and SRI Funds were not designed to be self-sustaining. As a result, the National Housing Act of 1990, as amended, provides for appropriations from Congress to finance the operations of these Funds. For Credit Reform loan guarantees, 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. For pre-Credit Reform loan guarantees, FHA has permanent indefinite appropriation authority to finance the cash requirements of operations.

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

Full Cost Reporting

SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards*, requires that Federal agencies report the full cost of program outputs in the financial statements. Full cost reporting includes all direct, indirect, and inter-entity costs. For purposes of HUD's consolidated financial statements, HUD identified each responsibility segment's share of the program costs or resources provided by other Federal agencies. As a responsibility segment of HUD, FHA's portion of these costs is included in FHA's financial statements as an imputed cost for the Consolidated Statement of Net Cost, and an imputed financing for the Consolidated Statement of Changes in Net Position and the Combined Statement of Financing. According to FASAB's SFFAS No. 4, recognition of inter-entity costs that are not fully reimbursed is limited to material items that are significant to the receiving entity.

In a separate effort, FHA conducted a mid-year and end-of-year time allocation survey of all Office of Housing operational managers throughout the field and headquarters, to determine FHA's direct personnel cost associated with the Housing Salaries and Expenses (S&E) transfer to HUD and to allocate these costs between the unsubsidized and subsidized programs. The HUD CFO's office also conducted a survey to determine how the department's fiscal year overhead, Office of Inspector General, and Working Capital Fund costs, which are paid for by S&E funds, should be accounted for by responsibility segments. This data is an integral part of the FHA direct cost S&E allocation prepared for financial statement reporting.

Distributive Shares

As mutual funds, the MMI and CMHI Funds distribute excess revenues to mortgagors at the discretion of the Secretary of HUD. Such distributions are determined based on the MMI and CMHI Funds' financial positions and their projected revenues and costs. As previously discussed, in November 1990, Congress passed the NAHA, which effectively suspended payment of distributive shares from the MMI Fund, other than those already declared by the Secretary, until the Fund meets certain capitalization requirements. Although the capitalization requirements were met at September 30, 2001 and 2000, no distributive shares were declared from the MMI Fund because legislation is not yet enacted. The NAHA does not affect distributions from the CMHI Fund.

Liabilities Covered by Budgetary Resources

Liabilities are to be classified as those covered and not covered by budgetary resources, as defined by OMB, and in accordance with SFFAS No. 1, *Selected Assets and Liabilities*. In the event that available resources are insufficient to cover liabilities due at a point in time, FHA has authority to borrow monies from the U.S. Treasury or to draw on permanent indefinite appropriations to satisfy the liabilities. Thus, all of FHA's liabilities are considered covered by budgetary resources.

Note 2. Fund Balances with the U.S. Treasury

Substantially all of FHA's cash transactions are processed by the U.S. Treasury. Fund balances with the U.S. Treasury at September 30, were composed of the following:

(dollars in millions)

Entity Assets	**2001**	**2000**
Intragovernmental Assets:		
Appropriated Funds	$ 393	$ 344
Revolving Funds	8,389	7,494
Fund Balances with the U.S. Treasury	$ 8,782	$ 7,838
Non-Entity Assets		
Intragovernmental Assets:		
Escrow Funds	$ 40	$ 77
Fund Balances with the U.S. Treasury	$ 40	$ 77
Total Fund Balances with the U.S. Treasury	$ 8,822	$ 7,915

Appropriated Funds

Appropriated funds are provided by legislation. Some appropriated funds expire if not obligated by the end of the time period specified in the authorizing legislation.

Revolving Funds

FHA's revolving funds are authorized by specific provisions of law to finance a continuing cycle of operations in which expenditures generate receipts and the receipts are available for expenditure without further action by the Congress.

Escrow Funds

FHA's escrow funds represent deposits made by mortgagees to pay for property taxes and insurance related to defaulted guaranteed mortgage notes assigned for direct collection and notes received under the direct loan program.

Note 3. Investments in U.S. Government Securities

As discussed in Note 1, all investments are in non-marketable securities issued by the U.S. Treasury and, are therefore considered intragovernmental. These securities carry market-based interest rates. The cost, par value, net unamortized discount, net investment, and market values as of September 30, 2001 were as follows:

Investment, Net (dollars in millions) **Maturity**	**Weighted Average Interest Rate**	**Cost**	**Par Value**	**Unamortized Discount (Premium), Net**	**Investment, Net**	**Market Value**
One year or less	4.54%	$ 3,505	$ 3,534	$ 11	$ 3,523	$ 3,530
After one year through five	5.85%	8,259	8,455	89	8,366	9,034
After five year through ten	7.21%	2,863	2,882	13	2,869	3,193
After ten years through fifteen	7.25%	51	62	7	55	74
After fifteen years	6.25%	2,282	2,349	57	2,292	2,580
Total		$ 16,960	$ 17,282	$ 177	$ 17,105	$ 18,411

The cost, par value, net unamortized discount, net investment, and market values as of September 30, 2000 were as follows:

(dollars in millions) **Maturity**	**Weighted Average Interest Rate**	**Cost**	**Par Value**	**Unamortized Discount (Premium), Net**	**Investment, Net**	**Market Value**
One year or less	5.22%	$ 1,979	$ 1,993	$ 2	$ 1,991	$ 1,987
After one year through five	5.95%	6,700	6,801	57	6,744	6,805
After five year through ten	6.34%	5,828	5,973	89	5,884	6,035
After ten years through fifteen	13.88%	99	82	(6)	88	112
After fifteen years	6.28%	2,332	2,411	67	2,345	2,462
Total		$ 16,938	$ 17,260	$ 209	$ 17,052	$ 17,401

Note 4. Accounts Receivable, Net

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

	Gross		Allowance		Net	
(dollars in millions)	**2001**	**2000**	**2001**	**2000**	**2001**	**2000**
Intragovernmental Accounts Receivable:						
HUD Section 312 rehabilitation loan program receivables	$ 6	$ 5	$ -	$ -	$ 6	$ 5
HUD Multifamily rental assistance receivables	3	14	-	-	3	14
Total	$ 9	$ 19	$ -	$ -	$ 9	$ 19
Accounts Receivable from the Public:						
Receivables related to asset sales	$ 7	$ 52	$ -	$ -	$ 7	$ 52
Receivables related to credit program assets	181	150	(68)	(80)	113	70
Premiums receivable	248	54	(34)	-	214	54
Total	$ 436	$ 256	$(102)	$ (80)	$334	$176

Receivables Related to Asset Sales

FHA conducts sales of its foreclosed Single Family and Multifamily properties and mortgage notes. Receivables have been recorded to reflect amounts due from purchasers.

Receivables Related to Credit Program Assets

These receivables include amounts due from the public for miscellaneous administrative charges such as late fees, services charges and interest on administrative charges associated with loans receivables. They also include overpayment of claims to lenders and rent due on foreclosed properties.

Premiums Receivable

As discussed in Note 1, FHA collects premiums related to its various insurance programs. This amount only reflects the receivable for premiums associated with pre-Credit Reform loan guarantees, as premiums associated with post-Credit Reform loan guarantees are used in the determination of the LLG.

Allowance for Loss

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

Note 5. Credit Program Assets and Liabilities for Loan Guarantees

An analysis of credit program assets, loan guarantees, and the liabilities for loan guarantees is provided in the following tables as of September 30:

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

	Loans Receivable, Gross	Interest Receivable	Allowance for Loan and Interest Losses	Foreclosed Property	Value of Assets related to Direct Loans
Total Direct Loan Programs:					
FY 2001	$ 42	$ -	$ (23)	$ -	$ 19
FY 2000	56	2	(32)	-	26

Direct Loans Obligated After Fiscal Year 1991:
(dollars in millions)

	Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Foreclosed Property	Value of Assets related to Direct Loans
Total Direct Loan Programs:					
FY 2001	$ 1	$ -	$ (2)	$ -	$ (1)
FY 2000	1	-	(2)	-	(1)

Defaulted Guaranteed Loans from Pre-Credit Reform Guarantees (Allowance for Loss Method):
(dollars in millions)

	Loans Receivable, Gross	Interest Receivable	Allowance for Loan and Interest Losses	Foreclosed Property, Net	Defaulted Guaranteed Loans Receivable, Net
Total Loan Guarantee Programs:					
FY 2001	$ 2,057	$ 91	$ (1,292)	$ 259	$ 1,115
FY 2000	2,305	221	(1,914)	370	982

Defaulted Guaranteed Loans from Credit Reform Guarantees:
(dollars in millions)

	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Foreclosed Property, Gross	Value of Assets related to Defaulted Guaranteed Loans Receivables
Total Loan Guarantee Programs:					
FY 2001	$ 793	$ 81	$ (1,367)	$ 2,045	$ 1,552
FY 2000	647	7	(1,218)	2,278	1,714

	2001	**2000**
Total Credit Program Receivables and Related Foreclosed Property, Net	$ 2,685	$ 2,721

Guaranteed Loans Outstanding:
(dollars in millions)

	Outstanding Principal, Guaranteed Loans, Face Value	Amount of Outstanding Principal Guarantee
Total Loan Guarantee Programs:		
FY 2001	$ 601,715	$ 555,463
FY 2000	589,678	544,601

The potential future losses related to FHA's central business of providing mortgage insurance are accounted for as liabilities for loan guarantees in the consolidated financial statements. This liability includes the post-credit reform Liabilities for Loan Guarantees (LLG) and the pre-credit reform Loan Loss Reserve (LLR) as required by Statement of Federal Financial Accounting Standards (SFFAS) No. 2, "Accounting for Direct Loans and Loan Guarantees."

Liabilities for Loan Guarantees:
(dollars in millions)

	LLG	LLR	Total Liabilities
Total Loan Guarantee Programs:			
FY 2001	$ (311)	$ 6,364	$ 6,053
FY 2000	327	7,195	7,522

The balances as of the September 30, 2001 and 2000 and a reconciliation of the changes in the balances of the LLG and the LLR during fiscal years 2001 and 2000 follows:

Schedule of Changes in the Liabilities for Loan Guarantees	**FY 2001**		**FY 2000**	
(dollars in millions)	**LLG**	**LLR**	**LLG**	**LLR**
Beginning Balance	$ 327	$7,195	$(2,519)	$8,322
Fiscal Year Activity:				
Positive subsidy for guaranteed loans disbursed during the year	101	-	163	-
Negative subsidy for guaranteed loans disbursed during the year	(2,389)	-	(1,926)	-
Loan Guarantee Modification	-	-	(1)	-
Fees Received	3,313	-	3,694	-
Foreclosed Property and Loans Acquired	2,228	-	3,254	-
Claim Payments to Lenders	(5,423)	-	(5,566)	-
Interest Accumulation on the Liability Balance	(66)	-	(180)	-
Adjustments of prior years' credit subsidy expense	2,481	-	-	-
Other	77	-	(31)	-
Ending Balance before Reestimates	649	7,195	(3,112)	8,322
Year-end Reestimates	(960)	(831)	3,439	(1,127)
Ending Balance	$ (311)	$6,364	$ 327	$7,195

In fiscal year 2001, FHA recorded a change in estimate of the MMI credit subsidy expense in the amount of $2,481 million relating to the adjustment of fiscal year 1999 and fiscal year 2000 re-estimates. This adjustment was the result of an agreement between FHA and OMB regarding the use of the actuarial review studies to calculate the LLG.

Foreclosed Property

The average holding period of Single Family properties is approximately 6 months while the average holding period of Multifamily properties is approximately 2 years. Additional requirements are usually attached to FHA's foreclosed property to restrict future use or disposal of those assets. The following table is a summary of FHA's foreclosed properties resulting from loans and loan guarantees at September 30:

		Pre-Credit Reform		**Credit Reform**	
(number of properties)		**Single Family**	**Multifamily**	**Single Family**	**Multifamily**
Foreclosed Properties:					
	FY 2001	6,644	54	22,962	1
	FY 2000	9,229	62	24,869	2

The following tables summarize the dollar amount and number of FHA's foreclosure proceedings in process at September 30:

	Pre-Credit Reform		Credit Reform	
(dollars in millions)	Single Family	Multifamily	Single Family	Multifamily
Outstanding Principal:				
FY 2001	$10	$102	$4	$93
FY 2000	0.2	116	0.1	22

	Pre-Credit Reform		Credit Reform	
	Single Family	Multifamily	Single Family	Multifamily
Number of Properties:				
FY 2001	225	54	61	18
FY 2000	4	2	2	3

Pre-Credit Reform Valuation Methodology

FHA values its pre-Credit Reform loan guarantee liability and related notes and properties in inventory at net realizable value, determined on the basis of net cash flows. To value these items, FHA uses historical claim rates, collections, and expenses of selling and maintaining property, adjusted for predicted changes in the economy and housing markets.

FHA records loss estimates for Single Family programs to provide for anticipated losses incurred (e.g., claims on insured mortgages where defaults have taken place but claims have not yet been filed). Using the net realizable value method, FHA computes an estimate based on historical claims and loss experience data and adjusts the estimate to incorporate management assumptions about current economic factors.

FHA records a loss estimate for Multifamily programs when defaults are considered probable but have not yet occurred or been reported. The loss estimate is based on a case-by-case analysis of approximately 87 percent of Multifamily projects required to submit audited financial statements. Management further adjusts the estimate based on factors such as defaulted projects. The recovery rate assumptions used in the loss estimates are based on historical experience.

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

- No action: Projects that could continue to pay their operating expenses and mortgage payment from remaining revenues.

- Partial claim: Projects that could pay their operating expenses but could not make a full mortgage payment.

- Full Claim: Projects that could no longer meet their mortgage payment and operating expenses.

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

Credit Reform Valuation Methodology

FHA values its Credit Reform LLG and related receivables on notes and properties in inventory at the net present value of their estimated future cash flows. The disbursement weighted interest rate on U.S. Treasury securities of maturity comparable to the guaranteed loan term is the discount factor in the present value calculation for cohorts 1992 to 2000. For cohorts 2001 onwards the rate on U.S. Treasury securities of maturity comparable to the term of each cash flow for the loan guarantee is used in the present value calculation. This methodology is referred to as the basket of zeros discounting methodology. OMB provides these rates to all Federal agencies for use in preparing credit subsidy estimates and requires their use under OMB Circular A-34, "Instructions on Budget Execution."

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

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

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

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

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

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

Additional information about loan performance assumptions is provided below:

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

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

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

- Current legislation and regulatory structure: FHA's future plans allowed under current legislative authority have been taken into account in formulating assumptions when relevant. For example, the Departments of Veterans Affairs and Housing and Urban Development Appropriations Act, 1999, allows mortgage notes to be assigned to FHA and transferred to a third party for servicing. The single-family program office expects to begin a pilot of this program in fiscal year 2002 so FHA estimates recoveries on such notes in the MMI model. In contrast, future changes in legislative authority may affect the cash flows associated with FHA insurance programs. These changes cannot be reflected in LLG calculations because of uncertainty over their nature and outcome.

- Single Family loss mitigation program: FHA's estimates relating to claim payments and recovery amounts are affected by assumptions made about the loss mitigation program, which became effective in April 1996. FHA based these assumptions on recent experience and the industry expertise of FHA staff.

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

Discussion of Change in the Liability for Loan Guarantees - To comply with Credit Reform, FHA has estimated and applied credit subsidy rates to each FHA loan guarantee program since fiscal year 1992. Over this time FHA's credit subsidy rates have varied. Variance is caused by two factors: (1) additional loan performance data underlying the credit subsidy rate estimates, and (2) revisions to the calculation methodology used to estimate the credit subsidy rates. Loan performance data, which reflect mortgage market performance and FHA policy direction, are added as they become available. Revisions to the estimation methodology result from legislative direction and technical enhancements.

FHA estimated the credit subsidy rates for 2001 cohorts in fiscal year 1999. At the time of budget submission, the rates reflected prevailing policy and loan performance assumptions based on the most recent information available. These credit subsidy rates can be compared to the credit subsidy rates estimated at the end of 2001. The two rates can be reconciled through credit subsidy re-estimates, which allow FHA to adjust the LLG and subsidy expense to reflect the most current and accurate credit subsidy rate.

Described below are the programs that comprise the majority of FHA's fiscal year 2001 new business. In addition, the Hospital Insurance program is also described. These descriptions highlight the factors that contributed to changing credit subsidy rates and the credit subsidy re-estimate. Overall, FHA's liability decreased from the fiscal year 2000 values. The MMI Fund has a downward re-estimate of approximately $2.7 billion.

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

Due to the magnitude of the MMI Fund, program changes can significantly affect the overall LLG and subsidy expense recorded in the financial statements. During fiscal year 2001, recent data and changing economic conditions reduced the liability of the MMI fund. The majority of this change is due to the addition of the 2001 cohort to the LLG, which has a negative liability. Excluding the 2001 cohort, the total liability for cohorts 1992 to 2000 has increased due primarily to a change in the loss mitigation methodology. FHA used a more conservative approach, based on an analysis of additional data, to incorporate the impact of loss mitigation into the model. The LLG was also affected by the conditional claim and prepayment rates predicted by the *Actuarial Review of the MMI Fund as of Fiscal Year 2001*. In general, the new rates predict fewer claims and more prepayments, which reduces the overall liability of the fund.

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

The Section 221(d)(4) credit subsidy rate for the 2001 cohort, estimated in 1999, was higher than the rate calculated at the end of fiscal year 2001. This difference contributes to the downward credit subsidy re-estimate for fiscal year 2001 and decreases the LLG and subsidy expense. There are two reasons for the decrease in subsidy expense.

First, the Section of the Act codes used to model the experience of 221(d)(4) were modified in 2001. Previously FHA included the experience from the Section 220 Urban Renewal loans in the calculation of the loan performance assumptions for 221(d)(4). Now these loans are part of a new risk category called Other Rental, which contains market rate rental projects that differ in risk from 221(d)(4). Removal of these loans resulted in lower claim termination rates.

Second, the data underlying the subsidy expense estimate have been updated to reflect an additional year of loan performance information. The updated data reflected loan performance and economic factors, including the continued strength of the housing market and policies affecting the Section 221(d)(4) program. These new data resulted in reduced claim termination rates and lowered the subsidy expense and the LLG estimate.

GI/SRI Section 242 - The Office of Insured Health Care Facilities (OIHCF) operates within FHA. The OIHCF provides loan insurance through the Section 242 mortgage insurance program for the new construction of hospitals or the refinancing of existing FHA-insured hospitals. Many of the hospitals insured through the Section 242 program serve as community anchors that provide jobs and health care services to populations in need. Hospitals in New York State constitute approximately 90 percent of the Section 242 portfolio. The LLG estimate and subsidy expense for the Section 242 program decreased in 2001 due to the following two reasons.

Historical data on Section 242 program claim terminations are supplemented based on an OMB-designed defaulting methodology. Under this methodology, currently insured hospital loans are defaulted artificially in the data if they fail to meet three measures of financial strength and are on the Department of Health and Human Services (HHS) Priority Watch List (PWL). A revised HHS PWL and updated financial criteria data led to an increase in the number of hospitals artificially defaulted under this methodology in fiscal year 2001. Although the number of artificially defaulted hospitals increased, the claim termination rates decreased. This decrease in the claim terminations is due to lower unpaid principal balances on the hospital loans that were artificially defaulted in 2001 than those that were artificially defaulted in 2000. This decreased the LLG and subsidy expense.

Second, the recovery rate increased for the Section 242 program in 2001. The increase in the recovery rate resulted from the addition of data on two note sales in 2001, which represented large recoveries for FHA. These new data increased the recovery rate for Section 242 and lowered the LLG estimate and subsidy expense.

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

The majority of the change in the LLG is due to the incorporation of loss mitigation into the modeling process for the 234(c) program. The use of loss mitigation reduces projected claims and therefore results in a greater positive cash flow. The conditional claim and prepayment rates are another significant factor in the projections. The conditional claim and prepayment rates for the 234(c) program are based on the MMI rates predicted by the *Actuarial Review of the MMI Fund as of Fiscal Year 2001*. A new methodology for adjusting these rates, combined with the new MMI claim and prepayment rates, increases the liability. Overall, the recent data and changing economic conditions produces greater positive cash flow for the 234(c) program.

GI/SRI Section 203(k) - The section 203(k) program allows a homebuyer to finance the purchase and rehabilitation of a Single Family property with a mortgage loan insured by FHA. This program recently encountered incidents of fraud in New York City. Parties illegally obtained 203(k) loans by using not-for-profits as fronts to buy properties at inflated values. The property values were further inflated by falsely reporting that certain rehabilitation work would be performed. FHA explicitly accounted for these risks through its LLG estimates.

FHA developed these assumptions based on data and management's judgments about future loan performance. As a result, both the ordinary risks associated with potential fraudulent activities and the identified risks are accounted for in the LLG estimation. Overall, the claim costs plus the additional rehabilitation and maintenance costs increased the LLG by approximately $252 million as of September 30, 2001.

Differences in the Multifamily credit subsidy re-estimate

The GI/SRI Fund's Multifamily liability for loan guarantee (LLG) and associated credit subsidy re-estimate reported in FHA's fiscal year 2001 financial statements differ from the liability and credit subsidy re-estimate approved for apportionment by the Office of Management and Budget (OMB). The liability and credit subsidy re-estimate approved by OMB are based on different claim and prepayment rate assumptions for the Multifamily new construction programs. Use of the claim and prepayment rate assumptions approved by OMB results in a lower liability, and therefore decreases the amount of credit subsidy required by FHA to cover the liability. Thus, OMB approved a credit subsidy re-estimate $228 million lower than the re-estimate provided in FHA's fiscal year 2001 financial statements.

Recently, industry groups recommended improvements to the Multifamily credit subsidy model and OMB suggested that FHA consider the use of econometric methods to estimate claim and prepayment rates for its Multifamily programs. Based on these requests, FHA initiated a study to review the methods used to prepare its Multifamily LLG and credit subsidy estimates. Consistent with recommendations from OMB, FHA used loan level data from the 1963-2001 period in a logistic regression model to estimate conditional claim and prepayment rates.

At the conclusion of the study, OMB and FHA agreed to use the claim and prepayment rates from this new methodology to estimate FHA's fiscal year 2003 President's Budget credit subsidy rates for its Multifamily programs. Due to differences in the timing of the budget process and the issuance of FHA's fiscal year 2001 financial statements, the more conservative claim and prepayment rates were used to estimate the Multifamily LLG for financial statement purposes.

To ensure consistency between OMB's credit subsidy re-estimates and the financial statements, FHA submitted its credit subsidy re-estimate for the 1992-2001 cohorts to OMB based on the LLG used in the financial statements. Although FHA requested that OMB approve the LLG and credit subsidy re-estimate used in the financial statements, OMB required FHA to submit the re-estimate based on the new claim and prepayment rate assumptions. Since the credit subsidy re-estimate approved for apportionment by OMB differs from the credit subsidy re-estimate in the fiscal year 2001 financial statements by $228 million, such differences will be recorded in fiscal year 2002 apportioned authority. Per OMB Circular A-34, FHA will submit an apportionment request for the re-estimate in fiscal year 2002 that reflects the differences.

Note 6. Other Assets

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

Other Entity Assets (dollars in millions)	**2001**	**2000**
Intragovernmental Assets:		
Receivables from unapplied disbursements	$ 42	$ 41
Advances to HUD for working capital fund expenses	37	-
Total	$ 79	$ 41
Assets with the Public:		
Advances and Undistributed Charges	$ 15	$ 15
Other Assets	-	1
Total	$ 15	$ 16

Other Non-Entity Assets (dollars in millions)	**2001**	**2000**
Intragovernmental Assets:		
Mortgagor Reserves for Replacement – Investments	$ 7	$ 8
Assets With the Public:		
Mortgagor Reserves for Replacement – Cash	$ 110	$ 74

Total Other Assets		
Intragovernmental	$ 86	$ 49
Assets with the Public	125	90

Receivables from Unapplied Disbursements

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

Before fiscal year 2001, the receivables and payables were classified as receivable from and payable to the U.S. Treasury. In fiscal year 2001, these receivables and payables are classified as receivables and payables between different FHA U.S. Treasury accounts to more appropriately reflect the nature of the differences. As a result, in the process of preparing the FHA consolidated financial statements, these intra-FHA receivables and payables are eliminated. The remaining receivable or payable is reclassified to a receivable or payable with other U.S. Federal agencies. Accordingly, in fiscal year 2000, the offsetting receivables and payables in the amount of $280 million have been eliminated to conform to the fiscal year 2001 presentation.

Mortgagor Reserves for Replacement

FHA holds in trust amounts to cover repairs and renovations to properties associated with Multifamily mortgages held in its portfolio. These amounts have either been invested in U.S. Government securities or are deposited in minority-owned banks.

Note 7. Debt

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

Debentures Issued to Claimants and Borrowings from U.S. Treasury

(dollars in millions)	**2001**	**2000**
Agency Debt:		
Debentures Issued to Public – Par Value	$ 221	$ 218
Other Debt:		
Borrowings from U.S. Treasury	4,544	7,155
Total Debt	$ 4,765	$ 7,373
Classification of Debt:		
Intragovernmental Debt	$ 4,544	$ 7,155
Debt with the Public	221	218
Total Debt	$ 4,765	$ 7,373

Debentures Issued to Public

The National Housing Act authorizes FHA, in certain cases, to issue debentures in lieu of cash to settle claims. FHA-issued debentures bear interest at rates established by the U.S. Treasury. Interest rates related to the outstanding debentures ranged from 4.00 percent to 12.875 percent in 2001 and from 4.00 percent to 13.38 percent in 2000. They may be redeemed by lenders prior to maturity to pay mortgage insurance premiums to FHA, or they may be called with the approval of the Secretary of the U.S. Treasury.

The par value of debentures outstanding at September 30, was $221 million in fiscal year 2001 and $218 million in fiscal year 2000. The fair value based on original maturity dates was $278 million in fiscal year 2001, and $296 million in fiscal year 2000.

Borrowings from U.S. Treasury

In accordance with Credit Reform, FHA borrowed from the U.S. Treasury when cash was needed. Usually, a need for cash was recognized when FHA initially determined negative credit subsidy amounts related to new loan disbursements or to existing loan modifications. In some instances, borrowings were needed where available cash was less than claim payments due or downward subsidy re-estimates. All borrowings were made by FHA's financing accounts. Negative subsidies are generated primarily by the MMI/CMHI Fund financing account; downward re-estimates have occurred from activity of the FHA's loan guarantee financing accounts.

During fiscal years 2001 and 2000, FHA's U.S. Treasury borrowings carried interest rates ranging from 5.68 percent to 7.59 percent. Maturity dates occur from September 2004 – September 2020. Loans may be repaid in whole or in part without penalty at any time prior to maturity.

Funded borrowings and repayments as of September 30 were:

	From the Public		**From U.S. Treasury**		**Total**	
(dollars in millions)	**2001**	**2000**	**2001**	**2000**	**2001**	**2000**
Total borrowing, beginning of year	$ 218	$ 107	$ 7,155	$ 7,997	$ 7,373	$ 8,104
New borrowing	127	111	901	703	1,028	814
Repayments	(124)	-	(3,512)	(1,545)	(3,636)	(1,545)
Total borrowing, end of year	$ 221	$ 218	$ 4,544	$ 7,155	$ 4,765	$ 7,373

Note 8. Other Liabilities

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

Other Liabilities Covered by Budgetary Resources
(dollars in millions)

Intragovernmental Liabilities:	**Current**		**Non-Current**		**Total**	
	2001	**2000**	**2001**	**2000**	**2001**	**2000**
HUD – Section 312 rehabilitation program payable	$ 8	$ 7	$ -	$ -	$ 8	$ 7
Payable to other government agencies	22	-	-	-	22	-
Total	$ 30	$ 7	$ -	$ -	$ 30	$ 7

Liabilities with the Public:	**Current**		**Non-Current**		**Total**	
	2001	**2000**	**2001**	**2000**	**2001**	**2000**
Escrow funds and earnest money	$ 136	$ 167	$ -	$ -	$ 136	$ 167
Interest enhancement – Multifamily mortgage auctions	9	10	-	-	9	10
Certificates of claims payable	-	-	12	12	12	12
Amounts withheld from claims paid for foreclosure costs	-	-	12	14	12	14
Interest payable on debentures and outstanding claims	20	12	-	-	20	12
Trust and deposits related to coinsurance program	13	13	-	-	13	13
Miscellaneous undistributed credits and other payables	151	85	12	10	163	95
Payables and undistributed credit for credit program asset	39	21	-	(2)	39	19
Unconfirmed cash with U.S. Treasury (disbursements-in-transit)	68	101	-	-	68	101
Total	$ 436	$ 409	$ 36	$ 34	$ 472	$ 443

Note 9. Unexpended Appropriations

The Unexpended Appropriations for all program accounts are comprised of:

Unexpended Appropriations (dollars in millions)	**2001**	**2000**
Unobligated:		
Available	$1,889	$ 957
Unavailable	97	36
Undelivered Orders	143	158
Total	$2,129	$ 1,151

Prior to fiscal year 2000, appropriations were received by FHA's subsidized program funds (GI/SRI) for positive subsidy expenses and administrative expenses. FHA's unsubsidized program funds (MMI/CMHI) received appropriations of negative subsidy generated by the financing funds that were used to cover administrative expenses. Starting in fiscal year 2000, salary and administrative expenses and administrative contracts costs allocated to FHA were funded by annual appropriations received in both the MMI and the GI and SRI program accounts. At the end of the fiscal year, the unobligated balances include only unexpended appropriations for positive subsidy expense and contract expenses.

FHA's undelivered orders represent obligations for goods and services ordered but not yet received, obligations for credit subsidy of guaranteed loans committed but not yet disbursed by lenders, direct loans obligated but not yet disbursed by FHA, and administrative contract expenses committed but not disbursed as of September 30.

Note 10. Earned Revenue

FHA insures private lenders against loss on mortgages financing the purchase of Single Family homes, Multifamily projects, health care facilities, property improvements, and manufactured homes. FHA earned revenue is generated from its loan guarantee operations with the public except for interest income received from Fund Balance deposited at Treasury and Investments in U.S. Government Securities. The insurance premium is the primary revenue source for the MMI and CMHI Fund. Insurance premiums and other financing sources (congressional appropriations) support the GI and SRI Funds. The premium structure, set by the National Affordable Housing Act and published in the Code of Federal Regulations, which became effective July of fiscal year 1991, includes both an up-front premium for Single Family MMI, Multifamily GI, SRI and CMHI, and a periodic premium for all Funds, both Single Family and Multifamily. The premium rates generally remain constant from year to year.

Up-front Premiums

The up-front premium rate is used to calculate the up-front premium paid by borrowers. Rates, which are set by legislation, vary according to the mortgage type and the year of origination. Single Family up-front premiums for pre-Credit Reform cases 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 Multifamily up-front premium for pre-Credit Reform cases is treated much like a periodic premium, and is amortized 1/12 per month for the first full year.

The up-front premium rates in fiscal year 2001 were:

Up-front Premium Rates

	Mortgage Term 15 Years or Less	Mortgage Term More Than 15 Years
Single Family	1.50%	1.50%
Multifamily	.50%	.50%

Periodic Premiums

The periodic premium rate is used to calculate monthly or annual premium receipts. These rates, which are legislated, vary by mortgage type and program. Periodic premiums can be calculated on an amortized or unamortized basis, depending on the Fund. The periodic premium rate in fiscal year 2001 and 2000 for Single Family and Multifamily were:

Periodic Premium Rates

	Mortgage Term 15 Years or Less	Mortgage Term More Than 15 Years
Single Family	.25%	.50%
Multifamily	.50%	.50%

Although the up-front and periodic premium rates can vary slightly by Multifamily risk category, generally both rates remain 0.50 percent regardless of the mortgage term. For the Title I program, the maximum insurance premium paid is equal to 0.50 percent of the loan amount multiplied by the number of years of the loan term. The annual insurance premium paid for a Property Improvement loan is 0.50 percent of the loan amount until the maximum insurance charge is paid. Manufactured Housing's annual premium structure is tiered by loan term until the maximum insurance charge is paid.

Pre-Credit Reform insurance premiums earned during fiscal year 2001 totaled $278 million compared to $426 million in fiscal year 2000. Pre-Credit Reform income on sale of mortgage notes during fiscal year 2001 totaled $281 million compared to $98 million in fiscal year 2000. In accordance with the Credit Reform Act, all post-Credit Reform premium revenues have been recognized in the LLG. Interest income from Investments in U.S. Government Securities and from Fund Balance deposited at Treasury equals $1.609 billion in fiscal year 2001 and $1.42 billion in fiscal year 2000. Interest Income earned from Credit Program Notes and Credit Subsidy Re-estimate in fiscal year 2001 is $1.042 billion and in fiscal year 2000 is $1.144 billion. Other revenues totaled $44 million for fiscal year 2001, compared to $56 million in fiscal year 2000.

Note 11. Subsidy Expense Generated by New Endorsements

The following table identifies the components of subsidy expense generated by new insurance endorsements in fiscal year 2001:

Components of Subsidy Expense Generated by New Endorsements
(dollars in millions)

	Endorsement Amount	Default Component	Fees Component	Other Component	Subsidy Amount
MMI/CMHI	$ 107,410	$ 1,447	$ (4,055)	$ 334	$ (2,274)
GI/SRI					
Single Family	10,152	187	(251)	-	(64)
Title I	167	7	(7)	-	-
Multifamily	4,910	292	(242)	-	50
	15,229	486	(500)	-	(14)
Total	$ 122,639	$ 1,933	$ (4,555)	$ 334	$ (2,288)

The following table identifies the components of subsidy expense generated by new insurance endorsements in fiscal year 2000:

Components of Subsidy Expense Generated by New Endorsements
(dollars in millions)

	Endorsement Amount	Default Component	Fees Component	Other Component	Subsidy Amount
MMI	$ 86,227	$ 1,722	$ (4,047)	$ 461	$ (1,864)
GI/SRI					
Single Family	8,285	317	(318)	-	(1)
Title I	268	14	(10)	-	4
Multifamily	4,080	332	(219)	-	113
	12,633	663	(547)	-	116
Total	$ 98,860	$ 2,385	$ (4,594)	$ 461	$ (1,748)

Note 12. Gross Cost and Earned Revenue by Budget Functional Classification

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

Note 13. Status of Budgetary Resources

FHA has two program, two liquidating, and four financing appropriations. For presentation purposes, the four financing accounts have been collapsed into two due to small dollar amounts for appropriation 86X4242 and 86X4105.

The Statement of Budgetary Resources has been prepared as a combining statement and as such, intra-entity transactions have not been eliminated.

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

Pursuant to Public Law 101-510, unobligated balances associated with appropriations that expire at the end of the fiscal year remain available for obligation adjustments, but not for new obligations, until that account is canceled. When accounts are canceled, five years after they expire, amounts are not available for obligations or expenditure for any purpose.

The amount of budgetary resources obligated for unliquidated obligations at the end of the period were:

(dollars in millions)	2001	2000
Unliquidated Obligations, beginning of the year	$ 1,445	$ 1,468
Obligations Incurred during the year	20,718	12,004
Less: Expenditures during the year	20,686	12,027
Unliquidated Obligations, end of year	$ 1,477	$ 1,445

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

Financing sources for repayments are from premiums earned, and the maturity dates on these borrowings are generally 20 years or more. The balances of the Capital Transfers and Redemption of Debt line item in the Statement of Budgetary Resources in fiscal year 2001 and fiscal year 2000 are $4,880 million and $1,545 million respectively. In fiscal year 2001, the $4,880 million amount is composed of a repayment of $124 million for debentures, a repayment of $3,512 million for borrowing from the U.S. Treasury and a transfer to the U.S. Treasury of $1,244 million of unobligated balances that remained in the GI/SRI liquidating account at the end of fiscal year 2000.

Note 14. Financing Sources yet to be Provided

FHA financing sources yet to be provided will be paid from resources realized in the future. All liabilities are considered covered by budgetary resources because FHA has permanent indefinite appropriation authority, as discussed in Note 1.

(dollars in millions)	2001	2000
Financing sources yet to be provided:		
Subsidy expense from upward credit subsidy re-estimates	$ 1,552	$ 3,168
Interest expense from upward credit subsidy re-estimates	421	776
Total financing sources yet to be provided	$ 1,973	$ 3,944

Note 15. Financial Statement Presentation and Policy Changes

During fiscal year 2001, FHA management made several changes in accounting and reporting policy, some of which resulted in modifications to the balances of several line items of the fiscal year 2000 financial statements.

In fiscal year 2000, any interest that resulted from the passage of time in the loan guarantee financing accounts was recorded on a gross basis. In fiscal year 2001, this interest is recorded on a net basis to be consistent with that in the direct loan financing accounts and U.S. Treasury illustrated Credit Reform accounting guidance.

In fiscal year 2001, the Accounts Receivable, Net line item was added to the Balance Sheet. The fiscal year 2000 Balance Sheet was adjusted accordingly for comparative purposes. In fiscal year 2000, the accounts in this line item were included in the Other Asset line item.

Also, in fiscal year 2000 the balances of accounts receivable and accounts payable in the financing accounts were eliminated with their corresponding revenue and expenses. To comply with the U.S. Treasury guidance on reporting of receivables from the public and Credit Reform accounting, in fiscal year 2001, the balances of these receivables and payables are not eliminated.

FHA management made two significant changes to the calculation of the fiscal year 2001 Multifamily loan performance assumptions used to estimate the liability for loan guarantee (LLG). First, FHA included the historical experience of assisted loans to calculate the assumptions for the refinance and second mortgage risk categories. Previously, FHA did not include data from assisted loans in any risk category. The addition of the assisted loan data to the refinance and second mortgage risk categories decreased the LLG by $141 million.

Second, FHA created a new risk category called “Other Rental” for smaller, market-rate new construction programs previously grouped within the Section 221(d)(4) risk category. FHA reclassified the Section 220 Urban Renewal, Section 231 Market-Rate Elderly Housing, and Section 207 Mobile Home Park programs to the “Other Rental” risk category because they differ in risk from the Section 221(d)(4) loans. The “Other Rental” loan data are no longer used to calculate loan performance assumptions for Section 221(d)(4) or any of the smaller new construction risk categories that use Section 221(d)(4) data as a proxy. Since the more conservative “Other Rental” assumptions now apply to a smaller portion of FHA’s insured Multifamily portfolio, the LLG decreased by approximately $13 million.

Note 16. Prior Period Adjustments

FHA recorded $261 million in prior period adjustments in the year ended September 30, 2001. The adjustments consist of the following items:

Description	**Amount** (dollars in millions)
Adjustment to reclassify mortgage notes	$ 265
Reallocation of contract obligations	(12)
Other adjustments	8
Total prior period adjustments	$ 261

In prior years when mortgage notes were determined to be non-performing, interest collected prior to that determination was incorrectly reclassified as reductions of the notes principal. Accordingly, a prior period adjustment of $265 million was recorded to properly reflect the interest income earned in prior fiscal years.

The $12 million adjustment relates to FHA's correction of the allocation of contract obligations to the specific appropriation. In fiscal year 2001, FHA management refined the allocation methodology for contract obligations to better reflect the relationships between the services and specific programs.

The majority of the $8 million of Other adjustments relates to Fund Balance with Treasury corrections.

In fiscal year 2000, FHA recorded a prior period adjustment of $8 million to correct Single family accounting transactions.

Note 17. Contingencies

Litigation

FHA is party in various legal actions and claims brought by or against it. In the opinion of management and general counsel, the ultimate resolution of these legal actions and claims will not materially affect FHA's consolidated financial statements as of, and for, the fiscal years ended September 30, 2001 and 2000.

Required Supplementary Information

Schedule A: Intragovernmental Assets
(dollars in millions)

FHA's intragovernmental assets, by federal entity, are as follows:

Agency	Fund Balance with U.S. Treasury	Investments in U.S. Gov't Securities	Interest Receivable from U.S. Gov't Securities	Accounts Receivable	Other Assets
U.S. Treasury	$ 8,822	$ 17,105	$ 226	$ -	$ 7
HUD	-	-	-	9	37
Other Governmental Agencies	-	-	-	-	42
Total	$ 8,822	$ 17,105	$ 226	$ 9	$ 86

Schedule B: Intragovernmental Liabilities
(dollars in millions)

FHA's intragovernmental liabilities, by federal entity, are as follows:

Agency	Borrowings from U.S. Treasury	Payable to Special Receipt Acct for Subsidy Re-estimate	Other Liabilities
U.S. Treasury	$ 4,544	$ 1,396	$ -
HUD	-	-	7
Other Governmental Agencies	-	-	23
Total	$ 4,544	$ 1,396	$ 30

Required Supplementary Information

Schedule C: Budgetary Resources by Fund

	MMI/CMHI Total		GI/SRI Total		Total	
	2001	2000	2001	2000	2001	2000
Budget Authority						
Appropriations	$ 4,517	$ 491	$ 3,089	$ 1,456	$ 7,606	$ 1,947
Borrowing Authority	500	703	528	112	1,028	815
Unobligated Balances Carried Forward	20,447	17,503	3,029	2,450	23,476	19,953
Spending Authority from Offsetting Collections	15,308	11,748	2,534	2,391	17,842	14,139
Adjustments						
Recoveries of Prior Year Obligations	11	113	9	58	20	171
Enacted rescissions	(1)	-	(1)	-	(2)	-
Capital Transfers and Redemption of Debt	(3,022)	(904)	(1,858)	(641)	(4,880)	(1,545)
NET BUDGETARY RESOURCES	$ 37,760	$ 29,654	$ 7,330	$ 5,826	$45,090	$ 35,480
Status of Budgetary Resources:						
Obligations Incurred	$ 17,289	$ 9,207	$ 3,429	$ 2,797	$20,718	$ 12,004
Unobligated Balances - Available	1,945	3,823	1,815	1,084	3,760	4,907
Unobligated Balances - Not Available	18,526	16,624	2,086	1,945	20,612	18,569
TOTAL STATUS OF BUDGETARY RESOURCES	$ 37,760	$ 29,654	$ 7,330	$ 5,826	$45,090	$ 35,480
Outlays:						
Obligations Incurred	$ 17,289	$ 9,207	$ 3,429	$ 2,797	$20,718	$ 12,004
Less: Spending Authority from Offsetting Collections and Recoveries	15,319	11,861	2,543	2,449	17,862	14,310
Obligated Balance, Net - Beginning of Period	825	825	620	643	1,445	1,468
Less: Obligated Balance, Net - End of Period	685	825	792	620	1,477	1,445
TOTAL NET OUTLAYS	$ 2,110	$ (2,654)	$ 714	$ 371	$ 2,824	$ (2,283)

Required Supplementary Information

Schedule D: Comparative Budgetary Resources by Appropriation for the MMI/CMHI Funds– Fiscal Year 2001

	86 0183	86x4070	86x4587 & 86x4242	MMI/CMHI Total
Budget Authority				
Appropriations	$ 4,517	$ -	$ -	$ 4,517
Borrowing Authority	-	-	500	500
Unobligated Balances Carried Forward	11	17,767	2,669	20,447
Spending Authority from Offsetting Collections	-	4,565	10,743	15,308
Adjustments				
Recoveries of Prior Year Obligations	1	7	3	11
Enacted rescissions	(1)	-	-	(1)
Capital Transfers and Redemption of Debt	-	-	(3,022)	(3,022)
NET BUDGETARY RESOURCES	$ 4,528	$ 22,339	$ 10,893	$ 37,760
Status of Budgetary Resources:				
Obligations Incurred	$ 4,514	$ 4,592	$ 8,183	$ 17,289
Unobligated Balances - Available	11	603	1,331	1,945
Unobligated Balances - Not Available	3	17,144	1,379	18,526
TOTAL STATUS OF BUDGETARY RESOURCES	$ 4,528	$22,339	$10,893	$ 37,760
Outlays:				
Obligations Incurred	$ 4,514	$ 4,592	$ 8,183	$ 17,289
Less: Spending Authority from Offsetting Collections and Recoveries	1	4,572	10,746	15,319
Obligated Balance, Net - Beginning of Period	140	370	315	825
Less: Obligated Balance, Net - End of Period	120	541	24	685
TOTAL NET OUTLAYS	$ 4,533	$ (151)	$(2,272)	$ 2,110

Required Supplementary Information

Schedule D: Comparative Budgetary Resources by Appropriation for the MMI/CMHI Funds–Fiscal Year 2000

	86 0183	86x4070	86x4587 & 86x4242	MMI/CMHI Total
Budget Authority				
Appropriations	$ 491	$ -	$ -	$ 491
Borrowing Authority	-	-	703	703
Unobligated Balances Carried Forward	-	14,531	2,972	17,503
Spending Authority from Offsetting Collections	-	3,939	7,809	11,748
Adjustments				
Recoveries of Prior Year Obligations	-	109	4	113
Capital Transfers and Redemption of Debt	-	-	(904)	(904)
NET BUDGETARY RESOURCES	$ 491	$ 18,579	$ 10,584	$ 29,654
Status of Budgetary Resources:				
Obligations Incurred	$ 482	$ 810	$ 7,915	$ 9,207
Unobligated Balances - Available	9	2,082	1,732	3,823
Unobligated Balances - Not Available	-	15,687	937	16,624
TOTAL STATUS OF BUDGETARY RESOURCES	$ 491	$ 18,579	$ 10,584	$ 29,654
Outlays:				
Obligations Incurred	$ 482	$ 810	$ 7,915	$ 9,207
Less: Spending Authority from Offsetting Collections and Recoveries	-	4,048	7,813	11,861
Obligated Balance, Net - Beginning of Period	-	887	(62)	825
Less: Obligated Balance, Net - End of Period	141	369	315	825
TOTAL NET OUTLAYS	$ 341	$ (2,720)	$ (275)	$ (2,654)

Required Supplementary Information

Schedule E: Comparative Budgetary Resources by Appropriation for the GI/SRI Funds– Fiscal Year 2001

	86 0200	86x4072	86x4077 & 86x4105	GI/SRI Total
Budget Authority				
Appropriations	$ 743	$ 2,346	$ -	$ 3,089
Borrowing Authority	-	128	400	528
Unobligated Balances Carried Forward	64	1,163	1,802	3,029
Spending Authority from Offsetting Collections	(7)	984	1,557	2,534
Adjustments				
Recoveries of Prior Year Obligations	2	7	-	9
Enacted rescissions	(1)	-	-	(1)
Capital Transfers and Redemption of Debt	-	(1,368)	(490)	(1,858)
NET BUDGETARY RESOURCES	$ 801	$ 3,260	$ 3,269	$ 7,330
Status of Budgetary Resources:				
Obligations Incurred	$ 654	$ 1,273	$ 1,502	$ 3,429
Unobligated Balances - Available	53	900	862	1,815
Unobligated Balances - Not Available	94	1,087	905	2,086
TOTAL STATUS OF BUDGETARY RESOURCES	$ 801	$ 3,260	$ 3,269	$ 7,330
Outlays:				
Obligations Incurred	$ 654	$ 1,273	$ 1,502	$ 3,429
Less: Spending Authority from Offsetting Collections and Recoveries	(5)	991	1,557	2,543
Obligated Balance, Net - Beginning of Period	130	593	(103)	620
Less: Obligated Balance, Net - End of Period	113	802	(123)	792
TOTAL NET OUTLAYS	$ 676	$ 73	$ (35)	$ 714

Required Supplementary Information

Schedule E: Comparative Budgetary Resources by Appropriation for the GI/SRI Funds– Fiscal Year 2000

	86 0200	86x4072	86x4077 & 86x4105	GI/SRI Total
Budget Authority				
Appropriations	$ 262	$ 1,194	-	$ 1,456
Borrowing Authority	-	112	-	112
Unobligated Balances Carried Forward	266	257	$ 1,927	2,450
Spending Authority from Offsetting Collections	7	863	1,521	2,391
Adjustments				
Recoveries of Prior Year Obligations	13	38	7	58
Capital Transfers and Redemption of Debt	-	-	(641)	(641)
NET BUDGETARY RESOURCES	$ 548	$ 2,464	$ 2,814	$ 5,826
Status of Budgetary Resources:				
Obligations Incurred	$ 484	$ 1,301	$ 1,012	$ 2,797
Unobligated Balances - Available	28	677	379	1,084
Unobligated Balances - Not Available	36	486	1,423	1,945
TOTAL STATUS OF BUDGETARY RESOURCES	$ 548	$ 2,464	$ 2,814	$ 5,826
Outlays:				
Obligations Incurred	$ 484	$ 1,301	$ 1,012	$ 2,797
Less: Spending Authority from Offsetting Collections and Recoveries	20	901	1,528	2,449
Obligated Balance, Net - Beginning of Period	62	636	(55)	643
Less: Obligated Balance, Net - End of Period	129	594	(103)	620
TOTAL NET OUTLAYS	$ 397	$ 442	$ (468)	$ 371

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Secretary's Representatives
Chief, Housing Branch, Office of Management and Budget, 725 17th Street, NW, Room 9226, New Executive Office Bldg., Washington, DC 20503
Chairman, Committee on Governmental Affairs, United States Senate, Washington, DC 20510
Ranking Minority Member, Committee on Governmental Affairs, United States Senate, Washington, DC 20510

Chairman, Committee on Government Reform, House of Representatives, Washington, DC 20515
Ranking Minority Member, Committee on Government Reform, House of Representatives, Washington, DC 20515
Senior Advisor, Subcommittee on Criminal Justice, Drug Policy & Human Resources, B373 Rayburn House Office Building, Washington, DC 20515
Subcommittee on Oversight and Investigations, Room 212, O'Neil House Office Building, Washington, DC 20515
Committee on Financial Services, 2129 Rayburn House Office Building, Washington, DC 20515
Director, Civil Agencies' Financial Management, US GAO, 441 G Street NW, Room 5089, Washington, DC 20548
Assistant Associate Director, Housing and Telecommunications Issues, US GAO, 441 G Street, NW, Room 2T23, Washington, DC 20548