audit
report

Issue Date
February 27, 2002

Case Number
2002-FO-0003

TO: Angela Antonelli, Chief Financial Officer, F

//signed//
FROM: Randy W. McGinnis, Director, Financial Audits Division, GAF
SUBJECT: **Audit of the U.S. Department of Housing and Urban Development (HUD) Financial Statements for Fiscal Years 2001 and 2000**

In accordance with the Chief Financial Officers (CFO) Act of 1990, as amended, this report presents the results of our audit of HUD's principal financial statements for the years ended September 30, 2001 and 2000. Also provided are assessments of HUD's internal controls and compliance with laws and regulations. Our report includes a copy of HUD's principal financial statements. By February 27, 2002, HUD is required to submit the audit report to the Office of Management and Budget (OMB) along with additional required supplementary information, including Management's Discussion and Analysis, Required Supplementary Stewardship Information and information on intra-governmental amounts. Pursuant to the Reports Consolidation Act of 2000 (PL 106-531), HUD is preparing its *Fiscal Year 2001 Performance and Accountability Report*, which will consolidate these and other reports, including HUD's fiscal year 2001 performance report required by the Government Performance and Results Act and a statement prepared by the HUD Inspector General that summarizes what he considers to be the most serious management and performance challenges facing HUD. The *Fiscal Year 2001 Performance and Accountability Report* is to be submitted by HUD to OMB and appropriate committees and subcommittees of the Congress no later than March 29, 2002. We also identified several matters which, although not reportable conditions, will be communicated in a separate management letter to the Department. We appreciate the courtesies and cooperation extended to the OIG staff and our contractor.

In accordance with HUD Handbook 2000.6 REV-3, within 60 days, please submit to me, for each recommendation listed in the first section of Appendix B that is addressed to the CFO, a status report on: (1) the corrective action taken; (2) the proposed corrective action and target completion dates; or (3) why action is considered unnecessary. For recommendations addressed to the Deputy Secretary, the assistant secretaries or their staffs, please coordinate their response or, at your option, request that they respond directly to me. An additional status report is required on any recommendation without a management decision after 110 days. Also, please furnish us with copies of any correspondence or directives issued in response to our report.

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Abbreviations:

BRP	business resumption plan
CM	configuration management
CFO	Chief Financial Officer
DEC	Departmental Enforcement Center
FERA	Front-End Risk Assessment
FFMIA	Federal Financial Management Improvement Act
FHA	Federal Housing Administration
FMC	Financial Management Center (Section 8)
FMFIA	Federal Managers' Financial Integrity Act
FSI	Financial Systems Integration
GAO	General Accounting Office
GPRA	Government Performance and Results Act
GTR	Government Technical Representative
HA	housing authority
HAP	housing assistance payment
HUD	Department of Housing and Urban Development
HUDCAPS	HUD's Central Accounting and Program System
IA	independent auditor
IBS	Integrated Business System
IDIS	Integrated Disbursement and Information System
IRS	Internal Revenue Service
IT	information technology
LOCCS	Line of Credit and Control System
MTCS	Multifamily Tenant Characteristics System
OIG	Office of Inspector General
OMB	Office of Management and Budget
PAS	Program Accounting System
PHAS	Public Housing Assessment System
PHMAP	Public Housing Management Assessment Program
PIH	Office of Public and Indian Housing
POH	Primary Organization Head
REAC	Real Estate Assessment Center
REAP	Resource Estimation and Allocation Process
REMS	Real Estate Management System
RHIIP	Rental Housing Integrity Improvement Project
SEMAP	Section 8 Management Assessment Program
SFFAS	Statement of Federal Financial Accounting Standards
SGL	Standard General Ledger (of the United States Government)
SHFA	State Housing Finance Agency
SS	Social Security
SSA	Social Security Administration
SSI	Supplemental Security Income
TARC	Troubled Agency Recovery Center
TRACS	Tenant Rental Assistance Certification System

Independent Auditor's Report

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

In accordance with the Chief Financial Officers (CFO) Act of 1990, we have audited the accompanying consolidated balance sheets of the Department of Housing and Urban Development (HUD) 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 fiscal years then ended. The objective of our audit was to express an opinion on the fair presentation of these principal financial statements. In connection with our audit, we also considered HUD's internal control over financial reporting and tested HUD's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its principal financial statements.

Opinion on the Financial Statements

In our opinion, the accompanying principal financial statements present fairly, in all material respects, the financial position of HUD as of September 30, 2001 and 2000 and the net costs of operations, changes in net position, status of budgetary resources, and reconciliation of net costs to budgetary obligations for the fiscal years then ended, in conformity with generally accepted accounting principles.

Our audit also disclosed:

- Material weaknesses in internal controls in fiscal year 2001 related to the need to:
  - complete improvements to financial systems;
  - improve oversight and monitoring of housing subsidy determinations;
  - ensure that rental subsidies are based on correct tenant income;
  - improve Federal Housing Administration's (FHA) controls over budget execution and funds control; and
  - enhance FHA information technology systems to more effectively support FHA's business processes.
- Reportable conditions in internal controls in fiscal year 2001 related to the need to:
  - refine performance measures to effectively implement results management;
  - improve controls over project-based subsidy payments;
  - strengthen controls over HUD's computing environment;
  - improve personnel security for systems' access;
  - improve processes for reviewing obligation balances;
  - more effectively manage controls over the FHA systems' portfolio;
  - place more emphasis on monitoring lender underwriting and improving early warning and loss prevention for FHA single family insured mortgages;
  - sufficiently monitor FHA's single family property inventory; and
  - improve FHA's process for preparing timely estimates and properly reporting credit subsidy adjustments.

Most of these control weaknesses were reported in prior efforts to audit HUD's financial statements and represent long-standing problems. In its *Fiscal Year 2000 Performance and Accountability Report*, HUD reported that it complied with Section 2 of the Federal Managers' Financial Integrity Act (FMFIA), with the exception of the material weaknesses and nonconformances specifically identified in that report. Section 2 and related guidance require that: (1) an agency's internal accounting and administrative controls provide reasonable assurance that obligations and costs are in compliance with applicable laws; (2) funds, property and assets are adequately safeguarded; and (3) revenues and expenditures are properly and reliably accounted for and reported. HUD was unable to report compliance with Section 4, which requires that accounting systems conform to the accounting principles and standards mandated by the Comptroller General of the United States. For fiscal year 2000 and prior years, we disagreed with the Department's statement of overall assurance in the Department's *Accountability Reports*. HUD's compliance determinations did not fully consider the magnitude of the problems HUD acknowledges in its own FMFIA process. As permitted by the Reports Consolidation Act of 2000 (PL 106-531), HUD did not prepare a separate FMFIA report for fiscal year 2001, but will be addressing those reporting requirements in its *Fiscal Year 2001 Performance and Accountability Report*. Given the magnitude of the problems that still remain, we continue to believe that an FMFIA statement of noncompliance would be appropriate for HUD.

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

- HUD did not substantially comply with the Federal Financial Management Improvement Act (FFMIA). In this regard, HUD's financial management systems did not substantially comply with (1) Federal Financial Management Systems Requirements, (2) applicable accounting standards, and (3) the U.S. Standard General Ledger (SGL) at the transaction level.

- HUD did not comply with the United States Housing Act of 1937, as amended by the Quality Housing and Work Responsibility Act of 1998. Specifically, HUD is not timely or properly enforcing the act's requirements for the timely expenditure and obligation by housing agencies (HA) of public housing modernization/capital funds. As discussed later, HUD disagreed with our conclusion when we first reported this matter, and as a result, we referred the matter to the Comptroller General of the United States.

Consolidating Financial Information

We conducted our audit for the purpose of forming an opinion on the fiscal years 2001 and 2000 principal financial statements taken as a whole. HUD plans to present consolidating balance sheets and related consolidating statements of net costs and changes in net position, and combining statements of budgetary resources and financing as supplementary information in its *Fiscal Year 2001 Performance and Accountability Report*. The consolidating and combining financial information is to be presented for purposes of additional analysis of the financial statements rather than to present the financial position, changes in net position, status of budgetary resources, and reconciliation of net costs to budgetary obligations of HUD's major activities. The consolidating and combining financial information is not a required part of the principal financial statements. The financial information has been subjected to the auditing procedures applied to the principal financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

Required Supplementary Information

In their *Fiscal Year 2001 Performance and Accountability Report*, HUD plans to present "Required Supplemental Stewardship Information," specifically, information on investments in non-federal physical property and human capital. In addition, HUD plans to present a (Management's) "Discussion and Analysis of Operations" and information on intra-governmental balances. This information is not a required part of the basic financial statements but is supplementary information required by the Federal Accounting Standards Advisory Board and Office of Management and Budget (OMB) Bulletin 01-09, *Form and Content of Agency Financial Statements*. We did not audit and do not express an opinion on this information, however, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. In accordance with guidelines required by the January 7, 2000 technical amendment to OMB Bulletin 97-01, the Department, through confirmations, reconciled their intragovernmental transactions with their trading partners with immaterial differences.

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

Issues with HUD's Internal Control Environment

Most of the material weaknesses and reportable conditions discussed in this report relate to issues discussed in prior years' reports on HUD's financial statements. HUD has been taking actions to address the weaknesses and in some instances has made progress in correcting them. For the most part, progress has been at a slow pace because HUD needs to address issues that fundamentally impact its internal control environment. These issues are Department-wide in scope and must be addressed for HUD to more effectively manage its programs. We have reported for the past several years that HUD has made progress toward overhauling its operations and addressing its management problems through these efforts, but challenges remain. As discussed below, HUD's ability to address its problems will substantially improve if it completes the efforts to:

- deploy a reliable financial management system that meets its program and financial management needs and complies with federal requirements, and

- develop a process to identify and justify its staff resource requirements.

The most critical need faced by HUD in improving its control environment is to complete development of adequate systems. The lack of an integrated financial system in compliance with federal financial system requirements has been reported as a material weakness since fiscal year 1991. To correct financial management deficiencies in a Department-wide manner, HUD initiated a project to design and implement an integrated financial system consisting of both financial and mixed systems. Over the years, the Department's plans have experienced significant schedule delays, changes in direction and cost overruns.

In addition to improving its financial systems, HUD will need to more effectively manage its limited staff resources. Many of the weaknesses discussed in this report, particularly those concerning HUD's oversight of program recipients, are exacerbated by HUD's resource management shortcomings. Accordingly, we consider it critical for the Department to address these shortcomings through the successful completion of ongoing plans.

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

Housing Assistance Program Delivery

HUD provides housing assistance funds under various grant and subsidy programs to multifamily project owners (both nonprofits and for profit) and HAs. These intermediaries, in-turn, provide housing assistance to benefit primarily low-income households. HUD spent about $21 billion in fiscal year 2001 to provide rent and operating subsidies that benefited over 4 million households. Weaknesses exist in HUD's control structure such that HUD cannot be assured that these funds are expended in accordance with the laws and regulations authorizing the grant and subsidy programs.

Legislation authorizing HUD's housing assistance programs includes specific criteria concerning tenant eligibility and providing assistance for housing that meets acceptable physical standards. Moreover, legislation authorizing HUD's programs also establishes minimum performance levels to be achieved. For example, subsidized housing must comply with HUD's housing quality standards.

HUD relies heavily upon intermediaries to ensure that rent calculations for assisted households are based on HUD requirements. Ultimately, these rent calculations determine the amount of subsidy HUD pays on behalf of the assisted household. Under project-based programs administered by the Office of Housing, the individual project owners or agents carry out this responsibility. Under public housing and tenant-based Section 8 programs, the HAs determine eligibility and rent amounts for eligible households residing in public housing or at approved housing provided by private landlords. In prior reports on HUD's financial statements, we have expressed concerns about the significant risk to HUD that these intermediaries are not properly carrying out this responsibility. HUD's control structure does not adequately address this risk due to insufficient on-site monitoring along with the absence of an on-going quality control program that would periodically assess the accuracy of intermediaries' rent determinations.

A recently completed contracted study of rent determinations under HUD's major housing assistance programs estimates that errors made by project owners and HAs resulted in substantial subsidy overpayments and underpayments. The purpose of the study was to provide national estimates of the extent, severity, costs, and sources of errors occurring in the certification and recertification procedures used by HAs and owners in calculating tenant rents. The study projected that annually, about $1.7 billion in subsidies was overpaid on behalf of households paying too little rent and about $0.6 billion in subsidies was underpaid on behalf of households paying too much rent based on HUD requirements.

Verification of Subsidy Payments

As discussed above, HUD provides rent and operating subsidies through a variety of programs, including public housing and Section 8. The admission of a household to these rental assistance programs and the size of the subsidy it receives depend directly on it's the household's self-reported income. HUD matched computer income with its assisted housing universe and estimated that housing subsidy overpayments from tenants misreporting their income totaled $978 million during calendar year 2000. Tenants often do not report income or under report income which, if not detected, causes HUD to make excessive subsidy payments. Tenant income is a major factor affecting eligibility for, and the amount of, housing assistance a family receives, and indirectly, the amount of subsidy HUD pays. Generally, HUD's subsidy payment makes up the difference between 30 percent of a household's adjusted income and the housing unit's actual rent or, under the Section 8 voucher program, a payment standard.

In fiscal year 2001, HUD initiated the Rental Housing Integrity Improvement Project (RHIIP), which calls for systems capability that will identify relevant tenant and program data for rent calculations, and requires the data to be submitted by HAs. HUD would use the data to identify possible HAs certification or re-certification processing deficiencies. This increased capability and information could also make the large-scale computer match a viable option for identifying excess rental subsidy or tenant overpayments.

System and Accounting Issues

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

- controls over the computing environment; and

- administration of personnel security operations.

We also noted the need for HUD to improve its processes for reviewing outstanding obligations to ensure that unneeded amounts are deobligated in a timely manner. Major deficiencies include:

- Specific statutory or grant requirements for outstanding obligations are not being enforced.
- A lack of integration between accounting systems and the need for accurate databases has hampered HUD's ability to evaluate unexpended Section 8 project-based obligations.

Results of the Audit of FHA's Financial Statements

A separate audit was performed of FHA's fiscal year 2001 and 2000 financial statements by the independent certified public accounting firm of KPMG LLP. Their report on FHA's financial statements, dated January 31, 2002,[1] includes an unqualified opinion on FHA's financial statements, along with discussions of two material weaknesses and four reportable conditions. The FHA material weaknesses are as follows:

- HUD/FHA's ADP system environment must be enhanced to more effectively support FHA's business processes. HUD and FHA are conducting day-to-day business with legacy-based systems. Several systems directly impact FHA's financial activity and necessitate financial transactions to be processed through non-integrated systems, requiring manual analysis and summary entries to be posted to FHA's general ledger. FHA's and HUD's inability to implement modern information technology adversely affects the internal controls related to accounting and reporting financial activities.
- 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 ADP integrated process. 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 the risk of errors resulting from reliance on manual processes.

KPMG LLP also notes four reportable conditions regarding the need for FHA and HUD to: (1) more effectively manage controls over the FHA ADP systems portfolio, (2) continue to place more emphasis on monitoring lender underwriting and improving early warning and loss prevention for single family insured mortgages, (3) sufficiently monitor its single family property inventory, and (4) continue to improve its process for preparing timely estimates and properly reporting credit subsidy adjustments.

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[1] KPMG LLP's report on FHA entitled, "Audit of Federal Housing Administration Financial Statements for Fiscal Years 2001 and 2000" (2002-FO-0002, dated February 22, 2002) was incorporated in our report.

We consider the above issues to be material weaknesses and reportable conditions at the Departmental level. A more detailed discussion of these issues can be found in KPMG LLP's report on FHA's fiscal years 2001 and 2000 financial statements.

Results of the Audit of Ginnie Mae's Financial Statements

A separate audit was performed of the Government National Mortgage Association's (Ginnie Mae) financial statements for fiscal years 2001 and 2000 by KPMG LLP. Their report on Ginnie Mae's financial statements, dated January 14, 2002,[2] includes an unqualified opinion on these financial statements. In addition, the audit results indicate that there were no material weaknesses or reportable conditions with Ginnie Mae's internal controls, or material instances of non-compliance with laws and regulations.

HUD Has Made Progress in Addressing Management Deficiencies, but More Progress is Needed

Most of the issues described in this report represent long-standing weaknesses that will be difficult to resolve. HUD's management deficiencies have received much attention in recent years. For example, in January 1994, GAO designated HUD as a high-risk area, the first time such a designation was given to a cabinet level agency. Since that time, HUD has devoted considerable attention and priority to addressing the Department's management deficiencies and has made some progress. In their January 2001 update, GAO redefined and reduced the number of programs deemed to be high-risk. Specifically, because of the actions taken by HUD in response to GAO's recommendations to improve its management controls over its Community Planning and Development programs, GAO concluded that this program area is no longer high risk. However, GAO concluded that significant weaknesses still persist in two of HUD's major program areas: (1) single-family mortgage insurance and (2) rental housing assistance. In addition, HUD needs to continue addressing management challenges in two other areas: (1) information and financial management systems and (2) human capital.

With respect to fiscal years 2001 and 2000, we were able to conclude that HUD's consolidated financial statements were reliable in all material respects. However, because of continued weaknesses in HUD's internal controls and financial management systems, HUD continues to rely on extensive ad hoc analyses and special projects to develop account balances and necessary disclosures.

Agency Comments and Our Evaluation

On January 31, 2002, we provided a draft of the internal control and compliance sections of our report to the CFO and appropriate assistant secretaries and other Departmental officials for review and comment, and requested that the CFO coordinate a Department-wide response. The CFO responded in a memorandum dated February 14, 2002, which is

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[2] KPMG LLP's report on Ginnie Mae entitled, "Audit of Government National Mortgage Association Financial Statements for Fiscal Years 2001 and 2000" (2002-FO-0001, dated February 20, 2002) was incorporated in our report.

included in its entirety as Appendix D. Remaining sections of the draft report were provided on February 20, 2002. The Department generally agreed with our presentation of findings and recommendations subject to detailed comments included in the memorandum and attachments. The Department's response was considered in preparing the final version of this report. Our detailed evaluation of the response is included in Appendix E.

The following sections of this report provide additional details on our findings regarding HUD's internal control environment, housing assistance program delivery, verification of subsidy payments, system and accounting issues, and noncompliance with laws and regulations.

//signed//

James A. Heist
Assistant Inspector General
for Audit

February 25, 2002

HUD's Internal Control Environment

HUD Continues to be Impacted by Weaknesses in the Control Environment

Most of the material weaknesses and reportable conditions discussed in this report are the same as those included in prior years' reports on HUD's financial statements. HUD has been taking actions to address the weaknesses and in some instances has made progress in correcting them. For the most part, however, progress has been at a slow pace in large part because HUD needs to address issues that fundamentally impact its internal control environment. These issues are Department-wide in scope and must be addressed for HUD to more effectively manage its programs. We have reported for the past several years that HUD has made progress toward overhauling its operations and addressing its management problems through these efforts but challenges remain. As discussed below, HUD's ability to address its problems will substantially improve if it completes the efforts to:

- deploy a reliable financial management system that meets its program and financial management needs and complies with federal requirements, and

- develop a process to identify and justify its staff resource requirements.

Financial Systems

The most critical need faced by HUD in improving its control environment is to complete development of adequate systems. The lack of an integrated financial system in compliance with federal financial system requirements has been reported as a material weakness since fiscal year 1991. To correct financial management deficiencies in a Department-wide manner, HUD initiated a project to design and implement an integrated financial system consisting of both financial and mixed systems. Over the years, the Department's plans have experienced significant schedule delays, changes in direction and cost overruns. Later in this section of this report is a discussion of the material weakness relating to HUD's financial systems.

Resource Management

In addition to improving its financial systems, HUD will need to more effectively manage its limited staff resources. Many of the weaknesses discussed in this report, particularly those concerning HUD's oversight of program recipients, are exacerbated by HUD's resource management shortcomings. Accordingly, we consider it critical for the Department to address these shortcomings through the successful completion of ongoing plans. However, we have not categorized resource management as a separate internal control reportable condition because the effect on HUD's financial statements can be appropriately characterized as a contributing cause for internal control weaknesses described in other sections of our report.

To operate properly and hold individuals responsible for performance, HUD needs to know that it has the right number of staff with the proper skills. Our office and the National Academy of Public Administration (NAPA) recommended that HUD develop a resource management system to align resources with program needs. In 1997, HUD announced plans to implement a resource estimation process that "would be a disciplined and analytical approach, to identify, justify, and integrate resource requirements and budget allocations." HUD worked with NAPA to develop a methodology for resource estimation and allocation. NAPA's methodology was tested and refined in several HUD offices.

We reported in prior years that HUD had not developed a comprehensive strategy to manage its resources. To address staffing imbalances and other human capital challenges, the Department has implemented the Resource Estimation and Allocation Process (REAP). The last phase of REAP (a baseline for staffing requirements) was completed in December 2001. The next step in development of the Department's resource management strategy is the implementation of the Total Estimation and Allocation Mechanism (TEAM). TEAM is the validation component of REAP and will collect actual workload accomplishments and staff usage for comparison against the REAP baseline. TEAM is scheduled for implementation in the Spring of Fiscal Year 2002.

Other control environment issues

In addition to system and resource management issues, in prior years, we reported on other issues that HUD needed to address that we believed impacted its ability to effectively manage its programs. We are able to report some progress. For example, HUD has tightened controls over fund balance with Treasury reconciliations. This issue is no longer reported as a reportable condition. For another reportable condition, the process for reviewing obligations, progress has been made in implementing procedures and improving the information systems to ensure accurate data is used. Presented below is a discussion of the remaining material weaknesses and reportable conditions relating to the Department's control environment.

Material Weakness: Financial Management Systems are Not Substantially Compliant with Federal Financial System Requirements

The Federal Financial Management Improvement Act (FFMIA) requires that we report on whether the financial management systems comply substantially with the:

1. Federal financial management systems requirements, contained in OMB Circular A-127, and in the Joint Financial Management Improvement Program (JFMIP) functional requirements documents;

2. Applicable federal accounting standards; and

3. Standard General Ledger (SGL) at the transaction level.

Besides requiring agencies to record and classify their transactions in accordance with the SGL, these criteria require that the core financial management system be integrated through automated interfaces with other agency systems (financial, program, or a mixture of both) so that transactions are entered only once.

The components of the integrated financial management system, which should be electronically linked include:

- the core financial system that provides for the agency's standard general ledger, payment, receipt, cost, funds management, and reporting;
- other financial or program systems or a mixture of both that support the agency's ability to manage and operate its mission programs and/or financial operations;
- shared systems with another government agency, such as the U.S. Treasury; and
- an agency executive information system (e.g., data warehouse) that provides financial and program management information to all manager levels.

Based on the criteria above, the Department's financial management systems do not substantially comply with the federal financial management systems requirements. This noncompliance represents a material weakness in internal controls, as the risk for material misstatements in the financial statements has not been reduced to a relatively low level. Although the Department's remedial plan's actions have eliminated the deficiencies in access controls and Treasury reporting functions (SF-224) of the Department's general ledger (HUDCAPS), last year's reported deficiencies for the supporting financial management systems and their HUDCAPS interfaces still remain.

Prior year's deficiencies in the supporting financial management systems remain uncorrected

The following financial management system deficiencies, which were reported in last year's report, were present during fiscal year 2001:

- Several interfaces, such as that with the FHA's subsidiary ledger, to the core financial system's general ledger are either not automated or require manual analyses, reprocessing and additional entries.
- Deficient FHA general ledger and subsidiary systems.
- Inability to support adequate funds control for FHA.
- Inadequate assurance about the propriety of Section 8 rental assistance payments (see report sections beginning with "Controls Over Project-based Subsidy Payments Need to be Improved").
- Inability to fully support the timely identification of excess funds remaining on expired project-based Section 8 contracts (see report

section "HUD Needs to Develop an Accurate Database for Evaluating Section 8 Project-based Obligations").

In addition, the Department's financial systems continue to have access control weaknesses in the general control environment as reported elsewhere in this report.

Status of the Department's financial systems remediation plans

As reported last year, the FHA general ledger and its supporting subsidiary systems are not compliant with SGL and JFMIP requirements. Its 19 subsidiary systems that feed transactions to its commercial general ledger system lack the capabilities to process transactions in the SGL format and provide required credit reform data (accounts identified by the cohort year of loan or guarantee commitment and program risk category). The existing general ledger system also lacks an adequate funds control capability. Several manual processing steps, including the use of personal computer based software, are used to add credit reform data, convert the commercial account balances to government SGL, maintain funds control records, and transfer the resulting account balances to HUDCAPS.

During fiscal year 2000, FHA purchased a JFMIP compliant commercial "off-the-shelf" (COTS) SGL financial system to replace the current system, beginning with the general ledger system. Although the new general ledger was supposed to have been completed by March 2002, no significant implementation actions been made since last year's report because of delays in awarding the necessary procurement contracts for implementation services. The first of the planned procurement awards was not executed until December 2001. FHA now anticipates that the project will be implemented and ready for parallel testing by October 1, 2002.

During August 2000, the Deputy Chief Financial Officer issued a vision statement that concluded that HUDCAPS and the supporting payments and funds control systems, LOCCS and PAS, should be replaced. That vision statement has since been retracted because the necessary feasibility and cost-benefit studies to support that conclusion were not performed. Funds to contract out these studies were budgeted during FY 2001; however, there has been no progress on the contracting effort.

The Department also has not made any significant progress in the development of the consolidated Departmental Grants Management System (DGMS) or the Departmental Data Warehouse projects. A new DGMS project effort, contracted in January 2001, has recently failed and future OMB funding of any new efforts is questionable.

Other financial management system deficiencies identified

For the fiscal year 2001 Financial Statement Audit, we evaluated the core financial systems of HUDCAPS, PAS, LOCCS, and Hyperion (a financial statement reporting system), and the supporting financial management systems of the Integrated Disbursements and Information System (IDIS), a grants management system, and the Loan Accounting System (LAS), to determine the level of compliance with JFMIP requirements. We found the following noncompliance with the federal financial management systems requirements:

- The Department's federal grant management systems and the core financial payment systems are noncompliant with the June 2000 JFMIP requirements for federal grants accounting. This JFMIP pronouncement requires these systems to (1) record grant payments as either agency advances or expenses/payables and (2) to accrue unreimbursed grantee expenditures at fiscal year-end. Neither the Department's automated systems nor its manual processes have the current capability to obtain all required information

- The accounts payable amounts recorded in a HUDCAPS' subsystem, Project Cost Accounting System (PCAS) are understated (by an estimated $15 million as of July 2001.) This occurred because contractor invoices for services provided are not recorded until they are approved for payment, which are much later than when received.

- The crosswalk interfaces between HUDCAPS and its reporting system (Hyperion) have not been developed to transfer FHA and GNMA account balances. As a substitute, HUD is manually posting those entities' financial statement figures directly into Hyperion, which increases the chances for misstatements from human error or from any unreconciled differences with recorded balances.

- The Loan Accounting System (LAS), which was developed for construction loan accounting, was not modified to properly account for the different business rules associated with flexible subsidy loans. LAS replaced the system supporting the flexible subsidy loans because it was not Y2K complaint. As a result, much of the accounting for the flexible loans is done on a manual basis because loan balances recorded in LAS and HUDCAPS are not accurate.

HUD's Actions Planned and Underway to Improve its Financial Management Systems

As discussed under the "Status of the Department's financial systems remediation plans," HUD has established plans to improve its FHA and Departmental financial systems. Implementation of the FHA plans was delayed because of procurement problems. Although progress has been made in improving the Department's general ledger system (HUDCAPS), we identified some additional deficiencies this year. As a result, management has not had sufficient time to establish specific plans to address all of the deficiencies. With respect to LAS, however, the Department is preparing to modify LAS to accommodate the flexible subsidy projects and to automate the flexible subsidy project and transaction entry processes through the LOCCS/LAS interface. This will enable HUD to maintain an accurate portfolio until a more permanent solution is developed.

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

The JFMIP compliance problems with the FHA financial management systems can result in other financial problems. During this fiscal year, FHA has informed HUD and OMB officials that it violated the Anti-Deficiency Act for one of its appropriations during FY 2000. Because of the deficiencies in its financial systems, FHA has had difficulty in establishing the exact nature and amount of the violation. Initiation of the FHA general ledger and funds control project, which is supposed to help prevent such future problems, has made little progress since last year. HUD needs to assign improvement in the FHA financial management systems as one of its highest priorities.

By implementing the SF-224, financial reporting to treasury module, the CFO has made an important improvement to its Departmental general ledger system, HUDCAPS. As discussed earlier, other improvements in JFMIP compliance are needed. We believe that these improvements can be done within reasonable costs. Because additional enhancements are continually being performed on the HUDCAPS system, any feasibility and cost-benefit studies that will be contracted to determine the future system platform should be based upon an independent and unbiased effort, and be consistent with the direction to be set forth in the Department's Enterprise Architecture Plan. In regards to the LAS plans, we agree with the Department's interim solution to improve the accuracy of the flexible subsidy projects until the final solution has been developed.

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

OMB Bulletin 01-09, *Form and Content of Agency Financial Statements*, requires agencies to report performance measures about the efficiency and effectiveness of their programs. In prior years, we reported that HUD's *Accountability Report* and prior annual reports emphasized financial and non-financial operating results as input or simple output measures and lacked meaningful performance information. We noted concerns with the following key program areas that HUD is continuing to address in some manner:

- CPD's Integrated Disbursement and Information System (IDIS) was designed to provide field staffs with real-time performance data to assist monitoring efforts and ensure grantee compliance with program requirements. During implementation, IDIS experienced reporting problems and the last grantee was not converted to the system until the end of fiscal year 2000. Moreover, a regulation that only requires grantees to report performance on an annual basis, has delayed full realization of the purposes for which the system was designed. In addition, IDIS is currently undergoing a massive data cleanup effort. The objectives of this effort are to cleanup data that is currently in IDIS and maintain system data at a high quality level. The projected completion date of this effort is September 30, 2002.

We also noted that some performance data on the Homeless program, which does not derive its data from IDIS, came from projections on grant applications. The Homeless program is requiring that grantees report actual data in future annual progress reports which will be reported as performance information.

- Previously, we reported concerns about HUD's controls over the reliability of performance data as well as the adequacy of component factors to objectively determine Housing Authority performance, from the Public Housing Management Assessment Program (PHMAP). PHMAP is being replaced by the Public Housing Assessment System (PHAS). During fiscal year 2000, the Real Estate Assessment Center (REAC) began compiling and reporting the results of physical inspections of public housing agencies using PHAS. However, these scores were only advisory and field offices or Troubled Agency Recovery Centers (TARC) generally did not use the results in their monitoring programs. Additional administrative and legislative delays prevented PHAS from being fully implemented in fiscal year 2001. Modified official PHAS scores are scheduled to be issued for PHAs with fiscal years ending after June 30, 2001.

- The Departmental Enforcement Center (DEC) began reporting performance information in the fiscal year 1999 Accountability Report. The information included statistics on various enforcement activities completed along with monetary recoveries. We noted that the underlying source systems for this data were in various stages of completion and none were operational. An OIG report, "Nationwide Audit, Enforcement Center," (00-NY-177-0001, dated March 28, 2000), recommended the DEC develop a HUD wide tracking system to track enforcement actions. The DEC developed a tracking system during fiscal year 2000 but it was not capturing information on all enforcement actions. The system began producing initial reports in fiscal year 2001, but the DEC was not relying on the systems reports because it was not fully operational. Because of this, the DEC continued to use various sources for performance information including manual records. These sources are less reliable than a centralized system with good controls.

In prior years, we reported on our concerns over performance measure data reliability and the Department's plans to remedy the concern with a program requirement to submit quality assurance plans to the CFO for review and approval. A report issued by OIG resulting from a review of the reliability of data presented in HUD's fiscal year 1999 Annual Performance Report found a number of performance indicators with questionable data quality. Data quality has become the responsibility of the Office of the Chief Information Officer (OCIO). To date, the OCIO has accepted quality assurance plans for seven systems. They plan to assess eight additional systems during fiscal year 2002. They also plan to evaluate their data quality improvement effort and analyze improvements to performance measure data.

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Housing Assistance Program Delivery

Monitoring and Payment Processing Weaknesses Continue

HUD provides housing assistance funds under various grant and subsidy programs to multifamily project owners (both nonprofits and for profit) and HAs. These intermediaries, in-turn, provide housing assistance to benefit primarily low-income households. HUD spent about $21 billion in fiscal year 2001 to provide rent and operating subsidies that benefited over 4 million households. Weaknesses exist in HUD's control structure such that HUD cannot be assured that these funds are expended in accordance with the laws and regulations authorizing the grant and subsidy programs. The Office of Public and Indian Housing (PIH) provides funding for rent subsidies through its public housing operating subsidies and tenant-based Section 8 rental assistance programs. These programs are administered by HAs who are to provide housing to low-income families or make assistance payments to private owners who lease their rental units to assisted families.

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

Legislation authorizing HUD's housing assistance programs includes specific criteria concerning tenant eligibility and providing assistance for housing that meets acceptable physical standards. Moreover, legislation authorizing HUD's programs also establishes minimum performance levels to be achieved. For example, subsidized housing must comply with HUD's housing quality standards.

In prior reports on HUD's financial statements, we reported on weaknesses with the monitoring of HAs and multifamily projects. In our current report, we emphasize the impact these monitoring weaknesses have on HUD's ability to ensure that housing subsidies are being correctly calculated by HUD's intermediaries based on HUD requirements. The material weakness discussed below encompasses public housing and tenant-based Section 8 programs administered by PIH along with project-based subsidy programs administered by the Office of Housing. In addition, we continue to report on a separate reportable condition relating to the project-based subsidy payment process.

Material Weakness: Improvements Needed in Oversight and Monitoring of Subsidy Calculations

As in prior reports on HUD's financial statements, we continue to express concerns about the significant risk that HUD's intermediaries are not properly carrying out their responsibility to administer assisted housing programs according to HUD requirements. HUD relies upon intermediaries to ensure that rent calculations for assisted households are based on HUD requirements. These rent calculations determine the amount of subsidy HUD pays on behalf of the assisted household. Under project-based programs administered by the Office of Housing, the individual project owners or agents responsible for administering the programs carry out the rent calculations. Under public housing and tenant-based Section 8 programs, the HAs determine eligibility and rent for eligible households residing in public housing or at approved housing provided by private landlords. HUD's control structure does not adequately address this risk due to insufficient on-site monitoring along with the absence of an on-going quality control program that would periodically assess the accuracy of intermediaries' rent determinations. A contracted study[3] completed last year, based on data collected from 1999 and 2000, indicated that the risk was significant.

Subsidy payment errors are substantial

The study of HUD's major assisted housing programs estimates that the rent determinations errors made by project owners and HAs resulted in substantial subsidy overpayments and underpayments. The study was based on analyses of a statistical sample of tenant files, tenant interviews, and income verification data. The study concluded that on a monthly basis:

- 34 percent of all households paid at least $5 less rent than they should (with an average error of $95).
- 44 percent of all households paid the correct amount of rent within $5 (32 percent paid exactly the right amount).
- 22 percent of all households paid at least $5 more rent than they should have (with an average error of $56).

The study projected that annually, about $1.7 billion in subsidies was overpaid on behalf of households paying too little rent and about $0.6 billion in subsidies was underpaid on behalf of households paying too much rent based on HUD requirements. This year, HUD revised this estimate to include overpayments resulting from underreported income

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[3] "Quality Control for Rental Assistance Subsidies Determinations," Final Report dated June 20, 2001.

that is addressed in the section of the report entitled "Verification of Subsidy Payments".

By overpaying subsidy, HUD is able to serve fewer families who may be eligible but unable to participate because of limited funding. The impact of payment errors of this magnitude takes on added significance in light of HUD's estimate[4] that 5.4 million households have "worst case housing needs," and the number is increasing at twice the rate of population growth. This relates to the number of unassisted very-low-income renters who pay more than half of their income for housing or live in severely substandard housing.

Continued Efforts Needed to Improve Housing Authority Monitoring

HUD provides grants and subsidies to approximately 3,200 HAs nationwide. In previous years, we reported that HUD's management control structure did not provide reasonable assurance that program funds were expended in compliance with the laws and regulations authorizing the programs. In fiscal year 2001, problems remain that we believe HUD needs to address to provide assurance that HAs (1) provide the correct amount of subsidies for safe, decent, and sanitary housing and (2) protect the federal investment in their properties. Our most significant concern relates to payments made by HUD, through its operating subsidies and Section 8 rental assistance programs, to assist HAs in providing affordable housing that meets the eligibility requirements and housing quality standards to house eligible low-income households. Our concerns, and the efforts to address them, are discussed below.

Improved risk evaluation and monitoring of housing authorities needed

During fiscal year 2001, HUD continued to implement its performance oriented, risk based strategy for carrying out its HA oversight responsibilities. As noted in previous years, further improvements need to be made in the field offices' monitoring of its HAs in key monitoring areas such as HA risk assessments, on-site monitoring of high risk HAs, use of IA reports, implementation and use of available management assessment data (PHAS and SEMAP), and increased performance of on-site and remote monitoring activities. For fiscal year 2001, field offices performed risk assessments of all HAs within their jurisdictions by using a newly developed automated national risk assessment feature of the PIH Information Center (PIC). Based on these assessments, the field offices developed plans to monitor and/or provide technical assistance to those HAs determined to be in the greatest need of attention.

The risk assessment accomplished this year combined the tenant-based Section 8 and low-income risk assessments into a single assessment. As in previous years, HAs performance and IAs' compliance reviews were key components of HUD's risk based monitoring strategy for assessing

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[4] As stated in U.S. Department of Housing and Urban Development FY 2000–FY 2006 Strategic Plan, September 2000.

how well HAs' administered their low-income (public housing) programs. Also, HUD assessed performance using the PHAS performance indicators instead of the PHMAP performance certifications for the low-income program and attempted to use the SEMAP performance indicators for Section 8 tenant-based program. However, the resulting assessments were not reflective of the associated overall risk because of invalid Section 8 performance indicators. HUD had defaulted all of the SEMAP performance indicators to the maximum risk because a majority of the indicators were not available for the tenant-based Section 8 programs. This resulted in the tenant-based Section 8 programs being designated as high or moderate risk regardless of the actual risk, and identified all the tenant-based Section 8 programs as being a higher risk than the low-income programs.

In our testing of four field offices' risk assessments and monitoring of HA's low-income and tenant-based Section 8 programs, we found a number of key monitoring deficiencies still exist that need to be improved to ensure HA monitoring is more effective. For example, even though all four-field offices completed formal risk assessments on all HAs that administer low-income or tenant-based Section 8 programs, three of the offices did not always use the results to target high risk HAs for on-site monitoring. They targeted HAs based on qualitative factors, (e.g., local information such as media news, complaints, prior on-site reviews conducted in 1997, perceived performance, available resources, and IPA or OIG findings) rather than on an assessment of the HAs' performance.

On-site monitoring was limited

On-site monitoring of HAs is a key component in HUD's monitoring program. HUD performs targeted on-site reviews to evaluate and assist HAs in improving their housing operations. In fiscal year 2001, HUD performed a limited number of on-site reviews. For the four offices we reviewed, field office staff completed low-income and Section 8 on-site reviews for 60 of its 342 HAs portfolio. In addition, we found the performance of 215 HAs was assessed as high risk at the end of the fiscal year, which was 36 more than there were at the beginning. The decreased performance of the HAs, and the discrepancies identified in the report on rental subsidy determinations mentioned earlier, shows that the level of HA monitoring has not been effective.

Furthermore, HUD has been slow to implement corrective action to address the problems surrounding HAs rental subsidy determinations and does not plan to fully implement its planned corrective action until March 2004. Thus far, HUD has (1) issued a PIH notice in May 2001 to HAs on improving income integrity in efforts to reduce incorrect rental subsidy determinations, (2) made available a newly developed guidebook on housing choice vouchers, (3) reviewed rental calculations during some of the on-site monitoring reviews, and (4) drafted a new Public Housing Occupancy Handbook. Also, additional administrative and legislative delays prevented the PHAS and SEMAP HA assessment programs from being fully implemented. As such, we continue to have concerns regarding the reliability of the performance and compliance data used by HUD's field offices to evaluate HA operations.

Until PHAS, which provides an independent program for assessing HAs' performance and on-site inspections of low-income HAs' housing stock, is fully implemented and the results are used by all the field offices to help HAs improve operations, its usefulness as an effective monitoring tool for improving HA performance will be limited. Similarly, SEMAP is to provide the field offices with pertinent data, such as proper selection of applicants, rents, payment standards, and housing quality that will assist field office staff in making sound decisions in helping to improve HAs with Section 8 tenant-based programs.

PIH monitoring systems are not fully utilized

The PIC[5] supports the management of PIH programs by tracking key information critical to PIH business processes. HUD's staff uses the system to track data that can be analyzed to determine and improve HA performance. At the four field offices we tested, current and complete information was not always obtained from the HAs or entered into the PIC system. We also noted that the PIC was implemented prior to the development of some of its' data management features and the PIC's capabilities were not always available to all the field offices. For instance, PIC had a limited capability to track and monitor IA audit findings. In addition, changes to the system to meet field offices needs were not implemented until after the end of the fiscal year. With regard to having access to the PIC, the field offices did not always have access because of intermittent communication problems and system malfunctions. We found one of the field offices did not update information in the PIC during the year because of access problems. Also, at the other three field offices, audit-tracking data were not being entered into the PIC, but alternative tracking systems were used. In addition, event tracking system data were not entered into PIC in a timely manner at one field office, taking up to three months or longer to enter data. We also noted that because the field offices did not always enter data into or maintain the PIC on a current basis, management waived the requirement to maintain the PIC and encouraged the field office to use their individual systems as an alternative. Since the PIC is PIH's primary information system to remotely monitor HA business processes and performance, its usefulness as an effective monitoring tool is diminished when the system cannot be used and does not contain complete, consistent, and accurate data.

Delays in implementing PHAS and SEMAP continue to impede HA monitoring and improved performance

As previously reported in fiscal year 1998, HUD developed PHAS to provide for a more comprehensive monitoring system of public housing operations. However, during fiscal year 2001, as in fiscal year 2000 and 1999, HUD did not use PHAS as intended. PHAS was planned for implementation for HAs with fiscal years ending on or after September

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[5] The PIH's Information Center (PIC) replaced most of PIH's IBS data management functions in August 2000. The PIC is an internet-based data system that uses data entered by HAs as well as the field offices.

30, 1999. HUD delayed implementation again during fiscal year 2001 at the Congress's[6] direction. Congress directed HUD to delay the implementation of PHAS until HUD complied fully with the recommendations in a GAO report,[7] and clearly demonstrated to the Congress that it could administer PHAS reporting requirements. During this period, HUD was also instructed not to take adverse actions against HAs based solely on the PHAS scores. HUD continued issuing advisory scores for the residential physical and financial indicators, however only management operations scores were official. HUD provided a report to the Committee on Appropriations on March 1, 2001, describing the steps taken to improve the accuracy and reliability of PHAS. On May 30, 2001, HUD issued a notice[8] of a revised timetable for the issuance of official management operations scores and PHAS advisory scores. The notice also indicated that HUD would begin issuing modified official PHAS scores for PHAs with fiscal years ending after June 30, 2001.

Guidance[9] received in January 2001 by HUD field offices on using the PHAS scores was not implemented. The field offices were directed to provide technical assistance in the form of corrective action plans to HAs with failing PHAS financial and physical scores. However, only one of the four field offices we reviewed requested the HAs to provide corrective action plans based on failing financial and physical scores. The other three indicated that they provided assistance or requested the HAs to address the failing indicators, but didn't require corrective action plans because they viewed the plans as a prohibited adverse action or lacked resources to devote to this effort. Also, during our testing, we found HUD was slow in defining adverse action and establishing formal procedures to designate PHAS as troubled. As a result, HUD did not use the management operations scores as intended until the third quarter when seven troubled PHAs were transferred to the TARCs based on failing scores.

In fiscal year 2001, REAC performed 13,881 inspections of PIH properties that were administered by 2,714 HAs. Of the 13,881 inspections, 1,487 resulted in a failing physical score. Furthermore, 5,545 of the inspections identified one or more life threatening exigent health and safety issues. However, since the scores were still advisory in nature and except as noted above, the field offices and Troubled Agency

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[6] The Senate Report 106-410 identifies this requirement, which is referenced in Committee on Appropriations' Report 106-988. The Report 106-988 is also cited in PL 106-377, the fiscal year 2001 Appropriation Act signed by the President on October 27, 2000.

[7] The GAO report is GAO/RCED-00-168, titled "HUD Has Strengthened Physical Inspection but Needs to Resolve Concerns About Their Reliability," dated July 25, 2000.

[8] HUD issued Federal Register Notice 4687, "Revised timetable for the issuance of management operations official scores and PHAS advisory scores."

[9] PIH Memorandum, *Interim Guidance for PHAS Scores for 6/30/00 PHAs and MASS Scores of Less Than 60% for FYEs 9/30/99, 12/31/99 and 3/31/00*, dated January 16, 2001 provided interim guidance for PHAS scores.

Recovery Center (TARC) staff generally did not use the results in their monitoring programs. In addition, HUD found that REAC had not been granted authority to designate PHAs as troubled. PIH established a formal process and began in April 2001 to designate troubled HAs identified under PHAS, and shortly thereafter, resumed transferring troubled HAs from the field offices to the TARCs. Additionally, PIH field offices had limited automated means of tracking findings and issues identified from the physical inspections to ensure the deficiencies were corrected. PIH's PIC physical inspection sub-system for tracking deficiencies and the interface with PHAS had not been developed due to a low funding priority. Consequently, under the current environment, the physical inspection process has not had its fully intended impact on improving HA performance.

SEMAP is a management assessment program that HUD developed to measure the performance of approximately 2,600 HAs that administers tenant-based Section 8 rental assistance. Under SEMAP, HUD is to measure the performance of HAs that administer the Section 8 voucher program in key areas. If it is determined a HA is not performing adequately on any of the indicators, SEMAP requires the HA to take appropriate corrective action. As with PHAS, HUD intended to implement SEMAP in the fall of 1998. However, the initial official SEMAP performance scores were not available until February 2001, primarily due to system malfunctions and communication problems, and then only for some of the HAs with a fiscal year ending September 30, 2000. The remaining HAs with the September 30 year-end, and those with a December 31, 2000 year-end didn't receive a SEMAP score until August or September 2001. Thus, the program had limited impact on monitoring or improving HA's performance in fiscal year 2001.

Reliability and use of Single Audits is limited

Given HUD's reduced monitoring resources and its increased focus on HA performance, HUD claims it relies heavily on the audits the IAs complete on the HAs pursuant to the Single Audit Act. In accordance with the standards under which these audits are conducted, the IAs are required to review and test HA compliance with laws and regulations that are material to the HA's financial statements. HUD management updated the comprehensive compliance supplement for use by the IAs in performing audits of HAs. However, there are a number of issues that impede HUD's ability to place appropriate reliance on the IA reports.

In our prior years' testing of IAs' audits, we generally found IAs had not performed the audits in accordance with the PIH Compliance Supplement and questioned whether many of the IAs performed sufficient testing to determine if HAs were in full compliance with the program requirements. In fiscal year 2001, REAC completed 66 Quality Audit Reviews (QAR) at 14 IAs. The results at September 30 showed that 35 percent of the IAs, and possibly as high as 93 percent, did not perform adequate testing in accordance with the PIH compliance supplement. We also noted that three of the four field offices visited during our review did not fully utilize the IA report results in their monitoring activities.

HUD's Actions Planned and Underway to Improve HA Monitoring

Since fiscal year 1997, HUD has been in the process of implementing reforms to consolidate financial, funding, and processing activities and separate troubled agency recovery activities from HA oversight and technical assistance functions. These changes were implemented to allow field office staffs to concentrate on providing technical assistance and oversight to HAs with declining performance. Additionally, HUD consolidated its field offices into 27 hubs and 16 program centers. HUD also established (1) two TARCs in mid 1998 to support troubled HAs, and (2) the REAC to assess the performance assessments of HAs. The specific structural and operational actions HUD has taken in fiscal year 2001 or intends to implement in fiscal year 2002 include:

- During fiscal year 2001, the REAC continued to implement its major assessment systems to produce physical, financial, management and residential PHAS scores for approximately 3,200 HAs. However, REAC was only allowed to issue official PHAS management operations scores and advisory for the other indicators for the HAs assessed during fiscal year 2001. PIH attempted to use the advisory scores to initiate correction action plans for HAs with failing financial and physical indicators, but several of the field offices only provided technical assistance, which did not always result in improved HA performance. In November 2001, HAs with a fiscal year end of September 30, 2001 were notified to provide their management operations and financial indicator submissions to REAC by December 31, 2001, and REAC should begin issuing official PHAS scores for these HAs in February 2002.

- At September 30, 2001, PIH's two TARCs were providing service to an inventory of 18 troubled HAs, and 29 non-troubled HAs. During the year, the TARCs had recovered 35 HAs, returning 30 HAs to the field offices, and receiving 9 HAs from the field office, of which 7 were newly troubled HAs. The delay in fully implementing PHAS and SEMAP continues to limit the number of HAs serviced by the TARCs. They were originally established to serve more than 500 troubled HAs.

- PIH field operations developed a National Risk Assessment Module in PIC that allows PIH to perform quarterly risk assessments of its HAs on a national level. However, the module was not used for the FY 2002 risk assessment of HAs with low-income and tenant-based Section 8 programs because of ongoing system changes. Instead, the field offices used an alternative manual review to identify the performance risk. The risk established was used to develop a monitoring plan for the FY 2002 management plan. HUD plans to reassess the risk and possibly revise the monitoring plan later in the year when the system changes are complete.

- HUD advised the HAs with fiscal years ending September 30, 2001, to submit their SEMAP certifications directly to the SEMAP system by November 29, 2001. However, SEMAP system problems delayed some submissions and the HAs were given until January 31, 2002 to submit their data. The field offices were expected to finish the scoring profiles and notify the HAs of the results by February 28, 2002. This also delayed the field offices in reassessing the performance risk.

- HUD put together the Rental Housing Integrity Improvement Project (RHIIP) advisory group to develop a strategy to address the problems associated with rental subsidy calculations. The RHIIP advisory group originally developed a 10-part strategy that the Offices of Housing and PIH compressed into 8 tasks for implementation. These tasks include: (1) program simplification through statutory, regulatory, and administrative reform, (2) increasing tenant income data sharing for use in rent determinations, (3) developing automated tools for rent calculation and subsidy payment validation, (4) completing a periodic error measurement assessment, (5) establishing an on-going quality assurance program, (6) providing more effective incentives and sanctions for HAs and tenants, (7) updating guidance to reflect current program requirements and processes, and (8) initiating training on program requirements or HAs, tenants, and HUD staff. The tasks on training, developing handbook and data sharing efforts were in the completion stage during our fieldwork. The work on the other tasks appears to be on schedule.

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

As in previous years we could not fully assess HUD's measures aimed at improving oversight of HAs since the Department's plans to monitor and improve performance are not yet fully developed and continue to experience delays. Until HUD finalizes its implementation of it's plans, we cannot assess HUD's ability to fully implement its oversight strategy. Moreover, HUD's success in objectively assessing the quality of the public housing stock is dependent upon field offices receiving and acting on the performance and inspections to be performed by REAC. HUD has developed several assessment systems to determine performance of HAs, which thus far, field offices have not utilized to the fullest extent to target areas of improvement. In addition, the process used for evaluating HA risk in fiscal year 2001 did not uniformly rate the risk associated with the HAs' performance, and allowed field offices' to waive on-site monitoring of high risk HAs. Field offices waived the on-site monitoring for reasons other than HAs' improving their performance. Also, the highest risk HAs were not always given first priority for on-site monitoring. Finally, HUD has been slow to implement additional strategies needed to improve the quality control for the rental assistance subsidy determinations. Nevertheless, we do believe that some of the initiatives are positive.

Specifically, we agree with HUD's efforts to use the PHAS and SEMAP scores to provide monitoring and technical assistance to HAs and to focus its limited field office resources. With the advent of official PHAS and SEMAP scores, HUD will begin to target and improve the HAs' operations and performance. Also, we agree with HUD's efforts to establish and implement a national risk assessment system that will assess quarterly the risk associated with the HAs' performance. This quarterly assessment will allow the field offices to reevaluate HAs performance as new PHAS and SEMAP scores are made available. This gives HUD the ability to uniformly assess its' staffing and funding resource needs to give priority to those HAs that are deemed to have a high performance risk. The implementation of SEMAP and the annual assessments will greatly increase the field offices' ability to ensure that HAs are administering Section 8 tenant-based programs properly.

We also agree with HUD's initial efforts to address the incorrect rental subsidy determinations. During our audit we found several initiatives HUD has undertaken such as (1) providing the HAs the information on the problems associated with rental subsidy determinations, (2) making available a guidebook on the requirements of housing choice voucher, and (3) conducting reviews of rental determinations during some on-site monitoring reviews. However, it will be another two years before all of HUD's planned corrective actions are implemented to fully address the problems. In addition, it may take several more years before the success of these actions will be known.

Multifamily Project Monitoring Needs to Place More Emphasis on Oversight of Subsidy Determinations

HUD is responsible for monitoring multifamily projects to assure that subsidies (1) are provided only to projects that provided decent, safe and sanitary housing and (2) have been correctly calculated based on HUD eligibility requirements. To accomplish these two program goals, the Office of Housing uses the reporting from the REAC for physical inspections (PI) and review of annual financial statements (AFS). Office of Housing field staff or contract administrators (CA) have primary responsibility for following up on observations from REAC reporting and conducting management reviews. The Departmental Enforcement Center (DEC) handles projects, which are the most troubled based upon referral from the REAC or the Office of Housing. Monitoring of tenant eligibility at projects is accomplished by Office of Housing or CA staff performing management reviews with an added "occupancy review" component[10]. Office of Housing field staff is to oversee the efforts of CAs.

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[10] Occupancy reviews test compliance with occupancy requirements, generally seeking to validate that only tenants meeting eligibility requirements occupy the project, that this is documented by tenant certifications and recertifications maintained by the project owner, and that this information is correctly entered in TRACS.

HUD directly or indirectly insures or subsidizes about 32,000 multifamily projects. About 16,200 projects have FHA insured or HUD held mortgages, 24,800 receive some form of assistance on behalf of eligible tenants residing in those projects, and 9,100 are both insured and subsidized. The principal multifamily subsidy programs are:

- The Section 8 and Section 236 programs, which provide subsidies to project owners, who, in turn, provide housing units at reduced rents to eligible households.

- The Section 202 and Section 811 programs which provide grants to non-profit institutions for the construction of projects providing reduced rent units to the elderly and disabled, respectively. Ongoing rent subsidies are also provided under these programs once the units are occupied.

Audit approach to multifamily programs for both insured and assisted projects

We tested internal controls relating to asset and risk management and delivery of benefits to eligible tenants in multifamily projects. We focused on the use of the individual monitoring tools available to the Office of Housing and the overall communication, integrated risk management and reporting from the field offices to headquarters, as was reflected in the Real Estate Management System (REMS). In conjunction with efforts by our contractor on the FHA audit, KPMG LLP, we conducted interviews at both headquarters and field offices, tested project management files and performed additional procedures at six locations. Our selection of project files was based on a statistical sample designed by KPMG LLP's statistician and was used for both the FHA and HUD audits. The sample resulted in the selection of 430 project files of which 243 were assisted projects covering the entire range of risk for the multifamily projects.

Follow-up efforts need to improve on project monitoring findings

Multifamily Housing's use of both PI and the AFS improved during fiscal year 2001. The use of these monitoring tools was generally effective except for some follow-up efforts relating to obtaining property owner (1) certifications of corrections of Exigent Health and Safety (EH&S) deficiencies, (2) Corrective Action Plans, (3) Management Improvement and Operating Plans, and (4) responses to financial assessment compliance flags. In addition, we found instances where property owners did not respond to management/occupancy review findings and the responsible project managers did not conduct timely follow-up with the property owners.

A review of REMS activity records and 370 Office of Housing project files showed (1) 31 out of 190 instances where HUD field offices did not follow-up with owners to obtain certifications for correcting EH&S violations, and (2) 26 out of 139 instances where HUD field offices did not follow-up with owners to obtain Corrective Action Plans or Management Improvement and Operating Plans. This deficiency was also disclosed in a GAO study dated June 2001, which noted concerns with HUD field offices not following headquarters' procedures for correcting all physical deficiencies.[11]

Financial statements are submitted by owners annually and assessed by REAC using the Financial Assessment Subsystem (FASS). An automated risk assessment and financial compliance review is performed using pre-established financial indicators and program compliance flags. The financial assessment compliance flags issued by REAC identify conditions where the property owner's financial data are not in compliance with laws and regulations contained in the Regulatory and Contractual Agreements between the property owner and HUD. Based on the severity of compliance violations, a determination is made whether the submission should be referred to the appropriate multifamily housing field office or DEC for follow-up. A review of 70 statistically sampled assessments that were referred to a multifamily housing field office with compliance flags or additional financial data requests, showed that the field offices could improve their follow-up procedures for property owner responses. The results of our analysis showed that follow-up was conducted 82 percent of the time on projects with compliance flags and referrals.

Management/occupancy reviews provide HUD the opportunity to assess whether the property owner is ensuring that households receiving the benefits of subsidies and rental assistance are eligible under the statutory and program requirements and that any rental assistance provided is correctly calculated. Management /occupancy review findings identify areas that property owners need to address in order to satisfy HUD requirements. We reviewed 265 projects receiving management and/or occupancy reviews and found 21 instances where property owners did not provide the required response to HUD and the responsible project manager did not conduct timely follow-up with the property owner.

Substandard financial and management performance conditions are unnecessarily extended when timely follow-up with property owners is not performed. If left unchecked, as these periods where substandard conditions exist become longer or become greater in number, HUD may experience significant physical deterioration of assisted and non-assisted projects. This negatively affects the condition of HUD's overall property portfolio resulting in an increase in the required loan guarantee reserves. In addition, for assisted projects, there is increased risk of HUD providing assistance payments to owners for units that are not in a decent, safe, and sanitary condition. Ultimately, the resulting physical deterioration may diminish the financial viability of the projects.

The creation of new centers in the field, the transfer of former single-family personnel to multifamily, and other initiatives has resulted in a

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[11] United States General Accounting Office's Report to Congressional Requesters on HUD Multifamily Housing – Improved Follow-up Needed to Ensure That Physical Problems Are Corrected (GAO-01-668), June 2001.

reduction in the amount of multifamily experience available in the field. Although headquarters has focused on providing training to its new staff, replacement of institutional knowledge lost will take time to complete.

During fiscal year 2001, the Office of Housing transferred a portion of its Section 8 workload to CAs. However, the field organization remained responsible for contract renewals and oversight of the troubled portfolio. As a result, many of the Section 8 contracts were still administered by the field organization. This significant workload, in addition to the continuing oversight responsibilities over the non-assisted portfolio, adversely affects the ability to follow-up with property owners in a timely manner.

HUD needs to develop a comprehensive plan to monitor project owner's compliance with subsidy program requirements

Office of Housing or CA staff are to perform management reviews to monitor tenant eligibility and ensure accurate rents are charged at multifamily projects[12]. For 12,926 projects in place with CAs, HUD focuses its efforts on monitoring the CAs to see that they, in turn, are ensuring the housing owners are complying with statutory and regulatory requirements. For the remaining 9,279 Section 8 projects, HUD is responsible for direct oversight of the housing owner. The primary tool available to HUD is to conduct on-site reviews that assess the owners' compliance with HUD's occupancy requirements.

HUD's continued implementation of the CA initiative resulted in a substantial increase in the total number of management reviews conducted during fiscal year 2001 compared with the previous year. However at the end of fiscal year 2001, a substantial portion of the portfolio was still HUD's direct responsibility and HUD conducted management reviews at only a small portion of that part of the portfolio. According to data available in REMS, HUD conducted or had scheduled management reviews during fiscal year 2001 for 1,331 (14 percent) of the 9,279 projects receiving direct oversight by HUD. Over the past 3 fiscal years, HUD reviewed, was in the process of reviewing, or had scheduled management reviews of only 2,705 (29 percent) of those 9,279 projects. For the six Hubs visited, we reviewed the factors used to determine the projects selected for review. We found that the selection was based primarily on factors related to the risks associated with deteriorating physical conditions and with the risks associated with loan default. The scheduling of reviews did not include an assessment of factors directly associated with the risk of owner non-compliance with occupancy requirements. A comprehensive plan needs to be developed that would result in an increase of on-site reviews that would assess and ensure that all owners of assisted multifamily projects comply with HUD's occupancy requirements.

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[12] Includes all types of management reviews (e.g. Management and Occupancy Reviews, Management and FHEO reviews, etc.) except "Management Review Only" and FHEO Only" reviews, as these were not likely to address owner's compliance with occupancy requirements.

The performance of management reviews over assisted multifamily projects is essential in ensuring rental assistance is correctly calculated and that recipients are eligible.

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

HUD's plans include a variety of continuing efforts. Principle among these are: continued implementation of the CA initiative; increased enforcement through the DEC of project referrals because of problems detected through REAC's PI and AFS process or when owners fail to file required AFS; implementation of more targeted risk management of reinspections of properties based on baseline risk rankings according to the Final Rule[13]; use of mortgagee inspectors trained in the physical inspection data gathering protocol; increased frequency of management/occupancy reviews for assisted projects; development of an integrated risk reporting system in REMS, and the planned development of the Integrated Assessment Sub-system which will provide a comprehensive risk rating tool.

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

Our assessment of planned and completed actions is similar to that expressed last year. However, before repeating some cautions raised in last year's comments we would like to focus on noted improvements.

We are encouraged by the increased use of the AFS for the insured portfolio, and evolving enforcement efforts by the DEC for inadequate financial status or non-filing project owners. We hope the use of the PI monitoring tool continues to be effective. We support the plans to increase the frequency of management/occupancy reviews for the assisted portfolio and suggest that similar to the approach to physical reinspections, they be performed more frequently for troubled and potentially troubled projects, and that occupancy review work be emphasized. We applaud HUD's efforts in designing the Rental Housing Integrity Improvement Program (RHIIP)[14] and support the continued progress in addressing improper payments. The Office of Housing is increasingly dependent upon other HUD organizations (e.g. the REAC, DEC and the Section 8 Financial Management Center) and external contractors. The adequacy of what the Office of Housing receives from another HUD organization or external contractor depends on clear needs definitions and adequate resources to achieve full implementation.

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[13] "Uniform Physical Condition Standards and Physical Inspection Requirements for Certain HUD Housing; Administrative Process for Assessment of Insured and Assisted Properties; Final Rule," 24 CFR Parts 5 and 200, dated December 8, 2000.

[14] HUD initiated the RHIIP in response to a contracted study, "Quality Control for Rental Assistance Subsidies Determinations,' in an effort to develop to develop tools and the capability to minimize erroneous rental subsidy payments.

Moreover, increased use of external contractors increases the need for monitoring of these functions by the Office of Housing.

Reportable Condition: Controls over Project-Based Subsidy Payments Need to be Improved

In prior reports on HUD's financial statements, we reported on long-standing weaknesses with the processing of subsidy payment requests under the project-based programs administered by the Office of Housing. Historically, this process has been hampered by the need for improved information systems to eliminate manually intensive review procedures that HUD has been unable to adequately perform. To address this problem, the Office of Housing developed the Tenant Rental Assistance Certification System (TRACS). Owners input tenant information into TRACS and the system calculates the proper Housing Assistance Payment (HAP) for each tenant. Office of Housing field staff then compare information on the HAP voucher to TRACS. These comparisons, done on a sample basis, are known as post payment reviews because the reviews are performed after the vouchers are paid.

HUD administers various project-based assisted housing programs, most notably, Section 8. Although the payment processes differ, under each program, HUD pays the difference between the contract rent for the units and that portion of the rent a tenant is required to pay (30 percent of income.). HUD administers about 24,800 assistance contracts. Of the estimated 24,800 assisted contracts, Contract Administrators (CAs), such as State Housing Finance Agencies (SHFA) and Housing Authorities (HAs), oversee contracts relating to about 16,200 multifamily projects. This is about half of the multifamily projects insured or assisted by HUD (31,780). The projects not subject to oversight by CAs remain under HUD's administration. Responsibility is split between the Office of Housing and Public and Indian Housing's Financial Management Center (FMC). For both CA and HUD administered contracts, project owners are responsible to verify household income reported by the tenants and submit requests for payments due under the HAP contracts to HUD or the CAs.

Risks associated with the subsidy payment process continue

HUD's plan is for most HAP contracts to be transferred to CAs in the near future. When the contracts are transferred, the CAs will be responsible to ensure the tenant data are accurate. Multifamily Housing staff in field offices will be responsible to monitor the performance of the CAs. HUD's FMC will be responsible for the financial management aspects of these Annual Contribution Contracts (ACCs). The FMC will approve the budgets, make monthly advances, and perform year-end settlements. Approximately 40 states have CAs that are currently administering HAP contracts. The plan requires existing HAP Contracts (with some exceptions) to be converted to ACCs that will be administered by new CAs under a performance based system. However, the process has been delayed since over 1,200 of these HAP contracts are currently backlogged due to various problems, some of which are legal issues. Since many of these contracts have expired, HUD has created another, short term, contract with the owners to fund the owners' projects until the final conversion is completed.TRACS identifies about 400 vouchers for pre payment review a month (or about 2 percent of the vouchers submitted per month), and FMC's Voucher Processing Division (VPD) does a 100 percent review of these before they are paid. However, FMC staff only compare data that the owners input into TRACS to the data that the owners' claim on the HAP voucher. Reconciling owner input data to the owner prepared HAP voucher only ensures the two sets of owner data agree and the owner is consistent in what he puts on the voucher and in the system. The reconciliation does not show the tenant data is correct or payment is accurate.

Rent rate errors cause of data inaccuracies in TRACS

We tested the accuracy of income calculations for a sample of vouchers assuming tenant income was accurate. No material discrepancies were identified for this test. However, in performing this test we discovered 50 percent of the HAP contracts in the contract portion of TRACS did not contain the correct rent rate. As a result, incorrect rent amounts may be paid owners and scarce HUD resources must be expended to correct errors, make adjustments, and research contract information that would otherwise be unnecessary. We discussed this issue with Office of Multifamily Housing staff and determined updating of TRACS is the responsibility of the field offices; however, there are no written procedures that state when or by whom TRACS is to be updated after a rent change. The Office of Housing needs to develop policies and procedures that will ensure the timely and accurate input of rent change in TRACS.

There is not an effective control to ensure compliance with HUD regulations

The FMC's post payment reviews and the tracking of review results are not an effective internal control to ensure owner compliance with HUD regulations. The program reviews are not performed on a representative sample of contracts and sanctions are not enforced for violations. While the post-payment review has been functioning for at least two years with 552 (less than 1 percent) reviews completed in fiscal year 2001,there are no written policies and procedures that cover the process.Additionally, FMC staff has not suspended payments on contracts that failed to meet the current tenant certification requirement because the Office of Housing has not authorized the FMC to suspend payments. HUD's HAP contracts with project owners authorize Housing to suspend payments; however, since the FMC is accomplishing the reviews this authority needs to be transferred to the FMC. The FMC is developing an automated program that compares vouchered units with tenant data to determine which contracts have insufficient tenant data in TRACS. However, this new process is not operational. We recommended, in last year's report, when this program is in place the FMC should obtain the Office of Housing's concurrence to apply a sanction policy uniformly to all non-compliant owners. FMC management needs to (1) expedite the development of the automated process to identify non-compliance with tenant reporting requirements, (2) provide written policies and procedures for post payment reviews in the interim period until the automated post payment review process is operational, and (3) coordinate with the Office of Housing to establish sanctions and the authority to suspend payments to owners who do not comply with HUD's regulations.

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

Each report on HUD's financial statements since HUD has been subject to audit under the provisions of the CFO Act has identified the lack of effective controls over the project-based subsidy payment process. To date, HUD does not have a process to determine the accuracy of a payment requisition.

Under current HUD procedures, TRACS identifies voucher payment requests that exceed a specified percentage of the average monthly payments made during the prior 12 months. TRACS identifies about 400 of the vouchers for pre payment review a month (or about 2 percent of the vouchers submitted per month), and the FMC performs pre-payment reviews of the vouchers before they are paid. The FMC also conducts post payment reviews using its staff in Chicago but does not have written guidelines in place. The review process focuses on verifying that at least a specified percentage of the tenants on a subsidy voucher have a current certification in TRACS. The staff reviews vouchers that are generated in one month for a particular state. If vouchers are identified that fail to meet the specified percentage, the owner is contacted and asked to update the system within 30 days or face possible suspension of future subsidy payments. This review covers less than 1 percent of all vouchers.

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

Most Section 8 HAPs are being paid without any HUD review because the FMC is only able to review about 2 percent of the vouchers before payment and less than 1 percent after payment. The reviews are of limited value and only ensure the two sets of owner data agree. The reconciliation does not show the payment is accurate.While the post payment review process has been successful at instigating voluntary compliance on the part of some of the owners who have been contacted as part of a review, the management information system needs an analysis function to identify the effectiveness of the process. The FMC staff uses a spreadsheet as its management system to identify the universe of the vouchers they review, the results of their reviews, and identify the status of contracts, which were identified for possible suspension of future payments due to noncompliance with contract provisions. The system in place tracks the results of their reviews but FMC management does not use the data to track the contracts that failed the review to ensure that proper follow-up action is taken. We addressed the ineffectiveness of the post payment reviews in a recommendation in last year's audit report. However, the FMC and the Office of Housing have not implemented our recommendations and the weaknesses continue to exist.

HUD has elected to address the Section 8 control weakness through the transfer of the functions to contract administrators. HUD has transferred

HAP contracts to CAs in approximately 40 states thus far. HUD needs to complete the transfer, and adequately monitor the CAs' performance. HUD also needs to improve its own performance for those contracts not transferred. Additionally HUD needs to ensure an adequate system and policies and procedures are in place for the process.

Verification of Subsidy Payments

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

As discussed in the previous section of this report, HUD provides rent and operating subsidies through a variety of programs, including public housing and Section 8. Tenant income is the primary factor affecting eligibility for, and the amount of, housing assistance a family receives, and indirectly, the amount of subsidy HUD pays. Generally, HUD's subsidy payment makes up the difference between 30 percent of a household's adjusted income and the housing unit's actual rent or, under the Section 8 voucher program, a payment standard. The admission of a household to these rental assistance programs and the size of the subsidy the household receives depend directly on its self-reported income. However, a significant amount of excess subsidy payments occur as a result of undetected unreported or underreported income. In support of HUD's fiscal year 2001 financial statements, the Department developed an estimate of the annual excess subsidy payments attributed to undetected unreported or underestimated tenant incomes. In developing the estimate, the Department performed computer income matching with the assisted housing data used in the contracted study[15] on rental subsidy determinations. HUD estimated that housing subsidy overpayments from tenants misreporting their income totaled $978 million during calendar year 2000. This amount of excess subsidy overpayments was in addition to the $1.7 billion in erroneous overpayments indicated in the study. The study and the results of the computer income matching show that those tenants who do not report income or under report income cause HUD to make excessive subsidy payments if not detected.

The Department used the sample from the contracted study, which was a random sample of 2,403 households from HUD's automated tenant databases and matched tenant reported income with federal tax data in Social Security Administration (SSA) and Internal Revenue Service (IRS) databases. The computer matching results were compared with third party confirmations, source documents and tenant housing data obtained from tenant files during the contract study. Based on the results of the computer income matching, HUD statistically projected at the 95 percent confidence level that the amount of excess rental subsidies was $978 million plus or minus $247 million during calendar year 2000.

Under reporting or understating of income from a specific reported source is easier to detect than unreported income. Program regulations require HAs or project owners to verify through third party written documentation the applicant and tenant income and other factors relating to eligibility and rent determinations. The concern with this aspect of HUD's monitoring was discussed in the previous section of this report.

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[15] "Quality Control for Rental Assistance Subsidies Determinations," Final Report dated June 20, 2001.

HUD needs to continue initiatives to use available income matching tools to detect unreported tenant income

With regard to detection of unreported income, HUD, HAs and project owners have various legal, technical and administrative obstacles that impede them from ensuring tenants report all income sources during the certification and re-certification process. Since unreported income is difficult to detect, HUD began pursuing statutory authority from Congress to access and use the Health and Human Service's New Hires Database to detect unreported income during the certification and re-certification process. In addition, HUD continues to encourage HAs to verify income and computer match with State wage agencies to detect under reported and unreported income.

Since 1996, HUD has sampled its household databases to estimate the amount of excess subsidy payments reported for financial statement disclosure each year. Also, on a more limited basis, HUD completed a small-scale computer income matching project of a sample of 20,000 households at a few select HAs using the calendar year 1996 data, and a larger nationwide sampling project using calendar year 1998 data. HUD issued reports on both matching efforts during fiscal year 2001. The report for the small-scale match indicated that there was $217 million in excess rental subsidy paid in 1996, and the likelihood of recovery diminished over time primarily due to unresponsive former tenants. The results of the report for the large-scale match are discussed below.

HUD's progress in its income-matching program has been limited

During fiscal year 1999, REAC developed the Tenant Assessment Subsystem that would be used by HUD to conduct matching of tenant-reported income maintained in HUD's tenant databases with Federal tax data. In September 1999, the REAC obtained Federal tax data from the IRS and SSA for calendar year 1998 and performed a computer match of 2.3 million households to identify potential tenant income discrepancies. From the computer match, REAC identified approximately 216,000 households who had potential income discrepancies. However, the mailing of discrepancy notices to the 216,000 households was not completed until September 2000. By the time REAC resolved whether potential income discrepancies were valid, only 23,142 (11 percent) could be resolved as either valid or invalid discrepancies because former tenants could not be located or the HAs did not pursue resolution. Further, the HAs reported that they pursued and recovered a little over $3 million in excess rental assistance from 1,011 households. The report for the large-scale match also indicated that this matching process identified a substantial number[16] of potential discrepancies that could not be validated. The report concluded that HUD needed to obtain complete and accurate tenant data electronically to identify valid actionable income discrepancies that result in excess subsidy payments or overpayments by the tenants. A decision is pending from HUD's management on whether to continue large-scale matching.

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[16] The "Report on HUD's 1998 Computer Matching Income Verification Effort" issued September 2001, indicated that 89 percent of potential income discrepancies identified by the computer match could not or were not resolved.

In fiscal year 2001, HUD initiated the Rental Housing Integrity Improvement Project[17] (RHIIP) which calls for the design of systems capability that will identify relevant tenant and program data for rent calculations, and requires the data to be submitted by HAs. HUD would use the data to identify possible HAs certification or re-certification processing deficiencies. This increased capability and information could also make the large-scale computer match a viable option if the required information is captured for identifying excess rental subsidy (tenant underpayments) or tenant overpayments.

The Department also continued operations for the large-scale income verification and matching involving social security (SS) and supplemental security income (SSI) information. This information is made available to HAs, project owners and administrators of the Office of Housing's rental assistance programs who access the SS and SSI information via a secure Internet facility as a "front-end" way to verify income and annual tenant re-certifications.

PIH and the Office of Housing needs to ensure HA reporting into its MTCS and TRACS tenant databases

HUD uses the Multifamily Tenant Characteristics System (MTCS) data for PIH's income-matching program, financial planning, budget requests to Congress, estimates of staff workload, and program monitoring. HUD also uses the Tenant Rental Assistance Certification System (TRACS) data for the Office of Housing income-matching program and program monitoring. For HUD's income matching and other program efforts to be effective, it is essential that the MTCS and TRACS database have complete and accurate tenant information. However, MTCS and PIC system changes prevented HAs from reporting for most of the third and fourth quarters of fiscal year 2001, and the overall reporting rate of household data into the MTCS could not be determined in December 2001 because approximately half of the HAs had not reported. In addition, the reporting for the TRACS database needs improvement. This deficiency was previously discussed in the reportable condition on "Controls over Project-based Subsidy Payments Need to be Improved". The RHIIP advisory group has recommended that payment-processing incentives to improve TRACS database reporting be implemented. Maintaining a high reporting rate is a must if the MTCS and TRACS databases are to be of use in computer matching and monitoring of the HAs.

HUD's Actions Planned and Underway to Verify Tenant Income

REAC continued to develop the capability to implement a large-scale income verification of the information in its tenant databases. The

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[17] HUD initiated the RHIIP in response to the contracted study, "Quality Control for Rental Assistance Subsidies Determinations," in an effort to develop tools and the capability to minimize erroneous rental subsidy payments, which includes the excess rental subsidy caused by unreported and under-reported tenant income.

REAC completed its first large-scale computer matching of reported calendar year 1998 income from HUD's tenant databases to IRS and SS data files, and reported the results as of May 31, 2001. In FY 2001, HUD combined the measurement process used for previous income verification efforts with the process used in the contract study.

A review will be conducted of the results of this year's effort to establish a benchmark of the nature and scope of program errors. Based on this benchmark, HUD will be able to measure the accomplishments of future efforts in reducing improper payments and error rates over time. HUD's RHIIP advisory group has plans to use income matching as part of an annual comprehensive error measurement process. This annual measurement process will be incorporated into an ongoing quality control program conducted by the field offices. The quality control program will build upon existing monitoring activities by developing or revising field-monitoring guides and testing the guides as part of the annual measurement process. The initial testing will be conducted so that the selection of HAs and management agents coincide with the random selections for the annual measurement study. In conjunction with the ongoing quality control program, HUD will adopt a standard of performance based on an error rate percentage in tenant cases processed. The error rate standard would be implemented in December 2002, following the completion of the testing of the measurement and quality control processes. The HAs and management agents initially would be allowed discretion in meeting the standard, but if they fail to achieve the standard they would be required to use the yet to be developed front-end New Hires wage verification system and rent calculation tools or other practices that would allow them to meet the standards.

HUD also plans to upgrade the capability of MTCS to (1) provide for the collection of rent calculation information and (2) bring the rent calculation information directly into PIC. In addition, they also plan to provide automated web-based interface of the rent calculation software with TRACS database. The Office of Housing is pursuing incentives to improve TRACS data reporting, starting with 85% reporting goal. Funding had been provided in fiscal year 2001 for a business process redesign study on TRACS tenant data. This increased capability and information could make the large-scale computer match a viable option for identifying excess rental subsidy (tenant underpayments) or tenant overpayments if the efforts are coordinated.

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

HUD should continue to evaluate and assess the effectiveness of its ongoing computer matching projects, with particular emphasis on determining what effects the statutory restriction on re-disclosing federal income tax data to HAs and project owners has on the program's effectiveness. Also, HUD should develop the capability to obtain relevant tenant data that would allow the process to be a practical and cost effective computer matching technique to aid in quantifying, on a larger scale, the extent of abuses and the benefits of a permanent computer matching and income verification process. We are encouraged that HUD has taken action to develop the capability to capture additional tenant data in the MTCS and TRACS database, and the efforts to reduce erroneous payment errors by developing rent calculation tools and a front-end income verification system. HUD needs to ensure that the action to develop the capability to capture additional tenant data also considers the data needs for an ongoing large-scale income verification match.

In our report on HUD's fiscal year 2000 financial statements, we continued to express concerns as to whether HUD was ready to continue the large-scale computer matching income verification effort, especially since key issues relating to (1) developing and testing a suitable methodology, (2) establishing adequate information technology and (3) establishing a human resource infrastructure to support a large-scale matching effort had not been sufficiently developed nor implemented. The results of the calendar year 1998 income match as of May 31, 2001 indicate that the ratio of those resolved as invalid discrepancies to those resolved as valid discrepancies is almost four to one, and only 11 percent of the total potential income discrepancies were resolved. A majority of the potential discrepancies went unresolved because (1) the process took too long and most of the former tenants could not be found and (2) the HAs did not pursue resolution if the tenants were no longer receiving housing assistance. The calendar year 1998 income match was not a realistic determination of the validity of the discrepancies.

We are encouraged by the on-going actions HUD has taken to improve the reporting rate and data integrity of the MTCS. HUD needs to continue with its efforts to improve the quality and completeness of the MTCS databases by continuing to monitor and providing technical assistance to HAs and management agents who do not comply with the minimum reporting rate requirements (85 percent), and as appropriate, impose administrative sanctions on those that do not comply. Also, HUD needs to continue to pursue and initiate similar actions to improve the reporting rate and data integrity for TRACS database. As was evidenced by the significant improvement in the reporting rate for MTCS during fiscal year 2000, these actions have had a positive impact in improving the completeness and data integrity of MTCS.

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System and Accounting Issues

HUD Needs to Address System and Accounting Weaknesses

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

- controls over the computing environment, and
- administration of personnel security operations.

We also discuss the need for HUD to improve its processes for reviewing outstanding obligations to ensure that unneeded amounts are deobligated in a timely manner.

Reportable Condition: Controls Over HUD's Computing Environment Can be Further Strengthened

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

We evaluated selective system controls, and disaster recovery and physical security procedures for both the Hitachi and UNISYS mainframe computers. We also evaluated software change control, tested security over networks, and observed backup operations and physical access at selected field offices.

While significant improvements have been made, more can be done to reduce the risk of unauthorized activities

We previously reported in the fiscal year 2000 Financial Statement Audit that HUD has made substantial control improvements in the Hitachi mainframe-computing environment. During fiscal year 2001, HUD continued the effort to improve controls in the UNISYS mainframe-computing environment. Previously reported exposures of sensitive Privacy Act data and payment system data to unauthorized access have been corrected. Data files and software libraries are now protected by validation and verification methods to ensure that users requesting read and write access have the proper authority and need to know. In addition, the number of on-line UNISYS Demand users with access to powerful system commands has been reduced and an audit trail has been developed to track the authorized security and system administrative functions.

With respect to disaster recovery, HUD is following a schedule for conducting planned tests to determine the adequacy of HUD's Business Resumption Plan in the event of an unexpected disruption. These tests include file and database restores for multiple applications, and telecommunications links.

While the general controls have been significantly strengthened, software configuration management, network access controls, and physical access require additional improvements as discussed below.

Software Configuration Management

The Government Accounting Office (GAO) Federal Information System Controls Audit Manual (FISCAM) indicates controls should be established over the configuration of application software programs to ensure only authorized programs and modifications are implemented. This is accomplished by instituting policies, procedures, and techniques to ensure all software programs and program modifications are properly authorized, tested, and approved and that access to and distribution of programs is carefully controlled.

In prior reports on HUD's financial statements, we reported long-standing weaknesses on configuration management (CM). After a period of slow progress, HUD has made considerable stride to improve CM during fiscal year 2001. The CM tools, CMPlus for the UNISYS and Endevor for the Hitachi, are now used to control the software configuration for critical mainframe applications. However, controls over CM can be further strengthen in several areas as discussed below.

CM for mainframe applications is undermined by inadequate control over emergency software fixes

With respect to emergency fixes, the FISCAM states, "It is important that an entity follow established procedures to perform emergency software changes and reduce the risk of suspending or abbreviating normal controls." HUD CM Policy document provides in part, that HUD's Configuration Projects shall control changes to baselines and create products from the software baseline library and control their release according to documented procedures.

We tested the integrity of one critical application, the Program Accounting System (PAS), and found inconsistencies between the development and the production libraries. We identified 15 modules in the production library that did not exist in the development library and 9 modules with different time and dates of compilation. This means that as many as 24 modules in PAS lacked integrity. We were told that these inconsistencies occurred because a number of emergency changes were made directly on the production libraries. The normal CM procedure is to make the software modifications in the development libraries first and after testing, move to the production library. Although our tests were limited to one application, lack of software integrity could exist in other

UNISYS and HITACHI applications since there is lack of adequate follow-up and documentation procedures for making emergency software changes on both platforms. Inadequate control over emergency changes increases the risk of software errors, which could cause system failures, and/or data loss.

Controls over sharing of user identifications and passwords needs to be improved. With respect to CM implementation for the UNISYS applications, we have a concern regarding the sharing of user identifications (IDs) and passwords for production control work. The design of CMPlus forces production control personnel to share the "owner" user id and the associated password of an application in order to perform their duties such as placing new or modified programs into production. This practice is contrary to FISCAM recommendations that user ids and passwords be unique and not shared. We were informed by the Department that four production control technicians and two other users (one HUD employee and one contractor personnel) shared the access to the "owner" ids and passwords. As a result, individual accountability and audit trails of production control activities would be difficult to establish.

While we recognize the technically difficulty in modifying CMPlus to eliminate the need for sharing "owner" ids and passwords, a compensating control measure can be implemented. The periodic change of passwords would decrease the risk of misusing the "owner" user ids for unauthorized persons. However, we found the passwords of "owner" user ids are not periodically changed according to HUD standards.

CM for 12 of 14 critical UNISYS applications lacks separate libraries for development and testing

Another concern is the lack of separation between development work and testing. The FISCAM provides "Separate libraries should be established for programs being developed or modified, programs being tested by users, and programs approved for use (production programs). Access to these libraries should be limited and movement of programs and data among them should be controlled."

We found 12 of the 14 critical UNISYS systems lack separate libraries for development and testing. As a result, movement of programs between development and testing cannot be controlled for these applications. FISCAM provides "Inadequately controlled software libraries increase the risk that unauthorized changes could be made either inadvertently or deliberately for fraudulent or malicious purposes. In addition, inadequately controlled programs being developed or modified could make it difficult to determine which versions of the program are the most recent. Such an environment can result in inefficiencies and could lead to monetary losses and interruption of service."

CM implementation has been delayed for 6 critical client/server applications

Besides reviewing CM implementation for mainframe applications, we also evaluated progress made on LAN-based client/server critical financial applications. HUD selected an automated tool, PVCS, to control software changes and releases for most of the client/server applications in response to previously reported weaknesses in software configuration management. Although significant progress has been made, the implementation was not completed by the due date of December 14, 2001. Software changes for 31 out of 37 client/server applications are performed under the control of PVCS. However, five applications are still in the planning phase and one application, because of technical reasons, requires a different tool for configuration management.

Another concern is that HUD did not verify the accuracy and quality of the implementation. There are no verification procedures for performing the necessary technical work to ensure that the source code and the executable code are synchronized and all software modules are under the control of the CM tool.

We were told that the delay in implementation and the lack of verification were due to funding shortfalls and a shortage of qualified CM administration expertise within HUD. Without CM controls to maintain software integrity, the mission critical client/server applications are exposed to the risk of unauthorized, deliberate or unintentional, modifications which could result in errors, loss of data, or system failure.

Network Environment

In addition to reviewing mainframe system controls, we tested selected HUD network controls. Our network control tests were designed to determine if a person could obtain unauthorized access to network resources. Vulnerabilities in one area of the network can be manipulated to obtain greater access in another part. We also examined Novell server backup procedures at selected field sites. Novell servers in the field offices provide the necessary connectivity for field users to access HUD's financial application systems such as HUDCAPS, LOCCS and PAS. Our work this year indicates that the field offices have been provided sufficient tape back up units and spare servers to be adequately prepared for unexpected disruptions. Also, in response to previously reported weaknesses, the field IT Directors are actively using a security analysis software tool purchased to monitor access controls of Novell servers.

Network vulnerabilities have been reduced but weaknesses still exist.

During previous reviews of Novell Server user settings we determined that servers were not configured to limit unauthorized access and that many users were not following sound password practices. In response to our observations the Department has taken steps to address these weaknesses. While these steps have been effective in improving the security of these servers, more should be done. Controls over user passwords can be strengthened. We determined that 10 servers out of 22 tested had over 5 percent of users with easily guessed passwords. We also noted that 15 of the 22 servers were configured to allow unlimited login attempts to the SUPERVISOR account. This makes it possible for someone seeking unauthorized access to the account to guess the password without being stopped by the Novell operating system.

Another previously reported weakness is that Novell operating system files (the bindery) were not protected from unauthorized access. The bindery of 1 of the 22 Novell servers we tested permitted general users full access to these files, which would enable them to obtain passwords and system administration privileges. This information would allow a person to login as someone else and use that access to read files, destroy or alter data, and initiate transactions. Although this vulnerability was fixed soon after discovery, the field IT Directors should adopt preventive controls to minimize the exposure of the bindery to unauthorized access.

Physical Security

We observed physical access control practices at HUD's Computer Center (HCC) at Lanham, MD, and the Disaster Recovery Facility (DRF) at Reston, VA. We also observed the physical control of server rooms and storage areas for telecommunications and computer equipment at selected field sites. The results of our observation indicate two improvements should be considered as described below.

Physical access vulnerabilities identified for HCC and the DRF have not been adequately addressed.

HUD's Critical Infrastructure Protection Plan issued in July 2000 reported a number of physical access vulnerabilities. Weaknesses were identified for both the main HUD's Computer Center (HCC) at Lanham and the Development and Recovery Facility (DRF) at Reston, VA. Both the HCC and DRF lacked (1) barriers around the building, (2) magnetometer and x-ray scanner for screening incoming personnel, (3) screening of mail and delivery packages before being brought into the center, and (4) blast-resistant coating on street level windows. We also noticed that the DRF lacked card key entry control for exits, security guards, and security cameras. In addition, the DRF shares the facility with other tenants. HUD has not taken any action to address these vulnerabilities.

National Institute of Standard and Technology's Principles and Practices for Securing IT Systems states that physical and environmental security controls are implemented to protect the facility housing system resources, the system resources themselves, and the facilities used to support their operation. Organization's physical and environmental security program should address physical access controls, fire safety, failure of supporting utilities, structural collapse, plumbing leaks, interception of data, and mobile and portable systems to help prevent interruptions in computer services, physical damage, unauthorized disclosure of information, loss of control over system integrity, and theft.

Physical access control to computer facilities in field offices can be further strengthened

Physical access to computer equipment at field offices could also be improved. During our review of six Information Technology Division and ten Area Technology Administrator offices we noted that servers are stored in rooms with locks. However, only three offices had card entry systems with the capability for tracking who had accessed the facilities.

We also noticed two offices had telecommunications racks stored in unlocked space.

According to the FISCAM, physical access to computer facilities should be limited to personnel with a legitimate need for access to perform their duties. Management should regularly review the list of persons authorized to have physical access to sensitive facilities. It would be difficult to determine who had access to the computing facilities in the field offices without an entry system that has an audit trail capability. Physical access to these facilities must be adequately controlled to prevent unauthorized individuals intentionally or inadvertently damaging or destroying the network server equipment.

With respect to telecommunications racks, such equipment should be stored in a locked room to prevent unauthorized tampering.

HUD's Actions Planned and Underway to Improve Controls Over Its Computing Environment

On software configuration management for the mainframes, we have informed HUD of our concerns regarding (1) emergency software fixes, (2) sharing "owner" ids and passwords, and (3) the lack of separate libraries between development and testing for UNISYS applications. The Department indicated a willingness to address these concerns. With respect to the client/server applications, the Department is revising the schedule to complete the remaining six applications without CM.

On the network environment, the field IT Directors are continuing the use of Kane Security Analyst purchased to produce assessment reports of the settings of Novell servers. The assessment reports vulnerabilities such as unprotected operating system files, system administration accounts with default passwords, user accounts with easily guessed passwords and user accounts that have not been in use for long periods of time. These reports are run quarterly for the Novell servers at the field offices and used by the IT Directors to improve the access controls.

With respect to physical access control, the Department indicated that it has reviewed each of the physical access vulnerability's for the HUD Computer Center (HCC) and the Development and Recovery Facility (DRF) listed in the July 2000 Critical Infrastructure Protection Plan (CIPP). HUD determined that the cost and practicality of changing the existing facilities out weighed any advantages to be gained. There is no budget available to upgrade either facility. In addition, the Department indicated that it is in the process of re-competing the existing HIIPS contract so there are no plans to upgrade either facility. Regarding the physical access improvements to the computing facilities in the field, the Department has not addressed this area.

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

During fiscal year 2001, HUD has significantly improved the controls over its computing environment. We are hopeful that sufficient priority will be assigned to (1) improve controls over emergency software fixes, (2) reduce the risk of unauthorized changes for UNISYS applications, and (3) complete CM implementation for six remaining client/server financial applications.

With respect to the network security, continuing the use of the Kane Security Analyst program will help to improve the Novell server security. In addition to the quarterly assessment, the Department should run these reports more often for those sites unable to reduce easily guessed passwords to below 5 percent. Also, field IT Directors should pay particular attention to those sites that leave the bindery open. KANE should be used to continually monitor these sites after discovery and for a period of time after the fix.

With respect to vulnerabilities described in the July 2000 Critical Infrastructure Protection Plan (CIPP), HUD should conduct a formal risk analysis to determine whether the improvements mentioned in the report are warranted. This risk analysis should also consider the need to install card key entry systems for computer facilities in the field offices and for controlling the exits of the DRF. In addition, telecommunications equipment racks in field offices should always be stored in locked space.

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

For several years we have reported that HUD's personnel security over critical and sensitive systems' access has been inadequate. Although HUD has made some progress to address the reported problems, risks of unauthorized access to the Department's critical financial systems remain a major concern. Without adequate personnel security practices, inappropriate individuals may be granted access to HUD's facilities, information, and resources that could result in destruction or compromise of critical and sensitive data.

HUD Handbook 2400.24 REV-2, "Information Security Program," describes the Information Security Program for the Department. This document provides the policies and requirements for implementing security controls over HUD's information systems. It also specifies the responsibilities for security management of HUD's information resources. HUD Handbook 723.3 REV-1, "Personnel Security/Suitability" provides the policies and procedures for the administration and operation of the Department's Personnel Security and Suitability program.

A key control over systems access by employee and contractor personnel is the requirement for background screening. The Office of the Chief Information Officer (OCIO) is responsible for providing policy, guidance, and oversight for information security. HUD's system owners of critical and sensitive financial applications such as LOCCS, PAS and

HUDCAPS, are responsible for determining the appropriate levels of access for contractors and employees. The level of access required determines the appropriate level of screening for system users. The security administrators for each of the systems are responsible for ensuring that the investigative requirements are met for each user granted more than read access to mission-critical and sensitive systems. The Office of Human Resources (OHR) under the Office of Administration (OA) is responsible for the operations of the personnel security program, which includes the processing, tracking, and reporting of background investigations.

During fiscal year 2001, 825 users granted access to HUD's critical and sensitive systems lacked the appropriate background investigations. In our report on the fiscal year 2000 financial statements, we reported that 2004 out of 5793 employees and contractors (35 percent) who had access to HUD's critical and sensitive systems had no record of a background investigation. Recommendations to correct the problems include (1) enhancing the OHR's personnel security system reporting capability and (2) the OCIO providing better guidance and oversight. During fiscal year 2001, the backlog has been reduced. However, a high number of users with above read access to HUD's mission-critical and sensitive systems remain without the appropriate background investigation.

Quarterly reconciliation's are not being performed.

As reported in last year's report on the fiscal year 2000 financial statements, we again found that the OCIO is not submitting to OHR nor maintaining the required listings of users with access to critical and sensitive HUD systems for reconciliation purposes in accordance with the Personnel Security/Suitability Handbook 732.2. This helps ensure that all users of critical and sensitive systems have the appropriate background check. The Handbook also requires the OCIO provide OHR with a quarterly list of all individuals who require sensitive access to mission-critical systems within three working days following the end of each fiscal quarter. This handbook requires that the OHR be responsible for reconciling, as needed, the SCATS database with the IT listing of users who require above query access to mission critical (sensitive) systems.

Alternative method of OCIO does not identify all users who have access to critical and sensitive systems.

Rather than submitting to OHR a list of users with access to HUD's critical systems, the OCIO has established an alternative method for OHR to use in reconciling their personnel security database. An electronic mailbox was created where users would submit their requests for access to HUD's systems. This would allow OHR and OCIO to determine whether users have the appropriate background investigation by verifying the information in OHR's database before access is approved. However, this method is flawed since it only identifies users who have requested access to HUD's systems and submitted a background investigation request. This method also cannot prevent users from requesting above read access without the proper background investigation documents. Without ensuring that all users who have access to HUD's mission-critical and sensitive systems have the appropriate background investigation, HUD is at risk that unsuitable users may intentionally misuse, damage, or destroy HUD's data.

HUD's Actions Planned and Underway to Correct Personnel Security Weaknesses

In a memorandum dated October 18, 2001 from the Deputy Assistant Secretary for Resource Management, OA to the Director, Office of Systems Integrity and Efficiency, OCIO, the OA expressed concern regarding a backlog of 825 individuals who had greater than read access to sensitive systems and who had not submitted required background investigation documents. The memorandum indicated that this backlog has been outstanding since November 2000 despite repeated attempts by OA to get the system administrators and employees to submit the required forms. Accordingly, the OCIO was requested to take immediate action to discontinue system access of users who have failed to comply with personnel security requirements. The OCIO currently plans in the near future to remove access of those 825 individuals who have not provided the appropriate investigation documents. However, these plans have not been formalized.

The Director of ADP security stated that he was aware of the backlog problem and had initially set a deadline of September 11, 2001 for users to submit the required background investigation forms or have their access removed from the systems. However, the terrorist events of September 11, 2001 caused suspension of this deadline. We were informed verbally that the revised deadline is February 15, 2002. With respect to the use of the electronic mailbox to inform OHR of user requests for above read access, the Director of ADP Security believes this method is sufficient.

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

Immediate action must be taken to (1) eliminate the backlog of individuals who have greater than read access to sensitive systems and who have not submitted required background investigation documents and (2) ensure that corrective actions are taken to prevent reoccurrence. Although there has been some progress in reducing the backlog, more needs to be done. The OCIO, in coordination with the system users and OHR, needs to establish a formal action plan for resolving the backlog. This action plan should identify roles and responsibilities for all of the players involved and timelines for completion of this effort. Additionally, the OCIO should establish, disseminate, and enforce a policy requiring all users requesting above read access to HUD's mission-critical and sensitive systems to submit the proper investigation forms before they are allowed access to the systems.

With respect to the reconciliation process, we agree that using the electronic mailbox system does provide a more timely approach for reconciling OHR's personnel security database and can be used. However, it does not ensure that all personnel who have access to HUD's mission-critical and sensitive systems have the appropriate investigative documents and that the personnel security's database is accurate and complete. This can only be verified by comparing the access security data provided by the OCIO with the data residing in the personnel security's database on a periodic basis.

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

HUD needs to improve controls over the monitoring of obligated balances to determine whether they remain needed and legally valid as of the end of the fiscal year. HUD's procedures for identifying and deobligating funds that are no longer needed to meet its obligations are not always effective. Although HUD has made some progress in implementing procedures and improving its information systems to ensure accurate data are used, further improvements are still needed. Major deficiencies include:

- Specific statutory or grant requirements for outstanding obligations are not being enforced.

- A lack of integration between accounting systems and the need for accurate databases has hampered HUD's ability to evaluate unexpended Section 8 project-based obligations.

Annually, HUD performs a review of unliquidated obligations to determine whether the obligations should be continued, reduced, or canceled. We evaluated HUD's internal controls for monitoring obligated balances. As in prior reports, we found a number of weaknesses in the process including (1) reviews not considering specific statutory or other requirements relating to particular programs and (2) underlying financial systems do not support the process for identifying excess budget authority for the Section 8 project-based program because of data inconsistencies and inaccurate data.

We found a need for increased oversight and emphasis on the obligation review process in two areas. We found deficiencies in the controls over public housing modernization/capital funds and the need for correcting and verifying data underlying the Section 8 project-based obligations.

PIH did not assess the continued status of modernization/capital funds to assure compliance with statutory requirements

In the "Compliance with Laws and Regulations" section of this report, we report that HUD is not in compliance with the United States Housing Act of 1937, as amended by the Quality Housing and Work Responsibility Act of 1998. In this regard, HUD is not enforcing the requirements for the expenditure and obligation by HAs of public housing modernization/capital funds. In the annual review of HUD's outstanding obligations, these provisions were not considered in identifying obligated amounts that may no longer be valid. Moreover, HUD was not taking sufficient action to ensure that other enforcement actions relating to the timely use of modernization/capital funds were carried out in a timely manner.

HUD has made progress in identifying excess reserves in the Section 8 programs

Section 8 budget authority is generally available until expended. As a result, HUD should periodically assess and identify excess program reserves in the Section 8 programs as an offset to future budget requirements. Excess program reserves represent budget authority originally received, which will not be needed to fund the related contracts to their expiration. In 1997, HUD initiated action to identify and recapture excess budget authority in its Section 8 contracts. Prior to this HUD had been unaware of the extent of excess budget authority available to offset needs for new budget authority for the Section 8 programs.

HUD needs to develop an accurate database for evaluating Section 8 project-based obligations.

The Office of Housing has been hampered in its attempts to evaluate unexpended Section 8 project-based budget authority balances. The requirement to evaluate data from two payment methods, managed by different account systems (HUDCAPS and PAS/LOCCS) has necessitated separate budget reviews. In addition, an inability to associate recent payment data with all active contracts in the TRACS contracts database has impaired HUD's ability to evaluate unliquidated obligation balances. In fiscal year 2001, $734 million in unliquidated obligation balances were recaptured in the Section 8 project-based program on expired contracts. However, the related analyses of potential budget shortfalls and excesses for the 23,589 contracts paid through LOCCS showed only 17,574 contracts (75 percent) were included in the analysis and 6,015 contracts (25 percent) were excluded. Review of the excluded contracts showed contracts were excluded for a number of reasons including (1) invalid "burn rates" and disbursement dates, (2) inactive contracts, and (3) contracts expired. The available budget authority associated with these contracts totaled at least $2.6 billion. In addition, 243 of the contracts had expired prior to September 30, 2000. These 243 contracts had $19 million in excess funds potentially available for immediate recapture. Since HUD's procedures allow up to one year after contract expiration to complete the close out process and recapture any remaining funds, the $2.6 billion would not materially affect the fair presentation of HUD's financial statements. However, HUD needs to address data and systems weaknesses to ensure all contracts are considered in the recapture/shortfall budget process.

Process improved for recapturing excess tenant-based funds

PIH has improved its process for identifying excess unexpended budget authority on Section 8 tenant-based contracts and the underlying information systems to ensure accurate data can be obtained on these balances. In August 2001, PIH performed an analysis of budget authority for all years related to the Section 8 tenant-based program and estimated that approximately $1.84 billion of the unexpended budget authority was available for deobligation and recapture. This is funding that housing agencies received under contracts with HUD but did not expend or is not needed to make housing assistance payments.

HUD's Actions Planned and Underway to Improve the Process for Reviewing Obligation Balances

The Office of Housing plans to perform quality reviews of contract and obligation data to determine the causes and solutions for unavailable payment data. The Office of Housing also plans to initiate an in-house project to automate and combine budget analyses for contracts paid through HUDCAPS and PAS/LOCCS to (1) streamline the process for recapturing funds and (2) ensure that all Section 8 project-based obligations are reviewed consistently.

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

HUD's proposed actions to improve the Section 8 accounting systems and the continued emphasis on improving the integrity of the accounting information should facilitate the recapture and budgeting for Section 8 funds.

Compliance with Laws and Regulations

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

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

During fiscal year 2001, the Department continued to address its financial management deficiencies and has taken steps to bring the agency's financial management systems into compliance with FFMIA. In accordance with the requirements of FFMIA, HUD requested concurrence of OMB to extend the statutory three-year remediation timeframe to be in compliance with FFMIA. In its current remediation plan, HUD plans to develop a new FHA automated general ledger by October 2002. This new system will automate FHA headquarters' funds control processes, financial statement reporting, and updates to the departmental general ledger.

The Department is moving in the direction of becoming FFMIA compliant for three areas of substantial noncompliance: (1) federal financial management systems requirements (2) Federal Accounting Standards and (3) the SGL at the transaction level. We have included the specific nature of the noncompliance, responsible program offices and recommended remedial actions in Appendix C of this report.

Federal Financial Management Systems Requirements

In its *Fiscal Year 2001 Accountability Report*, HUD reports that 17 of its 57[18] financial management systems do not materially conform to the requirements of FMFIA and OMB Circular A-127, *Financial Management Systems*. The number of reported non-conforming systems was increased from the 11 reported in the *Fiscal Year 2000 Accountability Report* because 9 FHA systems that were previously assessed as conforming were reclassified as non-conforming systems. HUD also discontinued two systems and the Department corrected deficiencies in one non-conforming system. In addition to deficiencies noted in HUD's Accountability Report, we report as a material weakness that *HUD's Financial Systems are Not Compliant with Federal Financial Standards*. This material weakness addresses how HUD's financial management systems do not meet core financial system

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[18] At the end of the fiscal year, HUD showed 55 financial systems, however, as a result of a financial systems determination completed in December 2001 for 3 CPD systems, 2 systems which were originally determined as non-financial were determined as mixed-use systems.

requirements for integration through automated interfaces. The material weakness also notes noncompliance with the June 2000 JFMIP requirements for federal grants accounting,

We report as a reportable condition that *Controls over HUD's Computing Environment Can be Further Strengthened*. This reportable condition discusses how software configuration management, network access controls, and physical access require additional improvement. In addition A-127 compliance reviews have disclosed that security over financial information is not provided in accordance with OMB Circular A-130 *Management of Federal Information Resources*, Appendix III and the Government Information Security Reform Act.

Federal Accounting Standards

A material weakness was reported by KPMG LLP regarding controls over FHA's budget execution and funds control. FHA's lack of financial systems and processes that are capable of fully monitoring and controlling budgetary resources resulted in FHA's violation of the Anti-Deficiency Act. This results in a need to:

- implement budgetary controls to prevent misreporting of budget execution information relating to FHA appropriations (Statement of Federal Financial Accounting Standards (SFFAS) Number 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting).*

- review and reconcile obligations in order to provide complete financial information *(SFFAS Number 7, Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting).*

As discussed in our financial systems material weakness, the crosswalk interfaces between the HUDCAPS and its reporting system (Hyperion) has not been developed to transfer FHA and GNMA account balances. This process increases the chances for misstatements from human error or from any unreconciled differences with recorded balances.

Compliance with SGL at the transaction level

HUDCAPS is the Department's official standard general ledger system. FHA provides consolidated summary level data to HUDCAPS. FHA has 22 subsidiary systems that feed transactions to its commercial general ledger system. Fifteen of the 22 systems lack the capability to process transactions in the SGL format. To provide consolidated summary level data from FHA to HUDCAPS, FHA currently uses several manual processing steps, including the use of personal computer based software to convert the commercial accounts to government SGL, and transfer the account balances to HUDCAPS. JFMIP requires that the core financial system "...provide for automated month and year-end closing of SGL accounts and rollover of the SGL account balances".

During FY 2001, FHA completed the Initiate and Define phases of HUD's Systems Development Methodology for implementing a JFMIP compliant Commercial off the Shelf (COTS) financial software system. FHA intends to complete implementation of the COTS general ledger module in time to commence operations in October 2002. Upon implementing this module, FHA will integrate it's financial transaction repository and posting models, and provide an accounting system that satisfies Federal Generally Accepted Accounting Principles (Fed GAAP). In Phase II of the project, FHA plans to implement the SGL at the transaction level (targeted October 2002) and replace many manual and stand-alone automated accounting procedures with an integrated core financial management system (targeted December 2004).

HUD Did Not Comply with the United States Housing Act of 1937

HUD is not in compliance with the United States Housing Act of 1937, as amended by the Quality Housing and Work Responsibility Act of 1998 (the Act). HUD is not timely or properly enforcing the requirements for the expenditure and obligation by HAs of public housing modernization/capital funds. This is an unresolved issue from our reports on HUD's fiscal year 1999 and 2000 financial statements and was forwarded to the Comptroller General of the United States in August 2000 for a legal opinion and resolution.

PIH did not enforce the expenditure provisions of the Act for modernization funds

Our analysis of HUD records relating to expenditure of fiscal year 1997 and prior years public housing modernization funds showed $161 million in unexpended funds as of September 30, 2001. The Act provides that public housing modernization assistance received under The Act shall be spent not later than four years after the date on which funds become available for obligation. The Act provides that the Secretary shall enforce the requirement for expenditure of funds through default remedies up to and including the withdrawal of funds. For fiscal year 1999 and 2000, we reported the same deficiency. HUD believed the provisions of the Act, as it relates to expenditures, do not apply to funds made available prior to enactment of the Act. However, it is our opinion the provisions do apply because the Act specifically merged the previously awarded modernization assistance into the present "Capital Fund" thereby subjecting the previously awarded modernization funds to the enforcement provisions of the Act.

PIH did not enforce the obligation provisions of the Act for modernization / capital funds

Our review of records relating to public housing modernization or capital funds showed that HAs had $19 million in unobligated fiscal year 1998 and prior fiscal year funds as of September 30, 2001. HUD's policy with respect to these unobligated funds is not in compliance with the Act.

The Act provides with respect to the public housing capital funds, that such funds shall be fully obligated by the public housing agencies not later than 24 months after the date the funds become available to the agency for obligation. The Act provides that a public housing agency shall not be awarded assistance for any month during the fiscal year in which the public housing agency has funds unobligated in violation of the Act. Additionally, during any fiscal year in which the agency is in violation, the Secretary shall withhold all assistance that would otherwise be provided to the HA. If the HA cures its failure to comply during the year, it shall be provided with the share attributable to the months remaining in the year.

Our analysis as of September 30, 2001 showed that 37 HAs still had $17 million in fiscal year 1998 or prior year funds unobligated. Instead of following the Act's provisions for withholding assistance, HUD awarded $315 million in fiscal year 2001 funds to these 37 HAs.

Other Matters Under Review

In Conference Report HR 107-272, dated November 6, 2001, Congress expressed concerns over the management of Office of Multifamily Housing Assistance Restructuring (OMHAR) and potential violations of the Anti-Deficiency Act (ADA). Congress requested that we review these matters and we expect to issue a report shortly.

PRINCIPAL
FINANCIAL
STATEMENTS

Introduction

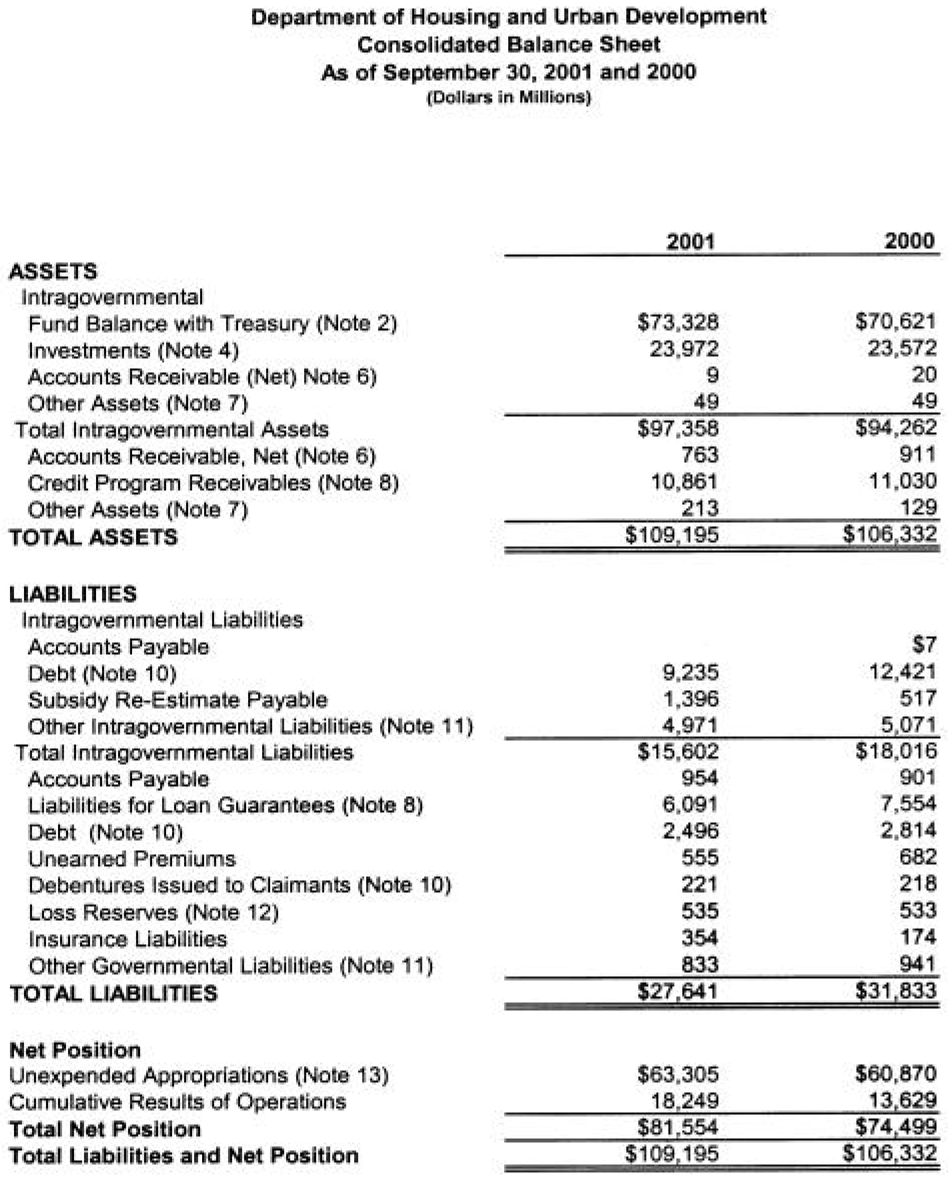
The principal financial statements have been prepared to report the financial position and results of operations of the Department of Housing and Urban Development, pursuant to the requirements of the Chief Financial Officers Act of 1990 (31 U.S.C. 3515 (b)). While the financial statements have been prepared from HUD's books and records in accordance with formats prescribed by the Office of Management and Budget, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

The principal financial statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. One implication is that liabilities reported in the financial statements cannot be liquidated without legislation that provides resources to do so.

The financial statements included in this annual report are as follows:

- Consolidated Balance Sheet
- Consolidating Statement of Net Cost
- Consolidating Statement of Changes in Net Position
- Combined Statement of Budgetary Resources; and
- Combined Statement of Financing

These financial statements include all of HUD's activities, including those of the Federal Housing Administration and the Government National Mortgage Association. These financial statements cover all of HUD's budget authority.



Department of Housing and Urban Development
Consolidated Balance Sheet
As of September 30, 2001 and 2000
(Dollars in Millions)

	2001	**2000**
ASSETS		
Intragovernmental		
Fund Balance with Treasury (Note 2)	$73,328	$70,621
Investments (Note 4)	23,972	23,572
Accounts Receivable (Net) Note 6)	9	20
Other Assets (Note 7)	49	49
Total Intragovernmental Assets	$97,358	$94,262
Accounts Receivable, Net (Note 6)	763	911
Credit Program Receivables (Note 8)	10,861	11,030
Other Assets (Note 7)	213	129
TOTAL ASSETS	$109,195	$106,332
LIABILITIES		
Intragovernmental Liabilities		
Accounts Payable		$7
Debt (Note 10)	9,235	12,421
Subsidy Re-Estimate Payable	1,396	517
Other Intragovernmental Liabilities (Note 11)	4,971	5,071
Total Intragovernmental Liabilities	$15,602	$18,016
Accounts Payable	954	901
Liabilities for Loan Guarantees (Note 8)	6,091	7,554
Debt (Note 10)	2,496	2,814
Unearned Premiums	555	682
Debentures Issued to Claimants (Note 10)	221	218
Loss Reserves (Note 12)	535	533
Insurance Liabilities	354	174
Other Governmental Liabilities (Note 11)	833	941
TOTAL LIABILITIES	$27,641	$31,833
Net Position		
Unexpended Appropriations (Note 13)	$63,305	$60,870
Cumulative Results of Operations	18,249	13,629
Total Net Position	$81,554	$74,499
Total Liabilities and Net Position	$109,195	$106,332

The accompanying notes are an integral part of these statements.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
CONSOLIDATING STATEMENT OF NET COST
For the Year Ended September 2001
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Public and Indian Housing	Housing (excluding FHA)	Community Planning and Development	Other	Consolidated
COSTS:							
Unsubsidized Program							
Intragovernmental	$431						$431
With the Public	(576)						(576)
Total Expenses	($145)	$0	$0	$0	$0	$0	($145)
Less: Earned Revenues	(2,383)						(2,383)
Net Program Costs	($2,528)						($2,528)
Subsidized Program							
Intragovernmental	$95						$95
With the Public	580						580
Total Expenses	$675	$0	$0	$0	$0	$0	$675
Less: Earned Revenues	(871)						(871)
Net Program Costs	($196)						($196)
Government National Mortgage							
With the Public		73					73
Total Expenses	$0	$73	$0	$0	$0	$0	$73
Less: Earned Revenues		(878)					(878)
Net Program Costs		($805)					($805)
Section 8							
Intragovernmental			$7	($126)			($119)
With the Public	0	0	9,543	7,209	11	0	16,763
Total Expenses	$0	$0	$9,550	$7,083	$11	$0	$16,644
Less: Earned Revenues			0	150	0		150
Net Program Costs			$9,550	$7,233	$11		$16,794
Low Rent Public Housing Loans and Grants							
Intragovernmental			$204				$204
With the Public	0	0	3,851	0	0	0	3,851
Total Expenses	$0	$0	$4,055	$0	$0	$0	$4,055
Less: Earned Revenues							
Net Program Costs			$4,055				$4,055
Operating Subsidies							
Intragovernmental			$35				$35
With the Public			3,112				3,112
Total Expenses	$0	$0	$3,147	$0	$0	$0	$3,147
Less: Earned Revenues			0				0
Net Program Costs			$3,147				$3,147
Housing for the Elderly and Disabled							
Intragovernmental				$314			$314
With the Public				784			784
Total Expenses	$0	$0	$0	$1,098	$0	$0	$1,098
Less: Earned Revenues				(665)			(665)
Net Program Costs				$433			$433
Community Development Block Grants							
Intragovernmental					32		32
With the Public	0	0	0	0	4,948	0	4,948
Total Expenses	$0	$0	$0	$0	$4,980	$0	$4,980
Less: Earned Revenues					0		0
Net Program Costs					$4,980		$4,980
HOME							
Intragovernmental					$11		$11
With the Public					1,425		1,425
Total Expenses	$0	$0	$0	$0	$1,436	$0	$1,436
Less: Earned Revenues					0		0
Net Program Costs					$1,436		$1,436
Other							
Intragovernmental			$51	$29	$45	$44	$169
With the Public			800	548	1,477	217	3,042
Total Expenses	$0	$0	$851	$577	$1,522	$261	$3,211
Less: Earned Revenues			(1)	(36)	(7)	(1)	(45)
Net Program Costs			$850	$541	$1,515	$260	$3,166
Costs Not Assigned to Programs	0	0	$154	$141	$87	0	$382
Net Cost of Operations	($2,724)	($805)	$17,756	$8,348	$8,029	$260	$30,864

The accompanying notes are an integral part of these statements.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
CONSOLIDATING STATEMENT OF NET COST
For the Year Ended September 2000
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Public and Indian Housing	Housing (excluding FHA)	Community Planning and Development	Other	Consolidated
COSTS:							
Unsubsidized Program							
Intragovernmental	$477						$477
With the Public	2,532						2,532
Total Expenses	$3,009						$3,009
Less: Earned Revenues	(2,886)						(2,886)
Net Program Costs	$123						$123
Subsidized Program							
Intragovernmental	$111						$111
With the Public	391						391
Total Expenses	$502						$502
Less: Earned Revenues	(579)						(579)
Net Program Costs	($77)						($77)
Government National Mortgage							
With the Public		$69					$69
Total Expenses		$69					$69
Less: Earned Revenues		(832)					(832)
Net Program Costs		($763)					($763)
Section 8							
Expenses With the Public/Net Program Costs			$8,823	$7,136	$31		$15,990
Low Rent Public Housing Loans and Grants							
Intragovernmental			$93				$93
With the Public			4,078				4,078
Total Expenses			$4,171				$4,171
Less: Earned Revenues			(3)				(3)
Net Program Costs			$4,168				$4,168
Operating Subsidies							
Expenses With the Public/Net Program Costs			$2,889				$2,889
Housing for the Elderly and Disabled							
Intragovernmental				$345			$345
With the Public				733			733
Total Expenses				$1,078			$1,078
Less: Earned Revenues				(674)			(674)
Net Program Costs				$404			$404
Community Development Block Grants:							
Expenses With the Public/Net Program Costs					$5,012		$5,012
HOME							
Intragovernmental					$3		$3
With the Public					1,496		1,496
Total Expenses/Net Program Costs					$1,499		$1,499
Other							
Intragovernmental			$2	$21	$7	$273	$303
With the Public			711	711	1,286	6	2,714
Total Expenses			$713	$732	$1,293	$279	$3,017
Less: Earned Revenues				(47)	(8)	93	38
Net Program Costs			$713	$685	$1,285	$372	$3,055
Costs Not Assigned to Programs			$152	$108	$84		$344
Net Cost of Operations	$46	($763)	$16,745	$8,333	$7,911	$372	$32,644

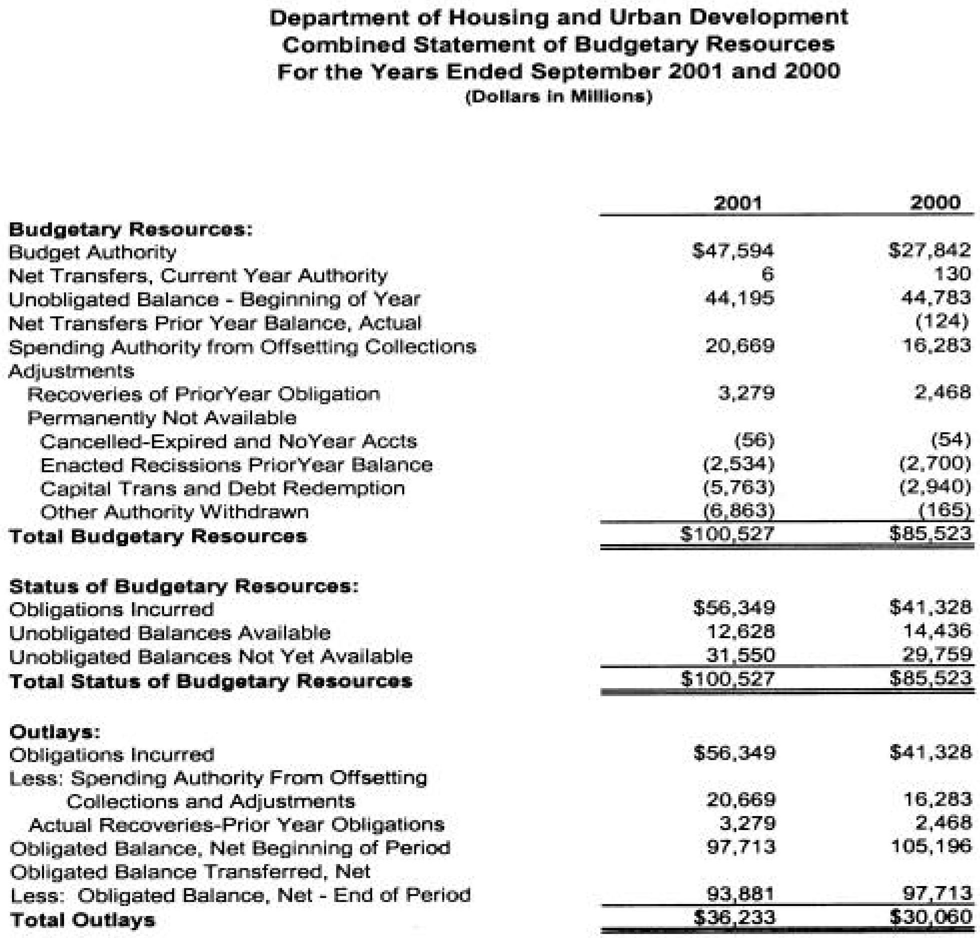
The accompanying notes are an integral part of these statements.

Department of Housing and Urban Development
Consolidating Statement of Changes in Net Position
For the Years ended September 2001and 2000
(Dollars in Millions)

2001	Federal Housing Administration	Government National Mortgage Association	Public and Indian Housing	Housing (excluding FHA)	Community Planning and Development
Net Cost of Operations	($2,724)	($805)	$17,756	$8,348	$8,029
Financing Sources					
(other than exchange revenue)					
Appropriations Used	(1,370)		(17,764)	(8,670)	(7,642)
Imputed Financing	(14)				
Transfers In/Out	1,284				
Other Financing Sources	7		(338)	(225)	(215)
Net Results of Operations	(2,817)	(805)	(346)	(547)	172
Prior Period Adjustments	($261)				
Net Change In Cumulative Results of Operations	(3,078)	(805)	(346)	(547)	172
Change in Unexpended Appropriations	($978)		$9,606	($11,120)	$85
Change in Net Position	(4,056)	(805)	9,260	(11,667)	257
Net Position-Beginning of Period	($11,058)	($7,319)	($4,320)	($23,280)	($27,759)
Net Position-End of Period	($15,114)	($8,124)	$4,940	($34,947)	($27,502)

2000	Federal Housing Administration	Government National Mortgage Association	Public and Indian Housing	Housing (excluding FHA)	Community Planning and Development
Net Cost of Operations	$46	($763)	$16,745	$8,333	$7,911
Financing Sources					
(other than exchange revenue)					
Appropriations Used	(1,124)		(16,748)	(8,720)	(7,848)
Imputed Financing	(11)				
Transfers (In) / Out	436			73	
Other Financing Sources				35	
Net Results of Operations	($653)	($763)	($3)	($279)	$63
Prior Period Adjustments	(8)				(13)
Net Change In Cumulative Results of Operations	($661)	($763)	($3)	($279)	$50
Change in Unexpended Appropriations	(837)		12,958	(11,388)	1,431
Change in Net Position	($1,498)	($763)	$12,955	($11,667)	$1,481
Net Position-Beginning of Period	(9,560)	(6,556)	(17,275)	(11,613)	(29,240)
Net Position-End of Period	($11,058)	($7,319)	($4,320)	($23,280)	($27,759)

The accompanying notes are an integral part of the statements.



Department of Housing and Urban Development
Combined Statement of Budgetary Resources
For the Years Ended September 2001 and 2000

(Dollars in Millions)

	2001	2000
Budgetary Resources:		
Budget Authority	$47,594	$27,842
Net Transfers, Current Year Authority	6	130
Unobligated Balance - Beginning of Year	44,195	44,783
Net Transfers Prior Year Balance, Actual		(124)
Spending Authority from Offsetting Collections	20,669	16,283
Adjustments		
Recoveries of PriorYear Obligation	3,279	2,468
Permanently Not Available		
Cancelled-Expired and NoYear Accts	(56)	(54)
Enacted Recissions PriorYear Balance	(2,534)	(2,700)
Capital Trans and Debt Redemption	(5,763)	(2,940)
Other Authority Withdrawn	(6,863)	(165)
Total Budgetary Resources	$100,527	$85,523
Status of Budgetary Resources:		
Obligations Incurred	$56,349	$41,328
Unobligated Balances Available	12,628	14,436
Unobligated Balances Not Yet Available	31,550	29,759
Total Status of Budgetary Resources	$100,527	$85,523
Outlays:		
Obligations Incurred	$56,349	$41,328
Less: Spending Authority From Offsetting Collections and Adjustments	20,669	16,283
Actual Recoveries-Prior Year Obligations	3,279	2,468
Obligated Balance, Net Beginning of Period	97,713	105,196
Obligated Balance Transferred, Net		
Less: Obligated Balance, Net - End of Period	93,881	97,713
Total Outlays	$36,233	$30,060

The accompanying notes are an integral part of these statements.

Department of Housing and Urban Development
Combined Statement of Financing
For the Year Ended September 2001 and 2000
(Dollars in Millions)

	2001	2000
Obligations and Nonbudgetary Resources		
Obligations Incurred	$56,349	$41,328
Spending Authority from Offsetting Collections and Adjustments	(20,669)	(16,213)
Recoveries-Prior Year Obligations	(3,279)	(2,468)
Financing Imputed for Cost Subsidies	70	49
Transfers In (Out)		
Exchange Revenue Not in the Budget	(66)	64
Non-Exchange Revenue Not in Budget	140	8
Exchange Revenue in the Budget	6	
Total Obligations as adjusted, and NonBudgetary Resources	$32,551	$22,768
Resources That Do Not Fund Net Cost of Operations		
Change in Amount of Goods, Services and Benefits Ordered, but not yet Received or Provided	$3,877	$7,309
Costs Capitalized on the Balance Sheet	5,758	2,155
Financing Sources that Fund Costs of Prior Periods	(8,363)	(11)
Other	(353)	(44)
Total Resources that do not Fund Net Cost of Operations	$919	$9,409
Costs That Do Not Require Resources		
Depreciation and Amortization	$4	$6
Bad Debts Related to Uncollectible Non-Credit Reform Receivables	(466)	70
Revaluation of assets & Liabilities	(831)	(1,127)
Loss of Disposition of Assets	748	728
Other	(4,045)	(3,171)
Total Costs Not Requiring Resources	($4,590)	($3,494)
Financing Sources Yet to be Provided	$1,984	$3,961
Net Cost of Operations	$30,864	$32,644

The accompanying notes are an integral part of these statements

NOTES TO FINANCIAL STATEMENTS

September 30, 2001 and 2000

NOTE 1 - ENTITY AND MISSION

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

HUD's major programs are as follows:

The **Federal Housing Administration** (FHA) was created as a Government corporation within HUD and administers active mortgage insurance programs that are designed to make mortgage financing more accessible to the home-buying public and thereby to develop affordable housing. FHA insures private lenders against loss on mortgages that finance single family homes, multifamily projects, health care facilities, property improvements, and manufactured homes.

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

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

Operating Subsidies are provided to Public Housing Authorities (PHAs) and Tribally Designated Housing Entities (TDHEs) to help finance the operations and maintenance costs of their housing projects.

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

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

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

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

Other Programs not included above consist of other smaller programs which provide grant, subsidy funding, and direct loans to support other HUD objectives such as fair housing and equal opportunity, energy conservation, assistance for the homeless, rehabilitation of housing units, and home ownership. These programs comprise approximately 9.9 percent of HUD's consolidated assets and 9.1 percent of HUD's consolidated revenues and financing sources for fiscal 2001 and 9.6 percent of HUD's consolidated assets and 8.4 percent of HUD's consolidated revenues and financing sources for fiscal 2000.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Consolidation

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

B. Basis of Accounting

The financial statements include the accounts and transactions of the Ginnie Mae, FHA, and HUD's Grant, Subsidy and Loan programs.

The financial statements are presented in accordance with the Office of Management and Budget (OMB) Bulletin 97-01, Form and Content of Agency Financial Statements, and in conformance with the Federal Accounting Standards Advisory Board's (FASAB) Statements of Federal Financial Accounting Standards (SFFAS).

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

C. Operating Revenue and Financing Sources

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

Appropriations for Grant and Subsidy Programs

HUD receives both annual and multi-year appropriations, and recognizes those appropriations as revenue when related program expenses are incurred. Accordingly, HUD recognizes grant-related revenue and related expenses as recipients perform under the contracts. HUD recognizes subsidy-related revenue and related expenses when the underlying assistance (e.g., provision of a Section 8 rental unit by a housing owner) is provided.

FHA Unearned Premiums

Premiums charged by FHA for single family mortgage insurance provided by its Mutual Mortgage Insurance (MMI) Fund and Cooperative Management Housing Insurance (CMHI) Fund include up-front and annual risk based premiums. Pre-credit reform 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 liability for loan guarantees (LLG) and not included in the unearned premium amount reported on the Balance Sheet, since the LLG represents the net present value of future cash flows associated with those insurance portfolios.

Ginnie Mae Fees

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

D. Appropriations and Moneys Received from Other HUD Programs

The General Insurance Fund (Gl) and Special Risk Insurance Fund (SRI) 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 post-1991 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-1992 loan guarantees, the FHA has permanent indefinite appropriations authority to finance the cash requirements of operations.

HUD records moneys received from other HUD programs, such as interest subsidies and rent supplements, as revenue for the liquidating accounts when services are rendered. Moneys received for the financing accounts are recorded as an addition to the liability for loan guarantees when collected.

E. Fund Balance with the U.S. Treasury

The U.S. Treasury, which, in effect, maintains HUD's bank accounts, processes substantially all of HUD's receipts and disbursements. The following shows HUD's fund balances with the U.S. Treasury as of September 30, 2001 and 2000 were as follows (dollars in millions):

Description	2001	2000
Revolving Funds	$ 11,870	$ 10,635
Appropriated Funds	61,454	59,909
Trust Funds	4	77
Total - Fund Balance	$ 73,328	$ 70,621

An immaterial difference exists between HUD's recorded Fund Balance with the US Treasury and the US Department of Treasury's records. It is the Department's practice to adjust its records to agree with

Treasury's balances at the end of the fiscal year. The adjustments are reversed at the beginning of the following fiscal year. During fiscal 2001 an immaterial amount of older items were written off.

F. Investments

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

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

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

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

G. Credit Program Receivables and Related Foreclosed Property

HUD finances mortgages and provides loans to support construction and rehabilitation of low rent housing, principally for the elderly and disabled under the Section 202/811 program. Prior to April 1996, mortgages were also assigned to HUD through FHA claims settlement (i.e., mortgage notes assigned (MNAs)). Single family mortgages were assigned to FHA when the mortgagor defaulted due to certain "temporary hardship" conditions beyond the control of the mortgagor, and when, in management's judgment, it is likely that the mortgage could be brought current in the future. During fiscal 2001, FHA continued to take single family assignments on those defaulted notes that were in process at the time the assignment program was terminated. In addition, multifamily mortgages are assigned to FHA when lenders file mortgage insurance claims for defaulted notes.

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 based on the direct loan obligation or loan guarantee commitment date. These valuations are in accordance with the Federal Credit Reform Act of 1990 and SFFAS No. 2, "Accounting for Direct Loans and Loan Guarantees", as amended by SFFAS No. 18. Those obligated or 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.

Credit program receivables resulting from obligations or commitments prior to October 1, 1991, (pre-Credit Reform) 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. Interest is recognized as income when earned. However, when full collection of principal is considered doubtful, the accrual of interest income is suspended and receipts (both interest and principal) are recorded as collections of principal. Pre-Credit Reform loans are reported net of allowance for loss and any unamortized discount. The estimate for the allowance on credit program receivables is based on historical loss rates and recovery rates resulting from asset sales and property recovery rates, net of 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 in defaulted loans obligated or loan guarantees committed prior to 1992 is valued at net realizable value. The estimate for the allowance for loss related to the net realizable value of foreclosed property is based on historical loss rates and recovery rates resulting from property sales, net of cost of sales.

H. Liability for Loan Guarantees

The liability for loan guarantees (LLG) related to Credit Reform loans (made 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 sales expense for sold properties, less anticipated cash inflows such as premium receipts, proceeds from property sales, and principal 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 insured mortgages 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 that are considered probable but have not been reported to FHA.

I. Full Cost Reporting

Beginning in fiscal 1998, SFFAS No. 4 required that full costing of program outputs be included in Federal agency financial statements. Full cost reporting includes direct, indirect, and inter-entity costs. For purposes of the consolidated department financial statements, HUD identified each responsible segment's share of the program costs or resources provided by HUD or other Federal agencies. These costs are treated as imputed cost for the Statement of Net Cost, and imputed financing for the Statement of Changes in Net Position and the Statement of Financing.

J. Accrued Unfunded Leave and Federal Employees Compensation Act (FECA) Liabilities

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

HUD also accrues the portion of the estimated liability for disability benefits assigned to the agency under the FECA, administered and determined by the Department of Labor. The liability, based on the net present value of estimated future payments based on a study conducted by the Department of Labor, was

$85 million as of September 30, 2001 and $75 million as of September 30, 2000. Future payments on this liability are to be funded by future appropriations. HUD offsets this unfunded liability by recording future financing sources.

K. Loss Reserves

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

L. Retirement Plans

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

A primary feature of FERS is that it offers a savings plan whereby HUD automatically contributes 1 percent of pay and matches any employee contribution up to an additional 4 percent of pay. Under CSRS, employees can contribute up to 6 percent of their pay to the savings plan, but there is no corresponding matching by HUD. Although HUD funds a portion of the benefits under FERS relating to its employees and makes the necessary withholdings from them, it has no liability for future payments to employees under these plans, nor does it report CSRS, FERS, or FECA assets, accumulated plan benefits, or unfunded liabilities applicable to its employees. These amounts are reported by the Office of Personnel Management (OPM) and are not allocated to the individual employers. HUD's matching contribution to these retirement plans during fiscal 2001 and 2000 was $66 million and $68 million, respectively.

M. Federal Employee and Veteran's Benefit

The Department's Federal Employee and Veteran's benefit expenses totaled approximately $122 million for fiscal 2001; this amount includes $32 million to be funded by the OPM. Federal Employee and Veteran's benefit expenses totaled approximately $102 million for fiscal 2000; this amount includes $16 million to be funded by the OPM. Amounts funded by OPM are charged to expense with a corresponding amount considered as an imputed financing source in the statement of changes in net position.

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

A. Contractual Commitments

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

Prior to fiscal 1988, HUD's subsidy programs, primarily the Section 8 program and the Section 235/236 programs, operated under contract authority. Each year, Congress provided HUD the authority to enter into multiyear contracts within annual and total contract limitation ceilings. HUD then drew on and continues to draw on permanent indefinite appropriations to fund the current year's portion of those multiyear contracts. Because of the duration of these contracts (up to 40 years), significant authority exists to draw on the permanent indefinite appropriations. Beginning in fiscal 1988, the Section 8 and the Section 235/236 programs began operating under multiyear budget authority whereby the Congress appropriates the funds "up-front" for the entire contract term in the initial year, the effect of which substantially increases HUD's net position.

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

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

The following shows HUD's obligations and contractual commitments under its grant, subsidy, and loan programs as of September 30, 2001 (dollars in millions):

	Commitments Funded Through		
Programs	Unexpended Appropriations	Permanent Indefinite Appropriations	Total Contractual Commitments
Section 8 Rental Assistance	$ 15,975	$ 26,412	$ 42,387
Community Development Block Grants	9,048	-	9,048
HOME Partnership Investment Program	4,370	-	4,370
Operating Subsidies	1,652	-	1,652
Low Rent Public Housing Grants and Loans	9,165	-	9,165
Housing for Elderly and Disabled	4,056	-	4,056
Section 235/236	138	9,517	9,655
All Other	7,103	64	7,167
Total	$ 51,507	$ 35,993	$ 87,500

Of the total Section 8 Rental Assistance contractual commitments as of September 30, 2001**,** $32.7 billion relates to project-based commitments, and $9.7 billion relates to tenant-based commitments.

The following shows HUD's obligations and contractual commitments under its grant, subsidy, and loan programs as of September 30, 2000 (dollars in millions):

	Commitments Funded Through		
Programs	Unexpended Appropriations	Permanent Indefinite Appropriations	Total Contractual Commitments
Section 8 Rental Assistance	$ 17,422	$ 28,622	$ 46,044
Community Development Block Grants	9,017	-	9,017
HOME Partnership Investment Program	4,092	-	4,092
Operating Subsidies	1,590	-	1,590
Low Rent Public Housing Grants and Loans	8,580	29	8,609
Housing for Elderly and Disabled	3,981	-	3,981
Section 235/236	78	10,620	10,698
All Other	6,650	81	6,731
Total	$ 51,410	$ 39,352	$ 90,762

Of the total Section 8 Rental Assistance contractual commitments as of September 30, 2000**,** $36.3 billion relates to project-based commitments, and $9.7 billion relates to tenant-based commitments. With the exception of the Housing for the Elderly and Disabled and Low Rent Public Housing Loan Programs (which have been converted to grant programs), Section 235/236, and a portion of "all other" programs, HUD management expects all of the above programs to continue to incur new commitments under authority granted by Congress in future years. However, estimated future commitments under such new authority are not included in the amounts above.

B. Administrative Commitments

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

The following shows HUD's administrative commitments as of September 30, 2001 (dollars in millions):

	Administrative Commitments Funded Through		
Programs	Unexpended Appropriations	Permanent Indefinite Appropriations	Total Reservations
Section 8 Rental Assistance Project-Based	$ 152	-	$ 152
Section 8 Rental Assistance Tenant-Based	4	-	4
Community Development Block Grants	771	-	771
HOME Partnership Investment Program	254	-	254
Low Rent Public Housing Grants and Loans	819	-	819
Housing for Elderly and Disabled	2,586	$ 73	2,659
All Other	1,185	15	1,200
Total	$ 5,771	$ 88	$ 5,859

The following shows HUD's administrative commitments as of September 30, 2000 (dollars in millions):

	Administrative Commitments Funded Through		
Programs	Unexpended Appropriations	Permanent Indefinite Appropriations	Total Reservations
Section 8 Rental Assistance Project-Based	-	$ 505	$ 505
Section 8 Rental Assistance Tenant-Based	-	8	8
Community Development Block Grants	$ 630	-	630
HOME Partnership Investment Program	148	-	148
Low Rent Public Housing Grants and Loans	1,568	-	1,568
Housing for Elderly and Disabled	2,385	73	2,458
All Other	1,205	4	1,209
Total	$ 5,936	$ 590	$ 6,526

NOTE 4 - INVESTMENTS

The U.S. Government securities are non-marketable intra-governmental securities. Interest rates are established by the U.S. Treasury and during fiscal 2001 ranged from 2.49 percent to 13.9 percent. During fiscal 2000 interest rates ranged from 5.25 percent to 7.87 percent. The amortized cost and estimated market value of investments in debt securities as of September 30, 2001 and 2000, were as follows (dollars in millions):

Fiscal Year	Cost	Par Value	Un-amortized Premium (Discount)	Accrued Interest	Net Investments	Unrealized Gain
FY 2001	23,517	$ 23,857	$ (195)	$ 310	$ 23,972	$ 1,641
FY 2000	23,109	$ 23,450	$ (227)	$ 349	$ 23,572	$ 419

NOTE 5 – ENTITY AND NON-ENTITY ASSETS

The following shows HUD's assets as of September 30, 2001 and 2000, were as follows (dollars in millions):

Description	2001			2000		
	Entity	Non-Entity	Total	Entity	Non-Entity	Total
Intragovernmental						
Fund Balance with Treasury	$ 72,946	$ 382	$ 73,328	$ 70,302	$ 319	$ 70,621
Investments	23,972	-	23,972	23,572	-	23,572
Accounts Receivable	9	-	9	20	-	20
Other Assets	42	7	49	41	8	49
Total Intragovernmental Assets	$ 96,969	$ 389	$ 97,358	$ 93,935	$ 327	$ 94,262
Accounts Receivable	519	244	763	604	307	911
Loan Receivables and Related Foreclosed Property	10,854	7	10,861	11,030	-	11,030
Other Assets	103	110	213	55	74	129
Total Assets	$ 108,445	$ 750	$ 109,195	$ 105,624	$ 708	$ 106,332

NOTE 6 - ACCOUNTS RECEIVABLE

Section 8 Settlements

Section 8 subsidies disbursed during the year under annual contribution contracts are based on estimated amounts due under the contracts by PHAs. At the end of each year the actual amount due under the contracts is determined. The excess of subsidies paid to PHAs during the year over the actual amount due is reflected as accounts receivable in the balance sheet. These amounts are "collected" by offsetting such amounts with subsidies due to PHAs in subsequent periods. As of September 30, 2001 and 2000, this amount totaled $150 million and $359 million, respectively.

Bond Refundings

Many of the Section 8 projects constructed in the late 1970s and early 1980s were financed with tax exempt bonds with maturities ranging from 20 to 40 years. The related Section 8 contracts provided that the subsidies would be based on the difference between what tenants could pay pursuant to a formula, and the total operating costs of the

Section 8 project, including debt service. The high interest rates during the construction period resulted in high subsidies. When interest rates came down in the 1980s, HUD was interested in getting the bonds refunded. One method used to account for the savings when bonds are refunded (PHA's sell a new series of bonds at a lower interest rate, to liquidate the original bonds), is to continue to pay the original amount of the bond debt service to a trustee. The amounts paid in excess of the lower "refunded" debt service and any related financing costs, are considered savings. One-half of these savings are provided to the PHA, the remaining half is returned to HUD. As of September 30, 2001 and 2000, HUD was due $241 million and $307 million, respectively.

The following shows accounts receivable as reflected in the Balance Sheet as of September 30, 2001 and 2000, as follows (dollars in millions):

Description	2001	2000
Section 8 Settlements	$ 150	$ 359
Bond Refundings	240	307
Other Receivables	382	265
Total	$ 772	$ 931

NOTE 7 - OTHER ASSETS

The following shows HUD’s Other Assets as of September 30, 2001 (dollars in millions):

Description	FHA	Ginnie Mae	Section 8 Rental Assistance	All Other	Total
Intragovernmental Assets:					
Receivables from unapplied disbursements	$ 42	-	$ -	-	$ 42
Sec. 312 Rehabilitation Loan Program Receivables	-	-	-	-	-
Mortgagor Reserves for Replacement - Investment	7	-	-	-	7
Other Assets	-	$ -	-	-	-
Total Intragovernmental Assets	$ 49	$ -	-	-	$ 49
Receivables Related to Asset Sales	-	-	-	-	-
Receivables Related to Credit Program Assets	-	-	-	-	-
Equity Interest in Multifamily Mortgage Trust 1996	-	-	-	-	-
Premiums Receivable	-	-	-	-	-
Property and Equipment	-	-	-	$ 65	65
Mortgagor Reserves for Replacement - Cash	110	-	-	-	110
Other Assets	15	22	-	1	38
Total	$ 174	$ 22	$ -	$ 66	$ 262

The following shows HUD’s Other Assets as of September 30, 2000 (dollars in millions):

Description	FHA	Ginnie Mae	Section 8 Rental Assistance	All Other	Total
Intragovernmental Assets:					
Receivables from unapplied disbursements	$ 41	-	-	-	$ 41
Sec. 312 Rehabilitation Loan Program Receivables	-	-	-	-	-
Mortgagor Reserves for Replacement - Investment	8	-	-	-	8
Other Assets	-	-	-	-	-
Total Intragovernmental Assets	$ 49	-	-	-	$ 49
Receivables Related to Asset Sales	-	-	-	-	-
Receivables Related to Credit Program Assets	-	-	-	-	-
Equity Interest in Multifamily Mortgage Trust 1996	-	-	-	-	-
Premiums Receivable	-	-	-	-	-
Property and Equipment	-	-	-	$ 27	27
Mortgagor Reserves for Replacement - Cash	74	-	-	-	74
Other Assets	16	$ 9	-	3	28
Total	$ 139	$ 9	$ -	$ 30	$ 178

Receivable 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 resulted in the establishment of the receivables and payables that reflect the differences between the Fund Balance with Treasury and the estimates recorded in FHA’s general ledger.

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

NOTE 8 - DIRECT LOANS AND LOAN GUARANTEES, NON-FEDERAL BORROWERS

HUD reports direct loan obligations or loan guarantee commitments made prior to fiscal 1992, and the resulting direct loans or defaulted guaranteed loans net of allowance for estimated uncollectable loans or estimated losses.

Direct loan obligations or loan guarantee commitments made after fiscal 1991, and the resulting direct loans or defaulted guaranteed loans are governed by the Federal Credit Reform Act of 1990, and are recorded as the net present value of the associated cash flows (i.e. interest rate differential, interest subsidies, estimated delinquencies and defaults, fee offsets, and other cash flows). The following is an analysis of loan receivables, loan guarantees, liability for loan guarantees, and the nature and amounts of the subsidy costs associated with the loans and loan guarantees for fiscal 2001 and 2000 were as follows:

A. List of HUD's Direct Loan and/or Loan Guarantee Programs:

1. FHA
2. Ginnie Mae
3. Housing for the Elderly and Disabled
4. Low Rent Public Housing Loan Fund
5. All Other
    a) Revolving Fund
    b) Flexible Subsidy
    c) CDBG, Section 108(b)
    d) Public and Indian Loan Guarantee
    e) Loan Guarantee Recovery Fund
    f) Public and Indian Housing Loan Fund

B. Direct Loans Obligated Prior to FY 1992 (Allowance for Loss Method)(dollars in millions):

	2001				
Direct Loan Programs	Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Direct Loans
FHA	$ 42	-	$ (23)	-	$ 19
Housing for Elderly and Disabled	7,804	$ 98	(20)	$ 9	7,891
Low Rent Public Housing Loans	3	2	-	-	5
All Other	807	54	(583)	2	280
Total	$ 8,656	$ 154	$ (626)	$ 11	$ 8,195

	2000				
Direct Loan Programs	Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Direct Loans
FHA	$ 56	$ 2	$ (32)	-	$ 26
Housing for Elderly and Disabled	7,923	83	(23)	$ 8	7,991
Low Rent Public Housing Loans	10	3	1	-	14
All Other	927	27	(652)	2	304
Total	$ 8,916	$ 115	$ (706)	$ 10	$ 8,335

C. Direct Loans Obligated After FY 1991(dollars in millions):

	2001				
Direct Loan Programs	Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Foreclosed Property	Value of Assets Related to Direct Loans
FHA	$ 1	$ -	$ (2)	$ -	$ (1)

	2000				
Direct Loan Programs	Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Foreclosed Property	Value of Assets Related to Direct Loans
FHA	$ 1	-	$ (2)	-	$ (1)

D. Defaulted Guaranteed Loans from Pre -1992 Guarantees (Allowance for Loss Method)(dollars in millions):

	2001				
Direct Loan Programs	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance for Loan and Interest Losses	Foreclosed Property, Net	Defaulted Guaranteed Loans Receivable, Net
FHA	$ 2,057	$ 91	$ (1,292)	$ 259	$ 1,115

	2000									
Direct Loan Programs	Defaulted Guaranteed Loans Receivable, Gross		Interest Receivable		Allowance for Loan and Interest Losses		Foreclosed Property, Net		Defaulted Guaranteed Loans Receivable, Net	
FHA	$	2,305	$	221	$	(1,914)	$	370	$	982

E. Defaulted Guaranteed Loans From Post-FY 1991 Guarantees (dollars in millions):

	2001									
Direct Loan Programs	Defaulted Guaranteed Loans Receivable, Gross		Interest Receivable		Allowance for Subsidy Cost (Present Value)		Foreclosed Property, Gross		Value of Assets Related to Defaulted Guaranteed Loans	
FHA	$	793	$	81	$	(1,367)	$	2,045	$	1,552

	2000									
Direct Loan Programs	Defaulted Guaranteed Loans Receivable, Gross		Interest Receivable		Allowance for Subsidy Cost (Present Value)		Foreclosed Property, Gross		Value of Assets Related to Defaulted Guaranteed Loans	
FHA	$	647	$	7	$	(1,218)	$	2,278	$	1,714

	2001	**2000**
Total Credit Program Receivables and Related Foreclosed Property, Net	**$10,861**	**1,030**

F. Guaranteed Loans Outstanding (dollars in millions):

	2001	
Loan Guarantee Programs	Outstanding Principal, Guaranteed Loans, Face Value	Amount of Outstanding Principal Guaranteed
FHA Programs	$ 601,715	$ 555,463
All Other	2,049	2,049
Total	$ 603,764	$ 557,512

	2000	
Loan Guarantee Programs	Outstanding Principal, Guaranteed Loans, Face Value	Amount of Outstanding Principal Guaranteed
FHA Programs	$ 590,000	$ 544,601
All Other	1,863	1,863
Total	$ 591,863	$ 546,464

G. Liability for Loan Guarantees (Estimated Future Default Claims, Pre-1992)(dollars in millions):

	2001		
Loan Guarantee Programs	Liabilities for Losses on Pre-1992 Guarantees, Estimated Future Default Claims	Liabilities for Loan Guarantees for Post-1991 Guarantees (Present Value)	Total Liabilities For Loan Guarantees
FHA Programs	$ 6,364	$ (311)	6,053
All Other	-	38	38
Total	$ 6,364	$ (273)	$ 6,091

	2000		
Loan Guarantee Programs	Liabilities for Losses on Pre-1992 Guarantees, Estimated Future Default Claims	Liabilities for Loan Guarantees for Post-1991 Guarantees (Present Value)	Total Liabilities For Loan Guarantees
FHA Programs	$ 7,195	$ 327	$ 7,522
All Other	-	32	$ 32
Total	$ 7,195	$ 359	$ 7,554

H. Subsidy Expense for Post-FY 1991 Loan Guarantees:

Subsidy Expense for Current Year Loan Guarantees (dollars in millions)

	2001				
Loan Guarantee Programs	Endorsement Amount	Default Component	Fees Component	Other Component	Subsidy Amount
FHA	$ 122,639	$ 1,933	$ (4,555)	$ 334	$ (2,288)
All Other	-	8	-	-	8
Total	$ 122,639	$ 1,941	$ (4,555)	$ 334	$ (2,280)

	2000				
Loan Guarantee Programs	Endorsement Amount	Default Component	Fees Component	Other Component	Subsidy Amount
FHA	$ 98,860	$ 2,385	$ (4,594)	$ 461	$ (1,748)
All Other	-	11	-	-	11
Total	$ 98,860	$ 2,396	$ (4,594)	$ 461	$ (1,737)

I. Foreclosed Property:

The average holding period of single family properties is approximately 7 months while the average holding period of multifamily properties is 8 years. Additional requirements are usually attached to FHA's foreclosed property to restrict future use or disposal of those assets. The following shows FHA's number of foreclosed properties resulting from loans and loan guarantees as of September 30, 2001 and 2000:

	Pre-1992		Post-1991	
Fiscal Year	Single Family	Multifamily	Single Family	Multifamily
FY 2001	6,644	54	22,962	1
FY 2000	9,229	62	24,869	2

FHA's outstanding principal balance of foreclosure proceedings in process as of September 30, 2001 and 2000 were as follows (dollars in millions):

	Pre-1992		Post-1991	
Fiscal Year	Single Family	Multifamily	Single Family	Multifamily
FY 2001	$ 10	$ 102	$ 4	$ 93
FY 2000	$ 0.2	$ 116	$ 0.1	$ 22

FHA's number of properties in foreclosure proceedings in process as of September 30, 2001 and 2000 were as follows (dollars in millions):

	Pre-1992		Post-1991	
Fiscal Year	Single Family	Multifamily	Single Family	Multifamily
FY 2001	225	54	61	18
FY 2000	4	2	2	3

NOTE 9 – LIABILITIES COVERED AND NOT COVERED BY BUDGETARY RESOURCES

The following shows HUD's liabilities as of September 30, 2001 and 2000 were as follows (dollars in millions):

Description	2001			2000		
	Covered	Not-Covered	Total	Covered	Not-Covered	Total
Intragovernmental						
Accounts Payable	-	-	-	$ 7	-	$ 7
Subsidy Re-Estimate Payable	$ 1,396	-	$ 1,396	517	-	517
Debt	4,853	$ 4,382	9,235	7,420	$ 5,001	12,421
Other Intragovernmental Liabilities	4,954	17	4,971	5,054	17	5,071
Total Intragovernmental Liabilities	$ 11,203	$ 4,399	$ 15,602	$ 12,998	$ 5,018	$ 18,016
Accounts Payable	954	-	954	901	-	901
Liabilities for Loan Guarantees	6,091	-	6,091	7,554	-	7,554
Unearned Premiums	555	-	555	682	-	682
Debentures Issued to Claimants	221	-	221	218	-	218
Insurance Liabilities	354	-	354	174	-	174
Loss Reserves	535	-	535	533	-	533
Debt	31	2,465	2,496	75	2,739	2,814
Other Liabilities	687	146	833	805	136	941
Total Liabilities	$ 20,631	$ 7,010	$ 27,641	$ 23,940	$ 7,893	$ 31,833

NOTE 10 - DEBT

Several HUD programs have the authority to borrow funds from the U.S. Treasury for program operations. Additionally, the National Housing Act authorizes FHA, in certain cases, to issue debentures in lieu of cash to pay claims. Also, PHAs and TDHEs borrowed funds from the private sector and from the Federal Financing Bank (FFB) to finance construction and rehabilitation of low rent housing. HUD is repaying these borrowings on behalf of the PHAs and TDHEs.

The following shows HUD borrowings, and borrowings by PHAs/TDHEs for which HUD is responsible for repayment, as of September 30, 2001 (dollars in millions):

Description	Beginning Balance	Net Borrowings	Ending Balance
Agency Debt:			
Held by Government Accounts	$ 1,431	$ (1)	$ 1,430
Held by the Public	3,032	(315)	2,717
Total Agency Debt	$ 4,463	$ (316)	$ 4,147
Other Debt:			
Debt to the U.S. Treasury	$ 10,979	$ (3,182)	$ 7,797
Debt to the Federal Financing Bank	11	(3)	$ 8
Total Other Debt	$ 10,990	$ (3,185)	$ 7,805
Total Debt	$ 15,453	$ (3,501)	$ 11,952
Classification of Debt:			
Intragovernmental Debt			$ 9,235
Debt held by the Public			2,496
Debentures Issued to Claimants			221
Total Debt			$ 11,952

The following shows HUD borrowings, and borrowings by PHAs/TDHEs for which HUD is responsible for repayment, as of September 30, 2000 (dollars in millions):

Description	Beginning Balance	Net Borrowings	Ending Balance
Agency Debt:			
Held by Government Accounts	$ 1,507	$ (77)	$ 1,430
Held by the Public	3,211	(179)	3,032
Total Agency Debt	$ 4,718	$ (256)	$ 4,462
Other Debt:			
Debt to the U.S. Treasury	$ 12,827	$ (1,847)	$ 10,980
Debt to the Federal Financing Bank	14	(3)	$ 11
Total Other Debt	$ 12,841	$ (1,850)	$ 10,991
Total Debt	$ 17,559	$ (2,106)	$ 15,453
Classification of Debt:			
Intragovernmental Debt			$ 12,421
Debt held by the Public			2,814
Debentures Issued to Claimants			218
Total Debt			$ 15,453

Interest paid on borrowings during the year ended September 30, 2001 and 2000 were $1.2 billion and $1.1 billion, respectively. The purposes of these borrowings are discussed in the following paragraphs.

Borrowings from the U.S. Treasury

HUD is authorized to borrow from the U.S. Treasury to finance Housing for Elderly and Disabled loans. The Treasury borrowings typically have a 15-year term, but may be repaid prior to maturity at HUD's discretion. However, such borrowings must be repaid in the sequence in which they were borrowed from Treasury. The interest rates on the borrowings are based on Treasury's 30-year bond yield at the time the notes are issued. Interest is payable on April 30 and October 31. Interest rates ranged from 7.44 percent to 9.2 percent during fiscal 2001 and 7.44 percent to 11.06 percent for fiscal 2000.

In fiscal 2001 and 2000, FHA borrowed $901million and $703 million respectively from the U.S. Treasury. The borrowings were needed 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-estimates. All borrowings were made by FHA's financing accounts. Negative subsidies were generated primarily by the MMI/CMHI Fund financing account; downward re-estimates have occurred from activity of the FHA's loan guarantee financing accounts. These borrowings carried interest rates ranging from 5.68 percent to 7.59 percent during fiscal 2001, and 5.36 percent to 7.59 percent during fiscal 2000.

Borrowings from the Federal Financing Bank (FFB) and the Public

During the 1960s, 1970s, and 1980s, PHAs obtained loans from the private sector and from the FFB to finance development and rehabilitation of low rent housing projects. HUD is repaying these borrowings on behalf of the PHAs, through the Low Rent Public Housing program. For borrowings from the Public, interest is payable throughout the year. Interest rates range from 2.25 percent to 6 percent for both fiscal 2001 and 2000. The borrowings from the FFB have terms up to 40 years; the borrowings from the private sector have terms up to 30 years. FFB interest is payable annually on November 1. Interest rates range from 10.67 percent to 16.18 percent for both fiscal 2001 and 2000.

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

Debentures Issued To Claimants

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 percent to 12.88 percent in fiscal 2001 and from 4 percent to 13.38 percent in fiscal 2000. Debentures may be redeemed by lenders prior to maturity to pay mortgage insurance premiums to FHA, or they may be called with the approval of the Secretary of the U. S. Treasury.

NOTE 11 - OTHER LIABILITIES

The following shows HUD’s Other Liabilities as of September 30, 2001 (dollars in millions):

Description	Non-Current	Current	Total
Intragovernmental Liabilities			
FHA Payable from Unapplied Receipts Recorded by Treasury	-	-	-
HUD-Section 312 Rehabilitation Program Payable	-	$ 8	$ 8
Unfunded FECA Liability	-	17	17
Resource Payable to Treasury	$ 4,407	-	4,407
Miscellaneous Receipts Payable to Treasury	511	-	511
Other Liabilities	-	28	28
Total Intragovernmental Liabilities	$ 4,918	$ 53	$ 4,971
Other Liabilities			
FHA Other Liabilities	$ 36	$ 278	$ 314
FHA Escrow Funds Related to Mortgage Notes	-	158	158
Ginnie Mae Accounts Payable and Accrued Liabilities	-	50	50
Deferred Credits	-	4	4
Deposit Funds	-	75	75
Accrued Unfunded Annual Leave	62	1	63
Accrued Funded Payroll Benefits	49	-	49
Federal Employee and Veteran's Benefit	85	-	85
Other	34	1	35
Total Other Liabilities	$ 5,184	$ 620	$ 5,804

The following shows HUD’s Other Liabilities as of September 30, 2000 (dollars in millions):

~~Description~~	Non-Current	Current	Total
Intragovernmental Liabilities			
FHA Payable from Unapplied Receipts Recorded by Treasury	-	-	-
HUD- Section 312 Rehabilition Program Payable	-	$ 7	$ 7
Unfunded FECA Liability	-	17	17
Resource Payable to Treasury	$ 4,451	-	4,451
Miscellaneous Receipts Payable to Treasury	591	-	591
Other Liabilities	-	5	5
Total Intragovernmental Liabilities	$ 5,042	$ 29	$ 5,071
Other Liabilities			
FHA Other Liabilities	$ 34	$ 250	$ 284
FHA Escrow Funds Related to Mortgage Notes	-	159	159
Ginnie Mae Accounts Payable and Accrued Liabilities	-	42	42
Deferred Credits	-	213	213
Deposit Funds	-	85	85
Accrued Unfunded Annual Leave	61	-	61
Federal Employee and Veteran's Benefit	75	-	75
Other	22	-	22
Total Other Liabilities	$ 5,234	$ 778	$ 6,012

NOTE 12 - LOSS RESERVES

For fiscal 2001 and 2000, Ginnie Mae established loss reserves of $535 million and $533 million, respectively, which represents probable defaults by issuers of mortgage-backed securities, through a provision charged to operations. The reserve is relieved as losses are realized from the disposal of the defaulted issuers' portfolios. Ginnie Mae recovers part of its losses through servicing fees on the performing portion of the portfolios and the sale of servicing rights that inure to Ginnie Mae upon the default of the issuer. Ginnie Mae management believes that its reserve is adequate to cover probable losses from defaults by issuers of Ginnie Mae guaranteed mortgage-backed securities.

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

NOTE 13 - UNEXPENDED APPROPRIATIONS

HUD receives appropriations on both an annual and multiyear basis for all non-revolving fund activity. Unexpended appropriations are amounts not yet expended, which have not lapsed, been rescinded, or been withdrawn. The following is an analysis of HUD's fiscal 2001 Unexpended Appropriations (dollars in millions):

	Unobligated				
Description	Available	Unavailable	Undelivered Orders	Accounts Receivable from Public	Total
FHA - Subsidized Programs	$ 1,878	$ 94	$ 78	-	$ 2,050
FHA - Unsubsidized Programs	11	3	65	-	79
Section 8 Rental Assistance	1,675	10	15,978	$ 150	17,813
CDBG	1,029	25	9,053	-	10,107
HOME	284	-	4,376	-	4,660
Operating Subsidies	141	-	1,652	-	1,793
Low Rent Public Housing Loans and Grants	862	-	8,569	636	10,067
Section 202/811	2,843	-	4,056	-	6,899
All Other	2,570	110	7,156	1	9,837
Total	$ 11,293	$ 242	$ 50,983	$ 787	$ 63,305

The following is an analysis of HUD's fiscal 2000 Unexpended Appropriations (dollars in millions):

	Unobligated				
Description	Available	Unavailable	Undelivered Orders	Accounts Receivable from Public	Total
FHA - Subsidized Programs	$ 948	$ 36	$ 78	-	$ 1,062
FHA - Unsubsidized Programs	9	-	80	-	89
Section 8 Rental Assistance	10	3	17,584	$ 3	17,600
CDBG	888	15	9,017	5	9,925
HOME	189	-	4,092	1	4,282
Operating Subsidies	55	1	1,590	-	1,646
Low Rent Public Housing Loans and Grants	1,641	-	7,893	731	10,265
Section 202/811	2,687	-	3,974	-	6,661
All Other	2,515	124	6,700	1	9,340
Total	$ 8,942	$ 179	$ 51,008	$ 741	$ 60,870

NOTE 14 - FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

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

A. FHA Mortgage Insurance

Unamortized insurance in force outstanding for FHA's mortgage insurance programs as of September 30, 2001 and 2000, was $602 billion and $590 billion, respectively and is discussed in Note 8F.

B. Ginnie Mae Mortgage-Backed Securities

Ginnie Mae financial instruments with off-balance sheet risk include guarantees of Mortgage-Backed Securities (MBS) and commitments to guaranty MBS. The securities are backed by pools of FHA-insured, RHS-insured, and VA-guaranteed mortgage loans. Ginnie Mae is exposed to credit loss in the event of non-performance by other parties to the financial instruments. The total amount of Ginnie Mae guaranteed securities outstanding at

September 30, 2001 and 2000, was approximately $604 billion. However, Ginnie Mae's potential loss is considerably less because the FHA and RHS insurance and VA guaranty serve to indemnify Ginnie Mae for most losses. Also, as a result of the structure of the security, Ginnie Mae bears no interest rate or liquidity risk.

During the mortgage closing period and prior to granting its guaranty, Ginnie Mae enters into commitments to guaranty MBS. The commitment ends when the MBS are issued or when the commitment period expires. Ginnie Mae's risks related to outstanding commitments are much less than for outstanding securities due, in part, to Ginnie Mae's ability to limit commitment authority granted to individual issuers of MBS. Outstanding commitments as of September 30, 2001 and 2000, were $43 billion and $36 billion, respectively. Generally, Ginnie Mae's MBS pools are diversified among issuers and geographic areas. No significant geographic concentrations of credit risk exist; however, to a limited extent, securities are concentrated among issuers.

In fiscal 2001 and 2000, Ginnie Mae issued a total of $67 billion and $42 billion respectively in its multi-class securities program. The estimated outstanding balance at September 30, 2001 and 2000, were $166 billion and $136 billion, respectively. These guaranteed securities do not subject Ginnie Mae to additional credit risk beyond that assumed under the MBS program.

C. Section 108 Loan Guarantees

Under HUD's Section 108 Loan Guarantee program, recipients of CDBG Entitlement Grant program funds may pledge future grant funds as collateral for loans guaranteed by HUD (these loans were provided from private lenders since July 1, 1986). This Loan Guarantee Program provides entitlement communities with a source of financing for projects that are too large to be financed from annual grants. The amount of loan guarantees outstanding as of September 30, 2001 and 2000, were $1.9 billion and $1.8 billion, respectively. HUD's management believes its exposure in providing these loan guarantees is limited, since loan repayments can be offset from future CDBG Entitlement Program Funds and, if necessary, other funds provided to the recipient by HUD. HUD has never had a loss under this program since its inception in 1974.

NOTE 15 - CONTINGENCIES

Lawsuits and Other

HUD is party in various legal actions and claims brought against it. In the opinion of HUD's management and General Counsel, the ultimate resolution of these legal actions and claims will not materially affect HUD's financial position or results of operations for the fiscal year ended September 30, 2001 and 2000. Payments made out of the Claims, Judgments and Relief Acts Fund in settlement of the legal proceedings are subject to the Department of Justice's approval.

A case was filed by owners of 43 multifamily projects regarding alleged breach of owners' mortgage contracts effected by the Emergency Low-Income Housing Preservation Act of 1987 (ELIHPA) and the Low-Income Housing Preservation and Resident Homeownership Act of 1990 (LIHPRHA). The Court of Federal Claims has ruled that the project owners' mortgage contracts had been breached by implementation of ELIHPA and LIHPRHA, and held a trial in November 1996 to determine damages, if any, with respect to that claim. The court awarded $3,061,107 in damages to the Plaintiffs for four "test" properties jointly selected by the parties. The United States appealed this judgment. On December 7, 1998, the United States Court of Appeals for the Federal Circuit reversed the judgment of the Court of Federal Claims, holding that ELIHPA and LIHPRHA did not breach contract between the plaintiffs and HUD. The Federal Circuit remanded the action to the Court of Federal claims for consideration of the plaintiffs' takings claim. On March 11, 1999, the Federal Circuit denied rehearing and declined rehearing *en banc*. On October 4, 1999, the United States Supreme Court denied certiorari.

In April 2001, the Court of Federal Claims held that because plaintiffs had chosen not to pursue their prepayment options through the statutorily required process, their takings claims were not ripe for review. HUD's motion for summary judgment was granted as to both the takings claims and the breach of contract claim; and the complaint was dismissed. On June 23, 2000, plaintiffs in this case filed a notice of appeal to the Federal Circuit. On September 18, 2001, the United States Court of Appeals for the Federal Circuit reversed the Court of Federal Claims decision which had held that plaintiff's taking claims were not ripe for review. The Federal Circuit remanded the case to the Court of Federal Claims to adjudicate the takings claims of the four model plaintiffs and of the owners of the 39 other plaintiff project owners so that, if the factual circumstances of any or all of the remaining owners present a similarly compelling case of administrative futility, the trial court should adjudicate their takings claims, as well.

On December 5, 2001, in the related case, the court granted the Government's motion for summary judgment with respect to plaintiff's taking claims and dismissed the complaint. The Court concluded that the prepayment rights contained in the mortgage loan notes between plaintiffs and their private lending institutions are not property protected by the Fifth Amendment's just Compensation Clause.

On January 8. 2002, the court issued an order directing that judgment be entered for the Government based upon the court's opinion issued in the related case of December5, 2001. The plaintiffs filed their Notice of Appeal on January 11, 2002.

In two-dozen similar ELIPHA/ LIHPRHA cases, involving almost 800 project owners nationwide, which were brought between 1987 and 1996, several have been dismissed, and the dismissal affirmed or not appealed. As of September 2001, only 11 cases (involving 243 projects) were still pending.

The United States intends to continue to defend the remaining LIHPRHA cases vigorously. HUD is unable at this time to form a judgment about the likelihood of an unfavorable outcome, or to make an estimate of the amount or range of potential loss if the plaintiffs should prevail. Any adverse judgment would be paid out of the permanent indefinite appropriation established by 31 U.S.C. Section 1304 (the Government's Judgment Fund).

NOTE 16 – RENTAL HOUSING SUBSIDY PAYMENT ERRORS

In support of HUD's fiscal 2001 financial statements, the Department developed statistical estimates of the extent of erroneous rental housing subsidy payments attributed to underreported tenant income and program processing errors by the public housing authorities, owners and agents (POAs) responsible for program administration. Estimates are based on prior year data from 2000, because this is the most recent period for which comprehensive independent sources of tenant income data are available for verification purposes.

Under HUD's rental assistance housing programs, tenants generally are required to pay 30 percent of their income towards rent, with HUD providing the balance of the rental payment. New applicants provide certain information on household characteristics, income, assets and expense activities used in determining the proper amount of rent they are to pay. Existing tenants are required to recertify their income on an annual basis, and in certain other circumstances when there are significant changes in household income. Applicant or tenant failure to correctly estimate their income, or the failure of the responsible POA to correctly process, calculate and bill the tenant's rental assistance, may result in the Department's overpayment or underpayment of housing subsidies.

In 2000, HUD began to expand the scope of its error measurement methodology to cover the three primary types of rental housing assistance program errors, including errors related to: 1) POA income and rent determinations, 2) tenant reporting of income, and 3) POA billings for subsidy payments. The current error measurement methodology addresses the first two of these three components, and has been improved to provide for interviewing a representative sample of tenants, verifying and validating tenant income reporting, and recalculating rents for comparison to POA determinations for the purpose of identifying errors. The below estimations are considered a baseline error measurement for the POA rent determination and tenant income reporting components. The estimated payment error attributed to tenant underreporting of income is higher than the prior year estimate of this error component, due to revisions in the methodology used for measuring this type of error. Past estimates only considered the impacts of underreported income amounts over a $3,000 threshold using a sample of tenants in HUD data systems. The methodology was revised this year to lower the threshold to $1,000 to better reflect program requirements, and was based on a random selection of all tenants, including those who were not covered by past income matching efforts. HUD plans to expand its baseline error measurement to cover the subsidy-billing component in 2002. Starting in 2003, HUD intends to annually measure and report on all three error components.

HUD estimates of erroneous payments attributed to POA rent calculation and processing errors were based on a HUD Office of Policy Development and Research (PD&R) study of "Quality Control for Rental Assistance Subsidies Determinations," which was published as a final report in June 2001. This PD&R study verified rent calculations for a representative sample of 2,403 households receiving assistance in 2000. The study found that 60 percent of the calculations had some type of administrative or calculation component error contributing to a subsidy overpayment or underpayment situation. Errors were considered if they exceeded a $5 impact threshold on monthly subsidy payment amounts. The study projected, with 95 percent confidence, annual subsidy overpayments of $1.669 billion ± $251 million and annual subsidy underpayments of $634 million ± $151 million, due to errors attributable to program administration by POAs.

In developing the estimate of subsidy overpayments attributed to tenant underreporting of income, the Department used the same PD&R sample of 2,403 households assisted in 2000, and compared earned and unearned household income reported to the POAs to income data from Social Security Administration (SSA) and Internal Revenue Service (IRS) databases. Identified cases of possible undisclosed income sources were verified with employers and further examined to determine if the income discrepancies would affect the computation of the correct HUD rental subsidy amount, or if the income discrepancies were attributed to other causes not affecting the subsidy amount, such as: data entry errors in any of the systems involved in the matching process, timing differences in the income data being considered, or tenant income excluded by program regulation. Validated income discrepancies were further assessed against the original POA error estimates for these sample cases to eliminate any duplication. Based on the results of this review, the Department projects, with 95 percent confidence, that the amount of subsidy overpayments attributed to tenant underreporting of income was $978 million ± $247 million.

The combined effect of the estimated $1.669 billion of overpayments and $634 million of underpayments attributed POA program processing errors, plus the $978 million of overpayments attributed to tenant underreporting of income, yields a gross payment error estimate of $3.281 billion. Offsetting the overpayment and underpayment error estimates yields a net annual subsidy overpayment estimate of $2.013 billion, which represents approximately 10.7 percent of the $18.883 billion in total rental subsidies paid by HUD in fiscal 2000.

HUD is taking actions to address the causes of erroneous subsidy payments, and is instituting necessary controls to better assure that payments are made in the correct amounts, in accordance with program statutory and regulatory requirements. HUD's goal is to reduce processing errors and resulting erroneous payments 50 percent by 2005. It should be noted that the reduction of errors and improper payments may not have as significant an impact on budget outlays as anticipated. HUD's experience indicates that its efforts may have the possible effect of causing some higher income tenants to leave subsidized housing with the potential result that they would be replaced by lower income tenants requiring increased outlays. To the extent there would be any significant outlay savings resulting from HUD's program integrity improvement efforts, HUD plans to work with OMB and the Congress to explore mechanisms for reuse of the funds to assist additional households in need.

NOTE 17 - TOTAL COST AND EARNED REVENUE BY BUDGET FUNCTIONAL CLASSIFICATION

The following shows HUD's total cost and earned revenue by budget functional classification for fiscal 2001 (dollars in millions):

Budget Functional Classification	Gross Cost	Earned Revenue	Net Cost
Intragovernmental:			
Commerce and Housing Credit	$ 829	$ 430	$ 399
Community and Regional Development	70	2	68
Income Security	273	12	261
Administration of Justice	-	-	-
Miscellaneous	-	-	-
Total Intragovernmental	$ 1,172	$ 444	$ 728
With the Public:			
Commerce and Housing Credit	$ 100	$ 4,373	$ (4,273)
Community and Regional Development	5,354	5	5,349
Income Security	28,893	(130)	29,023
Administration of Justice	37	-	37
Miscellaneous	-	-	-
Total with the Public	$ 34,384	$ 4,248	$ 30,136
TOTAL:			
Commerce and Housing Credit	$ 929	$ 4,803	$ (3,874)
Community and Regional Development	5,424	7	5,417
Income Security	29,166	(118)	29,284
Administration of Justice	37	-	37
Miscellaneous	-	-	-
TOTAL:	$ 35,556	$ 4,692	$ 30,864

The following shows HUD's total cost and earned revenue by budget functional classification for fiscal 2000 (dollars in millions):

Budget Functional Classification	Gross Cost	Earned Revenue	Net Cost
Intragovernmental:			
Commerce and Housing Credit	$ 938	$ 1,837	$ (899)
Community and Regional Development	51	2	49
Income Security	352	(73)	425
Administration of Justice	-	-	-
Miscellaneous	-	-	-
Total Intragovernmental	$ 1,341	$ 1,766	$ (425)
With the Public:			
Commerce and Housing Credit	$ 3,020	$ 3,134	$ (114)
Community and Regional Development	5.293	6	5.287
Income Security	27,891	30	27,861
Administration of Justice	35	-	35
Miscellaneous	-	-	-
Total with the Public	$ 36,239	$ 3,170	$ 33,069
TOTAL:			
Commerce and Housing Credit	$ 3,958	$ 4,971	$ (1,013)
Community and Regional Development	5.344	8	5.336
Income Security	28,243	(43)	28,286
Administration of Justice	35	-	35
Miscellaneous	-	-	-
TOTAL:	$ 37,580	$ 4,936	$ 32,644

Fiscal 2000 total cost and earned revenues were restated to more accurately reflect the department's net cost by Budget Functional Classifications (BFC). Costs and revenues previously reported under the Miscellaneous BFC have been added to the Income and Security BFC, with the exception of $263 million reduction in revenues and $263 million reduction in cost, which should have been reported under the Community and Regional Development BFC. These costs and revenues are intra-department elimination entries associated with appropriations reported under the Community and Regional Development and Income and Security BFCs

CONSOLIDATING FINANCIAL STATEMENTS

(BY MAJOR PROGRAM AREA)

Department of Housing and Urban Development
Consolidating Balance Sheet
As of September 30, 2001
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home	Operating Subsidies	Public and Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other	Elimination	Consolidating
ASSETS											
Entity Assets											
Intragovernmental											
Fund Balance with Treasury (Note 2)	$8,822	$2,043	$18,041	$10,149	$4,669	$1,829	$10,271	$7,065	$10,439		$73,328
Investments (Note 4)	17,331	6,641									23,972
Accounts Receivable, Net (Note 6)	9								8	(8)	9
Other Assets (Note 7)	86		2	6	6		10		30	(91)	49
Total Intragovernmental Assets	$26,248	$8,684	$18,043	$10,155	$4,675	$1,829	$10,281	$7,065	$10,477	($99)	$97,358
Accounts Receivable, Net (Note 6)	$334	$33	$391						$5		$763
Credit Program Receivables (Note 8)	2,685						5	7,891	280		10,861
Other Assets (Note 7)	125	22							66		213
TOTAL ASSETS	$29,392	$8,739	$18,434	$10,155	$4,675	$1,829	$10,286	$14,956	$10,828	($99)	$109,195
LIABILITIES											
Intragovernmental Liabilities											
Accounts Payable				$5					$3	($8)	$0
Debt (Note 10)	$4,544						$1,430	3,253	8		$9,235
Subsidy Re-Estimate Payable	1,396										1,396
Other Intragovernmental Liabilities (note 11)	30		$510					4,406	116	(91)	4,971
Total Intragovernmental Liabilities	$5,970		$510	$5	$0	$0	$1,430	$7,659	$127	($99)	$15,602
Accounts Payable	$653	$30	$105	$39	$14	$32	$35	$9	$37		$954
Liabilities for Loan Guarantees (Note 8)	6,053								38		6,091
Debt (Note 10)							2,496				2,496
Unearned Premiums	$555										555
Debentures Issued to Claimants (Note 10)	221										221
Loss Reserves (Note 12)		$535									535
Insurance Liabilities	354										354
Other Governmental Liabilities (Note 11)	472	50	7	4	1	4	6	24	265		833
TOTAL LIABILITIES	$14,278	$615	$622	$48	$15	$36	$3,967	$7,692	$467	($99)	$27,641
Net Position											
Unexpended Appropriations (Note 13)	$2,129		$17,812	$10,107	$4,660	$1,793	$10,068	$6,899	$9,837		$63,305
Cumulative Results of Operations	12,985	8,124					(3,749)	365	524		18,249
Total Net Position	$15,114	$8,124	$17,812	$10,107	$4,660	$1,793	$6,319	$7,264	$10,361		$81,554
Total Liabilities and Net Position	$29,392	$8,739	$18,434	$10,155	$4,675	$1,829	$10,286	$14,956	$10,828	($99)	$109,195

Department of Housing and Urban Development
Consolidating Balance Sheet
As of September 30, 2000
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home	Operating Subsidies	Public and Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other	Consolidating
ASSETS										
Intragovernmental										
Fund Balance with Treasury (Note 2)	$7,915	$1,618	$17,751	$9,979	$4,296	$1,730	$10,458	$6,961	$9,913	$70,621
Investments (Note 4)	17,312	6,260								23,572
Accounts Receivable (Net) (Note 6)	19								1	20
Other Assets (Note 7)	49									49
Total Intragovernmental Assets	$25,295	$7,878	$17,751	$9,979	$4,296	$1,730	$10,458	$6,961	$9,914	$94,262
Accounts Receivable, Net (Note 6)	176	32	669	5	1		6		22	911
Credit Program Receivables (Note 8)	2,721						13	7,992	304	11,030
Other Assets (Note 7)	90	9							30	129
TOTAL ASSETS	$28,282	$7,919	$18,420	$9,984	$4,297	$1,730	$10,477	$14,953	$10,270	$106,332
LIABILITIES										
Intragovernmental Liabilities										
Accounts Payable	$1		$4						$2	$7
Debt (Note 10)	7,155						1,431	3,824	11	12,421
Subsidy Re-Estimate Payable	517									517
Other Intragovernmental Liabilities (Note 11)	7		516					4,452	96	5,071
Total Intragovernmental Liabilities	$7,680		$520	$0	$0	$0	$1,431	$8,276	$109	$18,016
Accounts Payable	505	25	86	59	15	83	49	6	73	901
Liabilities for Loan Guarantees (Note 8)	7,522								32	7,554
Debt (Note 10)							2,814			2,814
Unearned Premiums	682									682
Debentures Issued to Claimants (Note 10)	218									218
Loss Reserves (Note 12)		533								533
Insurance Liabilities	174									174
Other Governmental Liabilities (Note 11)	443	42	214				9	10	223	941
TOTAL LIABILITIES	$17,224	$600	$820	$59	$15	$83	$4,303	$8,292	$437	$31,833
Net Position										
Unexpended Appropriations (Note 13)	$1,151		$17,600	$9,925	$4,282	$1,647	$10,264	$6,661	$9,340	$60,870
Cumulative Results of Operations	9,907	7,319					(4,090)		493	13,629
Total Net Position	$11,058	$7,319	$17,600	$9,925	$4,282	$1,647	$6,174	$6,661	$9,833	$74,499
Total Liabilities and Net Position	$28,282	$7,919	$18,420	$9,984	$4,297	$1,730	$10,477	$14,953	$10,270	$106,332

Department of Housing and Urban Development
Consolidating Statement of Changes in Net Position
For the Year ended September 2001
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home	Operating Subsidies	Public and Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other	Consolidating
Net Cost of Operations	($2,724)	($805)	$16,794	$4,980	$1,436	$3,147	$4,055	$433	$3,548	$30,864
Financing Sources (other than exchange revenue)										
Appropriations Used	(1,370)		(16,743)	(4,925)	(1,418)	(3,087)	(4,339)	(772)	(3,578)	(36,232)
Imputed Financing	(14)								(56)	(70)
Transfers (In) / Out	1,284								(204)	1,080
Other Financing Sources	7		(51)	(55)	(18)	(60)	(57)	(26)	260	
Net Results of Operations	($2,817)	($805)	$0	$0	$0	$0	($341)	(365)	($30)	($4,358)
Prior Period Adjustments	(261)									(261)
Net Changes in Cumulative Results of Operations	($3,078)	($805)	$0	$0	$0	$0	($341)	($365)	($30)	($4,619)
Change in Unexpended Appropriations	(978)		(212)	(182)	(378)	(146)	196	(238)	(498)	(2,436)
Change in Net Position	($4,056)	($805)	($212)	($182)	($378)	($146)	($145)	($603)	($528)	($7,055)
Net Position-Beginning of Period	(11,058)	(7,319)	(17,600)	(9,925)	(4,282)	(1,647)	(6,174)	(6,661)	(9,833)	(74,499)
Net Position-End of Period	($15,114)	($8,124)	($17,812)	($10,107)	($4,660)	($1,793)	($6,319)	($7,264)	($10,361)	($81,554)

Department of Housing and Urban Development
Consolidating Statement of Changes in Net Position
For the Year ended September 2000
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home	Operating Subsidies	Public and Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other	Consolidating
Net Cost of Operations	$46	($763)	$15,990	$5,012	$1,499	$2,889	$4,168	$404	$3,399	$32,644
Financing Sources										
(other than exchange revenue)										
Appropriations Used	(1,124)		(15,990)	(5,012)	(1,499)	(2,889)	(4,171)	(733)	(3,027)	(34,445)
Imputed Financing	(11)								(38)	(49)
Transfers (In) / Out	436								(234)	202
Other Financing Sources									35	35
Net Results of Operations	($653)	($763)	$0	$0	$0	$0	($3)	(329)	$135	($1,613)
Prior Period Adjustments	(8)								(13)	(21)
Net Change in Cumulative Results of Operations	($661)	($763)	$0	$0	$0	$0	($3)	($329)	$122	($1,634)
Change in Unexpended Appropriations	(837)		4,260	7	(148)	(268)	(446)	133	(632)	2,069
Change in Net Position	($1,498)	($763)	$4,260	$7	($148)	($268)	($449)	($196)	($510)	$435
Net Position-Beginning of Period	(9,560)	(6,556)	(21,860)	(9,932)	(4,134)	(1,379)	(5,725)	(6,465)	(9,323)	(74,934)
Net Position-End of Period	($11,058)	($7,319)	($17,600)	($9,925)	($4,282)	($1,647)	($6,174)	($6,661)	($9,833)	($74,499)

Department of Housing and Urban Development
Combining Statement of Budgetary Resources
For the Year Ended September 2001
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home	Operating Subsidies	Public and Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other	Combined
Budgetary Resources:										
Budget Authority	$8,634		$18,941	$5,602	$1,800	$3,242	$4,169	$1,083	$4,123	$47,594
Net Transfers, Current Year Auth									6	6
Unobligated Balance - Beginning of Year	23,476	7,839	2,958	903	189	57	1,714	2,876	4,183	44,195
Spending Authority from Offsetting Collections	17,842	918	(27)	0	(4)	(1)	77	793	1,071	20,669
Adjustments										
Recoveries of PriorYear Obligation	20		2,583	14	9	3	55	59	536	3,279
Permanently Not Available										
Cancelled-Expired & NoYear Accts			(8)	(5)		(1)			(42)	(56)
Enacted Recissions PriorYear Bal	(2)		(1,971)	(490)	(4)	(7)	(48)	(2)	(10)	(2,534)
Capital Trans & Debt Redemption	(4,880)						(94)	(666)	(123)	(5,763)
Other Authority Withdrawn			(5,149)				(584)		(1,130)	(6,863)
Total Budgetary Resources	$45,090	$8,757	$17,327	$6,024	$1,990	$3,293	$5,289	$4,143	$8,614	$100,527
Status of Budgetary Resources:										
Obligations Incurred	$20,718	$151	$15,642	$4,970	$1,706	$3,152	$4,406	$1,221	$4,383	$56,349
Unobligated Balances Available	3,760		739	1,027	284	138	867	2,846	2,967	12,628
Unobligated Balances Not Yet Available	20,612	8,606	946	27	0	3	16	76	1,264	31,550
Total Status of Budgetary Resources	$45,090	$8,757	$17,327	$6,024	$1,990	$3,293	$5,289	$4,143	$8,614	$100,527
Outlays:										
Obligations Incurred	$20,718	$151	$15,642	$4,970	$1,706	$3,152	$4,406	$1,221	$4,383	$56,349
Less: Spending Authority From Offsetting Collections and Adjustments	17,842	918	(27)	0	(4)	(1)	77	793	1,071	20,669
Actual Recoveries-Prior Year Obligations	20		2,583	14	9	3	55	59	536	3,279
Obligated Balance, Net Beginning of Period	1,445	(63)	46,129	9,074	4,106	1,671	13,690	4,157	17,504	97,713
Obligated Balance Transferred, Net										
Less: Obligated Balance, Net - End of Period	1,477	(39)	42,495	9,091	4,383	1,683	13,711	4,215	16,865	93,881
Total Outlays	$2,824	($791)	$16,720	$4,939	$1,424	$3,138	$4,253	$311	$3,415	$36,233

Department of Housing and Urban Development
Combining Statement of Budgetary Resources
For the Year Ended September 2000
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home	Operating Subsidies	Public and Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other	Combined
Budgetary Resources:										
Budget Authority	$2,762		$7,279	$4,833	$1,636	$3,167	$3,606	$929	$3,630	$27,842
Net Transfers, Current Year Authority			124	29	10				(33)	130
Unobligated Balance - Beginning of Year	19,953	7,024	5,955	947	194	23	2,790	3,665	4,232	44,783
Net Transfers Prior Year Balance, Actual			(233)				46		63	(124)
Spending Authority from Offsetting Collections	14,139	912					79	808	345	16,283
Adjustments										
Recoveries of PriorYear Obligation	171		1,885	13	3	8	137	22	229	2,468
Permanently Not Available										
Cancelled-Expired and NoYear Accts				(3)		(10)			(41)	(54)
Enacted Recissions PriorYear Balance			(2,356)	(18)			(276)		(50)	(2,700)
Capital Trans and Debt Redemption	(1,545)						(95)	(1,247)	(53)	(2,940)
Other Authority Withdrawn									(165)	(165)
Total Budgetary Resources	$35,480	$7,936	$12,654	$5,801	$1,843	$3,188	$6,287	$4,177	$8,157	$85,523
Status of Budgetary Resources:										
Obligations Incurred	$12,004	$97	$9,696	$4,899	$1,654	$3,132	$4,573	$1,300	$3,973	$41,328
Unobligated Balances Available	4,907		1,208	879	185	46	1,671	2,746	2,794	14,436
Unobligated Balances Not Yet Available	18,569	7,839	1,750	23	4	10	43	131	1,390	29,759
Total Status of Budgetary Resources	$35,480	$7,936	$12,654	$5,801	$1,843	$3,188	$6,287	$4,177	$8,157	$85,523
Outlays:										
Obligations Incurred	$12,004	$97	$9,696	$4,899	$1,654	$3,132	$4,573	$1,300	$3,973	$41,328
Less: Spending Authority From Offsetting Collections and Adjustments	14,139	912					79	808	345	16,283
Actual Recoveries-Prior Year Obligations	171		1,885	13	3	8	137	22	229	2,468
Obligated Balance, Net Beginning of Period	1,468	(46)	54,727	9,009	3,944	1,412	13,752	3,996	16,934	105,196
Obligated Balance Transferred, Net			(333)	169	1		5		158	
Less: Obligated Balance, Net - End of Period	1,445	(63)	46,129	9,074	4,107	1,671	13,690	4,156	17,504	97,713
Total Outlays	($2,283)	($796)	$16,076	$4,990	$1,489	$2,865	$4,424	$310	$2,987	$30,060

Combining Statement of Financing
For the Year Ended September 2001
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home	Operating Subsidies	Public and Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other	Combined
Obligations and Nonbudgetary Resources										
Obligations Incurred	$20,718	$151	$15,642	$4,970	$1,706	$3,152	$4,406	$1,221	$4,383	$56,349
Spending Authority from Offsetting Collections and Adjustments	(17,842)	(918)	27	(0)	4	1	(77)	(793)	(1,071)	(20,669)
Recoveries-Prior Year Obligations	(20)		(2,583)	(14)	(9)	(3)	(55)	(59)	(536)	(3,279)
Financing Imputed for Cost Subsidies	14								56	70
Transfers In (Out)	(203)								203	0
Exchange Revenue Not in the Budget							1	(15)	(52)	(66)
Non-Exchange Revenue Not in Budget			150						(10)	140
Exchange Revenue in the Budget								12	(6)	6
Other	(7)		51	55	18	59	57	27	(260)	0
Total Obligations as adjusted, and NonBudgetary Resources	$2,660	($767)	$13,287	$5,011	$1,719	$3,209	$4,332	$393	$2,707	$32,551
Resources That do Not Fund Net Cost of Operations										
Change in Amount of Goods, Services and Benefits Ordered, but not yet Received or Provided	$0	$0	$3,654	($36)	($283)	($62)	($18)	($75)	$697	3,877
Costs Capitalized on the Balance Sheet	$5,498	(62)					78	115	129	5,758
Financing Sources that Fund Costs of Prior Periods	(8,298)			5			6		(76)	(8,363)
Other	(61)						(343)		51	(353)
Total Resources that do not Fund Net Cost of Operations	($2,861)	($62)	$3,654	($31)	($283)	($62)	($277)	$40	$801	$919
Costs That Do Not Require Resources										
Depreciation and Amortization									$4	$4
Bad Debts Related to Uncollectible Non-Credit Reform Receivables	($327)		$3						(142)	(466)
Revaluation of assets & Liabilities	(831)									(831)
Loss of Disposition of Assets	697								51	748
Other	(4,035)	24	(150)						116	(4,045)
Total Costs Not Requiring Resources	($4,496)	$24	(147)	$0	$0	$0	($0)	$0	$29	($4,590)
Financing Sources Yet to be Provided	$1,973	$0	$0	$0	$0	$0	$0	$0	$11	$1,984
Net Cost of Operations	($2,724)	($805)	$16,794	$4,980	$1,436	$3,147	$4,055	$433	$3,548	$30,864

Department of Housing and Urban Development
Combining Statement of Financing
For the Year Ended September 2000
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home	Operating Subsidies	Public and Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other	Combined
Obligations and Nonbudgetary Resources										
Obligations Incurred	$12,004	$97	$9,696	$4,899	$1,654	$3,132	$4,573	$1,300	$3,973	$41,328
Spending Authority from Offsetting Collections and Adjustments	(14,139)	(912)					(79)	(808)	(275)	(16,213)
Recoveries-Prior Year Obligations	(171)		(1,885)	(13)	(3)	(8)	(137)	(22)	(229)	(2,468)
Financing Imputed for Cost Subsidies	11								38	49
Transfers In (Out)	(233)								233	
Exchange Revenue Not in the Budget							(2)		66	64
Non-Exchange Revenue Not in Budget								8		8
Total Obligations as adjusted, and NonBudgetary Resources	($2,528)	($815)	$7,811	$4,886	$1,651	$3,124	$4,355	$478	$3,806	$22,768
Resources That Do Not Fund Net Cost of Operations										
Change in Amount of Goods, Services and Benefits Ordered, but not yet Received or Provided			$8,166	$131	($152)	($235)	$89	($197)	($493)	$7,309
Costs Capitalized on the Balance sheet	1,907	30					78	124	16	2,155
Financing Sources that Fund Costs of Prior Periods				(5)			(5)		(1)	(11)
Other	289						(349)		16	(44)
Total Resources that do not Fund Net Cost of Operations	$2,196	$30	$8,166	$126	($152)	($235)	($187)	($73)	($462)	$9,409
Costs That Do Not Require Resources										
Depreciation and Amortization									$6	$6
Bad Debts Related to Uncollectible Non-Credit Reform Receivables	78		13					(1)	(20)	70
Revaluation of assets & Liabilities	(1,127)									(1,127)
Loss of Disposition of Assets	728									728
Other	(3,245)	22							52	(3,171)
Total Costs Not Requiring Resources	($3,566)	$22	$13					($1)	$38	($3,494)
Financing Sources Yet to be Provided	$3,944								$17	$3,961
Net Cost of Operations	$48	($763)	$15,990	$5,012	$1,499	$2,889	$4,168	$404	$3,399	$32,644

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Objectives, Scope and Methodology

Management is responsible for:

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

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

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

We considered HUD's internal control over Required Supplementary Stewardship Information to be reported in HUD's *Fiscal Year 2001 Performance and Accountability Report* by obtaining an understanding of the design of HUD's internal controls, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls as required by OMB Bulletin 01-02, *Audit Requirements for Federal Financial Statements* and not to provide assurance on these internal controls. Accordingly, we do not provide assurance on such controls.

With respect to internal controls related to performance measures to be reported in the "Management's Discussion and Analysis" and HUD's *Fiscal Year 2001 Performance and Accountability Report*, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin 01-02. Our procedures were not designed to provide assurance on internal control over reported performance measures and, accordingly, we do not provide an opinion on such controls. However, as reported in the "HUD's Internal Control Environment" section of this report, we noted certain significant deficiencies in internal control over certain reported performance measures that, in our judgment, could adversely affect HUD's ability to collect, process, record, and summarize those performance measurements in accordance with management's criteria.

To fulfill these responsibilities, we:

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

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

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

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

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

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

Recommendations

To facilitate tracking recommendations in the Departmental Automated Audits Management System, this appendix lists the newly developed recommendations resulting from our report on HUD'S fiscal year 2001 financial statements. Also listed are recommendations from prior years' reports that have not been fully implemented. This appendix does not include recommendations pertaining to FHA issues because they are tracked under separate financial statement audit reports of that entity.

Recommendations from the Current Report

With respect to the material weakness that HUD's financial management systems are not substantially compliant with Federal financial system requirements, we recommend that the **Chief Financial Officer** in coordination with the appropriate **program offices**:

1.a. Review the grant systems, with special emphasis on IDIS, to determine and implement needed system modifications or manual procedures (based upon cost benefits analysis) to properly account for federal grant transactions.

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

1.b. Revise its accounting policy to recognize accounts payable (and expenses) when invoices are received.

1.c. Create the crosswalks in Hyperion to accept GNMA and FHA SGL data.

1.d. Include the GNMA and FHA SGL data with the HUDCAPS/Hyperion load file for automatic generation of HUD's Consolidated Financial Statements.

1.e. Initiate and complete independent and unbiased feasibility and cost-benefit studies for the "Departmental General Ledger" project, and ensure that any system solution considered be consistent with the Department's Enterprise Architecture Plan being developed.

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

2.a. Develop the capability to provide summary reports on the performance, compliance and funding factors that result in the risk rating for the high and medium risk assessment categories in the National Risk Assessment component of the PIC. The identification of the risk factors should assist field offices in determining monitoring strategies and planning monitoring efforts in a more efficient manner.

2.b. Expand the utilization of PIC in management of monitoring and other efforts by developing the capability of all PIH field office staff in the use of the system, and requiring that all field staff use it in the monitoring efforts.

2.c. Direct the field offices to provide technical assistance when PHA's MTCS and SEMAP submissions fall below an 85 percent reporting requirement.

2.d. Ensure that the REAC's QAR efforts are expanded by redirecting resources to provide for increased coverage of IAs and awareness of the requirement for adequate testing in accordance with the PIH compliance supplement.

We recommend that the **Deputy Assistant Secretary for Multifamily Housing:**

2.e. Develop a plan with milestones that would increase, for that portion of the Section 8 portfolio that remains HUD's responsibility, the number of on-site management reviews conducted annually and would ensure owners of assisted multifamily projects comply with HUD's occupancy requirements.

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

2.f.. Make resources available to develop a realistic method to identify tenants/owners who erroneously report income.

With respect to the reportable condition that HUD still needs to strengthen the controls over its computing environment in regards to CM implementation, we recommend that the **Chief Information Officer**:

4.a. Establish policies and procedures to control emergency software changes for both the Unisys and Hitachi mainframe applications. Follow-up and documentation procedures should be stressed.

4.b. Change the passwords of UNISYS application "owner" user ids periodically.

4.c. Establish separate libraries for development and test work for the 12 critical UNISYS applications presently without separate libraries.

4.d. Fully fund CM implementation for those mission critical client/server financial applications without CM.

4.e. Develop in-house capability to technically verify the implementation of CM for mission critical client/server applications.

In regards to network vulnerabilities, we recommend that the **Office of Administration** coordinate with the **Chief Information Officer** to:

4.f. Reduce easily guessed passwords to less than 5 percent at all field offices. This may require running the Kane Analyst reports more frequently than each quarter for those field offices consistently with greater than 5 percent easily guessed passwords.

4.g. Limit the number of logins permitted under the SUPERVISOR account to one at all field offices and limit its use to maintenance only.

4.h. run Kane on all Novell servers to determine the number of servers whose operating system files (bindery) are open to general users; immediately close the bindery of the servers found open; and establish procedures to ensure the bindery are protected from unauthorized access.

In regards to physical security, we recommend that the **Chief Information Officer:**

4.i. Conduct a risk analysis to determine whether the protective measures for the data center and the backup facility identified in the July, 2000 HUD' Critical Infrastructure Protection Plan are warranted. The risk analysis should also consider whether a card key entry control system need to be installed to control exits in backup facility. The protective measures include barriers around the building, magnetometer and x-ray scanner for screening incoming personnel, screening of mail and delivery packages before being brought into the center, and blast-resistant coating on street level windows.

We also recommend that **the Office of Administration:**

4.j. Consider installing a key card system with audit trail capabilities to control access to computing facilities at field offices.

4.k. Ensure all telecommunication or server equipment is stored in a secure space controlled by a key card system.

With respect to the reportable condition that weak personnel security management continues to pose risks of unauthorized access to the Department's critical financial systems, we recommend that the **Chief Information Officer** coordinate with the **Office of Administration** and the **Program Offices** to:

5.a. Develop a plan of actions and milestones for completing the appropriate background investigations of those system users (825 identified so far) who were granted access to HUD's critical and sensitive systems without submitting the required background investigation forms.

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

5.b. Establish, disseminate, and enforce a policy requiring users requesting above read access to HUD's mission-critical and sensitive systems to submit the proper investigation forms before they are allowed access to the systems.

5.c. Provide the Office of Administration with the required quarterly listing of all individuals who have access to mission-critical systems within three working days following the end of each fiscal quarter. The information provided should include Social Security Numbers so that it can be readily reconciled with Office of Human Resource's personnel security database.

Unimplemented Recommendations from Prior Years' Reports

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

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

With respect to the resource management issues formerly classified as a material weakness, the following two recommendations remain open because corrective actions have not been fully implemented. Responsibility has been reassigned from the Assistant Secretary for Administration to the Deputy Secretary. We recommend that the **Deputy Secretary**:

2.b. Hold field offices and headquarters accountable for work accomplishments in line with available resources and established standards. (Final action target date is December 31, 2001.)

2.c. Ensure that once greater efficiencies are implemented, staffing standards are realigned to be consistent with the revised workload. (Final action target date is December 31, 2001.)

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

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

2.a. Assess the readiness of HUD to meet Statement of Federal Financial Accounting Standards No. 4, Managerial Cost Accounting Concepts and Standards, in Fiscal Year 1997 and to recommend a coordinated plan of action for HUD's major operating components that accomplish the Government Performance and Results Act and Statement of Federal Financial Accounting Standards objectives. (Final action target date is March 31, 2002.)

OIG Report Number 99-FO-177-0003 (Fiscal Year 1998 Financial Statements)

With respect to the reportable condition that controls over project-based subsidy payments need to be improved, we recommend that the **Director, Section 8 Financial Management Center** (Note: subsequent to the issuance of our fiscal year 1998 report, responsibility for this recommendation was transferred to the **Office of Housing**):

3.a. Verify that project-based Section 8 payments are accurate and allowable by testing source documentation through verification of tenant data. Examples of procedures that do this include confirmations and on-site reviews. (Final action target date is September 30, 2002.)

With respect to the reportable condition that HUD needs to improve processes for reviewing obligation balances, we recommend that the **Assistant Secretary for Housing-Federal Housing Commissioner**:

10.d. Ensure that data used in reviewing unliquidated obligation balances are complete, current, and accurate. (Final action target date is September 30, 2002.)

10.e. Ensure that all contract amounts determined to have excess budget authority are deobligated and recaptured. (Final action target date is September 30, 2002.)

OIG Report Number 00-FO-177-0003 (Fiscal Year 1999 Financial Statements)

With respect to the material weakness that HUD's financial systems are not compliant with federal financial standards, we recommend that the **Deputy Secretary**:

1.a. Direct CFO and FHA to work together to develop a general ledger interface with the FHA accounting system, which will provide for automated monthly transfers of financial information. (Final action target date is September 30, 2002.)

With respect to the management control program issues, we recommend that the **Chief Financial Officer**:

2.b Report to the Deputy Secretary issues that are not resolved. (Final action target date is September 30, 2001.)

2.c Establish due dates for responses to CFO reviews and hold program offices accountable. (Final action target date is September 30, 2001.)

With respect to the material weakness on improvements needed in multifamily project monitoring, and the reportable condition on controls over project based subsidy payments, we recommend that the **Assistant Secretary for Housing-Federal Housing Commissioner,** in consultation with the **Director, Section 8 Financial Management Center**:

3.a. Finalize plans to improve administration of HAP contracts remaining under HUD responsibility after the transfer to contract administrators is completed. In formulating these plans, HUD should consider the responsibilities being placed on contract administrators and design a comparable oversight strategy, establish organizational responsibilities, and at a minimum, address the following areas:

- management and occupancy reviews,
- rental adjustments,
- opt-out and contract termination,
- HAP payment processing including review of monthly vouchers,
- follow-up on health and safety issues and community/resident concerns,
- resolving deficient annual financial statements and physical inspection results, and
- renewing expiring assistance contracts.

(Final action target date is September 30, 2002.)

With respect to the reportable condition that HUD needs to improve its processes for reviewing obligation balances, the following recommendations remain open because the Office of Public and Indian Housing has been waiting on a decision from the Comptroller General since August 15, 2000. We recommend that the **Assistant Secretary for Public and Indian Housing**:

9.c. Enforce the requirement of the United States Housing Act of 1937, as amended by the Quality Housing and Work Responsibility Act of 1998 for the expenditure of public housing capital funds through default remedies up to and including the withdrawal of funds. (Final action target date is December 31, 2000.)

9.d. Issue clarifying guidance that is in accordance with the United States Housing Act of 1937, as amended by the Quality Housing and Work Responsibility Act's provisions regarding the obligation, by HAs, of capital funds. (Final action target date is December 31, 2000.)

(These recommendations are suspended in the audit tracking system.)

We recommend that the **Assistant Secretary for Housing-Federal Housing Commissioner,** in consultation with the **Chief Financial Officer:**

9.f. Improve systems and procedures to facilitate timely contract close-out and identification and recapture of excess budget authority on expired project based Section 8 contracts. This process should occur periodically during the fiscal year rather than after fiscal year end. (Final action target date is September 30, 2002.)

OIG Report Number 01-FO-0003 (Fiscal Year 2000 Financial Statements

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

1.c. Develop guidance that directs that the field offices to select and give priority for on-site monitoring to the at risk PHAs and HAs in order to maximize resources to abate the number of those that are at risk. In addition, on-site monitoring waivers of the at risk PHAs and HAs should be justified on the basis of the progress that the at risk PHAs and HAs made in eliminating the problems that caused them to become at risk.(Final action target date is May 18, 2002.)

1.d. Develop guidance that allows field offices to uniformly identify the at risk PHAs and HAs through the risk assessment process in PIH's risk based monitoring strategy. (Final action target date is May 18, 2002.)

1.e. Redirect priorities to fully implement the PIC capabilities for tracking and monitoring housing quality inspection deficiencies and IA audit report recommendations. In addition, hold the field office accountable for obtaining current and complete data from the HAs and for maintaining current and complete data in PIH's IBS and PIC in a timely manner. (Final action target date is May 18, 2002.)

We recommend that the **Deputy Assistant Secretary for Multifamily Housing**:

1.g. Continue plans to upgrade the reporting in REMS to provide for a dynamically updated computer ranking combining all the major monitoring tools available to the Office of Housing, as applicable, to the project being ranked. Specifically, we suggest the following upgrades to REMS, and in its use:

- Establish fields for each major monitoring tool indicating the proper date for the "next to be conducted" scoring or evaluation according to the protocol and populated this field by computer dating based on the last time the monitoring tool was used and rank reported.
- Establish a field that combines the ranking from all current monitoring tools used as applicable and conducted resulting in an overall ranking by the computer. This does not replace the existing judgment based ranking, but would be used to produce reporting when these rankings varied.
- Periodically review (no less than quarterly), the overall risk ranking for each HUB and any justifications for variance between the computer and judgment rankings as necessary.

(Final action target date is March 31, 2002.)

With respect to the reportable condition that controls over project-based subsidy payments need to be improved, we recommend that the **Director of the Section 8 Financial Management Center** (FMC):

2.a. Provide written policies and procedures for post payment reviews in the interim period before the automated post payment review process is operational.

- Appropriate voucher selection methods, i.e. random sampling, and results tracking mechanisms, should be established.
- Appropriate interaction with the Office of Housing should be taken to establish sanction policies and authority for suspension of payments to owners who do not comply with HUD regulations.

(Final action target date is May 18, 2002.)

With respect to the reportable condition that HUD still needs to strengthen the controls over its computing environment, we recommend that the **Chief Information Officer**:

3.k. Complete Department wide policies and procedures governing standards for implementing and managing configuration management (CM) on both the mainframe and client server platforms. (Final action target date is April 15, 2002.)

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

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

Federal Financial Management Systems Requirements

1. HUD's annual assurance statement issued pursuant to Section 4 of FMFIA is to report 17 non-conforming systems. HUD's number of non-conforming systems increased from 11 reported in the prior year. As a result of prior year's financial audits discussing FHA's feeder systems and respective non-compliance with the Standard General Ledger at the transaction level, HUD recast nine FHA systems that were previously assessed as conforming to it's list of non-conforming systems. In addition, 2 systems were discontinued and the Department corrected deficiencies in 1 non-conforming system.

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

Responsible Office	Number of Systems	Non-Conforming Systems
Office of Housing	22	15
Chief Financial Officer	17	1
Office of Administration	2	0
Office of Public and Indian Housing	3	1
Office of Fair Housing and Equal Opportunity	0	0
Government National Mortgage Association	8	0
Office of Community Planning and Development	4	0
Office of the Chief Procurement Officer	0	0
Real Estate Assessment Center	1	0
	57	17

The following section outlines the Department's plan to correct specific A-127 system non-conformances.

Office of Housing

System	**Outstanding Noncompliance Issue @ 09/30/01**	**Plan @9/30/01**	**Target date to Complete all Phases**	**Resources**
A43 Single Family Insurance System A43C Single Family Claims System A80B Single Family Premium Collection System –Periodic A80D Single Family Distributive Shares Refund System A80N Single Family Mortgage Notes Servicing A80R Single Family Premium Collection System – Upfront A80S Acquired Asset Management System F12 Home Equity Conversion Mortgage System F31 Cash, Control Accounting and Reporting System F47 Multifamily Insurance System F71 Title I Notes Servicing System F72 Title I Insurance and Claims System	• Classification structure • Integrated FMS • Application of SGL • Federal Accounting Standards • Financial Reporting • Budget Reporting • Functional Requirements (F31 only)	**Short term**: Implement a new FHA general ledger to automate FHA headquarters' funds control processes, financial statement reporting, and updates to the departmental general ledger **Mid Term:** • Automate funds control processes for FHA field offices • Implement a new FHA payment and collection software to improve FHA's accounting operations Note: The F31 system will be terminated at completion of this phase **Long Term**: Integrate or replace FHA insurance systems with the FHA subsidiary ledger software to improve accounting and insurance operations	10/2002 12/2004 12/2006	FY00 and prior - $2,381,000 FY01-$5,250,000 FY02-$8,800,000 FY03-$8,600,000 FY04-$7,322,000 FY05-$5,444,000 FY06-$5,067,000
F75 Multifamily Claims System	In addition to issues above, • Functional requirements • Clear Documentation • Training/User Support	Convert the system to a web-based platform Completion of this project is pending adequate funding levels	09/30/2002	FY01-$456,561 FY02-$366,000
A56 Mortgage Insurance General Accounting	• Classification structure • Integrated FMS • Application of SGL • Federal Accounting Standards • Financial Reporting • Budget Reporting • Functional Requirements • Clear Documentation • Internal Controls • Training/User Support • Maintenance	Document detailed functional requirements for the new FHA subsidiary ledger system (complete) Determine the best system solution for the new subsidiary ledger system Implement a new FHA general ledger to automate FHA headquarters' funds control processes, financial statement reporting, and updates to the departmental general ledger Terminate A-56 and replace with P013 FHA subsidiary ledger (COTS package)	04/17/00 Actual 09/01/00 Actual 10/02 04/03	
F87	The Office of Housing plans to re-evaluate this	Re-evaluate system deficiencies	09/02	To be determined

System	**Outstanding Noncompliance Issue @ 09/30/01**	**Plan @9/30/01**	**Target date to Complete all Phases**	**Resources**
	system in FY 2002 to identify system deficiencies			

Office of the Chief Financial Officer

System	**Outstanding Noncompliance Issue @ 09/30/01**	**Plan @9/30/01**	**Target date to Complete all Phases**	**Resources**
A21 - Loan Accounting System	• Integrated Financial Management System	Develop a statement of work to re-engineer/re-platform LAS	11/01 Actual	Not determined
		Award contract for Feasibility Study, Risk Analysis and Cost Benefit Analysis to analyze the options of outsourcing to an external organization, replatforming, re-engineering, or modifying LAS, or purchasing and implementing a COTS package	01/02	
		Implement a replacement system	Dependent upon results from previous task	

Office of Public and Indian Housing

System	**Outstanding Noncompliance Issue @ 09/30/01**	**Plan @09/30/01**	**Target date to Complete all Phases**	**Resources**
N07- Regional Operating Budget and Obligations Tracking (ROBOTS)	• Integrated financial management system • Functional requirements	• Implement PIH Information Center (PIC) system as the integrated solution for the PIH Operation Fund.	03/31/02 *Orig.: 7/99*	$2,250,000

2. Our audit disclosed reportable conditions regarding the security over financial information. Although reportable conditions, we are including security issues as a basis for noncompliance with FFMIA because of the collective effect of the issue and noncompliance with Circular A-130, Appendix 3 and the Government Information Security Reform Act (GISRA).. The responsible office, nature of the problem and primary causes are summarized below.[18]

Responsible Office	**Nature of the Problem**
Office of Housing	REMS, Which is a key FHA Multifamily application, lacks sufficient segregation of duties between key operational functions, such as data entry and transaction approval. The FHA Connection, an extremely sensitive Internet-based interface that allows lending institution employees to access mission critical FHA systems, lacks key security elements required by OMB Circular A-130.

The primary cause for these occurrences are that HUD has not provided adequate protection over sensitive programs and files. HUD has not enhanced the level of segregation of duties for key data processing functions, limiting contractor access to sensitive application security reports, and ensuring that security risk assessments are performed by key applications.

Office of Housing	The Cash Control Reporting System (CCARS) security plan does not contain accurate information on the use of system audit trails, and audit trails are not periodically reviewed for the system. A comprehensive risk assessment of the Computerized Homes Underwriting Management System (CHUMS) has not been performed since 1994.

The primary cause for this is occurrence is that key database controls are not adequate to provide assurance that computer resources are protected from unauthorized access.

Chief Information Officer	Inconsistencies existed between the development and production libraries of the Program Accounting System (PAS)

The primary cause for this is inadequate controls over emergency software fixes.

Chief Information Officer	Twelve of the 14 critical financial systems on the UNISYS lack a separate test environment to minimize the risk of unauthorized modification of production software.

The primary cause for this is CM for the UNISYS applications lacks adequate segregation of duties control

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[18] The issues are discussed in greater detail in the sections of this report relating to the reportable condition "Controls over HUD's Computing Environment Can be Further Strengthened" and "Weak Personnel Security Practices Continue to Pose Risks of Unauthorized Access to the Department's Critical Financial Systems". Also, KPMG LLP's separate report on their audit of FHA's fiscal year 2001 financial statements includes a reportable condition relating to "FHA/HUD Can More Effectively Manage Controls Over the FHA ADP Systems Portfolio

Responsible Office	**Nature of the Problem**
Chief Information Officer	The mission critical client/server applications are exposed to the risk of unauthorized, deliberate or unintentional, modifications which could result in errors, loss of data, or system failure.

The primary cause is that HUD has delayed CM implementation for critical client/server applications.

Chief Information Officer	Inappropriate individuals may be granted access to HUD's facilities, information and resources that could result in destruction or compromise of critical and sensitive data

The primary cause is that HUD has not implemented security controls to ensure background screening for employees and contract personnel who access critical and sensitive financial applications.

Specific recommendations to correct security weaknesses are listed in Appendix B of this report and KPMG LLP's separate report on their audit of FHA's fiscal years 2001 and 2000 financial statements.

Federal Accounting Standards

KPMG LLP reported in a material weakness that FHA's budgetary and Federal basis accounting resulted in an Anti-Deficiency Act violation. This resulted in a need to:

- Implement budgetary controls to prevent misreporting of budget execution information relating to FHA appropriations (Statement of Federal Financial Accounting Standards (SFFAS) Number 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting).*

- Review and reconcile obligations in order to provide complete financial information *(SFFAS Number 7, Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting).*

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

HUDCAPS is the Department's official standard general ledger system. FHA provides consolidated summary level data to HUDCAPS. FHA has 22 subsidiary systems that feed transactions to its commercial general ledger system. These systems lack the capability to process transaction in the SGL format. To provide consolidated summary level data from FHA to HUDCAPS, FHA uses several manual processing steps, including the use of personal computer based software to convert the commercial accounts to government SGL, and transfer the account balances to HUDCAPS. JFMIP requires that the core financial system "...provide for automated month-and year-end closing of SGL accounts and rollover of the SGL account balances". However, as discussed above, the Department is in the process of correcting this nonconformance item with the implementation of the U.S. Standard General Ledger (SGL) and credit reform accounts in the FHA general ledger. This project has a target completion date of 12/2006

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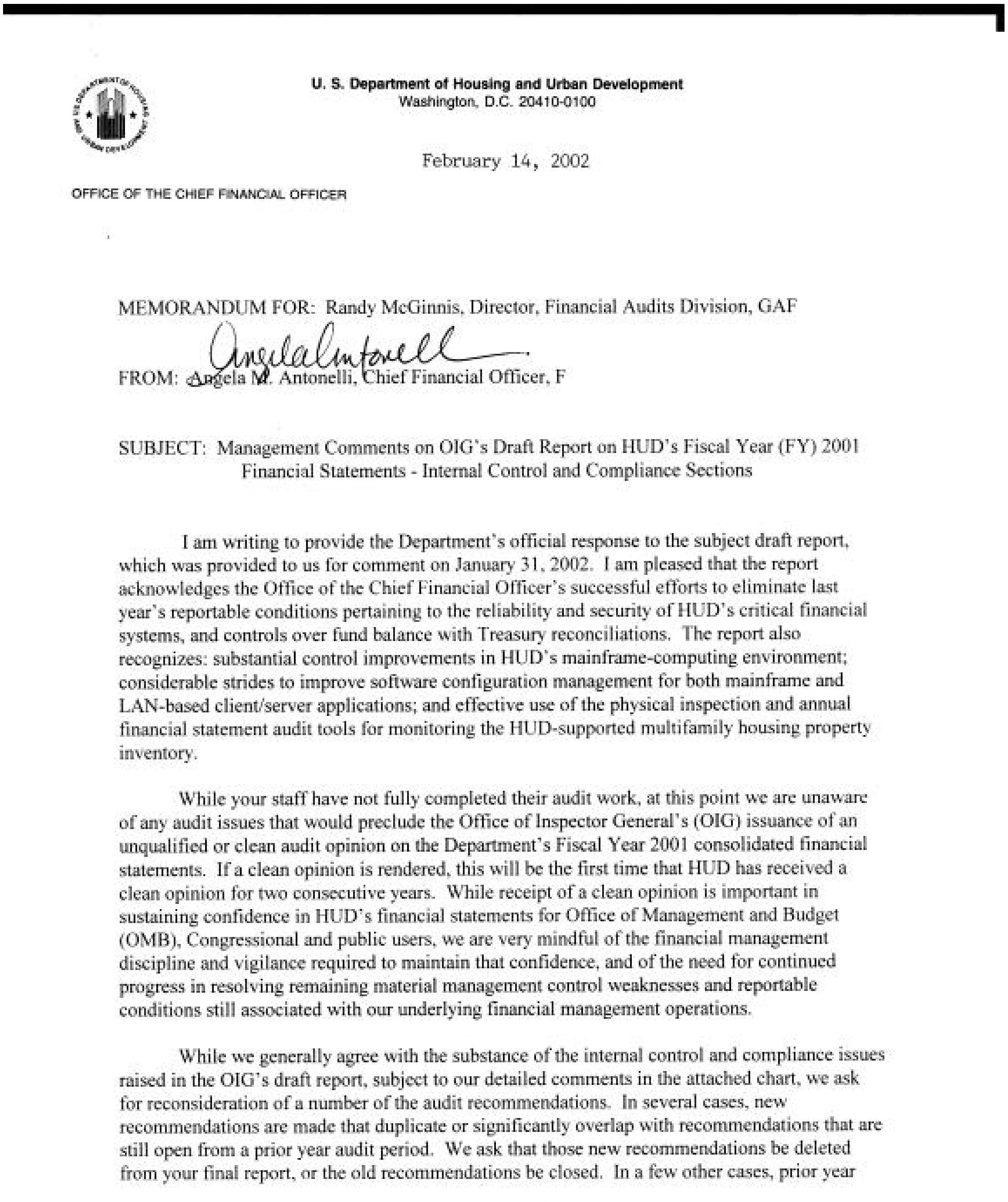

U. S. Department of Housing and Urban Development
Washington, D.C. 20410-0100

February 14, 2002

OFFICE OF THE CHIEF FINANCIAL OFFICER

MEMORANDUM FOR: Randy McGinnis, Director, Financial Audits Division, GAF

Angela Antonelli

FROM: Angela M. Antonelli, Chief Financial Officer, F

SUBJECT: Management Comments on OIG's Draft Report on HUD's Fiscal Year (FY) 2001 Financial Statements - Internal Control and Compliance Sections

I am writing to provide the Department's official response to the subject draft report, which was provided to us for comment on January 31, 2002. I am pleased that the report acknowledges the Office of the Chief Financial Officer's successful efforts to eliminate last year's reportable conditions pertaining to the reliability and security of HUD's critical financial systems, and controls over fund balance with Treasury reconciliations. The report also recognizes: substantial control improvements in HUD's mainframe-computing environment; considerable strides to improve software configuration management for both mainframe and LAN-based client/server applications; and effective use of the physical inspection and annual financial statement audit tools for monitoring the HUD-supported multifamily housing property inventory.

While your staff have not fully completed their audit work, at this point we are unaware of any audit issues that would preclude the Office of Inspector General's (OIG) issuance of an unqualified or clean audit opinion on the Department's Fiscal Year 2001 consolidated financial statements. If a clean opinion is rendered, this will be the first time that HUD has received a clean opinion for two consecutive years. While receipt of a clean opinion is important in sustaining confidence in HUD's financial statements for Office of Management and Budget (OMB), Congressional and public users, we are very mindful of the financial management discipline and vigilance required to maintain that confidence, and of the need for continued progress in resolving remaining material management control weaknesses and reportable conditions still associated with our underlying financial management operations.

While we generally agree with the substance of the internal control and compliance issues raised in the OIG's draft report, subject to our detailed comments in the attached chart, we ask for reconsideration of a number of the audit recommendations. In several cases, new recommendations are made that duplicate or significantly overlap with recommendations that are still open from a prior year audit period. We ask that those new recommendations be deleted from your final report, or the old recommendations be closed. In a few other cases, prior year recommendations are reported as open when they have been or should be closed. We ask that these recommendations also be deleted. Lastly, we ask that several other proposed new recommendations be reconsidered. Regarding the proposed recommendation that the OCFO conduct a cost-benefit analysis to support the OIG's position that HUD should revise its current grant accounting policies to be more compliant with federal financial management systems requirements, we request that OIG use its resources to conduct a cost-benefit analysis before recommending that such a policy change is in the best interests of the Department and other users of our financial statements. The other specific recommendations for which we have concerns are identified and further discussed in the attached chart. Please consider all the comments in the attached chart as you complete your final audit report.

I want to thank you and your audit staff for the collaborative working relationship we experienced on this year's audit. Our respective staffs, as well as other staff through out the Department, worked hard to support the preparation of HUD's FY 2001 consolidated financial statements, and the completion of the OIG's independent audit of those statements, by the pending statutory deadline of February 27, 2001. The rigor of the independent audit process assists HUD management in validating the effectiveness of our systems of internal control and identifying control weaknesses in need of corrective action.

Should you or your staff have any questions on our comments, please contact James M. Martin, Deputy Assistant Chief Financial Officer for Financial Management, on (202) 708-0614, extension 3706.

Attachment

No.	**Draft Report** **Reference**	**Management Comments for OIG's Consideration**
1.	Page 8, 2nd and 3rd paragraph. Pg. 10, 1st paragraph	Please consider and reflect that FHA did make progress in implementing a JFMIP compliant "commercial-off-the-shelf" SGL financial system 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.
2.	Page 8, 6th paragraph relating to DGMS	While OIG states that DGMS was a failure, we request that this section be revised to reflect that benefits were derived from the project, and that the products and staff resources are being incorporated into the Office of Management and Budget's (OMB's) priority interagency E-Government initiative on E-Grants. The DGMS project produced a proof of concept prototype showing a single, enterprise-wide application that can manage a common grants process for formula and discretionary programs across the Department. DGMS also produced: i) a standardized glossary of terms and data dictionary that would work not only for HUD's grants management system, but with the Federal Commons, and ii) a detailed Functional Requirements Document (FRD) covering the grantee functions for eighteen programs within the Offices of FHEO, CPD, PD&R, PIH, HHLHC and Housing. The data dictionary and FRD remain available as resources to HUD, other Federal agencies, and the E-Grants Initiative. The information developed under the DGMS project also formed the basis for the grants program portion of the Department's Enterprise Architecture, which will be used to guide decision making on future grant systems development efforts at HUD.
3.	Pg. 9, 1st and 3rd bullets	While we agree that the Department could be more technically compliant with federal financial management systems requirements on the accounting for grant expenditures versus advances, and on the automation of the process of producing combined financial statements, inclusive of FHA and GNMA, we believe that our current practices are reasonable and acceptable under the circumstances. We therefore disagree with OIG recommendations that we change our grant accounting policies and automate the process for producing combined financial statements. Further comments are provided on proposed recommendation numbers 1.a., 1.c. and 1.d. on page 54 of the draft report.
4.	Pg. 9, last bullet	Please recognize that the OCFO has done a significant amount of work over the past year to improve the quality of LAS data. We are now preparing to rebuild the flexible subsidy projects in LAS and to automate the flexible subsidy project entry and transaction entry process through the LOCCS/LAS interface. This will enable us to maintain an accurate portfolio until we decide upon the appropriate

No.	**Draft Report** **Reference**	**Management Comments for OIG's Consideration**
		solution for this portfolio, from options being developed in the LASHE study.
5.	Page 11, last paragraph	For clarification, the OCIO's data quality improvement (DQI) assessments have not been focused on the improvement of APP performance indicator data quality, but will serve to improve some APP-related data. We offer the following text as an accurate reflection of the past and planned DQI data quality assessments: To date, OCIO has accepted data quality plans for mission critical data from seven HUD information systems (REMS, LOCCS, PAS, MTCS, TRACS, HUDCAPS and SAMS) as part of its DQI initiative. HUD plans DQI assessments of eight additional mission critical information systems during FY 2002, as well as an evaluation of the DQI initiative. The contribution of DQI-driven data quality improvements to improved APP performance measure data will be analyzed during the DQI evaluation.
6.	Page 13, 2nd paragraph	This background section needs to reference the addition of the Performance-Based Contract Administrators (PBCAs) as a significant new resource in support of the Office of Housing's oversight of the Project-based Subsidy Programs.
7.	Page 16 & Page 34	Last paragraph, first line of page 16 and first paragraph, first line of page 34; change HUD's to *HUD …*
8.	Page 16: "Onsite monitoring was limited" section, 1st paragraph	The OIG makes the statement that the "decreased performance of the HAs… shows that the level of HA monitoring has not been effective." There is nothing in this section that supports such a statement, i.e., no indication as to whether the 80 HAs reviewed improved their operations or decreased their performance by the end of the FY. While HUD monitoring of high risk HAs is intended to put corrective actions in motion, it is unlikely that the high risk status of an HA is going to change in the course of a year. The increase in the number of high risk HAs could also have been the result of revisions to the risk assessment criteria, or further existing problem identification through remote and on-site monitoring processes, rather than an actual decrease in HA performance, as stated in the draft report.
9.	Page 16, last paragraph	In the last paragraph, please add the following language to the end of the second sentence: "Thus far, … *and (4) drafted a new Public Housing Occupancy Handbook*"
10.	Page 17, 2nd paragraph	The statement that "management waived the requirement to maintain the PIC on a current basis…" is not accurate. Management did not "waive" the requirement. Field Offices were instructed to continue to work with the system as best they could yet keep adequate control and tracking systems to support their expenditures. The PIC Events Tracking System was the most complicated and extensive module built for the PIC. It was also one of the first modules developed, meaning it was accompanied with a large learning curve from which we now benefit when developing other modules.

No.	Draft Report Reference	Management Comments for OIG's Consideration
11.	Page 18, 1st paragraph	The first paragraph does not include the resident services and satisfaction indicator when discussing the issuance of advisory scores on particular indicators. During the initial timeframe, advisory scores were issued for the indicator resident services and satisfaction.
12.	Pages 18-22	Under separate cover, the OIG was provided the Office of General Counsel's comments on suggested technical corrections to various references to the PHAS rule on pages 18-22 of the draft report.
13.	Page 19, 1st paragraph	There is a reference to the Troubled Agency Recovery Center (TARC) staff generally not using the PHAS advisory scores in their monitoring programs. The results of PHAS, both advisory and official, were utilized in the development of recovery plans and MOAs for all PHAs under the jurisdiction of the TARCs.
14.	Page 19, last paragraph, to the top of Page 20	*The OIG's stated reliance on their "…prior years' testing of IAs' audits…" may not be a valid representation of current year conditions. Further, it is unclear how the OIG determined from HUD's Quality Audit Reviews (QAR) that "…35% of the IAs and possibly as high as 93%, did not perform adequate testing…" It should be recognized that HUD resumed its QAR function to improve audit quality. We are also unclear as to the meaning of the comment that "… all four field offices visited during our review did not fully utilize the IA report results in their monitoring activities." It should be recognized that IA audit results are part of the risk assessment model that is used to develop the risk-based monitoring strategies deployed by PIH and other field staff.*
15.	Page 20	In the second bulleted paragraph, the last sentence states that the TARCs "were originally established to serve more than 500 troubled HAs." While this statement is true, it should be noted that the approved staffing levels at the TARCs have significantly decreased since the initial plan was developed. The current staffing plan would allow the TARCs to manage up to 150 PHAs per TARC depending on the complexity.
16.	Page 21, 2nd bullet	The report states that 10 RHIIP tasks were identified, but only 7 tasks are listed. Suggest that this be reworded as follows: "The RHIIP Advisory Group originally developed a 10 part strategy that the Offices of PIH and Housing have since compressed into the following 8 tasks for implementation: (1) program simplification through statutory, regulatory and administrative reform, (2) increase tenant income data sharing for use in rent determinations, (3) develop automated tools for rent calculation and subsidy payment validation, (4) complete a periodic error measurement methodology, (5) establish an on-going quality assurance program, (6) provide more effective incentives and sanctions for HAs and tenants, (7) update program guidance to reflect current requirements and processes, and (8) initiate training for HAs, tenants and HUD staff on program requirements."

No.	Draft Report Reference	Management Comments for OIG's Consideration
17.	Pages 22-26	We request that the report section entitled "Multifamily Project Monitoring Needs to Place More Emphasis on Oversight of Subsidy Determinations" be revised to only address that continuing issue. As currently written, the section also focuses on FHA mortgage insurance program activity, and the use of the physical inspection (PI) and annual financial statement (AFS) audit tools, which are not pertinent to the acknowledged need to further strengthen management controls over subsidy determinations. KPMG's audit of FHA's FY2001 financial statements reported no conditions associated with internal controls over the monitoring of insured multifamily projects. Furthermore, OIG's draft report concludes at the bottom of page 23 that the use of the PI and AFS monitoring tools "was generally effective." The continuing inclusion of these subjects in this material weakness write-up unfairly diminishes HUD's substantial improvement of its multifamily housing monitoring, and is misleading to the users of this report. We request that this section be re-written to only address the remaining conditions associated with internal controls over subsidy determinations.
18.	Pages 23-25	If the section entitled "Follow-up efforts need to improve on project monitoring findings" is retained in the final report, the following points need to be clarified. First, HUD's PI and AFS assessment tools apply to the entire project inventory, where required, for purposes of identifying compliance and performance deficiencies. The application of the PI and AFS tools has given HUD its first comprehensive nationwide assessment of the physical, financial and management conditions within the 29,000 multifamily housing project portfolio. Second, deficiencies identified by the PI and AFS assessment tools are addressed to the responsible project owners for correction, in all cases. Third, HUD practices risk-based site monitoring and deficiency follow-up, and the extent and timing of follow-up on each identified deficiency is both a risk and a resource consideration. Given the initial high volume of compliance deficiencies identified by the new nationwide assessment processes, and HUD's staffing limitations, it is not possible for HUD to follow-up on all identified deficiencies within a 30 or 60 day time standard. Nevertheless, the results of FY2001 audit testing by the OIG and KPMG audit teams indicates that follow-up actions were accomplished in accordance with desired monitoring standards in the majority of cases, as follows: • 84% successful follow-up on Exigent Health & Safety (EH&S) violations (159 of 190 cases sampled), • 81% successful follow-up on Corrective or Management Improvement Plans (113 out of 139 cases sampled), • 92% successful follow-up on Management/Occupancy Reviews (244 out of 265 cases sampled) and • 82% successful follow-up on AFS deficiencies (sample data not available). We believe this audit evidence supports that the monitoring process is working as

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		intended. The full deployment of the PBCA resources, and deterrence effect of the continued on-going use of the PI and AFS tools, will serve to even further improve the monitoring and performance of multifamily programs. This area is no longer viewed by management as a material weakness or reportable condition.
19.	Page 23, 2nd paragraph, 1st sentence	This sentence should be corrected to start: "Housing's or Multifamily Housing's use of REAC prepared .." Instead of "REAC's use"
20.	Page 25, 3rd paragraph	We request that this paragraph be revised to better reflect the implementation of the PBCA initiative, which has provided positive benefits to reduce the overall workload of MF Hub staff. The procedure for transition to PBCAs called for field staff to complete contract renewals that were already underway, or would be underway before the contract administrator had completed their start up efforts. To assign the task to the contract administrator any sooner would have been disruptive at best, and would have likely resulted in significant renewal delays. These contracts have been assigned to the PBCAs since their renewals were completed, unless there were other mitigating circumstances. We maintain that the temporary retention of contract renewal duties for contracts with imminent renewals, or renewals in process, was a reasonable and necessary component of a prudent transition plan. The actual working arrangements between the MF Hub staff and the PBCAs are displayed in detail on HUD's Web site, which is available to the public. Consequently, as the implementation has progressed, and as currently in force, MF field and headquarters staff have worked through whatever transitional inefficiencies may have existed and have begun to enjoy the increased economies of scale that the PBCA process has provided, as evidenced for example by the increase in management and occupancy reviews discussed elsewhere in our response.
21.	Page 25, 3rd paragraph to Page 26, 1st paragraph	While we appreciate the OIG's reference to a substantial increase in the total number of management reviews conducted during the fiscal year, the audit reporting focus is only on MF HUB staff monitoring, with omission of the efforts of the PBCA resources. Please add to your discussion that when the efforts of the PBCAs are added, that 70% of the assisted projects have been reviewed over the last three years. Furthermore, while monitoring is important for problem identification and correction, HUD's corrective action plans for this remaining material weakness area address more fundamental internal control issues designed to avoid subsidy determination errors. These actions, such as simplifying program requirements, updating program guidance, and providing a rent calculation tool and training, should both reduce errors and alleviate HUD's monitoring burden. These

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		corrective actions are reflected in the Rental Housing Integrity Improvement Project plan. Once those actions are implemented, the Office of Housing believes the level of monitoring it is providing to the rental assistance program area is sufficient.
22.	Page 27, 1st paragraph	The reference to a risk reporting system in REMS needs to be updated to include reference to the pending development of the Integrated Assessment Sub-System (NASS). NASS will eventually provide a comprehensive risk ranking by project that will be used to feed information to REMS to meet the OIG's recommendation from the FY 2000 financial statement audit, #1.g, presented on page 60 of this year's draft report.
23.	Pg 28, middle paragraph	The comments regarding OMHAR review efforts are not accurate, as the process only includes a review for eligibility for submission to OMHAR, not an OMHAR review. Furthermore, the sentence placement appears to include OMHAR as part of the delay without any further specifics. Consequently, we recommend deletion of the discussion of OMHAR's role due to its inaccuracy and inference.
24.	Pg 28, last paragraph & Page 30, 1st full paragraph	The draft report misconstrues the FMC's review process, as has occurred in prior year OIG reports. An important aspect of the voucher review is to ensure that the owner is billing for a number and mix of unit types authorized under the HAP contract. Contract unit counts and rents to which the voucher data are compared are not owner input. Discovery of discrepancies between the assistance contract and units billed, or rents reflected on the voucher and in the HUD-executed HAP contract have resulted in numerous payment adjustments and overpayment recoveries. Expansion of this type of review to the rest of the portfolio has the potential for reducing inappropriate payment of subsidy significantly. To suggest that these reviews are trivial or unproductive is simply incorrect. The RHIIP plan provides for greater automation of the project-based subsidy billing validation process, and increased site monitoring of support for program processing and billing.
25.	Page 29, 1st paragraph	The discussion concerning the use of incorrect rents appears to have a misstatement. The report states that, based on their review, 50 percent of the vouchers in TRACS did not contain the correct rent rates. We think the reviewer did not mean that 50 percent of the vouchers have or are based on the wrong rent, but that TRACS did not contain the correct rent rates 50 percent of the time. Our experience is that the vouchers generally have the correct rent, based on the approved rent schedule, but that the contract portion of TRACS has not always been updated with the current rents.
26.	Page 32	The write-up on the "Verification of Subsidy Payments" attributes the work on the erroneous payment estimates to REAC, when it would be more correct to attribute the effort to the Rental Housing Integrity Improvement Project (RHIIP) team, which includes PIH, Housing, PD&R and OCFO resources. Suggested edits to

No.	**Draft Report Reference**	**Management Comments for OIG's Consideration**
		this section were provided to OIG under separate cover.
27.	Page 33, 3rd paragraph	Please correct the following sentences to read as indicated: Sentence 1 – "During fiscal year 1999, REAC developed the Tenant Assessment Subsystem that would be used by HUD to conduct matching…" Sentence 4 – "However, the mailing of the discrepancy notices to the 216,000 households was not completed until September 2000."
28.	Page 34, 1st paragraph	Last sentence of the first paragraph should not mention large-scale match as a "viable option" but as an option that should be further explored. *(Note*: The problem is that the federal tax match data is 9 to 20 months old).
29.	Page 35, 3rd paragraph	Third paragraph should read: HUD's Office of PIH and Housing, at the advice of the RHIIP advisory group, plans …
30.	Page 40, 2nd Paragraph	We do not believe this finding accurately reflects what OCIO has accomplished. Although we agree that the source code and executable code is not synchronized at the time of PVCS implementation, we are following an industry-standard practice with a plan to synchronize these elements incrementally. As software releases are implemented under the control of the PVCS CM-tool, the correlation of source-to-executables will increase until all of the active modules are synchronized. This is a widely employed industry-standard practice for varied environments, such as HUD's. We followed this industry standard to minimize the impact to HUD's development and maintenance of software. The production objects and executables were obtained from the production servers and implemented in PVCS, while the source code was obtained from developers' libraries and implemented in PVCS. If this process were not followed, all development and maintenance would have ceased until the complete synchronization of source-to-executables was established through 100% regression testing, an extremely expensive and time-consuming process with very little cost-effectiveness. Further, a significant number of Web-based applications are inherently synchronized, since these directly use the source code to provide the processing instructions for the application. In these instances, there are no compilations or assemblies to generate executables. The components do not require synchronization, since the source and executables are one and the same.
31.	Page 45, 3rd paragraph	We request a revision of the second sentence to read: "However, the terrorist events of September 11, 2001 caused HUD to revise its general security priorities, delaying action on this personnel security backlog. Focus was given to GNMA activities critical to the financial markets, as well as protection of other systems, data, facilities, and people. Since then, OCIO and OHR staff, as well as Program

No.	Draft Report Reference	Management Comments for OIG's Consideration
		Area Security Administrators, have been working to resolve the personnel security backlog problem. As of January 18, 2002, action was taken on 247 users. Their accounts were reduced to read only status or the access was permanently removed. By February 15, 2002, the remaining 578 outstanding user accounts should have appropriate background investigation forms in OHR to continue their current level of access to a mission critical system."
32.	Page 46, reportable condition	Please acknowledge that the OCFO produces a monthly unobligated balances report, for distribution at the Deputy Secretary's monthly Executive Management Meeting with Principal Staff, as a basis for monitoring program office progress in reducing unobligated balances.
33.	Page 47, 3rd paragraph	Based on the explanations provided to OIG under separate cover, the specific implications and degree of data detail included in this paragraph are inappropriate. While we would not object to a more limited discussion of the additional work required to perfect our budget forecasting tools, such as the need for an application that assesses the entire inventory across both accounting systems, coupled with the acknowledgment in the "HUD's Actions Planned" section that we are making progress doing that work, we think that this description as it currently exists should not be included in the report.
34.	Page 49	FHA does not agree that it does not comply with SFFAS Number 7. It also has developed budgetary controls to reflect proper budget execution. Although FHA recognizes that certain vulnerabilities exist in its funds control system, it 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.
35.	Page 51	Under Compliance with Laws and Regulations: HUD Did Not Substantially Comply with the Federal Financial Management Improvement Act – Compliance with SGL at the Transaction Level, the last sentence of the last paragraph of the section incorrectly states: "In Phase II of the project, FHA plans to convert the Financial Transaction Repository to SGL, which is targeted for December 2004." A more accurate description might state: In Phase II of the project, FHA plans to implement the U.S. Standard General Ledger at the transaction level (October 2002) and replace many manual and stand-alone automated accounting procedures with an integrated core financial management system (December 2004). Under recommendations from the OIG's FY1999 financial statement audit, the Final Action target date for recommendation 1.a. should be October 2002 instead

No.	Draft Report Reference	Management Comments for OIG's Consideration
		of September 30, 2002 (for consistency - we always cite "October 2002")
36.	Pages 52-53	Subsequent to issuance of the draft report, we were advised by OIG that the "Compliance with Laws and Regulations" section of the report would be revised to disclose the Congressional request for a review of the funding of Office of Multifamily Housing Assistance Restructuring (OMHAR) technical assistance grants as an "other matter." We agree with the reporting of this matter in this manner.
37.	Page 54, Rec. # 1.a.	*We request that this recommendation be deleted until such time as OIG conducts a cost-benefit analysis to demonstrate that the proposed change in OCFO's current grant accounting policy is warranted. We further ask that OIG consider that the year-end adjustments suggested by the OIG's Notice of Findings and Recommendations on this issue would be off-set by the corresponding impacts on account balances at the beginning of the year. In essence, the accounting adjustments are a wash. The OCFO's existing policy is based on the premise that the cost of the proposed additional accounting precision on grant expenditures versus advances would far out-weigh any benefit, with no material impact on HUD's financial statements, or bearing on grant funding decision making. The cost-benefit of strict adherence to Federal financial management systems requirements is a factor that needs to be considered. At our exit conference, OIG confirmed that other major Federal grant programs follow the same accounting practice as HUD. We plan no change to our accounting policy on grant expenditures unless OIG can make a compelling case on the cost-benefit of the change proposed.*
38.	Page 54, Rec. # 1.b.	OCFO agrees to revise its accounting policy to recognize accounts payable/expenses for invoices received. Invoices will be recorded in general ledger consistent with financial statement reporting timelines.
39.	Page 54, Rec. #s 1.c, 1.d	We request that OIG reconsider and delete these proposed recommendations for further automation of the process for producing HUD's combined financial statements, inclusive of FHA and GNMA. It is the position of OCFO, FHA and GNMA that the risk of error associated with keying the final audited FHA and GNMA financial statement data directly to Hyperion is minimal. While we are sensitive to the fact that errors could occur when manually inputting information into Hyperion, we have developed compensating controls to provide reasonable assurance that the data are accurate. In addition, the OIG opines on HUD's Combined Financial Statements by reviewing the final statements based on their audit of OCFO statements, and the independent audits of FHA and GMNA. We oppose the recommendation that GNMA and FHA balances loaded to HUDCAPS be then uploaded to Hyperion to produce the consolidated financial statements. Both GNMA and FHA are responsible for producing their own

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		independently audited statements. Once HUDCAPS is shut down for the FY being reported, any adjustments required for reporting purposes must be entered directly into Hyperion and then into the new FY in HUDCAPS to adjust the opening balance, if appropriate. Adjustments are made right up to statement issuance. The strict edits in FACTS require us to make adjustments in Hyperion as well. GNMA and FHA go through the same process as does OCFO, in their own reporting systems. Under the OIG recommendations, OCFO would have to duplicate FHA and GNMA year-end adjustments in Hyperion, increasing OCFO workload, requiring reconciliation between Hyperion and GNMA/FHA reporting software, and most importantly, negatively affecting our ability to meet OMB's increasingly tighter reporting deadlines. As the recommendations relate to FHA, the FHA SGL information currently being provided to HUDCAPS is not sufficient to crosswalk to Hyperion financial statements. FHA merely provides SGL account balances, not attributes (for example, intra-government or with the public), when uploading its data to HUDCAPS. FHA is currently implementing a new general ledger system, scheduled to begin parallel testing in September 2002. As part of that implementation effort, OCFO and FHA will work together to develop a more efficient method of incorporating FHA's general ledger data into HUD's consolidated financial reporting.
40.	Page 54, Rec. # 2.a.	*We request that this proposed new recommendation be deleted from the final report because it duplicates open recommendation 1.d. from the FY2000 audit (see page 60 of the draft report), which also calls for a uniform risk assessment process for more effective direction of PIH field monitoring activities. Furthermore, the identification of the various performance, compliance and funding factors contributing to a risk rating is already available to field staff users through drill downs into the PIC data. We request further clarification from the OIG as to their further expectations related to recommendation 1.d. from the FY2000 audit.*
41.	Page 54, Rec. # 2.b.	*We request that this new recommendation be deleted from the final report because it duplicates open recommendation 1.e. from the FY2000 audit (see page 60 of the draft report), which also calls for the utilization of the* PIC system for managing PIH field monitoring activities. To fully address recommendation 1.e. from the FY2000 audit, the PHA Monitoring Handbook will be completed and distributed to the Field Staff by October 31, 2002**.** This document will include instructions for field office monitoring of PHAs and specific guidance to staff on how to use PIC and other systems during their monitoring process. We have also provided training on Monitoring in our Skills for the New Millennium training program, which will be fully implemented this fiscal year. This program discusses PIC and its use in the risk assessment process and tracking

<table>
<tr><th>No.</th><th>Draft Report
Reference</th><th>Management Comments for OIG’s Consideration</th></tr>
<tr><td></td><td></td><td>of reviews and visits.

We will provide more training to field staff on PIC’s various modules as enhancements are made or new releases occur.</td></tr>
<tr><td>42.</td><td>Page 54, Rec. # 2.c.</td><td>*We request that this proposed new recommendation be deleted from the final report because it also duplicates open recommendation 1.e. from the FY2000 audit (see page 60 of the draft report), which also calls for PIH field staff to monitor and assure complete and current PHA data submissions. In our Management Plan guidance for FY 2002, we stressed the accuracy of data and will continue to follow-up with field offices through our Field Operations Staff routine monitoring including on-site field office visits, Quality Management Reviews and HQ review of data systems.*</td></tr>
<tr><td>43.</td><td>Page 55, Rec. # 2.d.</td><td>We request that this recommendation be deleted as unnecessary. The audit has not disclosed a problem with the nature or extent of HUD’s QAR work on IA audits. In fact, the information presented on page 20 of the draft report supports that HUD is already addressing this issue.

QASS records indicate that a high percentage of the Public Housing Agency audits performed annually are done by a small concentration of CPA firms. For example, for fiscal years ending in calendar year 2000, the top ten percent (based on audits performed) of the CPA firms practicing in this area audited 68 percent of the PHAs filing submissions under the UFRS and PHAS regulations. As illustrated at Figure 1, the top ten percent of the firms practicing in this area consisted of 34 firms. QASS records indicate that many of these firms are either sole practitioners or firms with three or fewer CPAs on staff.

Figure 1 – Analysis of PHA Auditors
<table>
<tr><th></th><th># of Firms</th><th>% Audits</th><th>Audits</th></tr>
<tr><td>Top 10 percent</td><td>34</td><td>68%</td><td>1,463</td></tr>
<tr><td>All others</td><td>312</td><td>32%</td><td>691</td></tr>
<tr><td></td><td>346</td><td>100%</td><td>2,154</td></tr>
</table>
An analysis of QARs already completed indicates that several of these high volume practitioners do not have the resources to perform PHA audit engagements in accordance with professional auditing standards, within the timeframes required under the UFRS and PHAS. Thus, the QASS division’s strategic plan has focused its resources on these practitioners. Specifically, by conducting QARs of the top 34 audit firms, QASS is able to cover 68 percent of PIH’s audit portfolio in a cost effective manner. QASS is in the second year of a three-year plan to review these</td></tr>
</table>

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		firms. As of December 31, 2001, QASS has: • Performed QARs of 10 of the top 34 firms. • Plans to perform QARs of 11 of the top 34 firms during HUD fiscal year 2002. • Plans to perform QARs of the remaining 13 firms during fiscal year 2003 *It is REAC's position that expanding monitoring in this area would not be cost effective. Rather, HUD should continue to execute the REAC's strategic plan of focusing on the highest risk practitioners and continue making referrals to oversight bodies when substandard practices are identified.*
44.	Page 55, Rec. # 2.e.	*We request that this new recommendation be deleted from the final report because it duplicates open recommendation 3.a. from the FY1999 audit (see page 58 of the draft report), which also calls for plans for increased management and occupancy reviews.*
45.	Page 55, Rec. # 3.a.	*We request that this new recommendation be deleted from the final report because it duplicates open recommendation 3.a. from the FY1998 audit (see page 57 of the draft report), which also calls for the development of methods to verify tenant/owner data upon which subsidy payments are based. The FY1998 recommendation has been correctly addressed to the Office of Housing, rather than the FMC.*
46.	Page 55, Rec. # 4.a.	*We believe that recommendation 4.a. is unnecessary. Configuration Management (CM) policies currently in HUD Departmental clearance enforce the practice of making emergency changes through the CM tool. Further, HUD's CM procedures are based on the intent of those CM policies.*
47.	Page 55, Rec. # 4.b.	We disagree. Developers are not allowed access to CMplus on production systems. The CMplus user id exists as the owner of the files and properties of the application system. On the development platform (SYS3), this user id is used by a developer for CMplus administration. On the production platforms (SYS1 and SYS2), the same user id is used by Production Control technicians to perform releases. The passwords are different on the two environments, so developers cannot use the user id on production. Releases must be made by the owner user id of the application, and loaded on the production system under that same user id. Developers are not allowed any access to the CMplus environment on the production systems, and have read-only access to the program libraries.
48.	Page 55, Rec. # 4.h.	Recommendation 4.h. recommends that the Office of Administration in coordination with the Chief Information Officer set up procedures to prevent general users from accessing the Novell operating system files (bindery).

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		However, page 41, 2nd paragraph states that this vulnerability was fixed soon after discovery. Further, the Office of Administration Deputy Assistant Secretary for Operations, which has oversight over field IT operations, agreed that one instance was found where the bindery was not protected from unauthorized access, and as stated in the report, this situation was addressed immediately when discovered. Additionally, procedures have been set up to prevent unwarranted access and adherence to the procedures is checked when Kane reports are run. Since actions have already been taken to correct this vulnerability, we are requesting that this recommendation be removed from the draft report.
49.	Page 56, Rec. # 5.a.	Recommendation 5.a. is addressed to OCIO, Office of Administration, and Program Offices. We recommend that findings and recommendations should not be jointly assigned to multiple offices. We believe recommendations can and should be written in such a way that they are directed specifically to the office that has functional responsibility. In those rare instances where a recommendation cannot be specifically written and directed to a particular office, then the office that is considered to have the lead responsibility should be clearly identified.
50.	Page 56, Rec. # 5.a.	We believe that recommendation 5.a. should be changed to read: Develop a plan of actions and milestones for completing the appropriate background investigations of those system users (825 identified so far) who were granted above read access to HUD's critical and sensitive systems without submitting required proper background investigation forms.
51.	Page 56, Rec. # 5.c.	We disagree with this recommendation for the following reasons: Access to mission critical systems is approved by Program Area Management, not the OCIO. The OCIO is responsible for providing credentials (user id and password) to general support systems (GSS) (i.e. WAN, LAN, or mainframe). User access to a GSS does not imply the user will have greater-than-read access to a mission critical system. OMB Circular A-130 makes it clear that security staff should not authorize processing of a system. It is the responsibility of the appropriate program official to authorize access. Subsequently, OCIO security is not responsible for approving access to a mission critical system. We grant credentials that authenticate users to a general support system. Specific access permission (create, read, update, delete) is performed by a program area's System Security Administrator. Further, the Office of Administration is responsible for controlling personnel social security numbers (SSNs). We believe that any transferring of SSNs should come from Administration, and not OCIO. Any reconciling of user access should

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		come from the program offices and be reconciled with the Security Control and Tracking System (SCATS). SCATS is the authority for keeping track of those persons who have background investigations, not OCIO.
52.	Pg. 57, Rec. # 2.a.	OCFO has tasked a contractor to do the following, related to compliance with SFFAS4: Review key business objectives and related performance measures. Gather G/L costs for major programs. Identify preliminary candidates for activity-based costing (ABC). Review allocation feasibility and quantify benefits of ABC. Make recommendations for programs and activities for which the cost of ABC could be justified. OCFO will use the results of the study as we make plans to enhance or replace the Departmental general ledger.
53.	Pg. 58, Rec. # 1.a.	OCFO and FHA are working together to develop a monthly interface from the new FHA g/l to HUDCAPS. The new FHA G/L is to be implemented in October 2002, and we expect the interface to begin after that. OCFO has requested this recommendation be closed out. We believe agreed upon actions are complete, and request this recommendation be deleted from the final report.
54.	Pg. 58, Rec. # 1.d.	OCFO requested this recommendation be closed on 2/16/01. OIG declined to close the recommendation prior to testing in the 2001 audit. The draft report on internal controls and compliance states that controls over reconciliation of fund balances with Treasury is no longer a reportable condition. We request this recommendation be deleted from the final report.
55.	Pg. 58, Rec. # 1.f.	OCFO requested this recommendation be closed on 8/28/01. It was not listed on the 10/23/01 Consolidated Financial Audit Recommendation Status Report distributed to the OIG by the ACFO/FM, which would indicate the item was closed. We request this recommendation be deleted from the final report.
56.	Page 58, Rec. # 3.a.	This recommendation shows a target date of 3/31/01, which needs to be revised. According to our information, a request had been made to revise the date to 9/30/02. The recommendation is also repeated, in part, by the new recommendation 2.e. Consequently, we will be managing this process as part of the CMI function and the PBCA roll out, which had 10,050 projects with HAP contracts under their review at 12/21/02.

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57.	Pg. 59, Rec. # 10.a.	Final Action Certification for this recommendation was completed in January, 2001. This was not listed on the 10/23/01 Consolidated Financial Audit Recommendation Status Report distributed to OIG by the ACFO/FM, which would indicate the item was closed. We request this recommendation be deleted from the final report.
58.	Page 60, Rec. # 1.a. & 1.b.	We request that these recommendations be removed from the final report, or reported as closed, based on completed plans acknowledged by the OIG on pages 21 and 34 of the draft report. The Rental Housing Integrity Improvement Project (RHIIP) plan was established, in part, to address both of these recommendations. The Assistant Secretaries for Housing and Public and Indian Housing are responsible for carrying-out the plans. The plans have been incorporated into the goals for erroneous payment reduction under the President's Management Agenda, and the Deputy Secretary will track progress through his monthly Executive Management Meeting with Principal Staff. We are closing these recommendations in the Departmental Automated Audits Management System.
59.	Page 60, Rec. # 1.g.	An official response via the audit follow up process will be prepared, but please be advised that the actual system to be employed will be the Integrated Assessment Sub-System (NASS). This is a shared system. Risk-rankings developed by NASS will be shared in REMS.
60.	Page 61, Rec. # 2.a.	While this is addressed to the FMC, Multifamily Housing has been meeting with FMC to provide an official updated response through the audit follow-up process.
61.	Page 61, Rec. # 3.k.	Recommendation 3.k. states that the final action target date is January 31, 2002. The final action target date for this recommendation has been revised to April 15, 2002.

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OIG EVALUATION OF AGENCY COMMENTS

This appendix provides our comments on Attachment No. 1 to the Department's February 14, 2002 Response to the Draft Report on Internal Control and Compliance. Our individual comments correspond to the Department's numbered comments included in Attachment No. 1 to their response.

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1	We agree that the FHA project team has been updating its planning documents (initiate and define phase of the project) for the FHA general ledger project; however, no progress has been made since last year in initiating the design and development of the project. As a result, the reported long-standing deficiencies still remain.
2	The objective of the last development contract for DGMS was to provide for a functional grant system for the processes to be performed by the grantees. The grantees will provide the primary input for grant transactions and accounting. However, the contract was terminated without completing the work. We understand that a prototype of the system was presented at a demonstration hosted by the contractor. We did not evaluate the prototype's functionality therefore; we are unable to determine the future usefulness of the prototype. We disagree with management's comment that the DGMS team derived a detailed functional requirements (FRD) document. We found that the FRD, which served as a significant portion of the contract's scope of work, lacked sufficient identification and details on the associated business rules. This inadequacy was one of the main legal contentions between the Department and the contractor and contributed to the termination of the contract.
3	See our comments under No. 37 and 39.
4	We have modified the report to recognize the OCFO's efforts to improve the quality of LAS data.
5	The report was revised to reflect the changes indicated.
6	The report was revised to reflect the changes indicated.
7	The report was revised to reflect the changes indicated.
8	The conclusion that performance of HAs decreased was based on risk assessment information from the PIC's National Risk Assessment System and performance data from the SEMAP and PHAS systems. In the risk assessments we evaluated for fiscal year 2001 monitoring activities, there were 179 HAs rated as having a high performance risk, many of which were tenant-based Section 8 programs that had been rated at maximum risk. During the year, HA performance was assessed under PHAS. In addition, PIH field offices began implementing PIH Notice 2001-6, which is an annual assessment of program performance as required under the Section 8 Management Assessment Program (SEMAP) regulations (24 CFR 985.105). As new SEMAP and PHAS performance assessments were completed, the performance scores were reflected in SEMAP and PHAS, and subsequently, in the National Risk Assessment system in the quarterly risk assessment scores. At the end of the fiscal

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	year, the quarterly assessments from the National Risk Assessment system show that there was an increase of 36 HAs rated as high risk, which was mainly due to the Section 8 assessments completed during the year.
9	The report was revised to reflect that HUD had drafted a new *Public Housing Occupancy Handbook.*
10	The statement was made based on the notice that responded to a field office's questions on the PIC's Events Tracking System. The notice indicated that the system was in the midst of major retooling and enhancements pending approved funding, and that the current system was recognized to be complex and cumbersome and field offices were encouraged to use their individual tracking systems as an acceptable alternative until the system gets into a more workable environment. It also indicated that PIC in general had difficulties in full implementation due to various hardware design application and funding issues and it would not be prudent or fair to require field offices to input information into a data system that is not fully functioning, but encouraged the field offices to use the Events Tracking System to the extent practical.
11	The report was revised to indicate that HUD issued advisory resident services and satisfaction indicator scores in addition to the physical and financial indicators.
12	The report was revised to indicate that the PIH Memorandum, *Interim Guidance for PHAS Scores for 6/30/00 PHAs and MASS Scores of Less Than 60% for FYEs 9/30/99, 12/31/99 and 3/31/00,* dated January 16, 2001, provides interim guidance for PHAS Scores. The memorandum requires the FOs to provide targeted technical assistance to HAs to address problem areas identified by the relevant PHAS indicator(s) score of less than 60 percent. A technical assistance strategy via a Corrective Action Plan should be implemented for all deficiencies. The FO should ensure that the PHA addresses its PHAS deficiencies in the PHA Plan. PHAs with a MASS score less than 60% will be designated troubled and referred to the TARC.
13	The statement was made because the PHAS scores were advisory and if they would not have been advisory, those HAs with failing financial and physical scores would also have been designated as troubled and transferred to the TARCs as required.
14	The comments were considered. The statement that our prior year's testing of IA's audits was made to indicate that there has been a problem on relying on IA audit reports for several years, and evidence found during the current year indicates that IA audit reports still cannot be relied upon. The information regarding the QAR reviews was provided by the REAC and data presented is the IA audit data for the HAs with low income and tenant based Section 8 programs. The data indicated that five IAs were confirmed to have severe findings of non-compliance, while another nine IAs were identified as having severe findings of non-compliance but not confirmed awaiting a response from the IAs. The statement regarding the use of the IA report results in the on-site monitoring activities was based on the field office's response regarding use of the IA reports.
15	The requested changes were considered, but the current staffing plan was not evaluated during the audit and therefore, no comment can be made on the TARCs capability to manage

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	150 HAs.
16	The report was revised to indicate the HUD's updated plans. Specifically, the RHIIP Advisory Group originally developed a 10-part strategy that the Offices of PIH and Housing compressed into 8 tasks for implementation. These tasks include: (1) program simplification through statutory, regulatory and administrative reform, (2) increasing tenant income data sharing for use in rent determinations, (3) developing automated tools for rent calculation and subsidy payment validation, (4) completing a periodic error measurement assessment, (5) establishing an on-going quality assurance program, (6) providing more effective incentives and sanctions for HAs and tenants, (7) updating guidance to reflect current program requirements and processes, and (8) initiating training on program requirements or HAs, tenants and HUD staff .
17	Our audit approach was designed in consideration of multifamily overall approach to asset and risk management (as stated on page 23 of the draft). It was designed to meet the needs of both the HUD and FHA financial statement audits, and was carried out in conjunction with KPMG. Because HUD's financial statements include all FHA activity as well, it is appropriate to consider and report all aspects of the risk of misstatement, including the potential combined effect of two or more individually less significant risks. KPMG's audit did indeed identify "conditions associated with internal controls over the monitoring of the insured multifamily projects." These conditions were reported to multifamily management in written Notifications of Findings and Recommendations presented at the conclusion of the HUB site visits and were discussed with multifamily management at the DAS briefing in December 2001. The results of the internal control testing is fairly presented in the report and allows the reader to draw his or her own conclusion(s) as to whether the rate at which multifamily accomplishes follow-up on problems it has identified through the application of its tools is adequate.
18	Although the Multifamily monitoring process is working, our audit results indicate that improvements still need to be made. We hope that the full deployment of PBCA resources and other monitoring tools will improve Multifamily's follow-up actions next year.
19	The report was revised to reflect the changes indicated
20	We did not revise the report since the PBCA initiative was already addressed in comment No. 6.
21	According to data available in REMS, only 51% of projects with active rental assistance contracts as of September 30, 2001, has been reviewed over the last three years, not 70% as claimed. About two-thirds of these reviews were accomplished by PBCAs who are required to review each project every year. Since a majority of these projects will be re-reviewed in FY 2002, the overall rate will not climb much above the 51% unless HUD makes significant progress in placing more rental assistance contracts under PBCAs or HUD increases the

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	number of projects it reviews. We acknowledge HUD's plans for various improvements in internal controls that are to take place some time in the future; however, they did not operate during FY 2001 and had no bearing on the adequacy or effectiveness of controls for the year under audit.
22	We omitted the comment from the report about HUD's risk reporting system.
23	Since FMC officials are confused about OIG's use of the word review in relation to OMHAR and believe OIG wrongly indicated OMHAR was part of a delay, we removed the sentence dealing with OMHAR from the report. The sentence only added background information and was not necessary to understanding the finding.
24	The draft does not misconstrue FMC's review process. The draft deals with the review (prepayment) steps that are in place as a control to eliminate overpayment of monthly subsidy amounts to owners. FMC's comments address the review (prepayment) steps they do as a control to eliminate owners billing for more or the wrong sized units. We agree the prepayment review is an important control; however, the results of this and past audits do not indicate that owners billing for the wrong unit size or unit mix is a significant problem. None of the vouchers we tested, or FMC reviews we analyzed, identified that owners had attempted to bill for the wrong unit size, unit mix, or more units than were in the HAP contract. The focus of the draft report is on tenant data provided to Housing by the owner electronically and by hard copy voucher. We continue to maintain that the comparison of tenant data submitted by owners electronically to tenant data submitted by owners in hard copy are of limited value because they do not result in gaining knowledge of the accuracy of the payments. The reviews only reveal whether the owner has successfully self-reported the same two sets of tenant data for the given month of the voucher and HAP payment. We also believe a greater use of post payment reviews is needed. The report does not characterize the reviews as trivial or unproductive. The report only shows that the extent of the post payment and prepayment reviews are 1 and 2 percent, respectively of the total universe of vouchers.
25	We agree the wording identified in this comment could confuse readers and have edited two sentences in the paragraph to clarify the report.
26	The report was revised to indicate that HUD performed the verification of subsidy payments.
27	The requested editorial changes were considered. The statements were made based on the evidence gathered during the audit.
28	Management's comments were considered and our statement addresses management decision to exploring large-scale match as an option.
29	The requested change was considered and changed to: HUD also plans to upgrade the capability of MTCS to (1) provide for the collection of rent calculation information and (2) bring the rent calculation information directly into PIC**.**
30	The report states "HUD has made considerable stride to improve CM during FY2001." This is a fair and accurate portrayal of CM implementation. With respect to PVCS

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	implementation for client/server applications, the claim that HUD is following industry standard practices, while commendable, does not address the reported deficiency. We found no evidence to indicate that HUD verified the accuracy and quality of PVCS implementation. Also, during the audit HUD was unable to produce a listing from the PVCS server indicating that all of the software modules for a particular application were placed under the control of PVCS.
31	We cannot confirm the assertion that action had been taken to reduce or remove access of 247 users and that by February 15, 2002, 578 outstanding user accounts should have appropriate background investigation forms in OHR. During the review process, we attempted to obtain updated information to verify the actions taken by the Department to reduce the backlog. We requested this information numerous times during weekly status meetings hosted by the OCFO; no information has been received.
32	We revised the report to reflect HUD's periodic review of obligation balances.
33	We revised the report to include additional information to further explain system weaknesses that are hampering the Office of Housing's effort to evaluate unliquidated obligation balances.
34	In FHA's Fiscal Year 2000 audit report, KPMG credited the Department for it's efforts to enhance controls over budget execution and funds control. However, in fiscal year 2001, KPMG noted significant control issues that need to be addressed. For example FHA still does not have a collection of ADP financial systems and processes that are fully capable of monitoring and controlling budgetary resources. In addition, in fiscal year 2001 FHA determined that it had violated the Anti-Deficiency Act due to inappropriate funding allocations made in fiscal year 2000.
35	The report was revised to reflect the changes indicated.
36	We revised this section of the report to disclose the Congressional request for a review of the funding for the Office of Multifamily Housing Assistance Restructuring (OMHAR) technical assistance grants as "Other Matters Under Review."
37	We disagree. Our recommendation includes a prerequisite cost-benefit analysis to determine the most cost effective method to meet the JFMIP requirements. We disagree with your statements that any additional recording of transactions for grantee advances and accruing un-reimbursed grantee expenditures (accounts payable) has a "wash" effect on the financial statements. Currently, the Department is not recording either advances or accrued accounts payable amounts. As a result, both of these accounts are understated. Furthermore, generally accepted accounting principles do not permit the netting or offsetting of these two account balances. Failure to officially account for these financial transactions hinders control over assets as well as limits the amount of information available for management decisions. For example, the failure to maintain grantee advance balances results in loss control over these assets. Regarding the issue of unrecorded accounts payable, the failure to accrue and record these

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	amounts limits information available to the Department for cash planning and budget purposes. During a CFO briefing, we presented information regarding another agency's method for complying with the JFMIP grants issue. We were informed that the agency was complying with the JFMIP in recognizing and recording grantee advances and in the accrual and recording of the un-reimbursed grantee expenditures applicable to those advances. However, the agency was not accruing and recording the remaining un-reimbursed grantee expenditures. Although that agency was not in full compliance, we do not believe that this provides any justification for the Department to avoid complying with the JFMIP. It is important for the Department to recognize and record these unrecorded liabilities and assets.
38	The CFO agrees with our recommendation.
39	We disagree with the Department's request to remove this recommendation. Although management does not disagree with the requirement to perform financial reporting directly from its consolidated general ledger (HUDCAPS), HUD does not believe this is possible until the new FHA general ledger system is implemented. The system is expected to be ready for parallel testing in September 2002. The Department admits that the necessary crosswalks have not been developed in Hyperion to report transferred account balances (from its manual interface) by the required financial reporting attributes. The Department is also concerned that it cannot timely record last-minute FHA and GNMA adjusting entries and include those entries in its manual interface process. We believe that the Department should strive to implement this recommendation in the interim. There is no guarantee that the FHA general ledger system will be implemented on time. As time proceeds, any un-reconciled differences may continue to grow between the FHA and GNMA statement balances and the account balances transferred to HUDCAPS. In addition, OMB Bulletin No. 01-09 requires federal agencies to provide OMB and Congress with un-audited semiannual financial statements in FY 2002 and quarterly statements in FY 2003. In order to meet these requirements, HUD should improve and rely on its consolidated general ledger system, HUDCAPS, and Hyperion to automatically produce these statements.
40	The recommendation was revised to distinguish it from previous recommendations, which addresses the selection of HAs for monitoring. HUD developed the risk assessment procedures to effectively focus limited field office resources. The risk assessment process relies heavily on an assessment of HA performance, funding and compliance and identifies a level of risk associated with that performance, funding and compliance. This recommendation is addressing the development of summary reports that identify the factors upon which the risk assessments are based. The availability of the information through a series of screens is an inefficient and time-consuming approach in a system that is already recognized to be complex and cumbersome. This drill down approach places additional burdens on limited field office resources that could be better devoted to improving HA performance. Identifying these factors provides field offices an efficient means of targeting their monitoring activities to improve problems areas. The recommendation previously made was to ensure the field office's selection of HAs for increased monitoring was primarily based on whether an HA performance improved from previous years, something that is not

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	always done when high risk HA are not selected for on-site or increased monitoring.
41	The recommendation addresses having field office staff use the PIC system in their monitoring activities rather than channeling information though one person assigned PIC duties. The recommendation from last year's report addresses developing the capabilities in the PIC system to track REAC inspection results and IA report recommendations.
42	The request was considered and changes made accordingly. The recommendation, although similar to the recommendation last year, expands the responsibility of the field offices to ensure submission through the use of technical assistance to under performing HAs.
43	The request was considered and changes made accordingly. The recommendation, although similar to the recommendation last year, expands the responsibility of the field offices to ensure submission through the use of technical assistance to under performing HAs.
44	The request was considered and changes made accordingly.
45	Recommendation 3.a. has been redirected to Housing. We do not agree that it should be deleted. We believe the recommendation is needed to provide extra emphasis on a situation for which corrective action has been continually delayed.
46	Emergency changes are not included in HUD CM policies. HUD CM procedures do not have the follow-up after emergency changes. Section 5 of HUD CM procedures for the specific platforms provided emergency procedures for PVCS, but not Endevor or CMPlus.
47	Based on the comments and further evaluation, we have substantially revised the finding related to CM for the UNISYS applications. We have replaced the segregation of duties concerns with a concern regarding the sharing of the application "owner" ids and passwords.
48	Recommendation 4.h is still necessary. Novell servers provide HUD users the necessary connectivity to HUD's critical financial systems such as HUDCAPS, LOCCS, and PAS. An open Novell bindery would allow a knowledgeable user to gain full control over the server, which could then be used to gain unauthorized access to HUD's critical financial systems. While we commend the Department for immediately closing the bindery (operating system files) found open on a Novell server, the concern that the bindery was open still exists. In addition, we cannot determine how long the bindery was open. In addition, there may be other Novell servers with open binderies. However, based on the comments, we modified recommendation 4h to focus on using KANE to determine whether there are other Novell servers with open binderies and ensure the binderies are protected from unauthorized access.
49	We do not agree with the Department's contention that Recommendation 5.a should be directed to each individual office. As you described, the problem with the backlog of clearances for system users is that the problem affects more than one office. As you suggested, we are recommending the OCIO take the lead because it is responsible for providing policy, guidance, and oversight for information security as stated in HUD Handbook 2400.24 REV-2, Section 4-4. The OCIO should develop a plan of actions and milestones and coordinate with Program Offices and Office of Administration, to resolve the backlog of background investigations.

Comment Number	OIG Evaluation
50	We have revised the recommendation as requested.
51	The Department's comments did not address the intent of Recommendation 5.c. We agree that the program offices and the Office of Administration are primarily responsible for the reconciliation process. However, we believe the OCIO is an integral part of this process. The submission of the quarterly list provides a periodic and independent verification of the users and is commensurate with the OCIO information security oversight responsibilities for the Department. As we explained in our report, HUD Handbook 732.3 Personnel Security/Suitability instructs the CIO to provide the Office of Administration a list of users who require above read access to HUD's critical and sensitive systems within three (3) working days following the end of each quarter. This list is to be used by the Office of Administration Personnel Security Staff to perform a reconciliation of the personnel security (SCATS) database to ensure that all users of critical/sensitive systems have the appropriate Background Investigation. The Office of Administration (OA) maintains users' Social Security Numbers (SSNs) as the key identifier in their personnel security (SCATS) database. Accordingly, the OCIO needs to use the SSN as the key identifier of all of the users with above read access in the quarterly list so that it can be easily reconciled by the OA to the SCATS database. Therefore, the recommendation remains valid.
52	We have noted your comments.
53	Recommendation 1.a from the fiscal year 1999 Financial Statement Audit must remain open. The CFO anticipates that implementation of this recommendation (a monthly interface between the FHA general ledger and the consolidated general ledger) will be completed by October 2002 at the earliest. Consequently, this recommendation cannot be closed until the planned or final action is completed.
54	We issued a memorandum dated February 20, 2001, concurring with your request to close recommendation 1.d. from the fiscal year 1999 audit report. We will delete this recommendation from our report.
55	We verified that recommendation 1.f. was closed in DAAMS, effective August 30, 2001. We will delete this recommendation from our report.
56	We received and approved your request to extend the target dates for recommendations 3.a in the fiscal year 1998 and 3.a in the fiscal year 1999 audit reports. The target dates for both recommendations have been revised to September 30, 2002. We have revised the report accordingly.
57	We verified that recommendation 10.a. was closed in DAAMS, effective February 5, 2001. We will delete this recommendation from our report.
58	We have considered your request that recommendations 1.a. and 1.b. from Report Number 01-FO-0003 be removed from the final report, or reported as closed. The RHIIP Monthly Status Report dated February 19, 2001, satisfies recommendations 1.a and 1.b. We will close these recommendations in the Departmental Automated Audits Management System, and will monitor the progress being made on achieving the objectives of the plan.

Comment Number	OIG Evaluation
59	We request that comments provided here about the systems be included in the official response via the audit follow up process.
60	The Department’s comments are noted.
61	We verified that the final action target date had been changed to April 15, 2002 in DAAMS. We will revise our report accordingly.

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