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

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

SUBJECT: Audit of the Federal Housing Administration's Financial Statements for Fiscal Years 2002 and 2001

This report presents the results of KPMG LLP's (KPMG) audit of the Federal Housing Administration's (FHA) financial statements for the years ended September 30, 2002 and 2001. In KPMG's opinion, the financial statements present fairly, in all material respects, the financial position of FHA as of September 30, 2002 and 2001, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations, for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

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

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

Audit Scope and OMB Audit Requirements

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

- expanding the review of FHA's internal controls,
- reviewing the design of FHA's internal controls over key performance measures reported in the MD&A, and
- reporting under the Federal Financial Management Improvement Act (FFMIA) of 1996.

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

Results of KPMG's Audit

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

OIG Discussion of the Audit Results

FHA management generally agreed with most of KPMG's findings and recommendations. They disagreed with KPMG's determination described in Material Weakness No. 2, *Controls Over Budget Execution and Funds Control must be Improved.* Management believes the deficiencies described can be resolved primarily through the enhancements to the ADP systems environment discussed under the first material weakness and by implementing other compensating controls. KPMG's assessment was to recognize the establishment of compensating controls that are detective in nature. However, KPMG sees the need for implementing preventative controls, as part of an overall system of internal controls, in order to reduce to a relatively low level the risk that funds may be over-obligated. KPMG believes that the budget execution process risks identified in this material weakness could continue to exist even if FHA implements an integrated system in response to the first material weakness.

Recommendations and Follow-up on Prior Audits

In audit reports on FHA's prior years' financial statements, various recommendations were made to address FHA's internal control weaknesses. While FHA has taken certain actions to address these recommendations, corrective actions were incomplete. In accordance with the department's Audits Management System, we will continue to track the resolution of these prior years' audit recommendations. KPMG's recommendations from their fiscal year 2002 audit cover several of the same issues described in prior audits. FHA's management should review all outstanding recommendations and determine a course of corrective action that responds to the current status of all open findings.

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

Comments of FHA Officials

We provided a draft of KPMG's report to FHA officials for their review and comment. FHA's full response is included as Appendix B of KPMG's report. KPMG's assessment of FHA's response is contained in Appendix C.

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

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Table of Contents

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KPMG

2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report

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

To the Federal Housing Administration:

We have audited the accompanying consolidated balance sheets of the Federal Housing Administration (FHA) as of September 30, 2002 and 2001 and the related consolidated statements of net cost, changes in net position and financing, and combined statements of budgetary resources for the years then ended (hereinafter collectively referred to as consolidated financial statements). FHA is a wholly owned government corporation within the U.S. Department of Housing and Urban Development (HUD). The objective of our audits was to express an opinion on the fair presentation of these consolidated financial statements. In connection with our audits, we also considered FHA's internal control over financial reporting and tested FHA's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its consolidated financial statements.

SUMMARY

As stated in our opinion on the consolidated financial statements, we concluded that FHA's consolidated financial statements as of and for the years ended September 30, 2002 and 2001 are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

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

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

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

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

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

OPINION ON THE CONSOLIDATED FINANCIAL STATEMENTS

We have audited the accompanying consolidated balance sheets of FHA as of September 30, 2002 and 2001, and the related consolidated statements of net cost, changes in net position and financing, and combined statements of budgetary resources for the years then ended.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of FHA as of September 30, 2002 and 2001, and its net costs, changes in net position, reconciliation of net costs to budgetary obligations, and budgetary resources for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The information in the Required Supplementary Information section is not a required part of the consolidated financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America or OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information, and accordingly, we express no opinion on it.

INTERNAL CONTROL OVER FINANCIAL REPORTING

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

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

In our fiscal year 2002 audit, we noted certain matters, summarized below and more fully described in appendix A, involving internal control over financial reporting and its operation that we consider to be reportable conditions. The full text of management's response is included as appendix B. Our assessment of management's response is included in appendix C.

We believe the following two reportable conditions are material weaknesses:

- **HUD/FHA's ADP system environment must be enhanced to more effectively support FHA's business processes.** HUD/FHA continues to conduct day-to-day business with legacy-based systems. Several of these systems directly impact FHA's financial activity and result in financial transactions being processed through nonintegrated systems that require manual analysis to prepare summary entries for posting to FHA's general ledger. In addition, HUD/FHA's challenges in updating its ADP system environment adversely affect the internal controls related to accounting and reporting financial activities. For example, FHA uses 19 automated systems to process accounting data, which is then consolidated into the FHA general ledger not only through select system interfaces, but also through many manual data transfers and manual entry of journal vouchers. This issue has been reported for several years, and FHA is in the process of implementing corrective actions to address this situation. However, until corrective actions are made, FHA's control structure will rely on management oversight of the manual procedures.

- **Controls over budget execution and funds control must be improved.** As reported in prior audits, FHA's ADP financial systems, collectively, are not capable of fully monitoring and controlling budgetary resources in an integrated manner. Management reviews funds availability and oversees these processes in an attempt to compensate for the resulting weaknesses. In addition, FHA uses manual analysis and reconciliation to collect and summarize funds control information. Although these manual procedures assist FHA management to control the budget execution process, we believe the controls do not reduce the risk of material misstatement to a relatively low level. For example, FHA manually compiles the status of budgetary resources to prepare the SF-133, *Report on Budget Execution*, based on data gathered from at least eight systems. In addition, there continues to be a significant number of manual budgetary entries input into the general ledger, which undermines FHA's ability to monitor the status of budgetary resources on a real-time basis.

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

- **HUD/FHA can more effectively manage controls over the FHA ADP systems portfolio.** During fiscal year 2002, FHA has taken steps to enhance its ADP systems control environment, including enhancing segregation-of-duty controls for the Real Estate Management System (REMS) and enhancing access controls for FHA Connection. However, improvements are still needed in the area of ADP application security, system support, and preparation and maintenance of systems documentation.

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

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

- **FHA must improve the controls over the credit subsidy adjustment process.** FHA needs to enhance its internal control over the credit program loss estimate process to ensure that changes to the loss estimation models' methodologies and assumptions are properly reviewed and approved.

We also noted other matters involving internal control over financial reporting and its operation that we have reported to management of FHA in a separate letter dated January 10, 2003.

COMPLIANCE WITH LAWS AND REGULATIONS

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

There are matters currently under investigation or which have been reported by the Office of the Inspector General or the General Accounting Office, however, the ultimate resolution of these matters cannot presently be determined.

RESPONSIBILITIES

Management's Responsibilities

The Chief Financial Officers (CFO) Act of 1994 requires federal agencies to report annually to Congress on its financial status and any other information needed to fairly present the agencies' financial position and results of operations. To meet the CFO Act reporting requirements, FHA prepares annual consolidated financial statements, since FHA is a wholly owned government corporation within HUD.

Management is responsible for:

- Preparing the financial statements in conformity with accounting principles generally accepted in the United States of America;
- Establishing and maintaining internal controls over financial reporting and preparing the Management's Discussion and Analysis (including the performance measures), and required supplementary information; and
- Complying with laws and regulations.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies. Because of inherent limitations in internal control, misstatements due to error or fraud may nevertheless occur and not be detected.

Auditors' Responsibilities

Our responsibility is to express an opinion on the fiscal years 2002 and 2001 consolidated financial statements of FHA, based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* and OMB Bulletin No. 01-02. Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit includes:

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

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

In planning and performing our fiscal year 2002 audit, we considered FHA's internal control over financial reporting by obtaining an understanding of FHA's internal control, determining whether internal controls had been placed into operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our audit was not to provide assurance on internal controls over financial reporting. Consequently, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether FHA's fiscal year 2002 consolidated financial statements are free of material misstatement, we performed tests of FHA's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 01-02. Additionally, our audit procedures were not designed to test the requirements of OMB Bulletin No. 01-02 relating to the Federal Financial Management Improvement Act (FFMIA) of 1996, which were not considered applicable at the FHA level. FFMIA requirements will be reviewed and reported at the HUD consolidated level. We limited our tests of compliance to the provisions described above, and we did not test compliance with all laws and regulations applicable to FHA. Providing an opinion on compliance with laws and regulations was not an objective of our audit, and accordingly, we do not express such an opinion.

DISTRIBUTION

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

KPMG LLP

January 10, 2003

INTRODUCTION

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

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

The following section describes the material weaknesses and reportable conditions as of and for the year ended September 30, 2002 and our recommendations. FHA management's response and our assessment of that response are presented in appendices B and C, respectively.

MATERIAL WEAKNESSES

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

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

For many years, weaknesses in FHA's financial management system environment have been reported. FHA's challenges in acquiring more modern information technology has continued to deter FHA's efforts to be a more efficient and effective housing credit provider. FHA's challenges have included procurement delays for new systems, difficulties in linking to the HUD Enterprise Architecture, and budget constraints. Until the existing ADP systems and related interfaces are updated, especially those related to financial processing, FHA will continue to collect and report data inefficiently. For example, during fiscal year 2002 FHA continued to use 19 automated systems to process accounting data, which was then consolidated into the FHA legacy subsidiary ledger system (MSA-A56) not only through certain system interfaces, but also through many manual data transfers and the manual entry of journal vouchers. In addition, during fiscal year 2002 we again noted significant system control weaknesses with FHA's legacy subsidiary ledger system, resulting in the system being noncompliant with the Federal Financial Management Improvement Act of 1996 (FFMIA). FFMIA requires federal financial management systems and processes to comply with various federal system requirements, federal accounting standards, and the capability of the system to post transactions using the Standard General Ledger (SGL).

FHA is implementing a plan that has been in place for a few years to improve its financial systems processing environment. This plan, or "blueprint," includes steps to implement a new subsidiary ledger system and many new supporting automated interfaces with FHA operational systems. The new interfaces will be designed, in part, based on the results of FHA business process re-engineering efforts, some of which have already been completed. The first phase of the new subsidiary ledger system, which includes the completion of the new general ledger posting models, was implemented early in fiscal year 2003, whereby the legacy FHA general ledger system was replaced with a commercial off-the-shelf (COTS) subsidiary ledger system. The full implementation of the new subsidiary ledger system is scheduled for fiscal year 2007.

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

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

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

To compensate for the lack of system integration and the resulting weaknesses, FHA must perform manual reconciliations and exercise a significant level of management oversight of the manual data transfer procedures. When considering the manual processes, we do not believe that the internal controls over FHA's financial accounting and reporting processes reduce the risk of material misstatement to the consolidated financial statements to a reasonably low level.

Recommendations to address the above continue to include:

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

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

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

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

As described in *Building the Public Trust: A Report to Congress on FHA Management Reform*, dated January 2001, FHA noted that system and manual processes were placed into operation during fiscal year 2001 that improved the process for managing budgetary funds. For example, in prior years FHA began performing a reconciliation of the MFIS and the Credit Subsidy Control System (CSCS), FHA's Multifamily insurance in force system and credit subsidy and related obligations system, respectively. In addition, in fiscal year 2000 FHA developed a funds control database to compare certain expenditures to remaining budgetary authorities prior to disbursement. FHA also embarked on a project in fiscal year 2001 to design and document procedures related to funds control and produced a report titled *FHA Funds Control Project Interim Process Report*, dated August 27, 2001. In its continued effort to improve, FHA enhanced its status of budgetary resources and undelivered orders compilation process by performing the analysis monthly. In fiscal year 2002, FHA performed the analysis monthly within the subsidiary systems but did not perform monthly analyses of all budgetary systems on a comprehensive basis.

Despite these improvements, during fiscal year 2002 we continue to note significant budgetary execution internal control issues that need to be addressed. For example, FHA continues to lack ADP financial systems and processes that are capable of fully monitoring and controlling budgetary resources. Manual processes in place include:

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

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

- For the CCARS, SAMS, CSCS, and PAS/LOCCS, we noted that FHA performed only quarterly reconciliations of obligations incurred and apportionments to identify obligations and then in February performed monthly reconciliations. Cash disbursements from these systems are subject to varying levels of documented authorization. In addition, funds control functionality is lacking from SAMS.

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

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

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

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

In addition, the Joint Financial Management Improvement Program (JFMIP) *Core Financial System Requirements*, dated November 2001, requires agency core financial systems to support the budget execution process by:

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

- Providing the ability to manage and control prior year funds in the current year, including the capability to identify prior year and current year deobligations separately;

- Providing control features that ensure that the amounts reflected in the funds control structure agree with the related general ledger account balances at the end of each update cycle; and

- Verifying that funds distributed do not exceed the amount of funds available for allotment or suballotment at each distribution level.

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

Lack of efficient and automated integration among funds control systems requires the use of manual analysis and reconciliation and the use of additional databases to collect and summarize funds control information. Additional control risk is introduced into the process as a result of applying these manual procedures.

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

To compensate for the lack of funds control and the resulting weaknesses, and until the FHA completes the implementation of systems that do provide comprehensive funds control, FHA has performed manual reviews of funds availability and provided management oversight to the appropriation and obligating systems processes. In light of the relative weakness of these manual processes and oversight controls we believe there to be significant deficiencies in the design and operations of the financial accounting and reporting processes that increase the risk for material financial statement misstatements to occur.

Recommendations to address the above continue to include:

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

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

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

REPORTABLE CONDITIONS

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

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

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

During fiscal year 2002, in response to prior year audit issues, HUD/FHA took several actions to enhance ADP controls for its systems, including enhanced segregation of duty controls for the Real Estate Management System (REMS) and enhanced access controls for FHA Connection. However, improvements are still needed in the areas of application security controls, ADP system portfolio management, and systems documentation.

Application security controls. Certain information security controls need improvement to provide HUD/FHA with a more secure ADP systems environment. These issues primarily relate to the need for stronger application access controls. Examples of identified control weaknesses include:

- Underwriting Reporting System (URS), which is a vital system used by Single Family Homeownership Center (HOC) personnel and Post Endorsement Technical Review (PETR) contractors as a quality control to monitor the underwriting performance of lenders with direct endorsement authority. We noted significant access control weaknesses with the system. Effective access controls for URS are not only critical from the perspective of ensuring data integrity and processing security, but also from the perspective of complying with the Privacy Act of 1974. The Privacy Act requires federal agencies to implement sufficient safeguards to ensure the security and confidentiality of individual records, which is relevant for URS, as the system contains sensitive information, such as FHA borrower names and addresses and the results of lender reviews. Consequently, unauthorized access to URS could subject FHA to Privacy Act compliance issues. FHA anticipates enhancing URS controls based on the results of a Single Family business process re-engineering effort, completed during fiscal year 2002. However, the timeframes for the URS control improvements have not yet been established.

- CSCS, which is used to control the reservation and obligation of credit subsidies for Single Family and Multifamily mortgages, has information security weaknesses. We noted significant access control weaknesses with CSCS during 2002, which were also reported during the fiscal year 2001 audit, and according to FHA management, were not addressed due to funding constraints. Plans are in place to address several of these issues during fiscal year 2003 and also to incorporate full CSCS functionality into the new FHA subsidiary ledger system by December 2004.

- Application security controls for the Development Application Processing (DAP) system can be improved. FHA is aware of these weaknesses and has developed a procurement statement of work to have a DAP security assessment performed and to address existing security weaknesses. FHA plans to conduct these activities during fiscal year 2003.

- The DAP application security weaknesses are significant, as DAP is used as an automated underwriting application system that supports processing and tracking of HUD Multifamily Housing applications from preapplication through loan closing. DAP maintains sensitive data, such as borrower's tax identification number and related borrower personal information. In addition, according to the Multifamily Insured Portfolio schedule of the FHA September 2002 monthly report, there were 1,104 endorsements during fiscal year 2002 amounting to $6.5 billion.

- Application security controls for MFIC can be improved. FHA recognizes these weaknesses and has plans to migrate MFIC to a newer technology platform during fiscal year 2003 to add functionality and to improve application security controls.

Details on these weaknesses are too sensitive to be included in this report, and were provided to FHA management through our Notification of Finding and Recommendation process.

Establishing and maintaining effective application security controls is not only good business practice, but also mandated by the Computer Security Act of 1987, the Government Information Security Reform Act (GISRA), FFMIA, and several OMB policies (Circular A-127, *Financial Management Systems*, and Circular A-130, *Management of Federal Information Resources*). Collectively, these regulations and policies require that federal agencies develop and implement effective information security policies, procedures, and control techniques. We recognize that many FHA systems operate on HUD platforms, and therefore are subject to HUD-managed information security controls. Consequently, the identified information security control weaknesses should be addressed in a coordinated effort between HUD and FHA.

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

- URS, which is used for key aspects of Single Family lender monitoring, consists of separate databases at each of the four Single Family HOCs. During discussions with FHA management, it was noted that URS is considered a part of FHA's Computerized Homes Underwriting Management System (CHUMS) processing cycle. However, URS is not documented as part of the CHUMS security plan, is not integrated with CHUMS, lacks system change procedures and controls, and lacks sufficient access controls, as noted earlier in this report.

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

As part of the planned FHA subsidiary ledger project, FHA intends to perform a business process re-engineering effort, and one of the goals of this effort is to ensure ADP systems supporting key FHA financial and business processes are adequately supported and included in the HUD OCIO's enterprise architecture and ADP systems portfolio.

Systems documentation. During fiscal year 2002, several FHA systems, including CCARS, MFIS, FHA Connection, and MFIC lacked system documentation supporting current operations. This is important for HUD/FHA, not only to assist in the day-to-day operation and management of systems, but also because HUD outsources many ADP functions, and with planned system enhancements in the areas of financial processing (e.g., FHA subsidiary ledger), detailed documentation supporting current system processing will be critical. In addition, many HUD/FHA personnel knowledgeable about the HUD/FHA systems environment could be eligible for retirement in the near future, so having fully documented systems is a critical aspect of system continuity.

FHA recognizes the importance of the maintaining current systems documentation and early in fiscal year 2003 finalized updated systems documentation for FHA Connection and MFIS. In addition, during fiscal year 2002 FHA engaged a contractor to review the 34 FHA systems to assess the level of compliance with system documentation requirements set forth by OMB Circulars A-127 and A-130. By the end of fiscal year 2003, FHA plans to make a determination as to which systems will receive focus from a documentation perspective and, for those systems, services will be procured, if funds are available, to update the necessary documentation.

Recommendations to address the above include:

3.a. The Deputy Assistant Secretary for Single Family Housing, in coordination with the HUD OCIO, should ensure that application security controls are enhanced for URS to address the identified weaknesses.

3.b. The Deputy Assistant Secretary for Finance and Budget, in coordination with the HUD OCIO, should ensure that application security controls are enhanced for CSCS to address the identified weaknesses.

3.c. The Deputy Assistant Secretary for Multifamily Housing and the Deputy Assistant Secretary for Finance and Budget, in coordination with the HUD OCIO, should ensure that application security controls are enhanced for DAP and MFIC to address the identified weaknesses.

3.d. The Deputy Assistant Secretary for Single Family Housing, Multifamily Housing, and Finance and Budget, in coordination with the HUD OCIO, should ensure that as the FHA business process re-engineering effort is performed, key FHA systems and related functionality are given sufficient attention and considered for inclusion into HUD's enterprise architecture. FHA management and the HUD OCIO should also coordinate to ensure that URS and CSCS are considered during these efforts.

3.e. The Deputy Assistant Secretary for Finance and Budget, in coordination with other FHA management officials, should ensure that systems documentation efforts be improved for systems with outdated or incomplete documentation. In addition, as new systems are implemented, systems documentation should be completed.

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

FHA performs several interrelated processes which are conducted by headquarters and the HOCs to process, manage, and monitor the insurance portfolio and account for the related risk assumed by the Mutual Mortgage Insurance fund (MMI) and the General Insurance and Special Risk Insurance funds (GI/SRI). These processes include regulations that govern the acceptance of direct endorsement lenders to the FHA program as well as annual re-certification of participating lenders. To manage the pipeline of endorsements, the HOCs monitor the lenders through programs that track early warning indicators of substandard underwriting practices by the lenders. Both headquarters and the HOCs conduct quality-assurance programs to determine the adequacy of contractor and lender performance. These processes are intended to ensure that poorly performing lenders are identified and timely corrective action is taken to properly identify and manage the credit risk of the portfolio.

Proper standards for acceptance of lenders to FHA programs and adherence to FHA underwriting standards are FHA's first line of protection against undue credit risk. Over 95% of FHA's Single Family endorsements are initiated by HUD-approved Direct Endorsement lenders. FHA relies on the quality of the underwriting performed by these Direct Endorsement lenders. To test the quality of the underwriting, contractors perform post-endorsement technical reviews (PETRs) on 7-10% of the endorsements, and the HOCs perform quality-assurance reviews (QARs) on 5-10% of the PETRs. The PETRs process rates each underwriter's ability to properly evaluate loan applications. The factors that are used in the evaluation are mortgage credit, valuation of property, and review of the loan closing package. Each of these factors are rated as either good, fair, or poor. The results of these reviews are captured by FHA in the URS for analysis and corrective action. We found that the effectiveness of these controls over loan underwriting should be improved as evidenced by:

- Based on our review of the lender approval process at headquarters, we identified 8 out of 30 sampled approved lenders for which the file did not contain certain required elements including quality-control plans for loan correspondents. There were also 2 out of 30 sampled lenders who did not meet the liquid asset threshold.

- Based on our review of the lender recertification process at headquarters, we identified recertified lenders for which the file did not contain certain required elements or the lender did not meet FHA requirements. One out of 30 sampled approved lenders did not meet the liquid asset threshold, and 4 out of 30 sampled approved lenders did not have an opinion or other form of assurance on internal controls.

- The results entered to the URS system for the portfolio as of April 30, 2002 showed that HOCs provided a rating of poor on a high percentage of endorsement case files regarding certain elements of the underwriting. The number of reviews performed from October 1, 2001 through April 30, 2002, and the percentage of those reviews that were rated as poor are as follows:

Exhibit 1

	Valuation/Underwriter		Mortgage Credit	
HOC	Number of Reviews	Percent that are Poor	Number of Reviews	Percent that are poor
Atlanta	5,567	30.82%	9,809	54.31%
Santa Ana	4,838	34.33%	13,131	93.17%
Philadelphia	7,313	34.47%	14,382	67.79%
Denver	1,029	10.11%	2,996	29.42%
Total	18,747	29.50%	40,318	63.44%

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

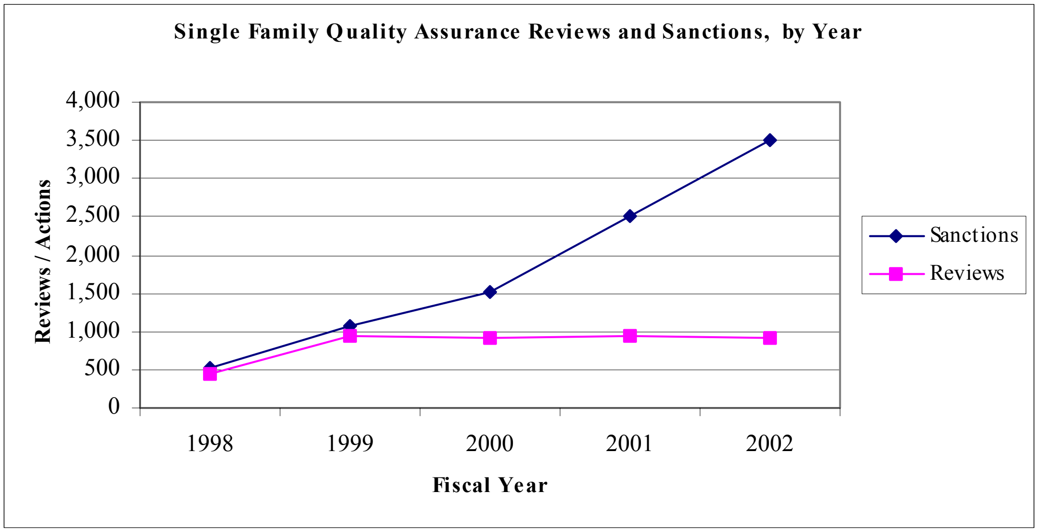
The lack of control effectiveness noted above is reflected in the percentage of loans rated as poor by the PETR process. OIG audit reports dating back to 1993, as well as our previous reports, have included concerns about the PETR process.

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

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

- **Single Family enforcement actions increased.** During fiscal year 2002, the four HOCs performed 916 lender-monitoring reviews. HUD has a variety of enforcement actions it can take with regard to lender violations. These include "Letters of Reprimand", "Settlement and Indemnification Agreements", and the "Suspension" or "Withdrawal of Mortgagee Approval". As shown in Exhibit 2, the total number of quality-assurance sanctions has steadily increased in recent years. These quality-assurance reviews resulted in approximately 3,500 corrective actions against lenders, including indemnifications and referrals to the Mortgagee Review Board, the Office of the Inspector General, and the Departmental Enforcement Center for further investigation or administrative sanctions.

Exhibit 2



Source: Single Family Quality Assurance Fiscal Year 2002 Activity Reported, as of September 30, 2002 (Quality Assurance Division)

- **Use of loss mitigation continues to expand.** The performance of the loss mitigation program has increased substantially in the past five fiscal years. In fiscal year 2002, through use of loss mitigation tools available to lenders, FHA has provided more than 60,000 borrowers an alternative to foreclosure. A lender-training program combined with increased monitoring of lender participation are the key drivers in the program's acceptance. In addition, FHA has developed an Accelerated Claims Disposition Program under Title VI, Section 601, of the Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriations Act of 1999, which was implemented in fiscal year 2003 for the purpose of expediting the claims disposition process.

- **Perform post-claim reviews.** On September 29, 2001, FHA awarded a contract for conducting post-claim reviews to a new contractor. The contractor is required to examine loss mitigation claims as well as full claims during its on-site reviews of mortgagees. In addition, broad oversight of lenders' compliance with loss mitigation requirements is mandatory under the servicing review contract. These reviews provide significant feedback to the lenders regarding their adherence to program requirements. During the period from December 2001 to September 2002, over 200 reviews were conducted, which included approximately 14,000 claims, and resulted in settlements of over $2 million.

- **Development and implementation of REAC's Lender Assessment Subsystem (LASS).** Starting in October 2001, LASS became available for lenders to use on a voluntary basis. LASS is a subsystem of the REAC that will automate and improve the process of capturing annual audited financial and program compliance data for FHA-approved nonsupervised lenders. Through this analysis, FHA will be able to identify potential problem lenders and take actions to ensure that these lenders do not cause increased losses to the insurance fund. The Final Uniform Financial Reporting Standards Rule (24 CFR Part 5) was published on August 15, 2002 and requires that FHA-approved lenders electronically submit their financial statement package required for annual lender recertification. The rule is effective for FHA-approved lenders with a fiscal year ending on or after September 30, 2002.

- **Appraisal reform.** In fiscal year 2002, HUD's Real Estate Assessment Center (REAC) implemented its Single Family Appraisal Subsystem (SASS), which uses specified indicators to statistically identify appraisals for review. FHA also increased its enforcement authority against poorly performing appraisers by employing the Single Family Appraiser Roster Removal Procedures and Appraisal Quality Assessment (AQA) system for appraisal field reviews. During fiscal year 2002, the HOCs began a risk-based approach to monitoring appraiser performance.

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

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

Recommendations to address the above continue to include:

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

4.b. The Deputy Assistant Secretary for Single Family Housing should continue implementation of more automated processes in the underwriting and endorsement process such as TOTAL scorecard.

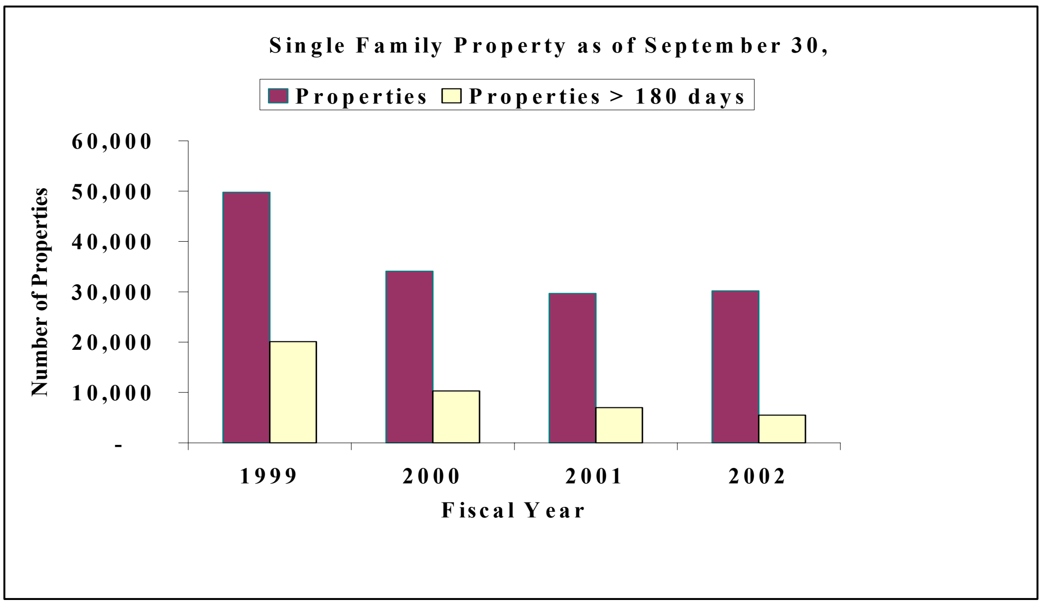
4.c. The Deputy Assistant Secretary for Single Family Housing should improve the performance of PETR contractors and provide more timely feedback to the lenders on the results of the PETR. The HOCs should increase their QARs and use the results of those reviews to provide specific feedback to the PETR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

5. FHA MUST SUFFICIENTLY MONITOR ITS SINGLE FAMILY PROPERTY INVENTORY

During fiscal year 2002, we continued to observe conditions relating to the Single Family property portfolio that need to be improved to maximize the return to FHA while preserving and protecting these properties. In addition, we noted that the portfolio statistics have remained constant in the current year as follows:

- FHA's Single Family property inventory increased slightly from 29,000 in fiscal year 2001 to 30,000 properties in fiscal year 2002, an increase of 3%, as shown in exhibit 3.
- The total net investment value was $2.6 billion at September 30, 2002 and 2001.
- Aged inventory over 180 days decreased from 7,000 properties in fiscal year 2001 to 5,500 properties in fiscal year 2002, a decrease of 21%, as shown in exhibit 3.

Exhibit 3



Source: Single Family Acquired Asset Management System

We found that the monitoring and performance of the Management and Marketing (M&M) contractors tasked with managing and selling properties continues to need improvement. The responsibilities associated with daily Single Family Secretary-owned property operations are performed by M&M contractors. The M&M contractors are responsible for the management, operations, repairs, maintenance, rental, and sale of Single Family properties.

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

We reviewed a sample of the monthly assessment reports and noted that the reporting of deficiencies in the M&M contractor monthly assessment report could be improved. The review of a sample of monthly assessment reports indicates that in 50% of the performance reports reviewed, there were significant deficiencies that were not identified in the report. In addition, in two of the three HOCs we visited, we noted there were no formal procedures in place to compare the case file review results generated by the HOCs to the contractor results for quality-control purposes. Without adequate monitoring of its M&M contractors, FHA's risk of loss related to REO properties increases. In addition, FHA may be unaware of the true physical condition of the REO properties held, causing management to use inappropriate recovery rate assumptions when estimating and reporting its liability for loan loss guarantees.

These procedures need to be strengthened to ensure that significant and recurring M&M contractor performance deficiencies (i.e., poor inspection, maintenance, and repair of REO properties) identified in prior audits and by third-party contract monitors are reported and more closely monitored and tracked.

Recommendations to address the above continue to include:

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

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

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

6. FHA MUST IMPROVE THE CONTROLS OVER THE CREDIT SUBSIDY ADJUSTMENT PROCESS

The potential future losses related to FHA's central business of providing mortgage insurance are reported in the financial statements as the Liabilities for Loan Guarantees (LLG) and the Loan Loss Reserve (LLR), as required by Statement of Federal Financial Accounting Standards (SFFAS) No. 2, *Accounting For Direct Loans and Loan Guarantees*. These liabilities are accounted for using both financing and liquidating accounts, respectively, in accordance with the Credit Reform Act of 1990. FHA management uses historical claim rates and other data to annually establish or refine assumptions about future loan performance in order to estimate future losses. These loss estimates are calculated using mathematical models that apply management's assumptions concerning future events to future net cash flows for post credit reform loan loss estimates or to loan balances for pre-credit reform loan loss estimates.

The Office of Evaluation, under the control of the Office of Finance and Budget, is the FHA department responsible for developing and maintaining the loss estimation model structure, developing the assumptions used in the models, and performing the loss estimation process.

Appropriate internal control over the loss estimate process must be present to ensure that the historical data used in the models is complete and accurate; that structural changes to the models' calculator and modifications made to key assumptions used to generate the loss estimates are properly documented; that all changes and modifications are adequately reviewed and approved by management; and that the resulting estimates are properly recorded and reported in the financial statements. Pursuant to the Federal Financial Accounting and Auditing Technical Release 3, *Preparing and Auditing Direct Loan and Loan Guarantee Subsidies Under the Federal Credit Reform Act*, issued July 31, 1999, Section III titled *Preparing Direct Loan and Loan Guarantee Subsidy Estimates*, under part B, the guidance states in part "Changes in key factors and assumptions used…must be explained, supported, and documented." Further the guidance continues later in part B to state that "Key assumptions…should be documented including the rationale, justification, and source of supporting documentation." The guidance requires that the agency maintain the appropriate supporting documentation for key assumptions and that management should ensure that the documentation is available. In regard to management approval, the guidance requires that management ensure that documentation regarding "the review and approval process…including the sign-off procedure within the agency" is available.

In accordance with the above guidance, documentation must be consistently maintained for reference and audit using a system that allows for quick information retrieval and requires evidence of management review. During our review of FHA's Single Family and Multifamily LLG and LLR estimation models and the related internal controls over its credit programs, we noted that all signatures evidencing management's formal approval of assumptions in the Single Family LLG and LLR and Multifamily LLR models had not been obtained. FHA performs many analyses and creates multiple scenarios as the LLG and the LLR estimates are developed. While we understand management held discussions to review and approve the assumptions and estimates used in the above referenced Single Family and Multifamily models, no documentation evidencing this discussion or formal approval of the models was prepared.

In addition, based on the Office of Management and Budget review, FHA changed the assumptions related to the '601' program and the loss mitigation program resulting in a net downward adjustment to the re-estimate in the amount of $473 million, thereby avoiding a discrepancy between the budget and the financial statements. In preparing estimates for financial statement purposes, the available historical data is preferred "to informed opinion, which may be used only as a last resort when relevant historical data and / or modeling capabilities are not available", pursuant to the guidance described above.

Recommendation to address the above include:

6.a. The Deputy Assistant Secretary for Finance and Budget should ensure that formal documentation evidencing management review and approval of assumptions and calculation methodologies is provided at the time FHA delivers the LLG and the LLR models. The Deputy Assistant Secretary should establish and implement further controls over the assumption and model review and approval process to ensure that formal evidence of management approval is adequate.

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

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

January 14, 2003

MEMORANDUM FOR: KPMG LLP

//signed//
FROM: Margaret A. Young, Deputy Assistant Secretary for Finance and Budget, HA

SUBJECT: Response to KPMG's Fiscal Year 2002 FHA Audit Report

Federal Housing Administration (FHA) management hereby presents our responses to your, January 10, 2003 audit report on the fiscal year 2002 FHA financial statements prepared in conformity with accounting principles generally accepted in the United States of America.

General Comments

We are pleased that KPMG has noted progress in many areas. While FHA recognizes that certain control weaknesses exist in its structure, due mostly to its outdated financial management system structure, FHA is taking aggressive actions to correct these weaknesses in the long term as well as to mitigate the negative effects during the short term. However, as noted in our response to the FY 2001 Audit, FHA continues to believe that while funds control remains a significant issue, the ultimate resolution of this problem, like that of the weaknesses in the financial systems, lies with the implementation of the FHA Subsidiary Ledger (SL) Project. Therefore, FHA does not agree that this issue should be presented as a separate material weakness.

During fiscal year 2002, FHA continued to concentrate its efforts on addressing management deficiencies and improving its overall business operations. While the report cites two material weaknesses and four reportable conditions, we appreciate the auditor's recognition that FHA has made progress in addressing these deficiencies and has demonstrated its ability to substantially mitigate their effects. Addressing these challenges will continue to be a priority as FHA strives to achieve its goal of becoming an even more high performing, results oriented organization that delivers quality products and services.

Report on Internal Controls – Material Weaknesses

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

FHA agrees with this finding and the associated recommendations.

FHA acknowledges the need for modernization of its financial systems and operations. FHA has made the development of integrated financial systems a high priority. On October 1, 2002, FHA implemented a new transaction-based general ledger, which represents a giant step in addressing this material weakness and ushers in a whole new era for FHA financial systems and reporting. FHA now has in place the core system around which all of its financial data will be integrated. Over the next four years, using a phased approach, FHA is planning to integrate its remaining 19 legacy systems into one comprehensive FHA Financial Reporting System.

FHA has long recognized the need to improve its financial management systems. FHA's initiative to integrate its financial systems is described in its *Blueprint for Financial Management Systems.* This initiative details the phased development of an integrated financial management system with intermediate milestones over the period to control scope and limit risks.

With regards to the second recommendation, iterative business process re-engineering (BPR) activities are required in the implementation of the FHA Subsidiary Ledger (SL) , and these BPR activities continue to identify opportunities to improve and automate FHA manual processes. FHA completed a BPR of all FHA manual business processes to identify the functions that must be present in the new FHA SL software. We revisited this BPR analysis again during fiscal year 2002 to prepare the initial operating procedures for the general ledger module. FHA will continue the analyses in the future with (1) a review of the initial operation of the general ledger to identify potential improvements, (2) a BPR of the Cash Control Accounting and Reporting System (CCARS), the Credit Subsidy Control System (CSCS), and the Funds Control Database (FCD) to facilitate integration into the core financial system, and (3) a planning review during Phase 3 (fiscal years 2004 - 2007).

FHA agrees with the need to ensure that the FHA SL is consistent with the HUD IT Enterprise Architecture and is working directly with the OCIO's Enterprise Architecture staff. In addition, the FHA SL project team is participating in FHA's ongoing architecture planning including the Single Family architecture planning relating to new underwriting systems and upgrades to the property management system.

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

FHA believes that both of the material weaknesses are interrelated and should not be separate. FHA agrees that funds control can and must be improved, and that is why the system actions recommended in the first material weakness are needed. The second material weakness is simply the result of the first weakness and not a separate weakness as KPMG has presented it. Therefore, neither material weakness can be corrected until implementation of the new FHA Subsidiary Ledger system is completed.

FHA recognizes that certain vulnerabilities exist in its funds control systems and has established compensating controls to monitor its funds. While the vulnerabilities that exist will be resolved with full implementation of the new financial system, FHA has developed, and will continue to enhance, compensating controls to address funds control.

FHA management is firmly committed to strengthening funds control procedures for its programs and has made progress during the past year. As a first step in integrating the FHA financial systems, including funds control mechanisms, FHA implemented the General Ledger Module of the FHA SL project on October 1, 2002. In addition, FHA is working with the Chief Financial Officer (CFO) in the Department's efforts to update the Departmental Funds Control Handbook and attendant processes.

By April 2004, FHA is planning to integrate into the FHA SL processes for controlling commitments and obligations of Multifamily and Single Family credit subsidy, replacing the CSCS, controlling disbursements of FHA funds and, replacing the interim Funds Control Database procedures. Also, where new business processes are developed as a part of the Department's revised Funds Control processes, FHA will integrate these into the operations of the FHA SL system.

The second recommendation requests that FHA consider implementing the functionality to account for "obligational activity" in the Funds Control Database. FHA concurs, in principle, with the recommendation. The funds control database does account for most activity on an obligation basis; however, the majority of FHA's disbursements (claims, property disposition) are obligated and disbursed simultaneously. Because of the nature of FHA's business, accounting for all obligations and matching disbursements against obligations, would be difficult and not cost effective. Given FHA's current operating processes and database constraints, the recommended modifications would require extensive changes in the business processes and costly system enhancements for short-term gain. Available resources are better used towards the implementation of the Funds Control Module into FHA's SL project.

Notwithstanding the preceding comments, FHA will explore additional interim options to improve funds control. For example, during fiscal year 2002, FHA began preparing monthly, as opposed to quarterly, management reports that reconcile obligations incurred with apportionment line items. These reports are used as a compensating control and by increasing the frequency of the reports; FHA is better able to ascertain spending patterns and request necessary apportionment action.

FHA also agrees with the third recommendation and is in the process of documenting the current allocation methodology used to obligate FHA's administrative contracts. A memorandum is issued at the beginning of each fiscal year informing FHA personnel involved in the procurement process of the most appropriate allocation of funds for the coming year. This distributes funding among the various sources available to FHA. Additionally, program officials are required to justify their recommendations of cost distribution between funding sources. This documentation will be a part of the permanent procurement file.

Finally, FHA remains strongly committed to implementing a new financial management system that will facilitate increased funds control. In the interim, FHA will continue to maintain compensating controls and processes that include the following:

- Maintaining the Funds Control Database;
- Continuing routine credit subsidy reconciliations;
- Confirming and reviewing the ending balance of undelivered orders;
- Enhancing staff budgetary accounting exposure and knowledge; and,
- Preparing monthly management reports.

Report on Internal Controls - Reportable Conditions

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

FHA concurs with this finding and associated recommendations.

Regarding the first recommendation, the business needs addressed by underwriting support files (URS) will be included in the re-engineered underwriting system. In fiscal year 2002, a BPR effort for the underwriting component of FHA's Single Family programs was completed. In addition, the Target Enterprise Architecture for Single Family Housing was completed. The re-engineering is part of the Single Family Integration effort that will begin in fiscal year 2003.

Building on the BPR and Enterprise Architecture elements, the fiscal year 2003 effort will prepare full functional requirements and technical design requirements for the new underwriting application. This design addresses previously cited weaknesses in FHA systems relating to Homeownership Center (HOC) data needs and support. It will provide a common and appropriate application security environment and begin the move of Single Family to a common technical architecture that is more cost effective and efficient.

With regards to the second recommendation, the CSCS will be replaced and integrated with the overall budgetary and funds control functions of the FHA SL. With the implementation of the WEB enabled release of the FHA SL and completion of the Credit Subsidy control functionality, the data capture for Credit Subsidy commitments will occur at the point of origin in the field. This will fully comply with all security control requirements because the FHA SL is a Joint Financial Management Improvement Program (JFMIP) approved commercial package that is fully compliant with all security requirements.

The third recommendation addresses both the Development Application Processing (DAP) and Multifamily Insurance Claims Subsystem (MFIC) systems. FHA does not concur with the recommendations regarding DAP. DAP already requires user passwords to be unique and at least six characters in length. User passwords are now encrypted and are no longer viewable by the Security Administrator.

The MFIC was rebuilt in fiscal year 2002, and migrated to a WEB environment compliant with HUD's Enterprise Architecture and work will begin in fiscal year 2003 to integrate the multifamily claims process with the FHA SL. Also, the security for MFIC is now handled through the Web Access Security System (WASS) application that meets the requirements for length and structure of passwords and encrypts the password data. User profiles include role-based levels of access and functionality control.

With regards to the fourth recommendation, Single Family Housing staff and staff from the Office of the Chief Information Officer worked closely together in fiscal year 2002, and completed a Target Enterprise Architecture for Single Family Housing. In addition, a BPR was completed for the underwriting business function. Another BPR has been initiated for the Asset Management function and will be completed early in fiscal year 2003. The FHA SL team is actively involved in the Enterprise Architecture project and the BPR efforts. This active level of coordination and integration of efforts within HUD allows FHA to take maximum advantage of the opportunities for integration of its business and financial operations using the JFMIP-certified capabilities of the new FHA financial system.

The Single Family Integration initiative, which begins in fiscal year 2003, includes proposed tasks to support the BPR for the servicing and participant management functions of Single Family Housing. The Multifamily Housing business area is also beginning a similar effort. In fiscal year 2003, certain business functions of Multifamily Housing will be subject to a BPR review. As each multifamily effort progresses, Housing will initiate a joint effort with the OCIO staff to complete an Enterprise Architecture for Multifamily Housing. As with the Single Family efforts, the FHA SL team will play an active role in these efforts.

As addressed in responses to the first and second recommendations, the CSCS will be integrated into the FHA SL and URS is included in both in the BPR processes and the Enterprise Architecture.

Regarding the final recommendation, in fiscal year 2002, FHA reviewed 34 systems, including all the major program and financial systems, addressing appropriate documentation requirements under OMB Circulars A-127 and A-130. A report on each system was prepared along with an executive summary. This report identified the existing documentation, the adequacy of the documentation, and recommendations for improving inadequate items. The fiscal year 2003 FHA Procurement Plan includes an action to secure contractor support to implement the recommendations of the report and to correct inadequate documentation.

In addition, new system efforts will maintain the required documentation. The department is in the process of re-competing all Information Technology (IT) services to performance-based contracts. The contracts include specific requirements for standard System Development Methodology (SDM) deliverables, including project plans and preparation of standard documentation.

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

FHA agrees that effective monitoring of its program participants is an important component of the organization's business and concurs with two of the audit's recommendations.

FHA concurs with the first recommendation and has implemented or begun development of several processes to increase its targeting of higher risk insured loans and program participants for monitoring and corrective action, if appropriate. For example, FHA has strengthened its *Credit Watch/Neighborhood Watch Program* that monitors the performance of mortgagees participating in Single Family's programs. FHA has begun development of an *Appraiser Watch Program* to track the performance of appraisers participating in FHA programs, strengthened its processes for targeting loans for post-closing review, and, engaged in rule making designed to further reduce the potential for abuse in its programs such as rules prohibiting "property flipping."

FHA also agrees that further steps can be taken and, as recommended in the audit, is undertaking a revision to its Default Monitoring Subsystem to begin capturing 30- and 60-day delinquency data. FHA is also exploring the use of a post-origination loan scoring system to further target those loans that would benefit most from early intervention.

FHA also concurs with the second recommendation and intends to deploy the TOTAL mortgage scorecard during FY 2003. Also, to provide an incentive for lenders who utilize the FHA scorecard, we are exploring the possibility of offering a streamlined, e-Endorsement program which would allow the lender to transmit loan-level data through the FHA Connection for insurance endorsement and thereby eliminate the use of staff intensive paper submissions.

FHA is also exploring the possibility of adding additional automated functions to the underwriting process to reduce the potential occurrence of activities such as property flipping, inflated appraisals, and identity theft.

With regards to the third recommendation, FHA agrees that the Post Endorsement Technical Review (PETR) function is significant to the underwriting performance of its lenders but does not agree that the performance of the PETR contractors needs improvement. A recent survey of the HOCs indicates satisfaction with the performance of the PETR contractors and there was only a single incident where a contractor exceeded the acceptable threshold. To further assure this level of performance, FHA has added penalties to the PETR contracts if the error rate exceeds 10 percent.

FHA also disagrees with the recommendation that the HOCs should increase the number of Quality Assurance Reviews (QARs) currently performed on the PETRs completed by contractors. The standard review requirement is 5 percent and the HOCs are currently reviewing approximately 10 percent of the PETRs completed.

Finally, FHA considers the current method of providing feedback to its lenders concerning the adequacy of their performance appropriate. FHA discontinued reporting the results of each PETR review to lenders by Mortgagee Letter 95-36 because the process had proven to be costly and ineffective. At this time, FHA sends senior management quarterly summary reports of the results of the PETRs performed on their loans. In an attempt to increase the effectiveness of these reports, FHA has increased the specificity of the deficiencies noted and is considering adding an enhancement to the FHA Connection to allow lenders to obtain reports on cases that received PETRs and the results of those reviews. FHA continues to believe that the evaluation of a lender's performance should be communicated by the FHA as a function of its oversight of program participants rather than by FHA's contractor.

5. FHA Must Monitor its Single Family Property Inventory

FHA agrees with this finding and associated recommendations.

FHA agrees that comprehensive oversight tools and management reports are essential to facilitate effective monitoring of Management and Marketing (M&M) contractors, as stated in the first recommendation. FHA has made significant progress this year in developing improved tools for oversight of the M&M contractors including a Risk Based Targeting Model; enhancements to the collection and use of Special Property Inspection Data; a new case file review methodology based on both statistically valid random sampling and risk based selection of files; and, a contract that provides for a consistent scope of financial review services at each HOC.

The improvement in FHA's oversight of its M&M contractors is evidenced by performance results. The report noted there has been a 21% reduction in inventory aged over 180 days and the average days in inventory dropped from 199 days in FY 2001 to

177 days in FY 2002. Of most significance, the average net loss per case dropped from 34.8% in 2001 to 29.5% in 2002. This downward trend has continued with loss rates of 23.3% and 24.5% in October and November respectively.

FHA will continue to be aggressive in monitoring its REO program and will focus attention on improving the timeliness of feedback provided to contractors concerning the adequacy of their performance.

FHA concurs with the second recommendation and has fully implemented plans to use risk-based sampling in its file review process. Each month FHA's file review contractor selects a sample of files, completes an on-site review, and inputs the data into a computer model that identifies and ranks the results by risk factors determined by FHA. Monthly file review results for all cases are web-accessible to FHA staff. In addition, each month the 30 case files that exhibit the highest risk factors are highlighted for quick identification and follow up by FHA staff. Also, over the last two years, the file review contractor's method of file selection has improved from a random selection to the exclusive use of the risk ranking results of the prior month's review.

FHA also agrees with the third recommendation. While the current M&M contracts do contain some performance-based aspects, they do not provide effective incentives and disincentives to ensure optimal performance. Currently, FHA is in the process of re-procuring these contract services on a national basis. The new contract will be performance based and will include financial incentives and disincentives based on objective performance measures. We anticipate contract award during the fourth quarter of FY 2003.

6. FHA Must Improve the Controls Over the Credit Subsidy Adjustment Process.

Although FHA agrees to this recommendation, management does not believe that this finding warrants being a reportable condition.

As requested in the recommendation, FHA will review and revise its guidelines to maintain formal documentation of management approval of the LLG and LLR assumptions and make that documentation available the time of model delivery to the auditors.

However, FHA does feel that key model assumptions are supported and the required approval by senior management was, in fact, obtained during the development of the LLG and LLR estimates. FHA provided the auditors with the databases used to calculate most of the model assumptions, the cash flow models, the assumption calculation worksheets, and written assumption documentation, which described, in detail, how the assumptions were derived. FHA also provided memoranda and documentation to support management and policy assumptions not calculated directly from the database.

Before the LLG and LLR models were finalized, FHA's Office of Evaluation held discussions with key internal stakeholders for their review and approval of the model's methodologies and assumptions. These discussions involved the Office of Single Family Housing, the Office of Housing Budget, the FHA Comptroller's Office, the Deputy Assistant Secretary for Finance and Budget, and the Assistant Secretary for Housing-Federal Housing Commissioner.

FHA agrees that, in using the models, available historical data is preferred to informed opinion, which should be used only as a last resort. However, in the specific case of the Section 601 program, FHA disagrees that future performance should be estimated only from the available historical data and not subject to adjustment resulting from management's review of available data. The first Section 601 sale consisted only of notes from the Philadelphia and Atlanta HOCs and the Philadelphia HOC currently has a much higher loss rate than that of the other three HOCs. FHA believes that as the Section 601 program is implemented nationally and claims from all HOCs are included, loan sales will yield higher returns. Also, because this was the first sale of its kind, investors were cautious about participating. Only one bid was submitted for the first Section 601 loan sale and FHA believes that this bid reflected a very conservative valuation of the product. FHA strongly believes that when results are known from the first sale additional investors will submit bids creating greater competition and that increased familiarity with the product will result in increased bids. For these reasons, FHA reviewed all available historical data but based its calculations on a combination of historical data and informed management opinion. FHA feels that this method of deriving the assumption for the Section 601 program complies with the requirements of the Federal Financial Accounting and Auditing Technical Release 3.

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Our Assessment of Management's Response

We obtained written comments on a draft of this report from Federal Housing Administration (FHA) management which is included as appendix B. The following is our assessment of management's response.

Assessment of management's response to material weakness No. 1:

We concur with management's response. FHA is in the process of implementing each of the recommendations specified.

Assessment of management's response to material weakness No. 2:

We note in the response that FHA believes that the lack of adequate funds control is the direct result of the general control environment, as noted in material weakness No. 1, and thus does not believe a separate material weakness related to the lack of adequate funds control should be reported.

Material weakness No. 1 reports the general lack of system integration and the weaknesses resulting from the use of manual controls within FHA's processing system environment to mitigate control weaknesses. Material weakness No. 2 reports FHA's inability to maintain a comprehensive processing system that provides timely and accurate funds control at the transaction level. We believe that even if FHA implements an integrated system that properly records the necessary proprietary transactions, the budget execution process risks identified in this material weakness could continue to exist. FHA recognizes the need for a comprehensive funds control system and has made progress toward addressing its control weaknesses through the implementation of compensating detective manual controls. We believe the implementation of preventative controls as part of an overall system of internal controls is imperative to reducing, to a relatively low level, the risk that funds may be over obligated. Therefore, until FHA can achieve funds control at the transaction level this material weakness will continue to be reported.

Assessment of management's response to reportable condition No. 3:

We concur with management's response. FHA has or is in the process of implementing each of the recommendations specified.

Assessment of management's response to reportable condition No. 4:

FHA management agrees with this finding and with two of the three recommendations. Management does not agree recommendation No. 4.c. which state the Post Endorsement Technical Review (PETR) process needs to be improved and that more Quality Assurance Reviews should be performed. However, FHA is planning to implement stronger sanctions over the PETR process to improve contractor performance.

We continue to believe that improved controls over the PETR process would result in better communication with lenders resulting in reduced risk in endorsement processes.

Assessment of management's response to reportable condition No. 5:

We concur with management's response. FHA is in the process of implementing each of the recommendations specified.

Assessment of management's response to reportable condition No. 6:

While management agrees with the recommendations and concurs that improvements to the Liability for Loan Guarantee (LLG) and Loan Loss Reserve (LLR) processes are necessary, management does not believe this finding should be a reportable condition.

We believe the issues reported in this finding are significant given the relative materiality of the LLG and LLR estimates to FHA's overall financial position and the guidance provided to federal agencies subject to credit reform. As noted in our Report and recognized by FHA, Federal Financial Accounting and Auditing Technical Release No. 3, *Preparing and Auditing Direct Loan and Loan Guarantee Subsidies Under the Federal Credit Reform Act*, requires federal agencies to develop and maintain an internal control structure which requires management to formally document its review and approval of key assumptions and to base all key assumptions used to generate the loss estimates upon historical data when such data exists.

PRINCIPAL FINANCIAL STATEMENTS

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FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED BALANCE SHEETS
As of September 30, 2002 and 2001
(Dollars in Millions)

	2002	2001
ASSETS		
Intragovernmental		
Fund Balance with U.S. Treasury (Note 3)	$ 9,597	$ 9,442
Investments in U.S. Treasury Securities (Note 4)	21,346	17,339
Accounts Receivable, Net (Note 5)	-	6
Other Assets (Note 7)	88	79
Total Intragovernmental	31,031	26,866
Accounts Receivable, Net (Note 5)	331	250
Loans Receivable and Related Foreclosed Property, Net (Note 6)	3,371	2,773
Other Assets (Note 7)	137	124
TOTAL ASSETS	**$34,870**	**$30,013**
LIABILITIES		
Intragovernmental		
Accounts Payable (Note 8)	$ 3,095	$ 2,046
Borrowings from U.S. Treasury (Note 9)	7,553	4,544
Total Intragovernmental	10,648	6,590
Accounts Payable (Note 8)	1,196	1,143
Loan Guarantee Liability (Note 6)	3,761	6,053
Debentures Issued to Claimants (Note 9)	288	224
Other Liabilities (Note 10)	850	889
TOTAL LIABILITIES	**16,743**	**14,899**
NET POSITION		
Unexpended Appropriations (Note 16)	761	2,129
Cumulative Results of Operations	17,366	12,985
TOTAL NET POSITION	**18,127**	**15,114**
TOTAL LIABILITIES AND NET POSITION	**$34,870**	**$30,013**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF NET COST
For the years ended September 30, 2002 and 2001
(Dollars in Millions)

	2002	2001
MMI/CMHI PROGRAM COSTS		
Intragovernmental Gross Costs (Note 12)	$ 516	$ 503
Less: Intragovernmental Earned Revenue (Note 13)	1,354	1,482
Intragovernmental Net Costs	(838)	(979)
Gross Costs with the Public (Note 12)	(1,084)	(1,234)
Less: Earned Revenue from the Public (Note 13)	678	313
Net Costs with the Public	(1,762)	(1,547)
NET MMI/CMHI PROGRAM COST (SURPLUS)	**(2,600)**	**(2,526)**
GI/SRI PROGRAM COSTS		
Intragovernmental Gross Costs (Note 12)	125	122
Less: Intragovernmental Earned Revenue (Note 13)	107	127
Intragovernmental Net Costs	18	(5)
Gross Costs with the Public (Note 12)	(987)	(469)
Less: Earned Revenue from the Public (Note 13)	366	143
Net Costs with the Public	(1,353)	(612)
NET GI/SRI PROGRAM COST (SURPLUS)	**(1,335)**	**(617)**
NET COST (SURPLUS) OF OPERATIONS	**$ (3,935)**	**$ (3,143)**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF CHANGES IN NET POSITION
For the years ended September 30, 2002 and 2001
(Dollars in Millions)

	2002	2002	2001	2001
	Cumulative Results of Operations	Unexpended Appropriations	Cumulative Results of Operations	Unexpended Appropriations
BEGINNING BALANCES	**$ 12,985**	**$ 2,129**	**$ 10,167**	**$ 1,152**
BUDGETARY FINANCING SOURCES				
Appropriations Received (Note 16)		2,982		3,580
Other Adjustments (Note 16)		17		13
Appropriations Used (Note 16)	2,381	(2,381)	1,370	(1,370)
Transfers-Out (Note 15)	(838)	(1,986)	(318)	(1,246)
OTHER FINANCING SOURCES				
Transfers-Out (Note 15)	(1,102)		(1,384)	
Imputed Financing (Note 12)	14		14	
Other (Note 15)	(9)		(7)	
TOTAL FINANCING SOURCES	**446**	**(1,368)**	**(325)**	**977**
NET (COST) SURPLUS OF OPERATIONS	**3,935**		**3,143**	
ENDING BALANCES	**$ 17,366**	**$ 761**	**$ 12,985**	**$ 2,129**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
COMBINED STATEMENTS OF BUDGETARY RESOURCES
For the years ended September 30, 2002 and 2001
(Dollars in Millions)

	2002 Budgetary	2002 Non-Budgetary	2001 Budgetary	2001 Non-Budgetary
BUDGETARY RESOURCES (Note 17)				
Budget Authority:				
Appropriations	$ 2,982	$ -	$ 7,606	$ -
Borrowing Authority	249	3,925	128	900
Unobligated Balance Carried Forward	19,894	4,478	19,005	4,471
Spending Authority from Offsetting Collections:				
Earned				
Collected	7,535	10,211	5,751	12,255
Receivable from Federal Sources	(112)	12	(210)	46
Recoveries of Prior Year Obligations	25	50	16	4
Permanently Not Available	(2,203)	(916)	(1,370)	(3,512)
TOTAL BUDGETARY RESOURCES	**$ 28,370**	**$ 17,760**	**$ 30,926**	**$ 14,164**
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred	$ 4,536	$ 14,739	$ 11,032	$ 9,686
Unobligated Balance-Apportioned	625	1,466	1,566	2,194
Unobligated Balance Not Available	23,209	1,555	18,328	2,284
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 28,370**	**$ 17,760**	**$ 30,926**	**$ 14,164**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS				
Obligated Balance, Net, Beginning of Period	$ 1,576	$ (99)	$ 1,233	$ 212
Obligated Balance, Net, End of Period:				
Accounts Receivable	(271)	(173)	(383)	(161)
Undelivered Orders	484	93	416	58
Accounts Payable	1,494	1	1,543	4
Outlays:				
Disbursements	4,492	14,657	10,883	9,947
Collections	(7,535)	(10,211)	(5,751)	(12,255)
Subtotal	(3,043)	4,446	5,132	(2,308)
Less: Offsetting Receipts	1,993	-	620	-
NET OUTLAYS	**$ (5,036)**	**$ 4,446**	**$ 4,512**	**$ (2,308)**

The accompanying notes are an integral part of these statements.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENTS OF FINANCING
For the years ended September 30, 2002 and 2001
(Dollars in Millions)

	2002	**2001**
RESOURCES USED TO FINANCE ACTIVITIES		
Obligations Incurred	$ 19,275	$ 20,718
Spending Authority from Offsetting Collections and Recoveries	(17,721)	(17,863)
Offsetting Receipt	(1,993)	(620)
Transfers Out	(1,102)	(1,384)
Imputed Financing from Costs Absorbed by Others	14	14
Other	(9)	(7)
TOTAL RESOURCES USED TO FINANCE ACTIVITIES	**(1,536)**	**858**
RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST (SURPLUS) OF OPERATIONS		
Change in Budgetary Resources Obligated for Goods and Services Ordered but not yet Provided	(154)	81
Resources that Fund Expenses Recognized in Prior Periods	(6,258)	(9,492)
Budgetary Offsetting Collections and Receipts that Do Not Affect the Net Cost (Surplus) of Operations	18,656	17,178
Resources that Finance the Acquisition of Assets	(10,355)	(8,565)
Transfer Out to HUD without Reimbursement Related to Salary and Expense Payments	(242)	(202)
Other Resources or Adjustments that do not Affect the Net Cost (Surplus) of Operations	599	(58)
TOTAL RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST (SURPLUS) OF OPERATIONS	**2,246**	**(1,058)**
TOTAL RESOURCES USED TO FINANCE THE NET COST (SURPLUS) OF OPERATIONS	**710**	**(200)**
COMPONENTS OF THE NET COST (SURPLUS) OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD		
Upward Reestimate of Credit Subsidy Expense	3,273	1,973
Downward Reestimate of Credit Subsidy Expense	(2,124)	(1,408)
Changes in Loan Loss Reserve Expense	(1,275)	(831)
Changes in Bad Debt Expenses Related to Uncollectible Pre-Credit Reform Receivables	(222)	(294)
Reduction of Credit Subsidy Expense from Endorsements and Modifications of Loan Guarantees	(3,203)	(2,389)
Gains or Losses on Sales of Credit Program Assets	387	697
Revenue Recognized as Transfer-in of Budgetary Resources in the Capital Reserve Account	(1,014)	-
Other	(467)	(691)
TOTAL COMPONENTS OF THE NET COST (SURPLUS) OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD	**(4,645)**	**(2,943)**
NET COST (SURPLUS) OF OPERATIONS	**$ (3,935)**	**$ (3,143)**

The accompanying notes are an integral part of these statements.

NOTES TO FINANCIAL STATEMENTS
September 30, 2002

Note 1. Significant Accounting Policies

Entity and Mission

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

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

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

FHA organizes its operations into two overall program types – MMI/CMHI and GI/SRI. These program types are composed of four major funds. The Mutual Mortgage Insurance fund (MMI), FHA's largest fund, provides basic Single Family mortgage insurance and is a mutual insurance fund, whereby mortgagors, upon non-claim termination of their mortgages, share surplus premiums paid into the MMI fund that are not required for operating expenses and losses or to build equity. The Cooperative Management Housing Insurance fund (CMHI), another mutual fund, provides mortgage insurance for management-type cooperatives. The General Insurance fund (GI), provides a large number of specialized mortgage insurance activities, including insurance of loans for property improvements, cooperatives, condominiums, housing for the elderly, land development, group practice medical facilities and nonprofit hospitals. The Special Risk Insurance fund (SRI) provides mortgage insurance on behalf of mortgagors eligible for interest reduction payments who otherwise would not be eligible for mortgage insurance.

Basis of Accounting

The principal financial statements are presented in conformity with accounting principles generally accepted in the United States of America (GAAP) applicable to Federal agencies as promulgated by the Federal Accounting Standards Advisory Board (FASAB). The recognition and measurement of budgetary resources and their status for purposes of preparing the Combined Statement of Budgetary Resources, is based on concepts and guidance provided by the Office of Management and Budget (OMB) Circular A-11, *Preparation, Submission, and Execution of the Budget*.

Reclassifications

Starting in fiscal year 2002, FHA prepared its financial statements in the illustrated format provided by the OMB Bulletin 01-09, "Form and Content of Agency Financial Statements". Certain prior-year line items therefore have been reclassified to conform to the fiscal year 2002 presentation. The changes in classifications have no effect on previously reported net position.

Basis of Consolidation

The accompanying principal financial statements include all Treasury Account Fund Symbols (TAFSs) designated to FHA, which consist of two principal general program funds, six revolving funds and two general funds. All inter-fund accounts receivable, accounts payable, transfers in and transfers out within these TAFSs have been eliminated to prepare the consolidated balance sheets, statements of net cost, statements of changes in net position and statements of financing. The statements of budgetary resources are prepared on a combined basis as allowed by OMB Bulletin 01-09.

Use of Estimates

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

Amounts reported for net loans receivable and related foreclosed property and the loan guarantee liability represent FHA's best estimates based on pertinent information available.

To estimate the allowance for subsidy (AFS) associated with loans receivable and related to foreclosed property and the liability for loan guarantees (LLG), FHA used cash flow model assumptions associated with loan guarantee cases subject to the Federal Credit Reform Act of 1990 (FCRA), as described in Note 6, to estimate the cash flows associated with future loan performance. To make reasonable projections of future loan performance, FHA developed assumptions, as described in Note 6, based on historical data, current and forecasted program and economic assumptions.

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

Fund Balance with U.S. Treasury

Fund balance with U.S. Treasury consists of amounts collected and available to fund payments for expenses and of amounts collected but unavailable until authorizing legislation is enacted (see Notes 2 and 3).

Credit Reform Accounting

The FCRA establishes the use of the program, financing, general fund receipt and capital reserve accounts for loan guarantees committed and direct loans obligated after September 30, 1991 (Credit Reform). It also establishes the liquidating account for activity relating to any loan guarantees committed and direct loans obligated before October 1, 1991 (pre-Credit Reform).

The program account is a budget account that receives and obligates appropriations to cover the subsidy cost of a direct loan or loan guarantee and disburses the subsidy cost to the financing account. The program account also receives appropriations for administrative expenses. The financing account is a non-budgetary account that records all of the cash flows resulting from Credit Reform direct loans or loan guarantees. It disburses loans, collects repayments and fees, makes claim payments, holds balances, borrows from U.S. Treasury, earns or pays interest, and receives the subsidy cost payment from the program account.

The general fund receipt account is a budget account used for the receipt of amounts paid from the financing account when there is a negative subsidy from the original estimate or a downward reestimate. In most cases, the receipt account is a general fund receipt account and amounts are not earmarked for the credit program. They are available for appropriations only in the sense that all general fund receipts are available for appropriations. Any assets in this account are non-entity assets and are offset by intragovernmental liabilities. At the beginning of the following fiscal year, the fund balance in the general fund receipt account is transferred to U.S. Treasury general fund. The FHA general fund receipt account of the GI and SRI funds falls into this category.

In order to resolve the different requirements between the FCRA and the National Affordable Housing Act of 1990 (NAHA), OMB instructed FHA to create the capital reserve account to retain the MMI/CMHI negative subsidy and subsequent downward reestimates. Specifically, the NAHA required that FHA’s MMI fund achieve a Capital Ratio of 2.0 percent by fiscal year 2000. The Capital Ratio is defined as the ratio of economic net worth (current cash plus the present value of all future net cash flows) of the MMI fund to unamortized insurance in force (the unpaid balance of insured mortgages). Therefore, to ensure that the calculated Capital Ratio reflects the actual strength of the MMI fund, the resources of the capital reserve account, which are considered FHA assets, are included in the calculation of the MMI fund’s economic net worth. At the end of fiscal year 1995, FHA met and has since maintained the Capital Ratio requirement. FHA's actuary estimates the September 30, 2002 Capital Ratio at 4.52 percent.

The liquidating account is a budget account that records all cash flows to and from FHA resulting from pre-Credit Reform direct loans or loan guarantees. Liquidating account collections in any year are available only for obligations incurred during that year or to repay debt. Unobligated balances remaining in the GI and SRI liquidating funds at year-end are transferred to the U.S. Treasury’s general fund. Consequently, in the event that resources in the GI/SRI liquidating account are otherwise insufficient to cover the payments for obligations or commitments, the FCRA provides the GI/SRI liquidating account with permanent indefinite authority to cover any resources shortages.

Investments in U.S. Treasury Securities

Under current legislation, FHA may invest available resources in excess of its current needs (in MMI/CMHI funds) and escrow monies received from borrowers of its acquired notes (in GI/SRI funds) in non-marketable market-based U.S. Treasury securities. These U.S. Treasury securities may not be sold on public securities exchanges, but do reflect prices and interest rates of similar marketable U.S. Treasury securities. The book value of these investments equals acquisition cost net of unamortized premium or discount. Amortization of the premium or discount is recognized monthly in interest income on investments in U.S. Treasury securities on a straight-line basis (see Note 4).

Loans Receivable and Related Foreclosed Property, Net

FHA’s loans receivable include purchase money mortgages (PMM) and mortgage notes assigned (MNA), also described as Secretary-held notes. Under the requirements of the FCRA, PMM notes are considered to be direct loans while MNA notes are considered to be defaulted guaranteed loans. The PMM loans are generated from the sales on credit of FHA’s foreclosed properties to qualified non-profit organizations. The MNA notes are created when FHA pays the lenders for claims on defaulted guaranteed loans and takes assignment of the defaulted loans for direct collections. In addition, Multifamily and Single Family performing notes insured pursuant to Section 221(g)(4) of the National Housing Act may be assigned automatically to FHA at a pre-determined point.

In accordance with the FCRA and Statement of Federal Financial Accounting Standards (SFFAS) No. 2, *Accounting for Direct Loans and Loan Guarantees*, Credit Reform direct loans, defaulted guaranteed loans and foreclosed property are reported at the net present value of expected cash flows associated with these assets. Pre-Credit Reform loans receivable and foreclosed property in inventory are recorded at net realizable value, which is based on historical recovery rates net of any selling expenses, (see Note 6).

General Property, Plant and Equipment

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

In fiscal year 2001, HUD developed a department-wide policy to implement SFFAS No. 10 *Accounting for Internal Use Software*, which provides federal agencies with guidance on accounting and reporting requirements for expenses to purchase, develop, and implement software for internal use. The policy indicates that HUD will either own the software or the functionality provided by the software in the case of licensed or leased software. This includes "commercial off-the-shelf" (COTS) software, contractor-developed software, and internally developed software. FHA had several procurement actions in place and had incurred expenses for software development. FHA identified and transferred those expenses to HUD to comply with departmental policy. The capitalizable software development cost identified and transferred to HUD by FHA in fiscal year 2002 and 2001 is $9 million and $13 million, respectively.

Loan Guarantee Liability

The potential future losses related to FHA's central business of providing mortgage insurance are accounted for as Loan Guarantee Liability in the consolidated balance sheet. As required by SFFAS No. 2, the Loan Guarantee Liability includes the Credit Reform liability or LLG and the pre-Credit Reform Loan Loss Reserve (LLR) (see Note 6).

The LLG is calculated as the present value of anticipated cash outflows for defaults, such as claim payments, premium refunds, property expense for on-hand properties and sale expense for sold properties, less anticipated cash inflows such as premium receipts, proceeds from asset sales and principal and interest on Secretary-held notes, as described above.

FHA records loss estimates in its MMI fund and single family GI/SRI loans to provide for anticipated losses incurred (e.g., claims on insured mortgages where defaults have taken place but claims have not yet been filed). Using the net realizable value method, FHA computes an estimate based on conditional claim rates and loss experience data, and adjusts the estimate to incorporate management assumptions about current economic factors.

FHA records loss estimates in its CMHI, GI and SRI funds when defaults are considered probable but have not yet occurred or been reported. The loss estimate is based on a case-by-case analysis of a majority of Multifamily projects required to submit audited financial statements. Management further adjusts the estimate based on factors such as defaulted projects and expected premium income on excellent and good performing mortgages. The recovery rate assumptions used in the loss estimates are based on historical experience.

Unearned Premiums

Unearned premiums are recognized for pre-Credit Reform loan guarantee premiums collected but not yet earned in the liquidating account. Premiums charged by FHA's MMI fund include up-front and annual risk-based premiums. Up-front risk-based premiums are recorded as unearned revenue upon collection and are recognized as revenue over the period in which losses and insurance costs are expected to occur. Annual risk-based premiums are recognized as revenue on a straight-line basis throughout the year. FHA's other funds charge periodic insurance premiums over the mortgage insurance term. Premiums on annual installment policies are recognized for the liquidating account on a straight-line basis throughout the year. Premiums associated with Credit Reform loan guarantees are included in the calculation of the LLG and are not included in the unearned premium amount reported in the consolidated balance sheets.

Appropriations and Monies Received from Other HUD Programs

The National Housing Act of 1990, as amended, provides for appropriations from Congress to finance the operations of GI and SRI funds. For Credit Reform loan guarantees, appropriations to the GI and SRI funds are provided at the beginning of each fiscal year to cover estimated losses on insured loans during the year. For pre-Credit Reform loan guarantees, FHA has permanent indefinite appropriation authority to finance any shortages of resources needed for operations.

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

Full Cost Reporting

SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards*, requires that Federal agencies report the full cost of program outputs in the financial statements. Full cost reporting includes all direct, indirect, and inter-entity costs. For purposes of HUD's consolidated financial statements, HUD identified each responsibility segment's share of the program costs or resources provided by other Federal agencies. As a responsibility segment of HUD, FHA's portion of these costs in the amount of $14 million is included in FHA's financial statements as an imputed cost in the Consolidated Statement of Net Cost, and an imputed financing in the Consolidated Statement of Changes in Net Position and the Combined Statement of Financing.

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

Distributive Shares

As mutual funds, the MMI and CMHI funds distribute excess revenues to mortgagors at the discretion of the Secretary of HUD. Such distributions are determined based on the funds' financial positions and their projected revenues and costs. As previously discussed, in November 1990, Congress passed the NAHA, which effectively suspended payment of distributive shares from the MMI fund, other than those already declared by the Secretary, until the fund meets certain Capital Ratio requirements. Although the Capital Ratio requirement has been met since September 30, 1995, no distributive shares have been declared from the MMI fund because legislation is not yet enacted. The NAHA does not affect distributions from the CMHI fund.

Liabilities Covered by Budgetary Resources

Liabilities of federal agencies are required to be classified as those covered and not covered by budgetary resources, as defined by OMB Bulletin 01-09, and in accordance with SFFAS No. 1, *Selected Assets and Liabilities*. In the event that available resources are insufficient to cover liabilities due at a point in time, FHA has authority to borrow monies from the U.S. Treasury (for post-1991 loan guarantees) or to draw on permanent indefinite appropriations (for pre-1992 loan guarantees) to satisfy the liabilities. Thus, all of FHA's liabilities are considered covered by budgetary resources.

Note 2. Non-entity Assets

Non-entity assets consist of assets that belong to other entities but are included in FHA's consolidated balance sheet. To reflect FHA's net position accurately, these non-entity assets are offset by various liabilities. FHA's non-entity assets at September 30 are as follows:

(Dollars in millions)	**2002**	**2001**
Intragovernmental:		
Fund Balance with U.S. Treasury	$ 2,048	$ 660
Investments in U.S. Treasury Securities	2	7
Total Intragovernmental	2,050	667
Other Assets	123	110
Total Non-entity Assets	2,173	777
Total Entity Assets	32,697	29,236
Total Assets	**$ 34,870**	**$ 30,013**

FHA's Non-entity assets consist of FHA's U.S. Treasury deposit of negative credit subsidy in the GI/SRI general fund receipt account and of escrow monies collected by FHA from the borrowers of its loans.

According to the FCRA, FHA transfers negative credit subsidy from new endorsements and downward credit subsidy reestimates from the GI/SRI financing account to the GI/SRI general fund receipt account. At the beginning of each fiscal year, fund balance in the GI/SRI general fund receipt account is transferred into the U.S. Treasury's general fund.

Other assets consisting of escrow monies collected by FHA from the borrowers of its loans receivable are either deposited at the U.S. Treasury or at minority-owned banks or invested in U.S. Treasury securities. Subsequently, FHA disburses these escrow monies to pay for property taxes, property insurance or maintenance expenses on behalf of the borrowers.

Note 3. Fund Balance with U.S. Treasury

FHA's fund balance with U.S. Treasury at September 30, was composed of the following:

(Dollars in millions)

	2002	2001
Fund Balances:		
Revolving Funds	$ 7,249	$ 8,430
Appropriated Funds	355	392
Other Funds	1,993	620
Total	**$ 9,597**	**$ 9,442**
Status of Fund Balance with U.S. Treasury:		
Unobligated Balance:		
Available	$ 2,091	$ 3,760
Unavailable	5,434	3,661
Obligated Balance not yet Disbursed	2,072	2,021
Total	**$ 9,597**	**$ 9,442**

Revolving Funds

FHA's revolving funds include the liquidating and financing accounts as required by the FCRA. These funds are created to finance a continuing cycle of business-like operations in which the fund charges for the sale of products or services. Included with these funds is the newly created capital reserve account that is used to retain the MMI/CMHI negative subsidy and downward credit subsidy reestimates transferred from the financing account. If subsequent upward credit subsidy reestimates are calculated in the financing account or there is shortage of budgetary resources in the liquidating account, the capital reserve account will return the retained negative subsidy to the financing account or transfer the needed funds to the liquidating account, respectively. These funds also use the proceeds to finance spending, usually without requirement of annual appropriations.

Appropriated Funds

FHA's appropriated funds consist of the program accounts created by the FCRA. Annual or multi-year program accounts expire for incurring new obligations at the end of the time period specified in the authorizing legislation. For the subsequent five fiscal years after expiration, the resources are available only to liquidate valid obligations incurred during the unexpired period. Adjustments are allowed to increase or decrease valid obligations incurred during the unexpired period that were not previously reported. At the end of the fifth expired year, the annual and multi-year program accounts are cancelled and their remaining resources are returned to the U.S. Treasury.

Other Funds

FHA's other funds include the general fund receipt accounts established under the FCRA. The general fund receipt account of the GI and SRI funds is used to accumulate resources related to negative credit subsidy from new endorsements and downward credit subsidy reestimates. At the beginning of the following fiscal year, these accumulated resources are transferred to the U.S. Treasury's general fund.

Status of Fund Balance with U.S. Treasury

Unobligated Fund Balance with U.S. Treasury represents Fund Balance with U.S. Treasury that has not been obligated to purchase goods or services either because FHA has not received apportionment authority from OMB to use the resources (unavailable unobligated balance) or because FHA has not obligated the apportioned resources (available unobligated balance). Fund Balance with U.S. Treasury that is obligated, but not yet disbursed, consists of resources that have been obligated for goods or services but not yet disbursed either because the ordered goods or services have not been delivered or because FHA has not yet paid for goods or services received by the end of the fiscal year.

Note 4. Investments in U.S. Treasury Securities

As discussed in Note 1, all FHA investments are in non-marketable securities issued by the U.S. Treasury. These securities carry market-based interest rates. The market value of these securities is calculated using the bid amount of similar marketable U.S. Treasury securities as of September 30. The cost, par value, net unamortized discount, net investment, and market values of FHA's investments in U.S. Treasury securities as of September 30, 2002 were as follows:

(Dollars in millions)

Investments	**Cost**	**Par Value**	**Unamortized Discount (Premium), Net**	**Investment, Net**	**Market Value**
MMI/CMHI Investments	$ 20,908	$ 21,249	$ 172	$ 21,077	$ 23,012
GI/SRI Investments	2	2	-	2	2
Subtotal	29,910	21,251	172	21,079	23,014
MMI/CMHI Accrued Interest	-	-	-	267	-
Total	**$ 20,910**	**$ 21,251**	**$ 172**	**$ 21,346**	**$ 23,014**

The cost, par value, net unamortized discount, net investment, and market values as of September 30, 2001 were as follows:

(Dollars in millions)

Investments	**Cost**	**Par Value**	**Unamortized Discount (Premium), Net**	**Investment, Net**	**Market Value**
MMI/CMHI Investments	$ 16,960	$ 17,283	$ 177	$ 17,106	$ 18,411
GI/SRI Investments	7	7	-	7	7
Subtotal	16,967	17,290	177	17,113	18,418
MMI/CMHI Accrued Interest	-	-	-	226	-
Total	**$ 16,967**	**$ 17,290**	**$ 177**	**$ 17,339**	**$ 18,418**

Note 5. Accounts Receivable, Net

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

(Dollars in millions)	Gross 2002	Gross 2001	Allowance 2002	Allowance 2001	Net 2002	Net 2001
Intragovernmental:						
Receivables from HUD	$ -	$ 6	$ -	$ -	$ -	$ 6
Total	**$ -**	**$ 6**	**$ -**	**$ -**	**$ -**	**$ 6**
From the Public:						
Receivables related to credit program assets	$ 87	$ 5	$ -	$ -	$ 87	$ 5
Premiums receivable	207	247	-	(34)	207	213
Miscellaneous receivables	116	96	(79)	(64)	37	32
Total	**$ 410**	**$ 348**	**$ (79)**	**$ (98)**	**$ 331**	**$ 250**

Receivables from HUD

These receivables from HUD consist of Section 312 receivables for the Single Family rehabilitation loan program. According to agreements with HUD, FHA manages and sells the Section 312 properties acquired by HUD under this program. FHA forwards to HUD any property sale proceeds received and is reimbursed by HUD for property maintenance expenses. Property maintenance expenses paid by FHA that have not been reimbursed by HUD are recorded as accounts receivable from HUD at the end of the reporting period.

Receivables Related to Credit Program Assets

These receivables represent the outstanding sale proceeds receivable from sales of FHA's foreclosed properties to the general public. These receivables should be differentiated from the PMM notes receivables, which are created by the sales of FHA's foreclosed properties on credit to qualifying non-profit organizations.

Premiums Receivable

This amount consists of the up-front and periodic premiums due to FHA from the mortgagors at the end of the reporting period. The details of FHA premium structure are discussed in Note 13 – Earned Revenue/Premium Revenue.

Miscellaneous Receivables

Miscellaneous receivables include late charges and penalties receivable on premiums receivable, generic debt receivables, refunds receivable from overpayments of claims and distributive shares and other immaterial receivables.

Allowance for Loss

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

Note 6. Direct Loans and Loan Guarantees, Non-Federal Borrowers

FHA Direct Loan and Loan Guarantee Programs and the related loans receivable, foreclosed property, and loan guarantee liability as of September 30 are as follows:

Direct Loan and Loan Guarantee Programs Administered by FHA Include:
MMI/CMHI Direct Loan Program
GI/SRI Direct Loan Program
MMI/CMHI Loan Guarantee Program
GI/SRI Loan Guarantee Program

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

(Dollars in millions)

Direct Loan Programs	Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Direct Loans
FY 2002: MMI/CMHI	$ 2	$ -	$ (2)	$ -	$ -
GI/SRI	25	-	(8)	-	17
FY 2002 Total	**$ 27**	**$ -**	**$ (10)**	**$ -**	**$ 17**
FY 2001: MMI/CMHI	$ 3	$ -	$ (2)	$ -	$ 1
GI/SRI	39	-	(21)	-	18
FY 2001 Total	**$ 42**	**$ -**	**$ (23)**	**$ -**	**$ 19**

Direct Loans Obligated After Fiscal Year 1991:

(Dollars in millions)

Direct Loan Programs	Loans Receivable, Gross	Interest Receivable	Foreclosed Property	Allowance for Subsidy Cost	Value of Assets Related to Direct Loans
FY 2002: MMI/CMHI	$ 1	$ -	$ -	$ (2)	$ (1)
GI/SRI	-	-	-	-	-
FY 2002 Total	**$ 1**	**$ -**	**$ -**	**$ (2)**	**$ (1)**
FY 2001: MMI/CMHI	$ 1	$ -	$ -	$ (2)	$ (1)
GI/SRI	-	-	-	-	-
FY 2001 Total	**$ 1**	**$ -**	**$ -**	**$ (2)**	**$ (1)**

Defaulted Guaranteed Loans from Pre-1992 Guarantees (Allowance for Loss Method):

(Dollars in millions)

Loan Guarantee Programs	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Defaulted Guaranteed Loans Receivable, Net
FY 2002: MMI/CMHI	$ 16	$ 1	$ (6)	$ 133	$ 144
GI/SRI	2,285	107	(979)	70	1,483
FY 2002 Total	**$ 2,301**	**$ 108**	**$ (985)**	**$ 203**	**$ 1,627**
FY 2001: MMI/CMHI	$ 20	$ 3	$ (21)	$ 175	$ 177
GI/SRI	2,037	10	(1,110)	89	1,026
FY 2001 Total	**$ 2,057**	**$ 13**	**$ (1,131)**	**$ 264**	**$ 1,203**

Defaulted Guaranteed Loans from Post-1991 Guarantees:

(Dollars in millions)

Loan Guarantee Programs	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Foreclosed Property	Allowance for Subsidy Cost	Value of Assets Related to Defaulted Guaranteed Loans Receivable, Net
FY 2002: MMI/CMHI	$ 180	$ -	$ 2,138	$ (864)	$ 1,454
GI/SRI	637	23	206	(592)	274
FY 2002 Total	**$ 817**	**$ 23**	**$ 2,344**	**$ (1,456)**	**$ 1,728**
FY 2001: MMI/CMHI	$ 122	$ -	$ 1,858	$ (774)	$ 1,206
GI/SRI	671	82	187	(594)	346
FY 2001 Total	**$ 793**	**$ 82**	**$ 2,045**	**$ (1,368)**	**$ 1,552**

Guaranteed Loans Outstanding:

(Dollars in millions)

Loan Guarantee Programs	Outstanding Principal of Guaranteed Loans, Face Value	Amount of Outstanding Principal Guaranteed
Guaranteed Loans Outstanding (FY 2002):		
MMI/CMHI	$ 501,289	$ 467,554
GI/SRI	106,800	95,824
Total	**$ 608,089**	**$ 563,378**
Guaranteed Loans Outstanding (FY 2001):		
MMI/CMHI	$ 493,847	$ 459,507
GI/SRI	107,868	95,956
Total	**$ 601,715**	**$ 555,463**
New Guaranteed Loans Disbursed (FY 2002):		
MMI/CMHI	$ 96,993	$ 96,050
GI/SRI	71,872	63,500
Total	**$ 168,865**	**$ 159,550**
New Guaranteed Loans Disbursed (FY 2001):		
MMI/CMHI	$ 82,493	$ 81,738
GI/SRI	68,163	61,172
Total	**$ 150,656**	**$ 142,910**

Loan Guarantee Liability, Net:

(Dollars in millions)

Loan Guarantee Programs	Liabilities for Losses on Pre-1992 Guarantees, Estimated Future Default Claims (LLR)	Liabilities for Loan Guarantees for Post-1991 Guarantees (LLG)	Total Loan Guarantee Liability, Net
FY 2002: MMI/CMHI	$ 139	$ (1,864)	$ (1,725)
GI/SRI	4,950	536	5,486
FY 2002 Total	**$ 5,089**	**$ (1,328)**	**$ 3,761**
FY 2001: MMI/CMHI	$ 306	$ (1,220)	$ (914)
GI/SRI	6,058	909	6,967
FY 2001 Total	**$ 6,364**	**$ (311)**	**$ 6,053**

Subsidy Expense for Loan Guarantees by Program and Component:

(Dollars in millions)

Subsidy Expense for New Loan Guarantees	Defaults	Fees and Other Collections	Other	Total
FY 2002: MMI/CMHI	$ 1,962	$ (5,072)	$ 258	$ (2,852)
GI/SRI	555	(892)	-	(337)
FY 2002 Total	**$ 2,517**	**$ (5,964)**	**$ 258**	**$ (3,189)**
FY 2001: MMI/CMHI	$ 1,447	$ (4,055)	$ 334	$ (2,274)
GI/SRI	486	(500)	-	(14)
FY 2001 Total	**$ 1,933**	**$ (4,555)**	**$ 334**	**$ (2,288)**

(Dollars in millions)

Subsidy Expense for Modifications and Reestimates	Total Modifications	Interest Rate Reestimates	Technical Reestimates	Total Reestimates
FY 2002: MMI/CMHI	$ -	$ -	$ 1,100	$ 1,100
GI/SRI	-	-	(149)	(149)
FY 2002 Total	**$ -**	**$ -**	**$ 951**	**$ 951**
FY 2001: MMI/CMHI	$ -	$ -	$ 1,094	$ 1,094
GI/SRI	-	-	(220)	(220)
FY 2001 Total	**$ -**	**$ -**	**$ 874**	**$ 874**

(Dollars in millions)

Total Loan Guarantee Subsidy Expense	2002	2001
MMI/CMHI	$ (1,752)	$ (1,180)
GI/SRI	(486)	(234)
Total	**$ (2,238)**	**$ (1,414)**

Subsidy Rates for Loan Guarantees by Program and Component:

(Percentage)

	Defaults	Fees and Other Collections	Other	Total
Budget Subsidy Rates for Loan Guarantees of FY 2002 Cohort:				
MMI/CMHI	1.54	(3.77)	0.16	(2.07)
GI/SRI	2.88	(4.48)	-	(1.60)
Budget Subsidy Rates for Loan Guarantees of FY 2001 Cohort:				
MMI/CMHI	1.15	(3.58)	.28	(2.15)
GI/SRI	3.22	(3.25)	-	(.03)

Schedule for Reconciling Loan Guarantee Liability Balances:

(Dollars in millions)	2002 LLR	2002 LLG	2001 LLR	2001 LLG
Beginning Balance of the Loan Guarantee Liability	**$ 6,364**	**$ (311)**	**$ 7,195**	**$ 327**
Add: Subsidy Expense for guaranteed loans disbursed during the reporting fiscal years by component:				
Default Costs (Net of Recoveries)		2,517		1,933
Fees and Other Collections		(5,964)		(4,555)
Other Subsidy Costs		258		334
Total of the above subsidy expense components	**-**	**(3,189)**	**-**	**(2,288)**
Adjustments:				
Fees Received	-	2,946	-	3,313
Foreclosed Property and Loans Acquired	-	3,313	-	2,228
Claim Payments to Lenders	-	(5,889)	-	(5,423)
Interest Accumulation on the Liability Balance	-	(152)	-	(66)
Adjustments of prior years' credit subsidy reestimates	-	(227)	-	2,481
Other	-	92	-	77
Ending Balance before Reestimates	**6,364**	**(3,417)**	**7,195**	**649**
Add or Subtract Subsidy Reestimates by Component:				
Technical/Default Reestimate	(1,275)	2,089	(831)	(960)
Total of the above reestimate components	**(1,275)**	**2,089**	**(831)**	**(960)**
Ending Balance of the Loan Guarantee Liability	**$ 5,089**	**$ (1,328)**	**$ 6,364**	**$ (311)**

Administrative Expense:

(Dollars in millions)	2002	2001
MMI/CMHI	$ 268	$ 274
GI/SRI	243	280
Total	**$ 511**	**$ 554**

Pre-Credit Reform Valuation Methodology

FHA values its pre-Credit Reform LLR and related notes and properties in inventory at net realizable value, determined on the basis of net cash flows. To value these items, FHA uses historical claim data, revenues from premiums and recoveries, and expenses of selling and maintaining property.

FHA records loss estimates in its MMI fund and single family GI/SRI loans to provide for anticipated losses incurred (e.g., claims on insured mortgages where defaults have taken place but claims have not yet been filed). Using the net realizable value method, FHA computes an estimate based on conditional claim rates and loss experience data, and adjusts the estimate to incorporate management assumptions about current economic factors.

FHA records loss estimates in its CMHI, GI and SRI funds when defaults are considered probable but have not yet occurred or been reported. The loss estimate is based on a case-by-case analysis of a majority of Multifamily projects required to submit audited financial statements. Management further adjusts the estimate based on factors such as defaulted projects and expected premium income on excellent and good performing mortgages. The recovery rate assumptions used in the loss estimates are based on historical experience.

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

<u>No action:</u> Projects that could continue to pay their operating expenses and mortgage payment from remaining revenues.

<u>Partial claim:</u> Projects that could pay their operating expenses but could not make a full mortgage payment.

<u>Full Claim:</u> Projects that could no longer meet their mortgage payment and operating expenses.

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

Pre-Credit Reform loans receivable are recorded at the lower of cost or fair value. Fair value is estimated based on the prevailing market interest rates at the date of the loan assignment. When fair value is less than cost, discounts are recorded and amortized to interest income over the remaining terms of the loans or upon sale of the loans. Pre-Credit Reform loans are reported net of allowance for loss and any unamortized discount. The estimate for the allowance for loss is based on historical recovery rates, net of selling expense. Pre-Credit Reform foreclosed property is reported at cost less allowance for loss, which is calculated based on historical recovery rates, net of selling expense.

Credit Reform Valuation Methodology

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

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

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

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

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

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

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

Additional information about loan performance assumptions is provided below:

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

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

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

<u>Current legislation and regulatory structure</u>: FHA's future plans allowed under current legislative authority have been taken into account in formulating assumptions when relevant. For example, the Departments of Veterans Affairs and Housing and Urban Development Appropriations Act, 1999, allows mortgage notes to be assigned to FHA and transferred to a third party for servicing. The single-family program office began a pilot of this program, Section 601 of the Independent Agencies Appropriations Act, in fiscal year 2003 so FHA estimated recoveries on such notes in the MMI model. In contrast, future changes in legislative authority may affect the cash flows associated with FHA insurance programs. These changes cannot be reflected in LLG calculations because of uncertainty over their nature and outcome.

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

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

Discussion of Change in the Liability for Loan Guarantees

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

FHA estimated the credit subsidy rates for the 2002 cohort in fiscal year 2000. At the time of budget submission, the rates reflected prevailing policy and loan performance assumptions based on the most recent information available. These credit subsidy rates can be compared to the credit subsidy rates estimated at the end of 2002. The two rates can be reconciled through credit subsidy reestimates, which allow FHA to adjust the LLG and subsidy expense to reflect the most current and accurate credit subsidy rate.

Described below are the programs that comprise the majority of FHA's fiscal year 2002 new business. In addition, the Hospital Insurance program is also described. These descriptions highlight the factors that contributed to changing credit subsidy rates and the credit subsidy reestimate. Overall, FHA's liability decreased by $1 billion from the fiscal year 2001 values.

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

Due to the magnitude of the MMI fund, program changes can significantly affect the overall LLG and subsidy expense recorded in the financial statements. During fiscal year 2002, recent data and changing economic conditions reduced the liability of the MMI fund. The majority of this change is due to the addition of the 2002 cohort to the LLG, which has a negative liability. Excluding the 2002 cohort, the total liability for cohorts 1992 to 2001 has slightly decreased due primarily to a reduction in the property acquisition loss rate. In addition, the LLG was also affected by the conditional claim and prepayment rates predicted by the *Actuarial Review of the MMI Fund as of Fiscal Year 2002* issued by independent consultants. The new rates predict fewer claims, but also many more prepayments that require premium refunds. Although the overall liability of the MMI Fund has decreased, the isolated effect of the new conditional claim and prepayments rates cause the liability of the fund to increase.

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

The Section 221(d)(4) credit subsidy rate for the 2002 cohort, estimated in 2000, was higher than the rate calculated at the end of fiscal year 2002. This difference contributes to the downward credit subsidy reestimate for fiscal year 2002 and decreases the LLG and subsidy expense. There are two reasons for the decrease in subsidy expense.

First, FHA used a new methodology to calculate the 221(d)(4) conditional claim and prepayment rates. Previously, FHA relied only on historical weighted averages to calculate the claim and prepayment rates for each policy year in the life of the loan guarantee. In accordance with OMB recommendations, FHA now uses binary logistic regression models that fit the historical loan performance data to time varying economic and policy explanatory variables. FHA predicts future conditional claim and prepayment rates using forecasted values of the economic and policy variables. Use of the regression methodology decreased the conditional claim rates from the claim rates generated by historical weighted averages.

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

GI/SRI Section 242 - The Office of Insured Health Care Facilities (OIHCF) operates within FHA. The OIHCF provides loan insurance through the Section 242 mortgage insurance program for the new construction of hospitals or the refinancing of existing FHA-insured hospitals. Many of the hospitals insured through the Section 242 program serve as community anchors that provide jobs and health care services to populations in need. Hospitals in New York State constitute approximately 86 percent of the Section 242 portfolio. The LLG estimate and subsidy expense for the Section 242 program decreased in 2002 due to the following reason.

Historical data on Section 242 program claim terminations are supplemented based on an OMB-designed defaulting methodology. Under this methodology, currently insured hospital loans are defaulted artificially in the data if they fail to meet three measures of financial strength and are on the Department of Health and Human Services (HHS) Priority Watch List (PWL). A revised HHS PWL and updated financial criteria data led to a decrease in the number of hospitals artificially defaulted under this methodology in fiscal year 2002, which decreased the claim termination rates. This decreased the LLG and subsidy expense.

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

The majority of the change in the LLG is due to the conditional claim and prepayment rates. In general, the new rates predict fewer claims and more prepayments, which in total decrease the overall liability of the 234(c) risk category. Overall, the recent data and changing economic conditions produces greater positive cash flow for the 234(c) program.

GI/SRI Section 203(k) - The section 203(k) program allows a homebuyer to finance the purchase and rehabilitation of a Single Family property with a single mortgage loan insured by FHA. In the past, this program encountered incidents of fraud and FHA explicitly accounts for these risks through its LLG estimates.

FHA developed these assumptions based on data and management's judgments about future loan performance. As a result, both the ordinary risks associated with potential fraudulent activities and the identified risks are accounted for in the LLG estimation. Overall, the claim costs plus the additional rehabilitation and maintenance costs increased the LLG by approximately $189 million as of September 30, 2002.

Note 7. Other Assets

The following table presents the composition of other assets held by FHA as of September 30:

(Dollars in millions)

	2002	2001
Intragovernmental:		
Advances to HUD for Working Capital Fund Expenses	$ 88	$ 37
Receivables from Unapplied Disbursements	-	42
Total	**$ 88**	**$ 79**
With the Public:		
Escrow Monies Deposited at Minority-Owned Banks	$ 123	$ 110
Undistributed Charges	14	14
Total	**$ 137**	**$ 124**

Advances to HUD for Working Capital Fund Expenses

The Working Capital Fund was established by HUD to consolidate, at the department level, the acquisition of certain property and equipment to be used by different organizations within HUD. Advances to HUD for Working Capital Fund expenses represent the amount of payments made by FHA to reimburse the HUD Working Capital Fund for its share of the fund's expenses prior to the receipt of goods or services from this fund.

Receivables from Unapplied Disbursements

The initial allocations of the confirmed Fund Balances with U.S. Treasury among the TAFSs that belong to FHA are based on estimates. At the end of the fiscal year, these estimates may result in the establishment of the receivables and payables that reflect the difference between FHA's Fund Balances with U.S. Treasury and the general ledger.

Escrow Monies Deposited at Minority-Owned Banks

FHA holds in trust escrow monies received from the borrowers of its Multifamily mortgage notes to cover property repairs and renovations expenses. These escrow monies are deposited at the U.S. Treasury (see Note 2), invested in U.S. Treasury securities (see Note 4 - GI/SRI Investments) or deposited at minority-owned banks.

Undistributed Charges

Undistributed charges include FHA disbursements processed by the U.S. Treasury but the identification of the specific FHA operating area associated with the disbursement has not been determined by the end of the reporting period. When the FHA operating area that initiated the disbursement is identified, the undistributed charges are reclassified by recognizing new expenses or by liquidating previously established accounts payable.

Note 8. Accounts Payable

Accounts payable as of September 30 are as follows:

(Dollars in millions)	2002	2001
Intragovernmental:		
Payables to HUD	$ -	$ 7
Payables to U.S. Treasury	3,095	2,039
Total	**$ 3,095**	**$ 2,046**
With the Public:		
Claims Payable	$ 571	$ 653
Premium Refunds Payable	425	329
Distributive Shares Payable	24	25
Disbursements in Transit	92	68
Miscellaneous Payables	84	68
Total	**$ 1,196**	**$ 1,143**

Payables to HUD

These payables to HUD consist of Section 312 payables for the Single Family rehabilitation loan program and Section 202 payables for the Multifamily Elderly Housing Program. According to agreements with HUD, FHA manages and sells the properties acquired by HUD under these credit programs. FHA forwards to HUD any property sale proceeds received and is reimbursed by HUD for property maintenance expenses. Sale proceeds collected by FHA, which have not been forwarded to HUD, are recorded as accounts payable to HUD at the end of the reporting period.

Payables to U.S. Treasury

These payables to U.S. Treasury consist primarily of payables to the GI/SRI general fund receipt account of negative credit subsidy from new endorsements and downward credit subsidy reestimates.

Claims Payable

Claims payable represents the amount of claims that have been processed by FHA, but the disbursement of payment to lenders has not taken place at the end of the reporting period.

Premium Refunds and Distributive Shares Payable

Premium refunds payable are refunds of previously collected Single Family premiums that will be returned to the borrowers resulting from prepayment of the insured mortgages. Distributive shares payable represents the amount of excess revenues in the liquidating account of the CMHI fund that is to be distributed to the mortgagors at the discretion of the Secretary of HUD.

Disbursements in Transit

Disbursements in transit represent the payments recorded in FHA financial systems that have not been processed by the U.S. Treasury. The disbursements in transit will be reclassified into the reductions of the Fund Balance with U.S. Treasury once the disbursements are confirmed as paid by the U.S. Treasury.

Miscellaneous Payables

Miscellaneous payables include interest enhancement payables, interest penalty payables for late payment of claims, generic debt payables and other payables related to various operating areas within FHA.

Note 9. Debt

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

(Dollars in millions)

	2001 Beginning Balance	2001 Net Borrowing	2001 Ending Balance	2002 Net Borrowing	2002 Ending Balance
Agency Debt:					
Debentures Issued to Claimants	$ 223	$ 1	$ 224	$ 64	$ 288
Other Debt:					
Borrowings from U.S. Treasury	7,155	(2,611)	4,544	3,009	7,553
Total	**$ 7,378**	**$ (2,610)**	**$ 4,768**	**$ 3,073**	**$ 7,841**

	2002	2001
Classification of Debt:		
Intragovernmental Debt	$ 7,553	$ 4,544
Debt held by the Public	288	224
Total	**$ 7,841**	**$ 4,768**

Debentures Issued to Public

The National Housing Act authorizes FHA, in certain cases, to issue debentures in lieu of cash to settle claims. FHA-issued debentures bear interest at rates established by the U.S. Treasury. Interest rates related to the outstanding debentures ranged from 4.00 percent to 12.875 percent in both 2002 and 2001. FHA 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.

The par value of debentures outstanding at September 30 was $284 million in fiscal year 2002 and $221 million in fiscal year 2001. The fair value based on original maturity dates was $368 million in fiscal year 2002, and $278 million in fiscal year 2001.

Borrowings from U.S. Treasury

In accordance with Credit Reform accounting, FHA borrows from the U.S. Treasury when cash is needed in its financing accounts. Usually, the need for cash arises when FHA has to transfer the negative credit subsidy amounts related to new loan disbursements, and existing loan modifications from the financing accounts to the general fund receipt account (for cases in GI/SRI funds) or to the liquidating account (for cases in MMI/CMHI funds). In some instances, borrowings are also needed to transfer the credit subsidy related to downward reestimates from the GI/SRI financing account to the GI/SRI receipt account or when available cash is less than claim payments due.

During fiscal years 2002 and 2001, FHA's U.S. Treasury borrowings carried interest rates ranging from 5.47 percent to 7.59 percent. Maturity dates occur from September 2003 – September 2021. Loans may be repaid in whole or in part without penalty at any time prior to maturity.

Note 10. Other Liabilities

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

(Dollars in millions)	Current		Non-Current		Total	
	2002	**2001**	**2002**	**2001**	**2002**	**2001**
With the Public:						
Trust and Deposit Liabilities	$ 269	$ 163	$ -	$ -	$ 269	$ 163
Unearned Premiums	-	-	381	556	381	556
Undistributed Credits	87	66	-	-	87	66
Claim Payment Withholding Payable	-	-	11	12	11	12
Miscellaneous Liabilities	102	92	-	-	102	92
Total	**$ 458**	**$ 321**	**$ 392**	**$ 568**	**$ 850**	**$ 889**

Trust and Deposit Liabilities

Trust and deposit liabilities include mainly escrow monies received by FHA for the borrowers of its mortgage notes and earnest money received from potential purchasers of the FHA foreclosed properties. The escrow monies are eventually disbursed to pay for insurance, property taxes, and maintenance expenses on behalf of the borrowers. The earnest money becomes part of the sale proceeds or is returned to any unsuccessful bidders.

Unearned Premiums

As discussed in Note 1, unearned premiums represent premiums collected for the pre-1992 loan guarantees, but not recognized as revenue because the earning process has not been completed.

Undistributed Credits

Undistributed credits represent FHA collections processed by U.S. Treasury, but the identification of the specific operating area associated with the collections has not been determined at the end of the reporting period. When the FHA operating area that is entitled to the collections is identified, the undistributed credits are reclassified by recognizing revenue or by liquidating previously established accounts receivable.

Claim Payment Withholding Payable

Claim payment withholding payable includes the one percent of claim amount withheld by FHA to use for future foreclosure cost of Multifamily properties.

Miscellaneous Liabilities

Miscellaneous liabilities include mainly other unearned revenue from Single Family and Multifamily operations.

Note 11. Commitments and Contingencies

Litigation

FHA is party in various legal actions and claims brought by or against it. In the opinion of management and general counsel, the ultimate resolution of the majority of these legal actions and claims will not materially affect FHA's consolidated financial statements as of, and for, the fiscal years ended September 30, 2002 and 2001. However, FHA recorded an $8.1 million liability for one pending case where judgment against FHA is considered probable. Additionally, there are eleven pending cases where judgment against FHA is considered reasonably possible, but the amount cannot be reliably estimated.

Note 12. Gross Costs

Gross costs incurred by FHA for the fiscal years ended on September 30 are as follows:

(Dollars in millions)	2002 MMI/CMHI	2002 GI/SRI	2001 MMI/CMHI	2001 GI/SRI
Intragovernmental:				
Interest Expense	$ 433	$ 92	$ 425	$ 87
Imputed Costs	6	8	6	8
Other Expenses	77	25	72	27
Total	**$ 516**	**$ 125**	**$ 503**	**$ 122**
With the Public:				
Salary and Administrative Expenses	$ 190	$ 218	$ 201	$ 253
Subsidy Expense	(1,752)	(486)	(1,180)	(234)
Interest Expense	427	42	(379)	(23)
Bad Debt Expense	(40)	(183)	(42)	(252)
Loan Loss Reserve Expense	(167)	(1,108)	(156)	(675)
Other Expenses	258	530	322	462
Total	**$ (1,084)**	**$ (987)**	**$ (1,234)**	**$ (469)**

Interest Expense

Intragovernmental interest expense includes interest expense on borrowings from U.S. Treasury in the financing account. Interest expense is calculated annually for each cohort using the interest rates provided by the U.S Treasury. Interest expense with the public consists of interest expense on debentures issued to claimants to settle claim payments and interest expense on the annual credit subsidy reestimates.

Imputed Costs/Imputed Financing

Imputed costs represent FHA's share of the departmental imputed cost calculated and allocated to FHA by the HUD CFO office. Federal agencies are required by SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards,* to account for costs assumed by other Federal organizations on their behalf. The HUD CFO receives its imputed cost data from the Office of Personnel Management (OPM) for pension costs, federal employee health benefits (FEHB) and life insurance costs. It also receives Federal Employee Compensated Absences (FECA) costs from the Department of Labor (DOL). Subsequently, using its internally developed allocation basis, HUD CFO allocates the imputed cost data to each of its reporting offices. The imputed cost reported by

FHA in its Statement of Net Cost is equal to the amount of imputed financing in its Statement of Changes in Net Position.

Salary and Administrative Expenses

Salary and administrative expenses include FHA's reimbursement to HUD for FHA personnel costs, FHA's share of the HUD expenses incurred in the Working Capital Fund, and FHA's payments to third party contractors for administrative contract expenses.

Subsidy Expense

Subsidy expense, positive and negative, consists of credit subsidy expense from new endorsements, modifications, and annual credit subsidy reestimates and the subsidy expense incurred by the Church Arson program. Credit subsidy expense is the estimated long-term cost to the U.S. Government of a direct loan or loan guarantee, calculated on a net present value basis of the estimated future cash flows associated with the direct loan or loan guarantee. Subsidy expense incurred by the Church Arson program is the expense of a HUD program administered by the Office of Community Planning and Development (CPD) even though its cost is funded through a FHA program account.

Bad Debt Expense

Bad debt expense represents the provision for loss recorded for uncollectible amounts related to FHA's pre-1992 accounts receivable and credit program assets. FHA calculates its bad debt expense based on the estimated change of these assets' historical loss experience and FHA management's judgment concerning current economic factors.

Loan Loss Reserve Expense

Loan loss reserve expense is recorded to account for the change in the balance of the loan loss reserve liabilities associated with FHA's pre-1992 loan guarantees. The loan loss reserve is provided for the estimated losses incurred by FHA to pay claims on its pre-1992 insured mortgages when defaults have taken place but, the claims have not yet been filed with FHA.

Other Expenses

Other expenses include only those associated with the FHA pre-1992 loan guarantees. They consist of net losses or gains on sales of FHA credit program assets, insurance claim expenses, fee expenses, and other miscellaneous expenses incurred to carry out FHA operations.

Note 13. Earned Revenue

Earned revenue generated by FHA for the fiscal years ended on September 30 are as follows:

(Dollars in millions)	2002 MMI/CMHI	2002 GI/SRI	2001 MMI/CMHI	2001 GI/SRI
Intragovernmental:				
Interest Revenue from Deposits at U.S. Treasury	$ 265	$ 107	$ 306	$ 127
Interest Revenue from MMI/CMHI Investments	1,089	-	1,176	-
Total	**$ 1,354**	**$ 107**	**$ 1,482**	**$ 127**
With the Public:				
Premium Revenue	$ 366	$ 115	$ 152	$ 126
Interest Revenue	11	6	16	5
Other Revenue	301	245	145	12
Total	**$ 678**	**$ 366**	**$ 313**	**$ 143**

Interest Revenue

Intragovernmental interest revenue includes interest revenue from deposits at U.S. Treasury and investments in U.S. Treasury securities. FHA's U.S. Treasury deposits are generated from post-1991 loan guarantees and direct loans in the financing accounts. FHA's investments in U.S. Treasury securities consist of investments of surplus resources in the MMI/CMHI liquidating accounts and of escrow monies collected from borrowers in the GI/SRI liquidating accounts.

Interest revenue with the public is generated mainly from FHA's acquisition of pre-1992 performing MNA notes from payments to lenders for defaulted guaranteed loans. Interest revenue associated with the post-1991 MNA notes is included in the Allowance for Subsidy balance.

Premium Revenue

According to the FCRA accounting, FHA's premium revenue includes only premiums associated with the pre-1992 loan guarantee business. Premium revenue for post-1991 loan guarantee cases is included in the balance of the LLG. The FHA premium structure, set by the National Affordable Housing Act and published in the Code of Federal Regulations, which became effective July 1991, includes both up-front premiums and annual periodic premiums.

Up-front Premiums

The up-front premium rates, which are set by legislation, vary according to the mortgage type and the year of origination. The pre-1992 up-front premiums in the MMI fund were recorded as unearned revenue upon collection and are recognized as revenue over the period in which losses and insurance costs are expected to occur. Other FHA funds' unearned revenue is recognized monthly as revenue on a straight-line basis. In fiscal year 2002, FHA increased the premiums charged on positive credit subsidy loan guarantees from .50% to .80%. This change in policy affected Section 221(d)(4) and other loan guarantees made for new construction, substantial rehabilitation, or additions for apartments. FHA continued to endorse all other loan guarantees at .50% premiums for fiscal year 2002.

The FHA up-front premium rates in fiscal year 2002 were:

	Mortgage Term 15 Years or Less	Mortgage Term More Than 15 Years
Single Family	1.50%	1.50%
Multifamily	.50% or .80%	.50% or .80%

Periodic Premiums

The periodic premium rate is used to calculate monthly or annual premiums receivable. These rates, which are also legislated, vary by mortgage type and program. The FHA periodic premium rate in fiscal year 2002 for Single Family and Multifamily were:

	Mortgage Term 15 Years or Less	Mortgage Term More Than 15 Years
Single Family	.25%	.50%
Multifamily	.50% or .80%	.50% or .80%

For Title I, the maximum insurance premium paid for guaranteed cases endorsed in years 1992 through 2001 is equal to 0.50 percent of the loan amount multiplied by the number of years of the loan term. The annual insurance premium for a Title I Property Improvement loan is 0.50 percent of the loan amount until the maximum insurance charge is paid. The annual insurance premium of a Title I Manufactured Housing loan is calculated in tiers by loan term until the maximum insurance charge is paid. For guaranteed cases endorsed beginning in fiscal year 2002, the Title I annual insurance premium is 1.00 percent of the loan amount until maturity.

Other Revenue

Other revenue includes revenue associated with FHA pre-1992 loan guarantees. FHA's other revenue consists of late charges and penalty revenue, fee income, and miscellaneous income generated from FHA operations.

Note 14. Gross Cost and Earned Revenue by Budget Functional Classification

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

Note 15. Transfers Out

Transfers out incurred by FHA for the fiscal years ended on September 30 are as follows:

(Dollars in millions)

	U.S. Treasury	HUD	Total
Budgetary Financing Sources	$ 2,582	$ 242	$ 2,824
Other Financing Sources	1,102	-	1,102
Other	-	9	9
FY 2002 Total	**$ 3,684**	**$ 251**	**$ 3,935**
Budgetary Financing Sources	$ 1,362	$ 202	$ 1,564
Other Financing Sources	1,384	-	1,384
Other	-	7	7
FY 2001 Total	**$ 2,746**	**$ 209**	**$ 2,955**

Transfers Out to U.S. Treasury

Transfers out to U.S. Treasury consists of negative subsidy from new endorsements, modifications and downward credit subsidy reestimates in the GI/SRI general fund receipt account, and the prior year unobligated balance of budgetary resources in the GI/SRI liquidating account.

Transfers Out to HUD

Transfers out to HUD include a certain portion of FHA's monthly payments to HUD for salaries and expenses as well as amounts related to FHA's share in the departmental Working Capital Fund capitalized expense.

Note 16. Unexpended Appropriations

Unexpended appropriation balances at September 30 are as follows:

(Dollars in millions)	Beginning Balance	Appropriations Received	Other Adjustments	Appropriations Used	Transfers-Out	Ending Balance
Positive Subsidy	$ 92	$ 15	$ (27)	$ (15)	$ -	$ 65
Administrative Expenses	211	878	44	(756)	-	377
Reestimates	-	995	-	(995)	-	-
GI/SRI Liquidating	1,826	1094	-	(615)	(1986)	319
FY 2002 Total	**$ 2,129**	**$ 2,982**	**$ 17**	**$ (2,381)**	**$ (1,986)**	**$ 761**
Positive Subsidy	$ 2	$ 141	$ -	$ (101)	$ -	$ 92
Administrative Expenses	179	846	13	(827)	-	211
Reestimates	-	246	-	(246)	-	-
GI/SRI Liquidating	921	2,347	-	(196)	(1,246)	1,826
FY 2001 Total	**$ 1,152**	**$ 3,580**	**$ 13**	**$ (1,370)**	**$ (1,246)**	**$ 2,129**

As required under FCRA, FHA receives appropriations to cover expenses or fund shortages related to its loan guarantee and direct loan operations.

FHA receives appropriations in the annual program accounts for administrative and contract expenses. The GI/SRI no-year program account also receives appropriations for positive credit subsidy and upward reestimates. Additionally, FHA obtains permanent indefinite appropriations to cover any shortfalls for its GI/SRI pre-1992 loan guarantee operations.

When appropriations are first received, they are reported as unexpended appropriations. As these appropriations are expended, appropriations used are increased and unexpended appropriations are decreased. Additionally, unexpended appropriations are decreased when: the year-end unobligated balance in the GI/SRI liquidating account is returned to the U.S. Treasury; appropriations are rescinded; or other miscellaneous adjustments are required.

Note 17. Budgetary Resources

FHA has two program, two liquidating, and four financing appropriations. The Statement of Budgetary Resources has been prepared as a combined statement and as such, intra-entity transactions have not been eliminated.

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

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

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

Financing sources for repayments are from premiums earned, and the maturity dates on these borrowings are generally 20 years or more. The balances of the Permanently Not Available line item in the Statement of Budgetary Resources in fiscal year 2002 and fiscal year 2001 are $3,119 million and $4,882 million, respectively. In fiscal year 2002, the $3,119 million amount is composed of a repayment of $182 million for debentures, a repayment of $916 million for borrowing from the U.S. Treasury, a return to the U.S. Treasury of $5 million for cancelled appropriations, a return to the U.S. Treasury of $30 million for unused credit subsidy appropriations, and a transfer to the U.S. Treasury of $1,986 million of unobligated balances that remained in the GI/SRI liquidating account at the end of fiscal year 2001.

In fiscal year 2001, the appropriations received in the Statement of Budgetary Resources ($7,606 million) were different than that in the Statement of Changes in Net Position ($3,580 million). This difference was the result of recording the $4,026 million appropriation received for the MMI/CMHI upward reestimates. Prior to fiscal year 2002, the MMI/CMHI upward reestimate transfer was accomplished through a program fund appropriation. In fiscal year 2002, the MMI/CMHI upward reestimate was not appropriated, rather the funds were moved to the program fund by a non-expenditure transfer.

Note 18. Explanations of the Differences between the Statement of Budgetary Resources and the Budget of the U.S. Government

At the end of fiscal year 2002, the Statement of Budgetary Resources reported $3 million less for obligations incurred than the amount reported in the Budget of the U.S. Government. This difference is due to adjustments relating to claims and contingent liabilities recorded as part of the closing process.

Required Supplementary Information

Schedule A: Intragovernmental Assets

FHA's intragovernmental assets, by federal entity, are as follows on September 30, 2002 and 2001:

(Dollars in millions)

Agency	Fund Balance with U.S. Treasury	Investments in U.S. Treasury Securities	Accounts Receivable	Other Assets
U.S. Treasury	$ 9,597	$ 21,346	$ -	$ -
HUD	-	-	-	88
Other	-	-	-	-
FY 2002 Total	**$ 9,597**	**$ 21,346**	**$ -**	**$ 88**
U.S. Treasury	$ 9,442	$ 17,339	$ -	$ -
HUD	-	-	6	37
Other	-	-	-	42
FY 2001 Total	**$ 9,442**	**$ 17,339**	**$ 6**	**$ 79**

Schedule B: Intragovernmental Liabilities

FHA's intragovernmental liabilities, by federal entity, are as follows on September 30, 2002 and 2001:

(Dollars in millions)

Agency	Accounts Payable	Borrowings from U.S. Treasury	Other Liabilities
HUD	$ -	$ -	$ -
U.S. Treasury	3,095	7,553	$ -
FY 2002 Total	**$ 3,095**	**$ 7,553**	**$ -**
HUD	$ 7	$ -	$ -
U.S. Treasury	2,039	3,009	$ -
FY 2001 Total	**$ 2,046**	**$ 3,009**	**$ -**

Required Supplementary Information

Schedule C: Comparative Combining Statement of Budgetary Resources by FHA Program

(Dollars in millions)	MMI/CMHI 2002	MMI/CMHI 2001	GI/SRI 2002	GI/SRI 2001	Total 2002	Total 2001
BUDGETARY RESOURCES						
Budget Authority:						
Appropriations received	$ 513	$ 4,517	$ 2,469	$ 3,089	$ 2,982	$ 7,606
Borrowing Authority	3,400	500	774	528	4,174	1,028
Unobligated Balance Carried Forward						
Beginning of period	20,471	20,447	3,901	3,029	24,372	23,476
Net Transfers						
Spending Authority from Offsetting Collections:						
Earned						
Collected	14,734	15,439	3,012	2,567	17,746	18,006
Receivable from Federal Sources	(134)	(131)	34	(33)	(100)	(164)
Recoveries of Prior Year Obligations	55	11	20	9	75	20
Permanently Not Available	(755)	(3,023)	(2,364)	(1,859)	(3,119)	(4,882)
TOTAL BUDGETARY RESOURCES	**$ 38,284**	**$ 37,760**	**$ 7,846**	**$ 7,330**	**$ 46,130**	**$ 45,090**
STATUS OF BUDGETARY RESOURCES						
Obligations Incurred	$ 13,561	$ 17,289	$ 5,714	$ 3,429	$ 19,275	$ 20,718
Unobligated Balance-Apportioned	1,164	1,945	927	1,815	2,091	3,760
Unobligated Balance Not Available	23,559	18,526	1,205	2,086	24,764	20,612
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 38,284**	**$ 37,760**	**$ 7,846**	**$ 7,330**	**$ 46,130**	**$ 45,090**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS						
Obligated Balance, Net, Beginning of Period	$ 686	$ 825	$ 791	$ 620	$ 1,477	$ 1,445
Obligated Balance, Net, End of Period:						
Accounts Receivable	(271)	(404)	(173)	(140)	(444)	(544)
Undelivered Orders	174	153	403	321	577	474
Accounts Payable	918	937	577	610	1,495	1,547
Outlays:						
Disbursements	13,503	17,549	5,646	3,281	19,149	20,830
Collections	(14,734)	(15,439)	(3,012)	(2,567)	(17,746)	(18,006)
Subtotal	(1,231)	2,110	2,634	714	1,403	2,824
Less: Offsetting Receipts	-	-	1,993	620	1,993	620
NET OUTLAYS	**$ (1,231)**	**$ 2,110**	**$ 641**	**$ 94**	**$ (590)**	**$ 2,204**

Required Supplementary Information

Schedule D: Comparative Combining Budgetary Resources by Appropriation for the MMI/CMHI Program–
Fiscal Year 2002

(Dollars in millions)

	86 0183	86x4070	86x4587 & 86x4242	86x0236	MMI/CMHI Total
BUDGETARY RESOURCES					
Budget Authority:					
Appropriations received	$ 513	$ -	$ -	$ -	$ 513
Borrowing Authority	-	-	3,400	-	3,400
Unobligated Balance Carried Forward					
Beginning of period	14	17,746	2,711	-	20,471
Net Transfers	1,017	(20,881)	-	19,864	-
Spending Authority from Offsetting Collections:					
Earned					
Collected	-	4,080	7,938	2,716	14,734
Receivable from Federal Sources	-	(370)	(31)	267	(134)
Recoveries of Prior Year Obligations	4	5	46	-	55
Permanently Not Available	-	-	(755)	-	(755)
TOTAL BUDGETARY RESOURCES	**$ 1,548**	**$ 580**	**$ 13,309**	**$ 22,847**	**$ 38,284**
STATUS OF BUDGETARY RESOURCES					
Obligations Incurred	$ 1,518	$ 336	$ 11,707	$ -	$ 13,561
Unobligated Balance-Apportioned	14	206	944	-	1,164
Unobligated Balance Not Available	16	38	658	22,847	23,559
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 1,548**	**$ 580**	**$ 13,309**	**$ 22,847**	**$ 38,284**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS					
Obligated Balance, Net, Beginning of Period	$ 120	$ 542	$ 24	$ -	$ 686
Obligated Balance, Net, End of Period:					
Accounts Receivable	-	(4)	-	(267)	(271)
Undelivered Orders	60	36	78	-	174
Accounts Payable	1	916	1	-	918
Outlays:					
Disbursements	1,574	293	11,636	-	13,503
Collections	-	(4,080)	(7,938)	(2,716)	(14,734)
Subtotal	1,574	(3,787)	3,698	(2,716)	(1,231)
Less: Offsetting Receipts	-	-	-	-	-
NET OUTLAYS	**$ 1,574**	**$ (3,787)**	**$ 3,698**	**$ (2,716)**	**$ (1,231)**

Required Supplementary Information

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

(Dollars in millions)

	86 0183	86x4070	86x4587 & 86x4242	MMI/CMHI Total
BUDGETARY RESOURCES				
Budget Authority:				
Appropriations received	$ 4,517	$ -	$ -	$ 4,517
Borrowing Authority	-	-	500	500
Unobligated Balance Carried Forward				
Beginning of period	11	17,767	2,669	20,447
Net Transfers				
Spending Authority from Offsetting Collections:				
Earned				
Collected	-	4,727	10,712	15,439
Receivable from Federal Sources	-	(162)	31	(131)
Recoveries of Prior Year Obligations	1	7	3	11
Permanently Not Available	(1)	-	(3,022)	(3,023)
TOTAL BUDGETARY RESOURCES	**$ 4,528**	**$ 22,339**	**$ 10,893**	**$ 37,760**
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred	$ 4,514	$ 4,592	$ 8,183	$ 17,289
Unobligated Balance-Apportioned	11	603	1,331	1,945
Unobligated Balance Not Available	3	17,144	1,379	18,526
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 4,528**	**$ 22,339**	**$ 10,893**	**$ 37,760**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS				
Obligated Balance, Net, Beginning of Period	$ 140	$ 370	$ 315	$ 825
Obligated Balance, Net, End of Period:				
Accounts Receivable	-	(373)	(31)	(404)
Undelivered Orders	66	36	51	153
Accounts Payable	54	879	4	937
Outlays:				
Disbursements	4,533	4,576	8,440	17,549
Collections	-	(4,727)	(10,712)	(15,439)
Subtotal	4,533	(151)	(2,272)	2,110
Less: Offsetting Receipts	-	-	-	-
NET OUTLAYS	**$ 4,533**	**$ (151)**	**$ (2,272)**	**$ 2,110**

Required Supplementary Information

Schedule E: Comparative Combining Budgetary Resources by Appropriation for the GI/SRI Program–Fiscal Year 2002

(Dollars in millions)

	86 0200	86x4072	86x4077 & 86x4105	GI/SRI Total
BUDGETARY RESOURCES				
Budget Authority:				
Appropriations received	$ 1,375	$ 1,094	$ -	$ 2,469
Borrowing Authority	-	249	525	774
Unobligated Balance Carried Forward				
Beginning of period	148	1,986	1,767	3,901
Net Transfers				
Spending Authority from Offsetting Collections:				
Earned				
Collected	-	739	2,273	3,012
Receivable from Federal Sources	-	(9)	43	34
Recoveries of Prior Year Obligations	7	10	3	20
Permanently Not Available	(34)	(2,169)	(161)	(2,364)
TOTAL BUDGETARY RESOURCES	**$ 1,496**	**$ 1,900**	**$ 4,450**	**$ 7,846**
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred	$ 1,313	$ 1,369	$ 3,032	$ 5,714
Unobligated Balance-Apportioned	69	336	522	927
Unobligated Balance Not Available	114	195	896	1,205
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 1,496**	**$ 1,900**	**$ 4,450**	**$ 7,846**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS				
Obligated Balance, Net, Beginning of Period	$ 112	$ 801	$ (122)	$ 791
Obligated Balance, Net, End of Period:				
Accounts Receivable	-	-	(173)	(173)
Undelivered Orders	76	312	15	403
Accounts Payable	2	575	-	577
Outlays:				
Disbursements	1,340	1,285	3,021	5,646
Collections	-	(739)	(2,273)	(3,012)
Subtotal	1,340	546	748	2,634
Less: Offsetting Receipts (Memorandum)	-	-	-	1,993
NET OUTLAYS	**$ 1,340**	**$ 546**	**$ 748**	**$ 641**

Required Supplementary Information

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

(Dollars in millions)

	86 0200	86x4072	86x4077 & 86x4105	GI/SRI Total
BUDGETARY RESOURCES				
Budget Authority:				
Appropriations received	$ 743	$ 2,346	$ -	$ 3,089
Borrowing Authority	-	128	400	528
Unobligated Balance Carried Forward				
Beginning of period	64	1,163	1,802	3,029
Net Transfers				
Spending Authority from Offsetting Collections:				
Earned				
Collected	-	1,025	1,542	2,567
Receivable from Federal Sources	(7)	(41)	15	(33)
Recoveries of Prior Year Obligations	2	7	-	9
Permanently Not Available	(1)	(1,368)	(490)	(1,859)
TOTAL BUDGETARY RESOURCES	**$ 801**	**$ 3,260**	**$ 3,269**	**$ 7,330**
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred	$ 654	$ 1,273	$ 1,502	$ 3,429
Unobligated Balance-Apportioned	53	900	862	1,815
Unobligated Balance Not Available	94	1,087	905	2,086
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 801**	**$ 3,260**	**$ 3,269**	**$ 7,330**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS				
Obligated Balance, Net, Beginning of Period	$ 130	$ 593	$ (103)	$ 620
Obligated Balance, Net, End of Period:				
Accounts Receivable	-	(10)	(130)	(140)
Undelivered Orders	78	236	7	321
Accounts Payable	33	577	-	610
Outlays:				
Disbursements	676	1,098	1,507	3,281
Collections	-	(1,025)	(1,542)	(2,567)
Subtotal	676	73	(35)	714
Less: Offsetting Receipts (Memorandum)	-	-	-	620
NET OUTLAYS	**$ 676**	**$ 73**	**$ (35)**	**$ 94**

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