AUDIT REPORT

U.S. DEPARTMENT OF HOUSING
AND URBAN DEVELOPMENT
AUDIT OF FISCAL YEAR 1998
FINANCIAL STATEMENTS

99-FO-177-0003

March 29, 1999

OFFICE OF AUDIT
FINANCIAL AUDITS DIVISION
WASHINGTON, DC

audit report

OFFICE OF INSPECTOR GENERAL

Issue Date	March 29, 1999
Audit Case Number	99-FO-177-0003

TO: William E. Dobrzykowski, Deputy Chief Financial Officer for Finance, FF

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

SUBJECT: Audit of the U.S. Department of Housing and Urban Development
Fiscal Year 1998 Financial Statements

In accordance with the Chief Financial Officers (CFO) Act of 1990, this report presents the results of our audit of HUD's principal financial statements for the year ended September 30, 1998. Also provided are assessments of HUD's internal controls and compliance with laws and regulations. HUD continues to face major challenges in its efforts to correct longstanding material internal control weaknesses that are hindering its ability to carry out its mission and improve program management. In particular, HUD needs to overcome issues with its internal control environment, including the need to upgrade financial systems and address resource issues. Our report discusses the significance of HUD's financial management and control problems and HUD's actions to correct them. Our report also contains recommendations to assist the Department in its continuing efforts to correct these longstanding problems.

We also identified several matters which, although not material to the financial statements, will be communicated in a separate management letter to the Department. That letter will also provide additional details on some of the internal control weaknesses described in this report. We appreciate the courtesies and cooperation extended to the OIG staff and our contractor.

In accordance with HUD Handbook 2000.6 REV-2, within 60 days, please submit to me, for each recommendation listed in the first section of Appendix B that is addressed to the CFO, a status report on: (1) the corrective action taken; (2) the proposed corrective action and target completion dates; or (3) why action is considered unnecessary. For recommendations addressed to the assistant secretaries or their staffs, please coordinate their response or, at your option, request that they respond directly to me. A status report is not required for recommendations 7.f. and 7.h. as we are issuing a management decision concurrent with the issuance of this report. An additional status report is required on any recommendation without a management decision after 110 days. Also, please furnish us with copies of any correspondence or directives issued in response to the audit.

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Abbreviations:

BRP ....business resumption plan
CDBG ....Community Development Block Grant
CHUMS..........................Computerized Homes Underwriting Management System
CAPER ....Consolidated Annual Performance and Evaluation Report
CPD ....Office of Community Planning and Development
CFO ....Chief Financial Officer
FERA ....Front-End Risk Assessment
FFMIA...........................Federal Financial Management Improvement Act
FHA ....Federal Housing Administration
FMC ....Financial Management Center (Section 8)
FMFIA...........................Federal Managers' Financial Integrity Act
FSI ....Financial Systems Integration
GAO ....General Accounting Office
GPRA ....Government Performance and Results Act
GTR ....Government Technical Representative
HA................................housing authority
HAP ....housing assistance payment
HUB ....Voucher Processing "Hub"
HUD ....Department of Housing and Urban Development
HUDCAPS......................HUD's Central Accounting and Program System
IA.................................independent auditor
IBS ....Integrated Business System
IDIS ....Integrated Disbursement and Information System
IRS ....Internal Revenue Service
IT ....information technology
LAN..............................Local Area Network
LOCCS ....Line of Credit and Control System
MTCS ....Multifamily Tenant Characteristics System
OIG...............................Office of Inspector General
OMB ....Office of Management and Budget
PAS ....Program Accounting System
PHAS ....Public Housing Assessment System
PHMAP ....Public Housing Management Assessment Program
PIH ....Office of Public and Indian Housing
POH ....Primary Organization Head
RAMS ....Risk Assessment Management System
REAC............................Real Estate Assessment Center
REMS ....Real Estate Management System
SEMAP..........................Section 8 Management Assessment Program
SFFAS...........................Statement of Federal Financial Accounting Standards
SGL ....Standard General Ledger (of the United States Government)
SHFA ....State Housing Finance Agency
SS.................................Social Security
SSA ....Social Security Administration
SSI................................Supplemental Security Income
TARC............................Troubled Agency Recovery Center

TEVS ....Tenant Eligibility Verification System
TRACS ....Tenant Rental Assistance Certification System
TSS................................Top Secret Security

Independent Auditor's Report

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

In accordance with the Chief Financial Officers (CFO) Act of 1990, we have audited the accompanying consolidated statement of financial position of the Department of Housing and Urban Development (HUD) as of September 30, 1998 and the related consolidated statements of net cost, changes in net position, budgetary resources and financing for the fiscal year then ended. The objective of our audit was to express an opinion on the fair presentation of HUD's fiscal year 1998 principal financial statements. In connection with our audit, we also considered HUD's internal control over financial reporting and tested HUD's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its principal financial statements.

Opinion on the Financial Statements

In our opinion, the accompanying principal financial statements present fairly, in all material respects, the financial position of HUD as of September 30, 1998 and the net costs of operations, changes in net position, status of budgetary resources, and reconciliation of net costs to budgetary obligations for the fiscal year then ended, in conformity with generally accepted federal accounting standards as described in Note 2 to the principal financial statements.

With respect to previous fiscal years, we were unable to conclude that HUD's consolidated financial statements were reliable in all material respects. Therefore, our ability to conclude that HUD's fiscal year 1998 financial statements were reliable was noteworthy. However, because of continued weaknesses in HUD's internal controls and financial management systems, this accomplishment came only after HUD and its contractors went through extensive ad hoc analyses and special projects to develop account balances and necessary disclosures, particularly in the following areas.

Federal Basis Accounting for FHA

Fiscal year 1998 was the first year in which the Federal Housing Administration (FHA) was able to prepare audited financial statements based on accounting standards applicable to federal agencies. This required extensive ad hoc efforts by Office of Housing and contractor support personnel. Specifically, FHA's general ledger was not compliant with the U.S. Standard General Ledger (SGL) and, as a result, additional analysis was required to prepare both the financial statements and reports to the U.S. Treasury on budget execution. In addition, staff surveys had to be completed to allocate administrative costs in accordance with standards on managerial cost accounting. Also, FHA's calculation of the liability for loan guarantees required refinement. Also, amounts associated with completed contracts and fulfilled purchase orders had not been deobligated, necessitating financial statement adjustments. Finally, reconciliations of commitments and endorsements identified nine items that had not been recorded in the budget system.

Overpayment of Housing Subsidies

Material control weaknesses affect subsidies disbursed by HUD through various programs, primarily the Section 8, Low Rent Public Housing

(Operating Subsidy) and Section 202/811 Programs. As a result, HUD lacks sufficient information to ensure that federally subsidized housing units are occupied by eligible families and that those families are paying the correct rents. Existing internal controls and financial systems do not provide adequate assurance that funds provided to housing authorities (HA) and multifamily project owners are correctly calculated based on participating families' eligibility, and that the objectives for which funding is provided are achieved. To provide for disclosure in HUD's financial statements as of September 30, 1998 and for the fiscal year then ended, as had been done in prior years, HUD completed a special project to estimate the amount of unreported and under reported income of participating families, and the effect on HUD subsidies. While this special project served as a basis for determining necessary disclosure, primarily for financial reporting purposes, it was limited in its scope, and was not intended to correct the material internal control weaknesses relating to the verification of these subsidy payments as discussed later in this report.

Our audit also disclosed:

- Material weaknesses in internal controls in fiscal year 1998 related to the need to:

  - complete improvements to financial systems;
  - complete organizational changes to more effectively manage HUD's resources;
  - ensure that subsidies are based on correct tenant income;
  - improve monitoring of multifamily projects;
  - address FHA staff and administrative resource issues;
  - continue to place more emphasis on early warning and loss prevention for FHA insured mortgages;
  - improve FHA's federal basis and budgetary accounting; and
  - improve FHA's information technology systems to support business processes more effectively.

- Reportable conditions in internal controls in fiscal year 1998 related to the need to:

  - improve HUD's management control program;
  - refine performance measures to effectively implement results management;
  - improve controls over project-based subsidy payments;
  - improve monitoring of HAs;
  - fully implement a strategy to oversee Community Planning and Development (CPD) program grantees;
  - improve general system security and other controls;
  - overhaul personnel security for systems' access;
  - strengthen access controls over HUD's major payment systems, the HUD Central Accounting and Program System (HUDCAPS) and the Line of Credit and Control System (LOCCS);
  - improve processes for reviewing obligation balances;
  - continue actions to quickly resolve FHA's Secretary-held multifamily mortgage notes and minimize additional mortgage note assignments;
  - sufficiently monitor and account for FHA's single family property inventory; and
  - enhance the design and operation of FHA's information systems' general and application controls.

Most of these control weaknesses were reported in prior efforts to audit HUD's financial statements and represent long-standing problems. In its *Fiscal Year 1998 Accountability Report*, HUD plans to report that it complied with Sections 2 and 4 of the Federal Managers' Financial Integrity Act (FMFIA), with the exception of the material weaknesses and nonconformances specifically identified in that report. Section 2 and related guidance require that: (1) an agency's internal accounting and administrative controls provide reasonable assurance that obligations and costs are in compliance with applicable laws; (2) funds, property and assets are adequately safeguarded; and (3) revenues and expenditures are properly and reliably accounted for and reported. Section 4 requires that accounting systems conform to the accounting principles and standards mandated by the Comptroller General of the United States. In prior years, we disagreed with the Department's statement of overall assurance in the Department's *Accountability Reports*. HUD's compliance determinations did not fully consider the magnitude of the problems HUD acknowledges in its own FMFIA process. With the Office of Management and Budget's (OMB) approval as part of an initiative to streamline financial reporting, HUD did not prepare a separate FMFIA report for fiscal year 1998, but will be addressing those reporting requirements in its *Fiscal Year 1998 Accountability Report.* Given the magnitude of the problems that still remain, we continue to believe that an FMFIA statement of noncompliance would be appropriate for HUD.

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

- HUD did not substantially comply with the Federal Financial Management Improvement Act (FFMIA).

- FHA was not in full compliance with data and accounting requirements of the Credit Reform Act. Specifically, FHA's single family periodic premiums system does not generate the required case-specific cash flow data required to reestimate its subsidies properly.

For informational purposes, the users of these financial statements should note that approximately $70 billion of HUD's reported net position comprises funds appropriated to HUD to provide housing and community assistance in the future under existing agreements. As discussed in Note 3 to the financial statements, HUD entered into long-term contracts and other commitments under its various grant and subsidy programs, most significantly, the Section 8 rental assistance program. Subsequent to 1988, the Congress appropriated funds to enter into and renew multiyear contracts for the entire contract terms in the initial year of the contract, the effect of which substantially increased HUD's net position. In recent years, the terms for Section 8 contract renewals have been generally declining to the point where recent renewals have generally been for a one year term. Amounts obligated for Section 8 contracts are based on estimated information such as household income, inflation and rent which often differ from actual information over the contract terms. To the extent that actual costs are less than amounts obligated, reserves can accumulate. During fiscal year 1998, HUD conducted a review of the costs of the tenant-based portion of the Section 8 contract renewal program administered by the Office of Public and Indian Housing (PIH) and deobligated about $1.3 billion in reserves that had accumulated that was in excess of amounts needed to fund the related Section 8 contracts to their expiration dates.

As further discussed in Note 3, with respect to other Section 8 programs, primarily the project-based Section 8 programs administered by the Office of Housing, a substantial number of contracts remain that were executed prior to 1988, when the Congress gave HUD the authority to enter into multiyear contracts that were not funded for their entire terms of up to 40 years. HUD then used (and continues to use) permanent indefinite appropriations to fund only the current year's portion of the multiyear contracts. Because of the duration of these contracts, substantial amounts of permanent indefinite appropriations will continue to be used in future years. Upon expiration of these project-based contracts, HUD's policy is to recapture remaining budget authority and use those funds to renew expiring contracts or fund amendments to active contracts that require additional funds. During fiscal year 1998, HUD recaptured about $0.4 billion from expired contracts. HUD recaptured an additional $1.3 billion after the end of fiscal year 1998 from contracts that had expired as of September 30, 1998. HUD has adjusted the financial statements to reduce the amount of reported outstanding obligations as of September 30, 1998. With respect to unexpired contracts and recently expired contracts in the closeout process, HUD plans to present an unaudited estimate of the amount of additional budget authority that will be required to fund these contracts over their remaining terms as supplemental information in its *Fiscal Year 1998 Accountability Report.* HUD's current estimate reports $10.2 billion of potential recapture amounts relating to those contracts which are projected to have remaining budget authority upon expiration. In addition, shortfalls of $12.1 billion were identified on other contracts which are projected to need additional budget authority to fully fund them to expiration

Consolidating Financial Information

We conducted our audit for the purpose of forming an opinion on the consolidated principal financial statements taken as a whole. HUD plans to present consolidating statements of financial position, changes in net position, budgetary resources and financing as supplemental information in its *Fiscal Year 1998 Accountability Report.* The consolidating financial information is to be presented for purposes of additional analysis of the financial statements rather than to present the financial position, changes in net position, status of budgetary resources and reconciliation of net costs to budgetary obligations of HUD's major activities. The consolidating financial information is not a required part of the consolidated principal financial statements. The consolidating financial information has been subjected to the auditing procedures applied in the consolidated principal financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the consolidated financial statements taken as a whole.

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

Issues with HUD's Internal Control Environment

Most of the material weaknesses and reportable conditions discussed in this report are the same as those included in prior years' reports on audits of HUD's financial statements. HUD has been taking actions to address the weaknesses and in some instances has made progress in correcting them. For the most part, however, progress has been at a slow pace in large part because HUD needs to address issues that fundamentally impact its internal control environment. HUD's most recent effort to address its management deficiencies is the *HUD 2020 Management Reform Plan (HUD 2020)*, announced in July 1997. As discussed below, HUD's ability to address its problems will substantially improve if it is successful in completing efforts to:

- upgrade its financial management systems,
- complete organizational changes to resolve resource issues,
- address weaknesses with its management control program, and
- improve performance measures for its programs.

The most critical need faced by HUD in improving its control environment is to complete development of adequate systems. While HUD's efforts have met with some measurable success, much work remains and HUD will continue to report material system nonconformances in its *Fiscal Year 1998 Accountability Report*, albeit on fewer systems than in prior years. Although HUD has invested seven years and more than twice the amount originally estimated to improve its financial management systems, there is still heavy reliance upon legacy systems. A number of critical financial management systems such as the Program Accounting System (PAS), Computerized Homes Underwriting Management System (CHUMS), LOCCS and others have been operational for over 15 years and are becoming increasingly difficult and costly to maintain. As part of *HUD 2020*, the Department revised its Financial Systems Integration (FSI) strategy. The *HUD 2020* plan calls for HUD to "modernize and integrate HUD's outdated financial management systems with an efficient, state-of-the-art system." However, changes to the FSI project scope and strategy are becoming more frequent. According to the most recent estimate from the CFO, FSI's total costs through fiscal year 1999 will total $255 million and the core financial management system will not be fully deployed until October 1999.

To remain on track, the FSI project team must complete several large and complex activities during fiscal year 1999. In fiscal year 1998, the project team worked diligently to complete scheduled activities. However, the project suffered schedule delays resulting in further cost increases. We believe the existing FSI project performance measurement and reporting process is ineffective in enabling the FSI project team to control project costs and schedules.

In addition to improving its financial management systems, HUD will need to successfully complete organization changes under *HUD 2020* to more effectively manage its declining resources. Many of the weaknesses discussed in this report, particularly those concerning HUD's monitoring of program recipients, are exacerbated by HUD's resource management shortcomings. While we agree that HUD must reform, and agree with some of the corrective measures in the *HUD 2020* plan, critical structural changes need to be fully implemented before HUD's new organization can effectively address these weaknesses. In particular, HUD must:

- Complete the transfer of the workload associated with approximately 21,000 housing assistance contracts to contract administrators.

- Complete implementation of the Real Estate Assessment Center (REAC) and provide for assessing the overall physical and financial condition of HUD's housing portfolio.

- Successfully streamline or outsource activities associated with the management and disposition of HUD-owned single family properties.

- Finalize and implement plans to permanently organize and adequately staff a Departmental income verification program.

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

Verification of Subsidy Payments

HUD spent about $19 billion in fiscal year 1998 to provide rent and operating subsidies to HAs and multifamily project owners that benefited over 4 million lower-income households through a variety of programs, including public housing and Section 8. HUD's control structure that was in place during fiscal year 1998 did not provide reasonable assurance that these funds were expended by HAs and project owners in compliance with the laws and regulations authorizing these programs. HUD estimates that excess subsidy payments totaled about $857 million for calendar year 1997. The admission of a household to these rental assistance programs and the size of the subsidy it receives depend directly on its self-reported income. HUD's control structure does not provide reasonable assurance that subsidies paid under these programs are valid and correctly calculated considering tenant incomes and contract rents.

Tenant income is a major factor affecting eligibility for, and the amount of, housing assistance a family receives, and indirectly, the amount of subsidy HUD pays. In general, HUD's subsidy payment makes up the difference between 30 percent of a household's adjusted income and the housing unit's actual rent or, under the Section 8 voucher program, a payment standard. Tenants often do not report income or under-report income from a specific source which, if not detected, causes excessive subsidy payments by HUD.

HUD has developed a nationwide estimate of the amount of excess rental subsidies paid during calendar year 1997. As we describe later in this report, various efforts are planned and underway to build upon this and address the need to institute an ongoing quality assurance program to improve controls over these payments. This includes various pilot federal income tax data matching projects. To ensure that these projects are effective, HUD needs to take action to improve the accuracy of and enforce requirements for HAs to timely update information in its tenant databases.

Monitoring Program Recipients

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

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

Historically, HUD monitored recipients based on compliance oriented procedures and review schedules that applied to all recipients. To deal with resource limitations, in recent years, HUD has revised its monitoring strategies for its major programs to make them more risk based and focused on performance. However, we found continuing problems, most notably with HUD's efforts to monitor multifamily projects.

Under the *HUD 2020* initiative, the REAC is to provide for assessing the overall physical and financial condition of HUD's housing portfolio. Moreover, HUD plans to outsource the workload associated with approximately 21,000 housing assistance contracts. HUD field offices are not sufficiently staffed to adequately review project and HA financial statements nor have they been able to perform sufficient on-site monitoring. Until the *HUD 2020* initiatives have been sufficiently implemented, HUD will continue to be hampered in its ability to effectively monitor its program participants.

System and Accounting Issues

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

- general system security and other controls, including year 2000 preparations;
- administration of personnel security operations; and
- access controls over HUD's two major payment systems, HUDCAPS and LOCCS.

We also discuss an accounting issue regarding the need for HUD to improve its processes for identifying and deobligating funds that are no longer needed. Major deficiencies include:

- Offices were either not reviewing unliquidated obligations or not performing reviews in a timely manner to determine whether the obligations should be continued, reduced, or canceled.

- Obligations identified as invalid were not being deobligated in a timely manner.

- A lack of integration between program and accounting systems producing data inconsistencies has hampered HUD's ability to evaluate unexpended Section 8 project-based obligations.

Problems with FHA's Internal Controls Continue

A separate audit was performed of FHA's fiscal year 1998 federal basis financial statements by the independent certified public accounting firm of KPMG LLP. Their report on FHA's financial statements, dated March 5, 1999,[1] includes discussions of interrelated material weaknesses, most of which were also reported in prior audits of FHA's financial statements as follows:

- ***FHA must address staff and administrative resource issues.*** FHA must review the staffing levels, personnel skills versus skill needs, and training resources available to conduct its mortgage insurance programs. As implementation of the *HUD 2020* reorganization proceeds, these issues remain critical to the management of FHA's programs.

- ***FHA must continue to place more emphasis on early warning and loss prevention for insured mortgages.*** FHA must focus more attention on reducing the frequency and loss severity of defaults on insured mortgages by improving its efforts to identify and cure troubled multifamily mortgages before they become seriously delinquent and by utilizing loss mitigation tools for the single family insured portfolio before properties are foreclosed.

- ***FHA must improve federal basis and budgetary accounting.*** FHA must perform analysis and reconciliation of obligations to ensure that obligated amounts are properly stated. In addition, formal documentation must be developed to support the preparation of federal basis financial statements, budgetary standard forms, and FHA's cost allocation process. Furthermore, FHA's methodology for calculation of the liability for loan guarantees required refinement.

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[1] KPMG LLP's report on FHA was incorporated in our report entitled, "Federal Housing Administration, Audit of Fiscal Year 1998 Federal Basis Financial Statements" (99-FO-131-0002, dated March 12, 1999).

- ***Information technology systems must be improved in order to support business processes more effectively.*** Improvements to the information systems are hindered because of the existence of other critical system priorities at HUD.

KPMG LLP also notes three reportable conditions regarding the need for FHA and HUD to: (1) continue actions to quickly resolve Secretary-held mortgage notes and minimize additional mortgage note assignments and note servicing responsibilities, (2) sufficiently monitor and account for its single family property inventory, and (3) enhance the design and operation of information systems general and application controls.

KPMG LLP also notes that FHA was not in full compliance with data and accounting requirements of the Credit Reform Act. Specifically, FHA's single family periodic premiums system does not generate the required case-specific cash flow data required to reestimate its subsidies properly.

We consider the above issues to be material weaknesses, reportable conditions and material noncompliance at the Departmental level. A more detailed discussion of these issues is not included in our report but can be found in KPMG LLP's report on FHA's fiscal year 1998 federal basis financial statements.

HUD 2020 Reforms Need Additional Time to Demonstrate Their Effectiveness

Many of the issues described in this report represent long-standing weaknesses that will be difficult to resolve. HUD's management deficiencies have received much attention in recent years. For example, in January 1994, the General Accounting Office (GAO) designated HUD as a high risk area, the first time such a designation was given to a cabinet level agency. In February 1997, GAO updated their assessment but concluded that HUD's programs will remain at high risk to fraud, waste, abuse and mismanagement until it completes more of its planned corrective actions. In their January 1999 update, GAO concluded that HUD is making significant changes and has made credible progress since 1997 in laying the framework for improving the way the Department is managed. GAO noted that HUD's Secretary and leadership team have given top priority to addressing the Department's management deficiencies through the *HUD 2020* plan and that this top management attention is critical and must be sustained in order to achieve real and lasting change. Given the nature and extent of the challenges facing the Department, both GAO and we acknowledge that it will take time to implement and assess the impact of any related reforms. While major reforms are under way, several were in the early stages of implementation as of the end of fiscal year 1998. Consequently, GAO continues to believe that HUD's management deficiencies, taken together, place the integrity and accountability of HUD's programs at high risk.

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

Agency Comments and Our Evaluation

On February 18, 1999, we provided a draft of the internal control and compliance sections of our report to the CFO and appropriate assistant secretaries and other Departmental officials for review and comment, and requested that the CFO coordinate a Department-wide response. A draft of the remaining sections of the report was provided on March 19, 1999. The Deputy CFO responded in a memorandum dated March 23, 1999 which is included in its entirety as Appendix D. That response, along with additional informal comments we received, were considered in preparing the final version of this report.

The Deputy CFO stated that the unqualified opinion included in this report was "...reflective of the many reforms accomplished through the implementation of the HUD 2020 reform plan." The Department did not disagree with our conclusions and recommendations, and recognized that challenges remain in correcting the Department's material weaknesses and reportable conditions. However, the Department felt that our report did not sufficiently describe the impact of *HUD 2020* accomplishments that HUD asserted had occurred subsequent to the end of fiscal year 1998.

As noted in our report, many of the key reforms in *HUD 2020* that are directed at HUD's internal control weaknesses had not begun implementation until well into or after the end of fiscal year 1998, the period covered by our audit. We did acknowledge the status of key actions being planned or taken to address the deficiencies, but concluded that the weaknesses had not been corrected as of September 30, 1998. It is too soon to reach a conclusion on the effectiveness of initiatives that even the Department acknowledges have not been fully implemented. With respect to our ability to issue an unqualified opinion on HUD's financial statements, this is not reflective of *HUD 2020* accomplishments, but as we mention earlier, resulted from substantial ad hoc analyses and special projects by HUD and contractor staff to develop account balances and necessary disclosures.

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

Susan Gaffney
Inspector General

March 17, 1999

HUD's Internal Control Environment

HUD Continues to be Impacted by Weaknesses in the Control Environment

Most of the material weaknesses and reportable conditions discussed in this report are the same as those included in prior years' reports on audits of HUD's financial statements. HUD has been taking actions to address the weaknesses and in some instances has made progress in correcting them. For the most part, however, progress has been at a slow pace in large part because HUD needs to address issues that fundamentally impact its internal control environment. HUD's most recent effort to address its management deficiencies is *HUD 2020*, announced in July 1997. As discussed below, HUD's ability to address its problems will substantially improve if it is successful in completing efforts to:

- upgrade its financial management systems,
- complete organizational changes to resolve resource issues,
- address weaknesses with its management control program, and
- improve performance measures for its programs.

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

HUD has made progress in implementing new integrated financial management systems. However, a considerable amount of work remains. Consequently, HUD continues to report material system non-conformances in its *Fiscal Year 1998 Accountability Report*, albeit on fewer systems than in prior years. Major deficiencies with HUD's financial management systems reported in prior years that continued through fiscal year 1998 to some degree include:

- Insufficient information regarding individual multifamily loans. This makes assessing and quantifying credit risk difficult and adversely impacts efficient, ongoing reporting of credit risk to senior management and effective monitoring of multifamily projects.
- Deficient FHA general ledger and subsidiary systems that impede better case level reporting, budgetary accounting and compliance with Credit Reform.
- Inadequate assurance about the propriety of Section 8 rental assistance payments.
- Incomplete information concerning FHA operations by program, geographical area, or other relevant components.
- Inability to blend financial and program data to develop meaningful performance measures.

- Lack of integration between program and accounting systems necessitating duplicate data entry.

- Security weaknesses in general and specific application controls.

Progress has been made toward accomplishing FSI objectives

The objective of the FSI project is to develop an integrated financial and management information system that will provide timely and accurate information to managers and enable the Department to properly manage its financial resources. Although HUD's integration strategy has changed several times since the FSI project's inception in 1991, there have been noteworthy accomplishments.

In 1995, the Department developed and deployed HUDCAPS, which handles core accounting transactions for several key programs. Deployments to date include the Section 8 tenant-based program, the salaries and expenses accounts, and the working capital account. In addition, as of October 1998, a consolidated HUD-wide general ledger with a new chart of accounts was deployed that is to include, for the first time, summary transactions for the Department.

Several financial, mixed use and programmatic system development efforts undertaken as part of the FSI project are complete. The Office of Housing uses the Tenant Rental Assistance Certification System (TRACS) for tenant voucher processing, contract processing, and budget development and analysis. The Integrated Disbursement Information System (IDIS) supports consolidated planning, disbursements, and reporting for approximately 950 CPD grantees. FHA implemented an electronic data interchange system to process and pay single family insurance claims, and established an Internet connection for lenders to check the status of their mortgages.

The Integrated Business System (IBS) was developed and is used by PIH and the Office of Native American Programs. IBS enables these offices to monitor their programs, including information related to all housing authorities in the country. To track and manage its procurement activities, the Department developed and implemented a new procurement system. A Grants Evaluation Management System was developed and deployed and is used by the Office of Fair Housing and Equal Opportunity to monitor their two major grant programs.

In support of *HUD 2020*, a Community 2020 Geographic Information System was developed to provide program and management information in a geo-coded format. The CFO also developed and deployed a Budget Formulation System to prepare and monitor the annual budget. Despite these accomplishments, much work remains unfinished and a number of weaknesses must be addressed.

FSI strategic and implementation plans need to be improved

Although HUD documented an integration strategy in a previous FSI project plan, the plan has not been updated to reflect the latest approach. HUD needs to develop and document an updated project strategy and an implementation plan for completing the integrated financial management information system project. Without a detailed implementation plan, management accountability and adequate oversight will be difficult to establish. As a result, the FSI project could be at risk of schedule delays and cost overruns.

The FSI Project Team annually prepares a project work plan that identifies objectives and related tasks as well as resource requirements for the fiscal year. The FSI work plan includes objectives related to two of the components, the core financial system and the consolidated database with an Executive Information System and a Geographic Information System. However, HUD lacks a plan to address how the core financial system, program accounting systems, and the consolidated database will be implemented and integrated.

Critical systems such as PAS, LOCCS, and others have been operational for over 15 years. These systems are becoming increasingly difficult and costly to maintain. This is a particular concern because numerous changes to legacy systems over the years were not adequately controlled or documented thereby making system maintenance and enhancement more complicated, and time consuming. For cost and schedule control purposes, the FSI plan should describe in detail, with cost and schedule estimates, how HUD intends to replace critical legacy systems.

Frequent project scope and strategy changes result in schedule delays and cost overruns

Although HUD has invested over $250 million over seven years, there is continued reliance on legacy systems. To replace increasingly difficult to maintain systems, the CFO must control fluctuations in FSI project scope. Frequent scope changes disrupt productivity of a project and inevitably result in higher costs and schedule delays.

According to a previous FSI project plan, the initial effort was to replace approximately 100 financial and mixed systems with nine standard systems, cost about $103 million and be completed by September 1998. In 1993, the Department changed its FSI strategy and focused on development of a Departmental core financial system that conforms to government-wide standards. Program offices became responsible for ensuring the integration of mixed systems with the core financial system. Because of this change, the completion date was pushed out to December 1998 and the estimated cost rose to $209 million.

In fiscal year 1997, HUD again revised its FSI strategy as part of the Secretary's *HUD 2020* plan. The revised FSI plan calls for consolidation of four general ledger systems into the core financial system. In fiscal year 1998, HUD included data standardization and cleanup as part of the FSI project and in fiscal year 1999, two new systems were added, the Travel Management System and the Grants Management System. According to the most recent estimate from the CFO, FSI costs through fiscal year 1999 will total $255 million and the core financial management system will not be fully deployed until October 1999.

Project management reporting and oversight needs improvement

To remain on track, the FSI project team must complete several large and complex activities during fiscal year 1999. In fiscal year 1998, the project team worked diligently toward completion of scheduled activities. The FSI project team also began to track progress by measuring cost and schedule variances or "earned value." Earned value is a measurement of project costs and schedule variance by comparing the value of work performed during a given period with the work scheduled for that same period. Used properly, earned value measurements can alert management to problems well in advance of project completion.

FSI is the first HUD project to use this industry accepted best practice for project management. However, the FSI project still suffered schedule delays resulting in further cost increases. The existing FSI performance measurement and reporting process is ineffective to control project costs and schedules.

The FSI project team generates earned valued reports summarizing project progress against the baseline schedule and cost estimates. Reports produced in fiscal year 1998 clearly indicated schedule delays and cost increases at the overall project level. However, project level reports did not provide a sufficient level of detail to identify the cause of performance deviations. To better monitor and control project progress, the project team should produce performance measurement reports for each individual FSI task. This can be accomplished by subdividing and reporting on major project deliverables in smaller, more manageable components. This change would; (1) improve the accuracy of cost, time and resource estimates and utilization reporting, (2) define incremental baselines for performance measurement and control, and (3) identify clear responsibility for progress and resource utilization.

Project performance reporting can provide stakeholders with the information to determine whether the resources are used cost effectively to achieve project objectives. However, they are of little value without predefined criteria specifying the acceptable variance results. So far, the CFO has not determined the acceptable cost and schedule variances for the FSI project.

Material Weakness: Effective Management of HUD's Resources Depends on Successful Completion of Organizational Changes

HUD's administrative resources have decreased over the years, while its workload has increased. We have previously reported that HUD has not developed a comprehensive strategy to manage its resources. Reducing and reallocating resources further weakens controls, particularly when coupled with inadequate financial systems. HUD is in the process of implementing significant organizational changes to overhaul and improve the Department's operations under the *HUD 2020* plan, announced in June 1997. The plan calls for major staff downsizing, modification of HUD's field and headquarters organizational framework, consolidation of HUD's programs and activities, and significant changes in the way HUD conducts its business.

HUD staffing changes have had a major impact on operations

As we reported in our *Semiannual Report to the Congress* for the six months ended September 1998, in May 1998, the Secretary revised the original *HUD 2020* plan, which would have reduced the Department's staffing level to 7,500. A new staffing level was set at 9,150. Before this announcement, there were more than 1,500 employees without permanent positions in the "new HUD." At the direction of the Acting Deputy Secretary, a major effort was made this past summer to place these individuals in positions where critical vacancies existed. Most of these placements allowed employees to continue working at their present locations and serve as out-stationed employees for their newly assigned duty stations.

As the *HUD 2020* plan was implemented during fiscal year 1998, there have been major changes in staffing due to newly created and revised positions. These positions were filled through directed reassignments, voluntary reassignments, and merit staffing. Many of these changes are resulting in staffing inefficiencies for several reasons. First, because so many staff moved to new program areas, they do not possess skills matching their new job requirements. Secondly, because a large number of staff are out-stationed, it is more difficult to manage workload and effectively supervise staff. The Department planned a major training effort in early fiscal year 1999 to improve employee skill levels.

Because of delays in *HUD 2020* implementation, most of the staffing efficiencies projected to result from *HUD 2020* have not yet been realized. The REAC has only recently begun its formal process of scoring HAs and multifamily projects. While the Enforcement Center and Troubled Agency Recovery Centers (TARC) are operational, their workloads of problem projects were identified through old business methods. Their existing workloads are well below the workload estimates projected in *HUD 2020*. Field offices continue to deal with Section 8 issues at the local level. For the most part, HUD's business operations continue to be conducted as in the past, with far fewer staff. In some instances, the lack of staff in critical positions has caused dysfunction in field locations.

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

Many of the weaknesses discussed in this report, particularly those concerning HUD's monitoring of program recipients, are exacerbated by HUD's resource management shortcomings. While we agree that HUD must reform, and agree with some of the corrective measures in the *HUD 2020* plan, critical structural changes need to be fully implemented before HUD's new organization can effectively address these weaknesses. In particular, HUD must:

- Complete the transfer of the workload associated with approximately 21,000 housing assistance contracts to contract administrators. The Section 8 Financial Management Center (FMC) is not staffed nor equipped with adequate financial management systems to process payments to project owners. Moreover, renewals of these contracts as they expire are becoming an increasing burden for already reduced Office of Housing field staffs because contracts are being renewed for one year terms rather than multi-year terms as they had been in prior years.

- Complete implementation of the REAC and provide for assessing the overall physical and financial condition of HUD's housing portfolio. HUD's field offices are not sufficiently staffed to adequately review project and HA financial statements nor have they been able to perform sufficient on-site monitoring. The REAC is considered the linchpin of *HUD 2020* because other HUD organizations are so dependent upon its work to better target their monitoring and enforcement resources.

- Successfully streamline or outsource activities associated with the management and disposition of HUD-owned single family properties. Single family staffing was cut by more than 50 percent under *HUD 2020*. It was never intended that HUD's four Home Ownership Centers would handle the full range of loan management and property management and disposition functions they are currently handling. Staffing decisions were based on the assumption that HUD's inventory of assigned notes would be sold and that contractors would manage the property disposition process. In February 1999, HUD awarded a series of "management and marketing" contracts to manage HUD-owned properties. Also, HUD awarded a contract in February 1999 to a private sector group to service all single family Secretary-held notes.

- Finalize and implement plans to permanently organize and adequately staff a Departmental income verification program. We had recommended this in our audit of HUD's fiscal year 1997 financial statements and it was only recently proposed by the CFO that the REAC should assume responsibility for a permanent income verification program for all HUD rental assistance and public housing programs. Prior efforts to carry out income verification activities have been fragmented, with the CFO and other headquarters organizations carrying out various activities, with formerly "unplaced" HUD employees in two HUD field offices providing the majority of the staff support.

We reported in a September 1997 audit[2] that HUD needs to address its contracting activities. HUD relies heavily on contractors to perform a wide variety of program administration activities. Because HUD's reliance on contractors is expected to increase, particularly in the areas noted above, HUD, in acknowledging weaknesses with its contracting activities, made procurement reform a priority in the *HUD 2020* plan. The Department is making good strides to improve HUD's procurement operations through the hiring of a Chief Procurement Officer and initiating ongoing operational improvements.

[2] "HUD Contracting" (97-PH-163-0001, dated September 30, 1997)

As noted later in this report as part of our concerns with monitoring of program recipients, HUD lacks adequate information concerning the quality of the housing stock under both the Office of Housing's multifamily and PIH administered programs. We reported in prior audits of HUD's financial statements that HUD had discontinued previous initiatives for addressing this concern through contracting for basic physical inspections of all multifamily projects and independent housing quality assessments at selected HAs. Instead, HUD's strategy now depends on the establishment of the REAC under *HUD 2020* and the implementation of a standardized inspection protocol. As we discuss later in this report, HUD needs to complete the initial round of REAC inspections and make the results of those inspections available to responsible officials for appropriate action. This first round of inspection activity is scheduled to be completed by the end of calendar year 1999.

It is too soon to determine whether HUD will ultimately be successful in carrying out the reforms called for in the *HUD 2020* plan. However, we are encouraged that HUD has recognized the need to address its resource shortcomings and has put forth such an extensive effort to restructure its operations. To improve on HUD's ability to more effectively manage its resources, the Department, in conjunction with the National Academy of Public Administration, has developed a proposed resource management methodology. The methodology is being piloted and following successful completion of the pilot studies, the methodology will be considered for implementation throughout the Department for resource requirement determination and allocation.

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

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

HUD has continued efforts to improve its management control program

In prior audits of HUD's financial statements we noted that an integral component of HUD's management control program was performing Front-End Risk Assessments (FERA) on new or substantially modified HUD programs and activities. However, we reported that, for the most part, program officials were neither preparing FERAs nor justifying to the CFO why they should not be performed. During fiscal year 1997, as part of the *HUD 2020* initiative, HUD began addressing the need to hold managers accountable for (1) continuously identifying systemic weaknesses in their programs and (2) implementing effective risk abatement strategies. The

CFO was assigned the responsibility for leading HUD's revitalized initiative known as the Management Integrity Program. To carry out the effort, the CFO established an Office of Risk Management which became operational during fiscal year 1998. The program has three major components.

- Incorporate FERAs into *HUD 2020* implementation efforts.
- Perform risk management reviews of existing programs and develop a risk evaluation database.
- Conduct special risk management reviews upon request from program managers.

During fiscal year 1998, the Department completed six FERAs and six special risk management reviews and completed one FERA after the fiscal year end and before the issuance of this report. The Department had 13 reviews in process and plans to start 5 more in fiscal year 1999.

In an effort to ensure that HUD's managers are cognizant of their risk management responsibilities, the CFO's Risk Management Division sponsored management control training for headquarters and field managers and supervisors. Based on the training evaluation summary prepared by the consultant administering the training, HUD staff reported, on the average, that their skills and knowledge was enhanced. As the goal of the course was to help create a common understanding among HUD managers, the CFO's office achieved that goal. The CFO plans to build on this basic understanding with follow-up training in fiscal year 1999 on monitoring activities and techniques.

Formal Departmental policy covering CFO and program responsibilities under the new Management Integrity Program (HUD Handbook 1840.1 Rev-3) has completed Departmental clearance should be issued in the near future.

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

The implementation of the HUD Management Integrity Program during fiscal year 1998 was designed on a risk based approach as described previously. FERAs were initiated for several types of new or modified programs or activities. To determine the effectiveness of the FERA process, we compared one of the six completed FERAs using December 1998 audit results from KPMG LLP on the FHA fiscal year 1998 financial statement audit. The FERA was for the Office of Housing Homeownership Centers.

The approach to preparing the FERA appeared thorough as were the review comments made by the CFO. However, examination of the substance of the documents disclosed the following concerns:

- ***Scope:*** To fully assess risks when assessing a new program or activity, it is essential that the evaluators consider all the key factors that could adversely affect the planned operating control conditions, such as the effect of delays or deferral of certain actions involving (1) interdependent organizations, (2) contract actions, (3) related business processes, (4) system software or hardware design and development, (5) new or updated policies and procedures, (6) adequate staff support, experience and training, and (7) legislated or regulated program changes.

- ***Future Plans***: The FERA assumed that indefinite plans to take or consider action in the future mitigate the risks currently identified or present. To reduce risk in an operating program or function, as contrasted with a future program or function, requires the presence of adequate interim management controls. Adding or assessing prospects about future resources, such as staff, training or systems, does not eliminate the current risk until such plans are deployed and determined to be operating effectively. Under some conditions, the absence of current operating controls increases both present and future risks rather than reducing or mitigating them. For example, KPMG LLP noted that when backlogs are created, processing shortcuts are used to overcome increasing customer complaints resulting in system and data or record denigration and the accompanying impact on staff morale.

The Management Integrity Program also depends on Primary Organization Heads (POH) and their responsible managers to routinely perform and document risk of existing programs or activities. The objective for each POH is to allocate monitoring resources to those programs or functions that pose the greatest risk of control weakness and for carrying their oversight responsibilities. No risk assessments were performed by POHs in fiscal year 1998, however, the CFO's memorandum of September 15, 1998 initiated several reviews for fiscal year 1999.

HUD has taken steps to assess its audit resolution process, but needs to take actions to resolve audits in a more timely manner

OMB Circular A-123 includes resolution of audit findings and other deficiencies as a specific management control standard. The purpose of HUD, Office of Inspector General (OIG) audits is to bring about positive change in HUD programs and operations. Audit resolution is the process by which the HUD, OIG and HUD management agree on the changes to be made. Then HUD management makes the changes.

As a result of prior OIG recommendations, the Department consolidated and centralized field audit liaison activities under the CFO's Office of Internal Control and Audit Resolution. In addition, the Department issued a directive which specifies that the Office of Internal Control and Audit Resolution (now the Audit Coordination Division) will conduct random reviews of audit resolution files to evaluate the documentation and procedures followed for audit resolution. This office conducted a quality control review of the resolution process during fiscal year 1998 and concluded that deficiencies noted in the OIG audits had, for the most part, been corrected.

Although the Department has shown improvement in the audit resolution process, as in past *Semiannual Reports to the Congress*, we continue to report concerns with the Department's ability to resolve audits in a timely manner. Most recently, in our September 1998 report, we noted seventeen examples of prolonged actions in bringing audit recommendations to closure or actions prematurely reported as complete. The examples include instances where HUD had reached a management decision (agreed to take actions), however, agreed upon actions had not been completed over a period of years after the initial agreement. We also discussed three instances where matters had to be referred to the Deputy Secretary because of disagreements with program officials. As a result of the time delays, the Department increases its risk of not recovering misused funds from program participants. In addition, uncorrected control weaknesses increase the Department's vulnerability to fraud, waste, abuse and mismanagement.

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

OMB Bulletin 97-01, *Form and Content of Agency Financial Statements*, requires agencies to report performance measures about the efficiency and effectiveness of their programs. We reported in prior years that there was a lack of performance information included in HUD's annual reports. HUD's *Accountability Report* and prior annual reports emphasized financial and non-financial operating results as input or simple output measures. In prior years, we noted particular concerns with the following key program areas, that HUD is addressing in some manner:

- Meaningful performance information is lacking for HUD's rental assistance programs, including Section 8 programs administered by both the Office of Housing and PIH. For these programs, HUD's *Accountability Report* only describes aggregate dollars expended and number of households assisted. No efficiency or effectiveness measures are provided including any that would address, for example, how well HUD is meeting a key requirement of these programs, that the housing complies with HUD's housing quality standards. A major effort initiated under *HUD 2020* is for the REAC to compile and report the results of physical inspections of public and assisted housing projects later in fiscal year 1999.

- Our review of CPD's monitoring of its program recipients identified that CPD does not effectively validate performance data reported by grantees. IDIS was designed to provide CPD field staffs with the capability to assess real-time performance data and ensure grantee compliance with requirements of all entitlement programs. However, we found various system and grantee monitoring problems with IDIS reporting that need to be addressed to improve the reliability of grantee performance information.

- The performance information for HAs includes information from the Public Housing Management Assessment Program (PHMAP). In light of concerns about HUD's controls over the reliability of this performance data as well as the adequacy of component factors to objectively determine HA performance, PHMAP is being replaced by the Public Housing Assessment System (PHAS), which is to be implemented at the end of fiscal year 1999.

On September 30, 1997, HUD issued its first Government Performance and Results Act (GPRA) strategic plan for fiscal years 1998-2003. It communicated seven broad strategic objectives for HUD’s long range plans together with seven goals under *HUD 2020*. Based on that strategic plan, HUD issued its fiscal year 1999 GPRA annual performance plan to the Congress in March 1998, containing 96 performance measures or indicators to accomplish the same seven objectives. The measures or indicators were predominantly process outputs with about 60 percent not identifying the baseline for fiscal year 1999 target performance. The House Report (H.R. 105-610) accompanying HUD’s fiscal year 1999 appropriations bill states, in part, “...HUD should pay greater attention to the establishment of results-oriented performance measurements rather than maintaining process-oriented performance measurements.” In developing new “Business and Operating Plans” in the last quarter of fiscal year 1998 and the first quarter of fiscal year 1999 to implement the management reforms under *HUD 2020*, the Department revised its strategic objectives from those in the strategic and annual performance plans.

As we stated in our prior audit report, HUD will require more development and reporting of performance information to satisfy both OMB and Congressional requests. Actual fiscal year 1999 performance compared to the annual performance plan will be reported to OMB and the Congress for the first time in fiscal year 2000. Fiscal year 1998 performance had not been compared against HUD’s submission under OMB Circular A-11, *Preparation and Submission of Budget Estimates,* because HUD decided to develop a new performance system to replace the Secretary’s Performance Reporting System. HUD has awarded contracts to assist program offices in the further development and reporting of their performance measures.

In prior years, we reported on our concerns over performance measure data reliability and the Department’s plans to remedy the concern with a program requirement to submit quality assurance plans to the CFO for review and approval. We were encouraged that major program areas completed and submitted their plans for fiscal year 1997 to the CFO. Each office provided assurance that the measures reported were both valid and accurate. However, the CFO decided to contract with the National Academy of Public Administration to review the HUD strategic plan as well as to evaluate the verification and validation process described in the fiscal year 1999 annual performance plan.

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Verification of Subsidy Payments

Greater Efforts Needed to Verify Subsidy Payments

HUD spent about $19 billion in fiscal year 1998 to provide rent and operating subsidies benefiting over 4 million lower-income households through a variety of programs, including public housing and Section 8. HUD's control structure that was in place during fiscal year 1998 did not provide reasonable assurance that these funds were expended by HAs and project owners in compliance with the laws and regulations authorizing these programs. The admission of a household to these rental assistance programs and the size of the subsidy it receives depend directly on its self-reported income. HUD's control structure does not provide reasonable assurance that subsidies paid under these programs are valid and correctly calculated considering tenant incomes and contract rents.

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

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

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

As reported in Note 15 to the financial statements, HUD performed computer income matching with its assisted housing universe and estimated that housing subsidy overpayments were $857 million, an amount we consider to be substantial. Tenant income is a major factor affecting eligibility for, and the amount of, housing assistance a family receives, and indirectly, the amount of subsidy HUD pays. Generally, HUD's subsidy payment makes up the difference between 30 percent of a household's adjusted income and the housing unit's actual rent or, under the Section 8 voucher program, a payment standard. Tenants often do not report income or under-report income which, if not detected, causes HUD to make excessive subsidy payments.

Under reporting or understating of income from a specific reported source is easier to detect than unreported income. Program regulations require

HAs or project owners to verify applicant and tenant income and other factors relating to eligibility and rent through third party written documentation. In the past, HUD field offices performed in-depth occupancy reviews of HAs and project owners which included file reviews that were specifically designed to ensure income reported by tenants and the amounts of income used to determine eligibility and computation of rent were consistent with the verification sources. While the Office of Housing continues to perform some occupancy reviews, PIH now essentially relies on audits performed by independent auditors (IA) to determine whether HAs are performing income verifications. Our concerns with HUD's reliance on IAs for monitoring HAs are discussed later in this report in the section addressing HA monitoring controls.

HUD has made limited use of available income matching tools to detect unreported tenant income

With regard to unreported income, various legal, technical and administrative obstacles exist that impede HUD, HAs and project owners from ensuring tenants report all income sources during the certification and recertification process. Consequently, HUD makes excessive subsidy payments and possibly provides assistance to ineligible families while denying access to housing assistance to eligible families who often are on large waiting lists maintained by many of the HAs. Since unreported income is difficult to detect, HUD has encouraged HAs to computer match with State wage agencies to detect unreported income. Unfortunately, most HAs do not have the technical and/or administrative resources to implement this technique.

To determine necessary disclosure for HUD's fiscal year 1998 financial statements, HUD performed computer income matching with federal income tax data to determine the magnitude and effect of under reported and unreported tenant income in calendar year 1997. HUD randomly sampled 1,000 households from its automated data bases and matched their reported income with federal tax data in Social Security Administration (SSA) and Internal Revenue Service (IRS) data bases. Using the staff of the Chicago and Seattle Income Verification Centers, HUD compared the computer matching results with source documents. Based on the results of the computer income matching project, HUD statistically projected at the 95 percent confidence level that the amount of excess rental subsidies was $774 million plus or minus $191 million, and that 8.4 percent plus or minus 1.7 percent of households had received excess rental assistance during calendar year 1997. Because the households in HUD's databases represented only about 90 percent of the estimated 4.4 million households that received assistance during 1997, HUD extrapolated these results to the entire estimated number of assisted households, yielding an excess rental subsidy estimate of $857 million plus or minus $211 million.

HUD continues to make progress in implementing its income matching program

Throughout fiscal year 1998, HUD continued its initiative with SSA for computer matching data on Social Security (SS) and Supplemental Security Income (SSI) benefits paid to tenants to the amount of income the tenant reported to HAs. PIH enhanced its Tenant Eligibility Verification System (TEVS) software to provide HAs and private owners/management agents with Internet access to SS and SSI data for use in tenant recertifications. In January 1999, PIH issued its first report (Phase II) that provides feedback concerning HAs' and tenants' actions to resolve income discrepancies identified from HUD's computer matching project performed for the fiscal year 1996 financial statements. In 1998, PIH also completed its Phase II analysis of its fiscal year 1997 pilot project where federal income tax data was matched for every tenant household at one selected HA. HUD plans to issue the final report for this project sometime in fiscal year 1999.

In fiscal year 1998, HUD expanded its income matching program and statistically selected two samples of 20,000 households (40,000 total) from its automated data bases for calendar year 1996 and matched the tenant reported income with federal tax data in SSA and IRS data bases. Income data on tenants with income differences greater than $10,000 were analyzed. HUD plans to report on the results during fiscal year 1999.

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

In addition to using the Multifamily Tenant Characteristics System (MTCS) data for PIH's income matching program, HUD uses MTCS for financial planning, budget requests to the Congress, estimates of staff workload, and program monitoring. Additionally, MTCS data will be used in seven of the fourteen indicators in the Section 8 Management Assessment Program (SEMAP) that is tentatively scheduled to be implemented in fiscal year 1999. For HUD's income matching and other program efforts to be effective, it is essential that the MTCS data base have complete and accurate tenant information. HUD's computer matching projects and monitoring efforts have identified MTCS data quality problems which can adversely affect computer matching results and other analyses of tenant data.

HUD's Actions Planned and Underway to Verify Tenant Income

At the time of our audit, the Department was in the process of completing its follow-up analysis for all outstanding income verification projects. HUD plans to prepare and issue separate reports on the results for all project phases during fiscal year 1999. Also, in fiscal year 1998 HUD engaged a contractor to conduct an analysis of current and prior income verification techniques to determine how well these techniques identified income discrepancies among program participants and to recommend a strategy for use of large-scale computer matching income verification to identify unreported tenant income. The contractor recommended in its November 1998 interim report that HUD immediately accelerate the implementation of large-scale computer matching income verification in fiscal year 1999. However, the techniques and methodology to implement this recommendation had not yet been fully developed or tested. Given the complexity of the task involved, full development and testing of a suitable methodology will likely be extended.

The CFO also established a Departmental task force to develop and implement an action plan to address HUD's material weakness with the verification of subsidy payments. The task force is composed of six teams that represent the Offices of the CFO, Housing, General Counsel, Policy Development and Research, PIH and the REAC.

HUD has taken a number of actions to improve the quality and completeness of the MTCS Database and has taken a number of administrative actions to encourage HAs to submit their data to the MTCS. This includes monitoring, on a monthly basis, the 140 largest HAs that were not meeting the MTCS reporting requirements and providing MTCS training to HUD staff in September 1998.

In January 1999, PIH issued a notice informing all HAs that administer public housing or Section 8 tenant-based assistance programs to submit, on a timely basis, 100 percent of the family records to MTCS. The notice establishes tighter minimum reporting rate requirements (85 percent) and administrative sanctions for HAs that do not comply. HUD is also proposing a rule that would specify actions HAs or owners/management agents would be required to take in HUD's assisted programs when participants underreport their incomes.

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

The computer matching projects currently underway should continue to be evaluated thoroughly to assess effectiveness, with particular emphasis on the effects of the statutory restriction on redisclosing federal income tax data to HAs and project owners. Also, HUD should continue to explore and evaluate practical and cost effective computer matching techniques and methodologies that will aid in quantifying, on a larger scale, the extent of abuses and the benefits of a permanent computer matching and income verification process. We are also encouraged by the number of on-going actions HUD is presently pursuing to improve the reporting rate and data integrity of the MTCS. If completed, these actions should help improve the completeness and data integrity of MTCS.

We continue to have concerns over the direction of the computer matching/income verification program. By the end of our audit, the Department had not yet approved a permanent organization structure. However, it appears the Department is moving towards making the accountable unit in charge of the program part of the REAC. In the interim, efforts to carry out income verification activities had been fragmented, with the CFO and other headquarters organizations carrying out various activities, with formerly "unplaced" HUD employees in two HUD field offices providing the majority of the staff support. For the income matching program to be effectively administered, we believe the Department needs to make a firm commitment to organize and properly staff this function.

We also have concerns as to whether the Department is ready to immediately embark on a large-scale computer matching income verification effort. At the time of our audit, key issues relating to developing and testing a suitable approach and the establishment of adequate information technology and human resources infrastructures to support a large-scale matching effort had not been sufficiently resolved.

Additionally, during our audit work at the Chicago Income Verification Center, staff expressed their concerns over the length of the time from receiving one income matching project to the next. This can result in inefficient use of staff and adversely affect employee morale. HUD should take appropriate actions to ensure computer matching projects and other assignments are planned far enough in advance to minimize down time.

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

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

HUD administers various project-based assisted housing programs, most notably, Section 8. Although the payment processes differ, under each program, HUD pays the difference between the contract rent for the units and that portion of the rent the tenant can pay based on their household income. HUD administers about 21,000 assistance contracts with multifamily project owners who are responsible for verifying household income reported by the tenants and submitting requests for payment to HUD due under HAP contracts.

The review of project owner payment requests continues to be labor intensive

Because post payment reviews were not being done consistently by the field offices, in fiscal year 1996, the Office of Housing established the Section 8 Voucher Processing "HUB" in Kansas City. The workload of the field offices was transferred to the HUB in stages and the transfer was completed in January 1998. The HUB performed two primary control functions. Voucher examiners did post payment reviews on between 15 and 20 percent of the HAP vouchers. This involved verifying that changes shown on the HAP voucher, such as tenant recertifications and move-ins, were recorded in TRACS. The HUB also reconciled the HAP amounts shown on vouchers to the actual payments, processed through a different HUD system, LOCCS.

At the time of our audit of HUD's fiscal year 1996 financial statements, the HUB director explained their control structure was evolving. HUD was to develop a TRACS payment module which would calculate and process payments to the owners based on tenant information in TRACS. The post payment reviews then served to test the accuracy of the data that was to eventually be the basis for the payments. If it had been implemented as planned, the payment module would have eliminated the need for post payment reviews or reconcilations to LOCCS. Instead, the staff could test the accuracy of owner input data in TRACS through confirmations with tenants, on-site reviews or income verifications. However, HUD abandoned plans to enhance TRACS payment processing capabilities.

Staffing changes and system weaknesses have increased risks associated with the subsidy payment process

A major initiative under *HUD 2020* is to transfer monitoring responsibilities for Section 8 Housing projects to "contract administrators" such as State Housing Finance Agencies (SHFA) and HAs. In addition to overseeing project owners' activities on HUD's behalf, the contract administrators are to process the HAP payments. HUD planned to have the contract administrators in place by September 1998. Accordingly, the HUB staff was cut to ten and transferred to Voucher Processing Division of PIH's Section 8 FMC. As projects are transferred to the contract administrators, project data residing in TRACS is to be transferred to PIH's HUDCAPS Section 8 system. Similar to the manner in which the tenant-based programs are administered, HUD would then use HUDCAPS to process payments to the contract administrators based on the payments they make to the project owners on HUD's behalf. Under this scenario, the Department has decided that full development of TRACS payment processing is not necessary.

Organizational and staffing changes have already been made, with the anticipation that the contracts with the SHFAs and HAs would be in place by September 1998, according to an early plan. However, the procurement action to accomplish this was delayed because OMB asked HUD to (1) provide a cost-benefit analysis of the proposal and (2) develop a performance-based contract containing incentive and disincentive clauses to assure that contractors perform at an optimum level. While HUD's budget for fiscal year 2000 has requested funding for these contract administrators, they will not be in place until October 1999 at the earliest.

During fiscal year 1998, reviews of project-based Section 8 vouchers have been reduced because of the *HUD 2020* staff cuts. In the first quarter of fiscal year 1998, HUD began having owners submit payment requests electronically, for processing and payment through LOCCS. In conjunction with implementing electronic processing, LOCCS was enhanced to identify payment requests that exceed a specified percentage of the average monthly payments made during the prior 12 months. Before processing of such payment requests can be completed, FMC staff review them to ensure they are valid. Because of the resources needed to resolve these payment requests, the FMC terminated post payment reviews in the first quarter of fiscal year 1998 and LOCCS reconcilations in the second quarter.

We traced the regular tenant assistance payments shown on 71 statistically sampled disbursements to TRACS. About ninety two percent of these 7,530 tenants had information in TRACS supporting the payment. The other 8 percent were not supported. The primary reason they were not supported is that owners did not update TRACS when they recertified tenants. Also, TRACS calculated a different rent than the owners, the owners were notified of the error, but the owners did not resubmit the tenant data.

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

Each audit report on HUD's financial statements since HUD has been subject to audit under the provisions of the CFO Act has identified the lack of effective controls over the project-based subsidy payment process. HUD does not have a process to determine the accuracy of a payment requisition. HUD has abandoned plans to fully implement a TRACS Payment Module because of decisions made as part of *HUD 2020.* In the interim, the FMC recently decided to resume post payment reviews in February 1999 using staff in Chicago and Washington, DC.

Ultimately, HUD plans to transfer monitoring responsibility for Section 8 projects to contact administrators such as SHFAs and HAs. This includes responsibility for making Section 8 payments to project owners. As this occurs, those projects are to be transferred to PIH's HUDCAPS Section 8 system.

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

Most Section 8 HAPs are being made without any HUD review because the FMC is only able to review about 2 percent of the vouchers before payment. If HUD had continued development of TRACS, including the payment module, and had developed procedures to ensure the accuracy of data in TRACS, there would have been adequate controls over payments. The post payment reviews were a valuable tool when HUD planned to continue TRACS development. TRACS data needed to be accurate because it was going to be the basis of the HAP. Now the reviews are of limited value. Reconciling owner input TRACS data to the owner prepared HAP voucher only ensures the two sets of owner data agree. The reconciliation does not show the payment is accurate. The only way to determine if a payment is accurate is to test source documentation through confirmations, on-site reviews or other procedures. The HAP vouchers submitted to the FMC are the source documents supporting HAP payments. HUD needs to commit sufficient resources to control the receipt and storage of these documents.

HUD has elected to address the Section 8 control weakness through the transfer of the functions to contract administrators, rather than fully developing TRACS payment processing functions. However, for this to be successful, HUD needs to successfully complete the transfer of these functions and adequately monitor those entities' performance.

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Monitoring Program Recipients

Weaknesses in Program Recipient Monitoring Continue

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

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

Material Weakness: Improvements Needed in Multifamily Project Monitoring

In prior years, we reported that the Office of Housing needed to improve the effectiveness of multifamily project monitoring and monitoring of SHFAs and HAs that administer assisted housing contracts on HUD's behalf. For fiscal year 1998, we again find that the monitoring of the multifamily projects was inadequate to assure that subsidies were provided only to projects that provided decent, safe and sanitary housing or on behalf of tenants that met HUD eligibility requirements. Also, HUD's monitoring of project based Section 8 contract administration by SHFAs and HAs has continued to be inadequate. HUD provides assistance for about 33,000 private and non-profit owned multifamily projects. This assistance includes FHA mortgage insurance and funds provided under several subsidy programs. The principal multifamily subsidy programs are:

- The Section 8 and Section 236 programs which provide subsidies to project owners, who, in turn, provide housing units at reduced rents to low income households. For the fiscal year ended September 30, 1998, approximately $7.4 billion and $0.6 billion in subsidies were provided under the project based Section 8 and Section 236 programs, respectively.

- The Section 202 and Section 811 programs provide grants to non-profit institutions for the construction of projects providing reduced rent units to the elderly and disabled, respectively. During fiscal year 1998, awards under these programs totaled about $1.1 billion.

Ongoing rent subsidies are also provided under these programs once the units are occupied.

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

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

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

We performed audit work at four HUD field offices. At these field offices we inquired about how properties were analyzed and classified as to the risk they represented to HUD. We did not find a uniform method of risk assessment, and often there was little or no documentation of the assessment process. Moreover, we were unable to determine that the assessments were performed on an annual basis. This is similar to the deficiency we identified with risk assessments during our 1997 audit. Results of such risk assessments should be used to identify troubled and potentially troubled projects and develop plans for asset managers to assist properties to regain financial and physical stability.

We also reviewed project monitoring at four HUD field offices. At all of the field offices, we found monitoring to be inadequate. We reviewed project files of 138 multifamily projects, the majority of which received rental assistance and were classified as troubled or potentially troubled. We reviewed the project files to determine if the most recent annual financial audit had been submitted and if the financial statements had been analyzed by the field office. We also reviewed the files to determine the date and results of the most recent physical inspection, management and/or occupancy review and whether HUD was following up on deficiencies identified during the project audit or review.

Financial analysis and follow-up on annual financial audits needed to be improved. Statements were received as required from only 83 percent of the projects and only 52 percent of the statements received were analyzed by the field offices. In addition, the performance and follow-up of physical inspections, and management and occupancy reviews for troubled and potentially troubled projects were inadequate. We found that only 26 percent of the physical inspections were conducted during fiscal year 1998 as required. We also noted for troubled and potentially troubled projects that only 30 percent of the required management and/or occupancy reviews were performed, of which only 60 percent received adequate follow-up by the field offices. Lack of adequate monitoring of troubled and potentially troubled projects continued to be a problem for the field offices.

HUD 2020 deployment priorities resulted in decreased monitoring and oversight of multifamily projects

Field office managers cited various reasons for not monitoring projects, such as lack of available travel funds when needed. In addition, deployment of *HUD 2020* changes, including efforts to enter data in the Real Estate Management System (REMS), affected staffing, workload and work focus. When monitoring activities are not performed or not performed in a timely manner, HUD lacks assurance that rental subsidies are being paid for decent, safe and sanitary housing or that the subsidized tenants meet the HUD established eligibility requirements. Thus, HUD lacks assurance that assistance payments are being made to properties and on behalf of tenants in a manner that complies with applicable laws and regulations.

In previous years, HUD relied on contractors to assist with performing physical inspections and receiving and analyzing project financial statements. In early 1997, field offices were instructed to terminate existing contracts for physical inspections, pending the award of four contracts for the basic physical inspections of all properties in the HUD multifamily housing portfolio. These contracts were awarded in March 1997 then terminated in May 1997. The REAC, organized as part of the *HUD 2020* initiative, was given responsibility for the physical inspection process, and performed pilot inspections during fiscal year 1998 to provide software and system checks for the electronic devices used to record inspection results. The center began receiving the first inspection reports electronically on September 29, 1998. For fiscal year 1998, the field offices did not have the REAC inspection reports available to assist in their monitoring efforts. However, by end of the first quarter of 1999 REAC anticipates having completed the inspections from the initial contract resulting in approximately a third of the multifamily projects where a score will be recorded in REMS for use by HUD field staff.

Better monitoring of “contract administrators” needed

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

In last year's report, we reported that only one field office had performed a timely review of the contract administrators within its jurisdiction. For fiscal year 1998, the field offices we visited did not review any of the contract administrators. Office managers cited lack of staff resources and other disruptions caused by the deployment of *HUD 2020* and other priorities. The lack of monitoring of Section 8 contract administrators continues to be a problem for the field offices. When HUD does not monitor the projects directly or indirectly, it adversely impacts HUD's ability to assure the propriety of Section 8 disbursements.

Clearer guidance needed in carrying out Management Plan goals

The Office of Housing establishes and reports priorities and performance in the *Commissioner's Executive Reports* which includes the *Fiscal Year 1998 Management Plan.* For the fiscal year 1998 plan, as in prior years, the reduction of the inventory of troubled projects and the placement of troubled projects under compliance plans were goals. These goals were established with the understanding that until the REAC and Enforcement Center were fully operational, the goals would be unchanged as goals for the Office of Housing. At one field office that we visited, the establishment of that field office's targets for these goals was not set according to Headquarters instructions, and achievements towards the target were not documented or verified by Headquarters.

The *Commissioner's Executive Report* also listed as a multifamily "Hub" field office goal, the data entry of all critical data elements for all 33,000 multifamily projects in REMS, subject to certification by field management. For the fiscal year ended September 30, 1998 the *Commissioner's Executive Report* indicated that these offices had reached an average of 88 percent of the goal of data entry and that no multifamily "Hub" had entered all their projects in REMS.

While other goals were listed for both the Office of Housing and FHA, they did not include any reporting on monitoring. Goals and requirements for monitoring traditionally have been documented as required by Office of Housing Handbooks and Notices. However, throughout the audit, both field program staff and we noticed various instances where authoritative criteria were out of date, incomplete, inconsistent, or absent. As a result, reliance was being placed on more informal electronic mail, satellite training, the Internet and guidance disseminated via conference calls.

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

The key initiative aimed at improving HUD's monitoring of multifamily projects is *HUD 2020.* There are several separate initiatives under this plan including the establishment of the REAC, the development of REMS and the Section 8 FMC.

- The REAC is to assess the financial and physical condition of all multifamily properties through receipt and analysis of projects' annual electronically formatted and submitted financial statements and periodic physical inspections results. The data are to be scored and the results are to be used to assign property status and future course of action to resolve identified problems.

- REMS is the core system that is to contain the complete project profile for the approximately 33,000 projects in the multifamily inventory. It is to improve the availability and maintenance of core data critical to managing multifamily housing projects and contain information about the property identification, ownership, financial statements, physical condition, subsidy status, property management, occupancy, FHA contracts, and a problem statement

- The FMC was established to perform duties related to rental subsidies for all HUD assisted properties using a "wholesale" concept where HUD would rely on SHFAs and HAs as the contract administrators who would be responsible for activities such as prevalidation of payments to owners, monitoring of compliance with HUD's occupancy rules, housing quality standards and project financial viability. HUD's budget for fiscal year 2000 has requested $209 million in funding for these administrators. HUD's goal is to commence contractor administrator oversight by October 1999, provided that the requested funds are appropriated.

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

REAC Services

In prior years we noted that the Office of Housing had introduced the Risk Assessment Management System (RAMS), but in early 1997, RAMS was abandoned as a mechanism to identify and rank troubled projects before it was put into widespread use. Although a ranking concept is to be used by the REAC when it becomes operational, the Office of Housing did not follow through with an opportunity to acquire a timely assessment of its portfolio prior to undergoing the reforms under *HUD 2020* and is now dependent on REAC operations.

Also in last year's report, we commented on the Office of Housing's cancellation of contracts to conduct physical inspections because the REAC was being organized to establish a uniform inspection protocol and receive and evaluate inspection results. As with RAMS, this effort was transferred to the REAC, but it represents another missed opportunity to obtain critical information because of reliance on *HUD 2020*. REAC has begun contracting for physical inspections, the results of which are being made available to project managers, beginning in February 1999. As of February 1999, REAC reported that more than 4,000 inspections of multifamily properties have been conducted and made available to field offices through REMS. REAC officials state that they are on target to complete the physical inspections of the entire project portfolio by December 1999.

REAC is also assuming responsibility for receipt of the annual audited financial statements filed by multifamily project owners. The deadline for filing of the calendar year 1998 statements has been extended from 60 days after the year end to June 30, 1999, because conversion to electronic submission was determined to be burdensome for the project owners. Scores are to be developed and recorded in REAC's systems which then have to interface with REMS for HUD multifamily project managers' use beginning February 1999. According to REAC officials, the analysis of financial statements is beginning in March and will be completed by the end of September 1999.

Finally, In June 1998, REAC reported the results of a FERA. In a letter to the Chief Financial Officer, the acting director of the REAC reported that the center should be rated as "high risk." The letter continued to say that, "...the FERA also demonstrated that we cannot expect the REAC's controls to be effective until an adequate number of staff are on board and trained in their jobs, good information systems are developed through a standard development methodology, and processes and procedures are developed, tested and documented." In a responding letter issued in July 1998, the CFO agreed with this assessment, particularly focusing on staffing. According to the timeline for implementation which accompanied the FERA, staffing and training is not expected to be complete until October 30, 1999.

REMS

REMS was deployed in March 1998, and was completing Phase 1 by the end of January 1999. REMS is being upgraded based on input from users in the field in workshop sessions, resulting in enhancements issued as "maintenance releases." The goal for REMS for fiscal year 1999 is to focus on data quality. To this end, HUD headquarters REMS staff maintain a log of user suggestions, have a help desk to answer user questions, apply internal diagnostics packages designed to correct errors, and hold user workshops. The data in REMS are considered accurate based on a certification of field management, subject to audit by a quality assurance team. These processes were ongoing at the end of fiscal year 1998.

We are concerned that the pace of REAC and REMS deployment could hinder the timely use of physical inspection results and financial analysis by HUD field property managers. Consequently, while the future plans appear to provide project managers with information that they need for monitoring, these two major tools for monitoring by project managers will not be available for most projects until later in fiscal year 1999. The Office of Housing will have to rely on other monitoring tools such as follow-up of known findings and management or occupancy reviews until such time as the data from REAC and REMS are fully available. Without such an effort, monitoring of multifamily projects will not be performed at sufficient levels.

FMC

Still another concern is the ongoing problem of monitoring Section 8 contract administrators. Under *HUD 2020*, the Department plans to transfer a majority of the more than 21,000 properties in its Housing portfolio to contract administrators. This represents a significant increase in the number of projects to be administered by SHFAs and HAs and possibly other entities. HUD needs to ensure that their activities are effectively monitored, something HUD has been unable to do for the past few years. Also, while HUD has taken steps to obtain the necessary funds for contract administration, they cannot begin their oversight until fiscal year 2000. Meanwhile, the Office of Multifamily Housing has eliminated or reassigned to property management functions all staff that used to oversee the SHFAs and HAs. Thus, under current plans, unless HUD management institutes some other mitigating control, monitoring of SHFAs and HAs will not be done in fiscal year 1999.

Reportable Condition: Continued Efforts Needed to Improve Housing Authority Monitoring

HUD provided about $16 billion in fiscal year 1998 in grants and subsidies to approximately 3,300 HAs nationwide. In prior years, we reported that HUD's control structure did not provide reasonable assurance that these funds were expended in compliance with the laws and regulations authorizing these programs. In fiscal year 1998, problems remain which we believe HUD needs to address to provide assurance that HAs provide safe, decent, and sanitary housing and protect the federal investment in their properties. Our most significant concern relates to payments made by HUD, through its operating subsidies and Section 8 rental assistance programs, to assist HAs in providing affordable housing that meets HUD's housing quality standards to house eligible low income households. Our specific concerns, and the *HUD 2020* initiatives to address them, are discussed below.

Improved risk evaluation and monitoring of housing authorities needed

During fiscal year 1998, HUD continued to implement its performance oriented, risk based strategy for carrying out its HA oversight responsibilities. HUD performed on-site monitoring reviews at a limited number of HAs to provide increased oversight and technical assistance in improving operations. In fiscal year 1998, HUD developed PHAS to replace its existing PHMAP. However, at the time of our audit the new system had not yet been implemented.

In fiscal year 1998, HUD's field offices were to continue performing risk assessments of all HAs within their jurisdictions by primarily considering HA performance and compliance data, and develop plans to monitor and/or provide technical assistance to those HAs determined to be in the greatest need of attention. As was the case in prior years, the HAs' PHMAP performance certifications and IAs' compliance reviews were key components of HUD's risk based monitoring strategy.

In our testing of four field offices' risk assessment and monitoring of HAs, we found none of the four field offices were adequately monitoring their HAs. In two of the four offices, no new risk assessment was performed in fiscal year 1998 on its HAs. Additionally, as described below, the PHMAP and IA report processes were not being used effectively to monitor the HAs. We continue to have concerns regarding the reliability of the performance and compliance data used by HUD's field offices to evaluate HA operations. Additionally, HA performance evaluation factors as currently reported do not effectively address or measure the overall quality of subsidized housing. In fiscal year 1998 and consistent with our findings in prior years, there generally was no independent program for on-site inspection of the actual condition of HAs' housing stock.

PHMAP is not always a reliable indicator of housing authority performance

In our prior audits, we reported that PHMAP is not always a reliable indicator of an HA's performance because HUD's controls did not assure the integrity of the scores and PHMAP performance data did not effectively assess the quality of the subsidized housing stock. In fiscal year 1998, HUD developed PHAS to replace PHMAP to provide for a more comprehensive monitoring system of public housing operations. The PHAS final rule was published on September 1, 1998.

PHAS will be effective for HAs with fiscal years ending during federal fiscal year 1999 and thereafter. In the interim, the REAC is to score HAs under the current PHMAP process and implement PHAS on a test basis. As we reported in previous years, HUD's controls over the PHMAP process in fiscal year 1998 did not assure the integrity of HA scores because limited confirmatory reviews were performed. HUD's field managers attributed the lack of confirmatory reviews to inadequate administrative resources and priorities associated with implementing *HUD 2020* initiatives. We also found that the field offices we tested did not ensure all its HAs implemented appropriate corrective actions to improve identified performance deficiencies.

Reliability of Single Audits is limited

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

In our prior year testing of IAs' audits, we generally found IAs had not performed the audits in accordance with the PIH Compliance Supplement. We also questioned whether many of the IAs performed sufficient testing to determine if HAs were in full compliance with the program requirements. Additionally, during our audit, we found that three of the four field offices we reviewed did not have an effective system in place to track the receipt of audit reports and their associated findings. We also found that not all the HAs submitted the IA reports to each of the field offices in a timely manner, and none of the four field offices took appropriate follow-up actions to obtain the missing reports. Thus we continue to question the usefulness of the IA reports as a monitoring tool by the field offices.

HUD's Actions Planned and Underway to Improve HA Monitoring

Under *HUD 2020* PIH reorganized to separate the enforcement, monitoring and program delivery functions. The new PIH structure consolidates financial, funding, and processing activities and separate troubled agency recovery activities from HA oversight and technical assistance functions so field office staffs can concentrate on providing technical assistance and oversight to HAs with declining performance. To accomplish this, HUD field offices were consolidated into 27 hubs and 16 program centers. Additionally, two TARCs were established in mid 1998 to support troubled HAs. Protocols for HA assessments were developed and/or assumed by the REAC. The specific structural and operational changes that were implemented by the end of our audit include:

- The field offices are to serve as the primary points of contact for all assigned HAs and provide oversight of program implementation and technical assistance to those HAs.

- To deal with troubled HAs, PIH established two TARCs in Cleveland, Ohio and Memphis, Tennessee. Any HA that receives a failing annual assessment score from a HUD field office (PHMAP) or, in the future, from the REAC (PHAS) will be referred to a TARC. In mid 1998, approximately 57 troubled HAs, mostly small and moderate sized, were formally transferred to the TARCs. As of September 1998, the TARCs had completed initial assessments on most of the HAs and were in the process of developing Memoranda of Agreement and in one case a Recovery Plan.

- The REAC is to conduct annual HA assessments under PHAS, which is to provide for a more comprehensive monitoring system for public housing operations by establishing new protocols that better measure HAs' financial performance, management practices, and physical condition (via on-site inspection) to identify at-risk and troubled HAs. REAC initiated this process in the first quarter of fiscal year 1999 and anticipates its first official HA assessment scores will be issued early in fiscal year 2000. In the interim, the REAC will be scoring HAs under the current PHMAP and implementing the new PHAS process on a test basis.

- The REAC plans to implement a quality assurance program over IA audits of HAs in the second quarter of fiscal year 1999. Initial selection of HAs to review will be restricted to those under 2,000 units to allow the REAC staff to gain experience on smaller engagements.

- On September 10, 1998, a final rule was published in the Federal Register establishing SEMAP to measure HA management performance in 14 key areas of the Section 8 tenant-based assistance programs. However, those sections dealing with actually conducting SEMAP assessments and assigning SEMAP performance ratings were "stayed" until further notice.

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

While we agree with *HUD 2020* measures aimed at improving oversight of HAs, the Department's plans to monitor and improve performance in this area are not yet fully developed and continue to experience delays. Until HUD finalizes its implementation plans, we cannot assess HUD's ability to fully implement its oversight strategy. Moreover, HUD's success in addressing the need to objectively assess the quality of the public housing stock is dependent upon field offices receiving and acting on the results of inspections to be performed by the REAC. Nevertheless, we do believe that some of the *HUD 2020* proposals are positive.

Specifically, we agree with HUD's efforts to establish and implement a standard inspection protocol to assess the physical condition and quality of public housing. The current process for evaluating HA performance does not consider the quality and livability of its housing stock. We also agree with HUD's decision to develop PHAS to replace the existing PHMAP to provide for a more complete assessment of HA operations. The current PHMAP process relies entirely too much on the HAs' self assessments of their performance.

As we pointed out in our *Semiannual Report to the Congress* as of September 30, 1998, we are concerned that the REAC is not handling all assessments for the Department. SEMAP, which is designed to measure an HA's performance in administering the tenant-based rental assistance program is not part of the REAC. Rather, the responsibility for implementing SEMAP rests with PIH headquarters and "Hub" offices. The TARCs are responsible for monitoring HAs with "troubled" SEMAP ratings. By consolidating these housing assessment programs into one organization, the Department would be assured of more consistency and uniformity in its assessment program and would realize staffing and training efficiencies.

Although we generally agree with HUD's decision to establish two TARCs to service troubled HAs, we have concerns over the emphasis placed on the PHMAP score itself. The PHMAP score is only an indication of an issue and improving the PHMAP score may not necessarily resolve the problems that caused the HA to be troubled.

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

HUD provides significant grant funds to State and local governments through its CPD programs. As in HUD's other program areas, CPD is in the process of shifting its compliance-oriented monitoring strategy to one focused on measuring and improving grantee performance. CPD began its transition to this performance-oriented strategy in fiscal year 1994. This transition included converting to a consolidated planning process for all CPD funds allocated to each grantee. Review of grantee plans for using CPD funds is an important part of this new strategy. CPD personnel provided a considerable amount of technical assistance to grantees in their efforts to formulate consolidated plans.

During fiscal year 1998, HUD incurred about $6 billion in grant expenses under CPD's two largest grant programs, the Community Development Block Grant (CDBG) program and HOME program. Legislation authorizing CPD programs includes numerous specific requirements such as:

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

Important aspects of oversight strategy not implemented

CPD's oversight strategy includes partnering with grantees and providing assistance, when possible, to improve grantees' performance while simultaneously performing up-front and continuous monitoring of their activities. This strategy resulted in a decline in on-site monitoring. CPD also began implementing a new computer system, the Integrated Disbursement and Information System (IDIS), and started training field staff and grantees on how to use it. During fiscal year 1995, CPD's implementation of the new oversight strategy emphasized completion of grantee consolidated plans. Field staff was tasked with providing assistance to communities in their efforts to complete these first time consolidated plans.

For fiscal year 1996, some important steps in CPD's oversight strategy were either not completed, not adequately documented, not timely, or did not include information on all grants. During fiscal year 1997, CPD issued its "Grants Management Policy Notebook" that formalized its oversight strategy and called it the "Grants Management System." Our audit determined that performance of two steps in this process involving evaluating and validating performance reported by grantees and performing an annual assessment of each grantee's accomplishments were inadequate. For fiscal year 1998, CPD revised its Grants Management Policy Notebook and included more details to direct field staff in their monitoring efforts. Our current audit concluded that CPD's monitoring process was not fully implemented. CPD is required to review the performance of each jurisdiction annually, including site visits by field staff and, insofar as practicable, assessing, among other things, the accuracy of performance reports. We found that efforts in this area were either inadequate or were not supported by adequate documentation. This problem has been attributed to a lack of resources, both staffing and funding, to perform this function.

Another problem involved the submission and review of grantees' performance reports using the Consolidated Annual Performance and Evaluation Report (CAPER) from IDIS. Submission of the performance reports and subsequent reviews by CPD did not occur in a timely manner for some grantees. This review is important because it formulates the basis for other steps in CPD's monitoring process. Problems with the CAPER occurred because IDIS was not producing accurate reports. A February 1998 memorandum from CPD said that all entitlement grantees should be using IDIS to report performance and stated that the importance of timely and accurate performance reports cannot be overstated. IDIS reporting problems delayed the submission of reports and resulted in many grantees returning to reporting under the formats prescribed by the individual programs rather than producing a consolidated report.

Our review also revealed that some grantees were not submitting the quarterly Federal Cash Transactions Report which lists all grantee draw downs and program income. This problem was accentuated by the fact that, due to the way IDIS processed program income, some grantees were not inputting this information. As a result, CPD staff did not know how much program income was being produced by grantees who were not inputting this information into IDIS and did not submit the report. Grantees who did not submit the Federal Cash Transactions Report stated that they thought the report was not necessary because draw down information was in IDIS.

IDIS was designed to provide CPD field staff with the capability to assess real-time performance data and ensure grantee compliance with requirements of all entitlement programs. We found problems with IDIS that inhibited CPD's ability to adequately monitor grantees. In addition to the problems with CAPERs and program income presented above, IDIS was not able to handle all aspects of the HOME program such as recording the required matching contribution. Another problem was grantees inputting "dummy" data into IDIS in order to satisfy required data fields and allow them to draw down funds. We also discovered that IDIS did not have adequate controls to prevent grantees from withdrawing all funds from a project and closing it out without inputting any performance information.

Single Audits are of little value in monitoring grantees

State and local governments receiving CPD funds over a threshold amount are required to have audits performed by IAs pursuant to the Single Audit Act. CPD personnel did not always ensure receipt of IA audit reports or follow-up on findings that were identified in the reports that were received. CPD personnel viewed IA reports as having little value in their evaluation of grantee operations. This was due to the untimely nature of and minimal CPD program information in IA reports.

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

CPD is continuing efforts to fully implement its performance-based strategy for monitoring grantees. A cornerstone of this effort is the development of IDIS. IDIS was designed to be the system grantees use to draw down funds and provide performance information regarding accomplishments achieved with those funds. When fully implemented, IDIS is intended to provide CPD with timely performance information for all grantees. CPD can then focus its monitoring resources on grantees who are performing below standard. During fiscal year 1998, CPD continued to bring grantees on line and using IDIS to draw down funds. However, system problems such as those noted above have caused CPD to slow its efforts to bring additional grantees on line until the problems are corrected. CPD has made an electronic data interchange available to grantees which allows them to extract information from their system and transfer it to IDIS. This would ease the process of entering performance information and should eliminate the cause for inputting "dummy" data. CPD has also begun a data verification program to obtain missing data and ensure that activity information in IDIS is appropriate. Also, CPD is planning to provide IDIS training to field personnel during fiscal year 1999.

CPD's process for overseeing grantees is contained in its Grants Management Policy Notebook. This strategy involves partnering with grantees to improve their performance while simultaneously monitoring grantee activities to ensure compliance with regulations and program requirements. The process calls for evaluating and validating performance reported by grantees and comparing it to planned actions. In addition, planned and completed actions will be accumulated and aggregated on a national level to facilitate CPD's performance reporting requirements pursuant to GPRA and specific requirements related to the CDBG and HOME programs.

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

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

CPD continued to bring grantees on line and using IDIS to draw down funds and report on performance. Once all grantees go on line with IDIS, it will serve as the primary tool for reviewing progress of planned activities. Therefore, CPD must ensure that each grantee and field representative is provided the necessary training and written guidance to become thoroughly proficient with the system. This should increase the accuracy of data input by grantees and enable field representatives to properly monitor grantee performance and progress. We are adding a recommendation regarding providing written guidance and training on IDIS to grantees and field representatives.

System and Accounting Issues

HUD Needs to Address System and Accounting Weaknesses

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

- general system security and other controls, including year 2000 preparations;
- administration of personnel security operations; and
- access controls over HUD's two major payment systems, HUDCAPS and LOCCS.

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

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

HUD's automated information systems are critical in supporting all facets of the Department's programs, mortgage insurance, servicing, and administrative operations. In prior years, we reported on various weaknesses with general system controls and controls over certain applications, as well as weak security management which provided limited assurance that funds, property, and assets were adequately safeguarded from waste, loss, unauthorized use or misappropriation. During fiscal year 1998, HUD has continued to make progress in enhancing computer security.

Security has improved but additional measures are needed

Progress in implementing planned security measures has been slow. Some target dates have been missed, new future dates established, and it was difficult to determine the status of some security plan enhancements. We also reviewed security over HUD's network environment and Federal taxpayer data, evaluated elements of HUD's disaster recovery processes and noted some observations about HUD's efforts to address the year 2000 computer problem.

Hitachi Environment

For the Hitachi environment, a number of security improvements have been made. The security software now requires user identification and a password for access to all applications. Moreover, a number of critical programs and data files have been defined to the security software, Top Secret Security (TSS). Additionally, we verified that last year's recommendation to protect sensitive security system configuration parameters from being read by general system users was implemented.

Sensitive and critical systems still are not fully protected

Last year we reported the Department had prepared a plan to initiate security enhancements to the Hitachi mainframe computer. The Department's plan included making changes to TSS. During our current review, we noted some progress, however we remain concerned that delayed full implementation of the access control software continues to put sensitive and critical resources at risk. HUD purchased the security software more than seven years ago yet did not begin to place all resources under its control until January 1998. As part of the security enhancement schedule, the Department planned to set the software global protection parameter to "fail mode" in February 1999. Not placing the security software in global fail mode results in vulnerabilities to critical system resources and data.

Access security for DB2 applications is inadequate

As discussed later in this report, HUD uses HUDCAPS in several areas of the Department to handle core accounting transactions for several key programs. In addition, for fiscal year 1999, the Department will use HUDCAPS as the consolidated HUD-wide general ledger.

DB2 is the data base management system HUDCAPS uses to store and access data. Several other critical Departmental applications use the DB2 database management system as well. The Department currently relies on the internal access control function of DB2 to control access to data and database functions. Individuals who are granted high level authorities such as the System Administrator and Database Administrator authority, can subsequently grant access privileges and authorities over data and resources to other users. These users can then grant the same access and authority to other users. Consequently, controls over DB2 access authorizations and privileges are ineffective because there is no means to control the subsequent granting of administrative privileges. This results in increased risk of sensitive and critical resources being accidentally or intentionally damaged or lost.

UNISYS Environment

Access controls over the UNISYS mainframes need improvement. Specifically, we could read the data from many sensitive computer applications that were not protected from unauthorized read access. Sensitive computer information not protected included:

- CHUMS mortgagor names and amounts borrowed;
- LOCCS computer control language that initiates connections and electronically transfers funds to the Department of Treasury;
- the LOCCS Voice Response System log, which shows the time and date of financial transactions made over the telephone, and possible account numbers used for financial transactions;
- UNISYS system files showing user IDs and related user names, date the user ID was last used, and date the user ID was created;
- MTCS names and addresses of properties and property owners; and
- security reports showing sensitive information, including CHUMS activity logs, LOCCS security access data, and single-family premium collection reports.

We were able to view these files because sufficient protective controls had not been placed on them. On UNISYS mainframe systems 1 and 2, we estimate that up to 1,100 users can read and potentially write and execute sensitive HUD program systems. As a result, systems such as LOCCS may be modified by unauthorized users, significantly affecting financial data. System files are potentially susceptible to fraudulent activities, such as modified LOCCS computer control language which controls the electronic transfer of funds from or to the Treasury Department. Lastly, the privacy of HUD employees and customers is compromised by the lack of access controls.

Network Environment

We tested selected controls in the network environment in addition to reviewing mainframe system controls. This testing included attempts to gain access to all levels of data on the system through selected HUD Local Area Networks (LAN) from an insider perspective. An insider with a low level user ID and password could attempt to gain access to computer resources beyond those normally available to the account.

The results of insider penetration tests indicated a need to improve access controls over HUD's LANs. We found that numerous user IDs existed without passwords, including one SUPERVISOR and three ADMINISTRATOR accounts. We also noticed that the user ID "GUEST" was active on 26 servers. Our testing this year indicates that most of the GUEST accounts allowed much greater access to LAN resources than allowed by HUD policy. Also, we determined that of seven LAN servers tested, five servers allowed an unlimited number of concurrent users to use the GUEST account and one LAN server allowed up to ten users to log on concurrently with the GUEST account.

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

Security Over Federal Taxpayer Data

TEVS matches income related information obtained from SSA and IRS to confirm the reasonableness of tenant income reported by families participating in HUD's rental assistance programs. IRS requires that computer systems containing Federal taxpayer data enforce access controls to make users individually accountable for their actions through login procedures, auditing of security-relevant events, and resource isolation. We reviewed computer security over Federal taxpayer data in TEVS and found deficiencies that must be corrected.

Disaster Recovery

Disaster recovery for HUD's field operations needs to be tested

In our testing of field offices' business resumption plans (BRP), we found a BRP for each field office that addressed the key requirements. However, the field offices have not tested their BRPs, and do not have current plans to do so. Although it is possible to consider most key requirements in developing a BRP, some conditions are often unforeseen. Testing is important to determine the adequacy of the plan and the recovery team's ability to react effectively during a disaster. We also learned that one field office does not store backup tapes off-site due to insufficient funding. Off-site storage of backup tapes is critical for restoring key operations. We also noted that the Department does not have a complete list of network servers. A key element of disaster preparedness is the ability to determine what resources are used by the Department, and how they are used.

TEVS does not have a disaster recovery plan

As part of their requirements for security over Federal taxpayer data, the IRS requires that a disaster recovery plan be developed and regularly tested to ensure there is an alternative way to run TEVS in case of an emergency when the computer system or data cannot be used or accessed. Some of the areas the plan should address include identification of resources to support the function, anticipation of potential contingencies or disasters, and selection of a contingency planing strategy based on practical considerations such as feasibility and cost. Finally, the contingency plan should be tested periodically and updated accordingly, as resources used to support TEVS may change.

Software Change Control

Implementation of application change control software continues to be a low priority

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

Although HUD purchased a software product for change control over five years ago, only three applications on the Hitachi mainframe are using this tool to control software changes. This problem was documented in a previous HUD, OIG audit report[3]. Since this report, there is little evidence that much has been accomplished in the area of configuration management. Consequently, critical applications continue to be exposed to unnecessary risk of unauthorized, unintentional, or malicious software modifications resulting in errors, loss of data, or system failure.

Year 2000 Computer Problem

HUD needs to reduce the risk of year 2000 failures

HUD has committed itself to performing year 2000 (Y2k) certification for all applications and the process has been in place for a period of time. Since 1996, the Department has invested considerable effort in fixing the Y2k date problem. Recently, at the urging of the Chief Information Officer, the Department placed a moratorium on system enhancements to ensure maximum efforts will be devoted to the Y2k date problem. However, while HUD has made progress in correcting the Y2k problem, more needs to done to minimize the risks and impacts of system failures caused by the millennium date change both internally for HUD's systems and externally for HUD's business partners. OIG has issued two reports as part of it's ongoing review of HUD's efforts to correct the Y2k problem[4]. The reports disclosed several weaknesses in the Department's Y2k quality control, configuration management, renovation, testing, and certification processes. There is a continued need for a senior level manager, such as the Chief Information Officer, to provide the necessary leadership and accountability over information technology (IT) operations and resources, including the Y2k project.

HUD's business partners are not prepared for the year 2000

Based on the results of an OIG survey of HUD's business partners (HAs and Multifamily project owners), we found that a significant number were not adequately preparing for the year 2000. A majority of the HAs and project owners had neither performed a risk and impact assessment for Y2k compliance nor prepared a Y2k contingency plan. More significant is that a majority of the HAs and project owners had not completed an inventory of equipment with date sensitive controls (embedded chips). The failure of these embedded systems would put at risk the health and safety of housing tenants and perhaps subject both HUD and its business partners to potential lawsuits.

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[3] "Controls Over Software Maintenance Must Be Significantly Strengthened," (96-DP-166-0001, dated March 5, 1996).

[4] "Review of HUD's Efforts to Correct Year 2000 Problems," (98-DP-166-0003, dated June 1, 1998, and 99-DP-166-0001, dated January 8, 1999).

HUD's Actions Planned and Underway to Correct System Security and Other Control Weaknesses

On the Hitachi, HUD successfully placed the TSS global control parameter in "implement" mode in December 1998 to actively validate requests for resources and facilities. While this setting prevents unauthorized requests by defined users, users not defined to TSS can execute normally if they are not accessing protected resources. In a prior report[5], we recommended the Department replace internal DB2 security with Top Secret/DB2 security software. The Department's response was that Top Secret/DB2 did not provide needed interfaces to ensure interoperability with other data base management and reporting products. The Department is already taking actions to implement controls to limit access to sensitive UNISYS mainframe files.

With respect to the LAN environment, the Department is evaluating the results of the penetration test to determine the extent of any necessary corrective actions, and has taken steps to remove user access to the critical areas of the operating system.

Regarding application software change control, the Department has implemented the software for only three Hitachi applications, but has revised its implementation schedule for the other critical applications. For the UNISYS environment, the Department evaluated and rejected one UNISYS mainframe configuration software package and is considering another product.

In regards to our concern over the protection of taxpayer data, the TEVS project manager intends to review system audit trails, develop a disaster recovery plan by September 1999 and research the system security test document.

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

We are encouraged that the Department has prepared a mainframe security enhancement plan. However, we are concerned that scheduled activities needed to accomplish some of the remaining enhancements do not have an adequate number of milestones or benchmarks to readily cite the status of the effort. The UNISYS SIMAN enhancements include four activities that began at or before April 1998, and are to be completed by the end of December 1999. There are no milestones in between the start date and end date to gauge the performance or progress of activities. Regarding DB2 security, we have researched the Department's response and disagree with the Department's argument that Top Secret/DB2 security will not work in the HUD environment because the Department has not provided sufficient empirical data to support their assertions.

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[5] "HUDCAPS Access Controls Need Improvement" (97-DP-166-0001, dated September 30, 1997).

UNISYS demand mode user access to sensitive program and individual financial and privacy information remains a concern. There are several legacy UNISYS applications that are invoked from the demand mode, not an environment that provides only the commands and functions needed by and within the application. As a result, those legacy application users that must start and operate their application from the demand mode are part of the up to 1,100 users who can read sensitive program and individual financial and privacy information from other applications. While the Department does have a plan to minimize access to sensitive files on the UNISYS 1 mainframe, they have not provided a plan to mitigate exposures on the UNISYS 2 mainframe. The UNISYS 2 mainframe has numerous sensitive HUD applications and files, with about 1,000 of the demand mode users who are able to access sensitive information.

Although the Department has taken steps to address weaknesses in the LAN environment, there are still problems. There does not appear to be any systematic monitoring of network security, and as a result, when problems exist, IT staff must be alerted by users. The Department should consider the acquisition of a LAN monitoring software program that would alert IT and field staff to problems and hacking attempts.

We remain concerned with the Department's lack of progress in using an automated tool to control the software changes for the critical applications on the Hitachi and UNISYS mainframes. After having purchased the Hitachi software change control product nearly six years ago, only three applications are fully implemented. Also, an automated tool is critically needed to control software changes for the UNISYS. The Department has had UNISYS mainframes for over twenty years and still lacks an adequate change control software for application programs. Change controls become even more critical when a significant number of application program changes have to be made for the Y2k conversion.

We are encouraged with TEVS' proactive plans to review the audit trails and develop a disaster recovery plan. However, we are concerned that TEVS system administrators are not technically proficient of the system for which they are responsible. Being able to generate audit trail reports and knowing whether sensitive data transmitted over telecommunication lines is encrypted is something that administrators should have knowledge of in the normal course of doing business.

Reportable Condition: Personnel Security for Systems' Access Requires Overhaul

A key control over systems' access by agency and contractor staff is the requirement for personnel (background) screening. HUD's security administrators for sensitive application programs, such as LOCCS and HUDCAPS, are responsible for requesting such screening for system users. The Office of Administration's Personnel Security Branch is responsible for processing and tracking the background screening status of applicable employees and contractor staff. The Office of Procurement and Contracts and agency Government Technical Representatives (GTR) requesting contractual services are to ensure that contracts include requirements for background screening as necessary. Finally, the Office of Information Security is responsible for providing policy guidance on information security.

Required background screening was not being performed. The Personnel Security Branch's database had not identified all individuals who should have such screening. In addition, the agency definition for access types requiring the more thorough background investigations excludes individuals with sensitive access. These problems, however, can be corrected by using two mainframe (UNISYS and Hitachi) user access lists, maintained by Information Security as a guide on who should have background screening. These listings contain various information on access privileges.

Records of employee and contractor clearance status were unreliable

We compared an Information Security staff listing of contractor personnel who had been provided access to the UNISYS mainframe system against the listing of contractor personnel on the Personnel Security Branch's database and found a wide discrepancy. The personnel staff were not able to find records for many individuals who should have had the required background investigations. HUD should be using information on individuals granted access to the mainframe systems to help identify persons needing background investigations. In addition, the mainframe access listings need to be updated periodically. In comparing the LOCCS access listings to other UNISYS information, we found name changes that were not updated. Although Information Security obtains periodic personnel disks containing new hires, separations and transfers, it does get other personnel changes such as name changes. Information Security also needs to get the names of those user accesses terminated by program security administrators for internal program reasons, as it would not have knowledge of these terminations.

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

In response to our finding that numerous background investigations, including those for contractor personnel, were overdue or overlooked, three offices (the Office of Procurement, the Personnel Security Branch, and the Office of Information Technology) collaborated to propose updates to certain personnel screening procedures. These updates are to clarify background investigation requirements for contract work on sensitive automated systems/applications and to identify steps for obtaining a background investigation. In addition, all automated system contracts are to be funneled through one office, IT, for improved personnel screening accountability. For each contract, responsibility is assigned to the GTRs to notify the contractor about particular forms that must be completed for each individual. The GTR forwards the completed forms to the Personnel Security Branch for processing. The process also requires that the GTR be notified in writing by the contractor when a contractor employee terminates employment under a HUD contract.

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

While the planned actions may help ensure that those contract employees working on sensitive computer systems receive the necessary background investigations, additional actions are needed to ensure that other contractor employees and all applicable HUD employees receive the appropriate background screening. The mainframes' user access listings, can provide a means to reconcile and ensure that the Personnel Security Branch's database identifies all individuals requiring such background screening. To be effectively used in the reconciliation process, the mainframe listings need to be updated for any employee name changes or security access terminations made by the program security administrators.

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

HUD maintains two major systems to process payments under major program areas and administrative activities. LOCCS processes disbursements of funds to a broad range of grant recipients that include State governments, municipalities, independent companies, non-profit institutions, and individuals. HUDCAPS processes disbursements for both administrative activities and PIH Section 8 programs. During fiscal year 1998, HUD disbursed approximately $24 billion and $9 billion, respectively, through LOCCS and HUDCAPS.

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

Controls over sensitive and other transactions need to be improved

HUDCAPS and LOCCS system logic controls require one employee to initiate a sensitive transaction, such as a payment transaction or a change to payee bank account number, and another employee to execute it. Generally, less sensitive transactions do not require two employees for processing.

Both system logic controls and physical segregation of duties are deficient. An excessive number of system users have the ability to initiate creation of payee bank accounts and changes thereto. At least nine employees can both initiate and execute bank account transactions. Many other transactions lack adequate segregation of employee duties.

LOCCS users with the ability to initiate ("data entry" access) payment transactions also have the ability to initiate bank account transactions. System officials were aware of this control deficiency and had planned to separate the entry access to payment vouchers from bank account numbers. The separation would require a software programming change that has not been made. The consolidation of the field accounting offices into the Ft. Worth accounting center during fiscal year 1998 has reduced the number of users with such data entry access to 45. Additional reductions are being planned.

The number of HUDCAPS employees with the ability to initiate transactions to the payee bank accounts has increased from 29 in fiscal 1995 to 413 in fiscal year 1998. Agency management has stated that decentralized small procurement operations (credit card, travel and training purchases) require employees in field and headquarters offices to enter such data for new employees and vendors. However, these employees have access to nationwide vendor and employee data, as well as their bank account numbers.

HUDCAPS also had another deficiency associated with two user access groups (PRTRPCSC and PRTRPCSS profiles), totaling nine Ft. Worth employees. These access rights provided each employee with both the ability to initiate and execute transactions to bank account numbers. Users with these profiles could divert payments to other bank accounts. These profiles should be modified to prevent the ability to execute bank account changes.

Our review found 36 user HUDCAPS profiles that permitted both data entry and execution of transactions of a less sensitive nature, such as intergovernmental fund transfers, budget execution documents, accounts receivable transactions and certain purchase documents. We recommended in prior reports that physical controls, such as sample reviews of entered transactions or hard-copy supervisory approvals of proposed transaction entries be instituted to compensate for lower system logic controls. HUD responded that compensating controls would be provided by supervisors in response to the quarterly recertification process of all HUDCAPS users. However, only one quarterly recertification was done for HUDCAPS during 1998 and compensating controls were not clearly identified.

Implementation of prior year recommendations

Certain control deficiencies in the past report have been corrected. Employees' access rights for both data entry and approval to the HUDCAPS UDIS table, used by PIH for maintaining data on residential units by bedroom size, have been restricted to only a few employees. The problem of certain LOCCS users in field offices with data entry access to programs in other field offices is being corrected, as data entry access is being limited to the consolidated nationwide accounting center at Ft. Worth. A new LOCCS security plan was issued on May 28, 1998. Although the plan stated that access to the bank account tables will be segregated from the "data entry" access, HUD has no definite plans to implement this provision.

HUD Comments on the Need to Strengthen Payment System Access Controls

The CFO responded that the following three controls provide adequate oversight regarding any possible unauthorized changes to the bank account numbers (VEND access) by the 413 employees who can now enter such changes: (1) another employee is required to execute such a change (a VACT table entry); (2) another employee is required to approve any initiated payments; and (3) an automated log provides data on what record was changed and who made the change. In regards to the nine users who have both VEND and VACT entry access (PRTRPCSC and PRTRPCSS profiles), the CFO stated that sufficient control is available from other employees, who are required to initiate and approve any payments, to prevent payment diversions.

OIG's Assessment of HUD's Comments

The three controls each have their own weaknesses or limits as to the oversight abilities of the bank account changes. As discussed previously, the VACT entry to execute a bank account change or establishment is made upon receipt of the direct deposit form; however, the form is not requested or received directly from the bank. In addition, audit tests performed during a prior audit revealed that in 80 percent of the instances, the VACT entry employees did not make the required call to the bank to confirm such deposit forms.

In regards to the second control, payments are often made on a routine or recurring basis; therefore, the users with VEND (and those with the PRTRPCSC and PRTRPCSS profiles) access do not need to initiate payments to divert funds to other bank accounts. Some payments, such as interest payments from the Prompt Payment Act, invoice price adjustments, etc., can result in unexpected payments for which the authorized payee might not be aware. Diverted payments in these cases may not produce a complaint. The VEND users also generally have access rights to initiate various obligation documents which can be the first step in starting the payment process.

The third control, the automated log of VEND record changes, will not prevent improper bank account establishments or changes. It has the ability to detect them but only if one receives a non-payment complaint or otherwise suspects an improper entry.

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

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

- Offices are either not reviewing unliquidated obligations or not performing reviews in a timely manner to determine whether the obligations should be continued, reduced, or canceled.

- Obligations identified as invalid are not being deobligated in a timely manner.

- A lack of integration between program and accounting systems producing data inconsistencies has hampered HUD's ability to evaluate unexpended Section 8 project-based obligations.

In our audit of the fiscal year 1997 financial statements, we reported in our management letter to HUD that the obligation review process did not always result in the deobligation of funds identified as no longer needed and a number of program offices did not respond to the request for deobligation information. As a result of the additional reporting requirements added by Statement of Budgetary Resources, additional deficiencies noted during this year's review, and the increased emphasis placed on the reported obligation balance, we are now assessing these concerns as a reportable condition.

HUD was not reviewing obligations and deobligating unneeded amounts in a timely manner

Annually, HUD performs a review of unliquidated obligations to determine whether the obligations should be continued, reduced, or canceled. We evaluated HUD's internal controls for monitoring obligated balances. We found a number of weaknesses in the process including (1) some offices not completing reviews in a timely manner or not completing the reviews, and (2) funds identified as invalid not being deobligated. These deficiencies were previously noted by GAO[6] and result from a lack of oversight and emphasis placed on validating outstanding balances.

HUD experienced delays in initiating and completing reviews as part of the annual process to certify obligations. Requests for obligation reviews were forwarded by the CFO to 17 program and administrative offices on September 4, 1998 and to the Assistant Secretary for Housing on September 22, 1998. HUD's guidance requested that the obligation reviews be completed and the certifications from each of the Assistant Secretaries as to whether the unliquidated obligated balances were valid be returned to the CFO's Office by October 15, 1998. The CFO relies on these certifications in order to certify to Treasury that all obligations at the end of the fiscal year are proper existing obligations. HUD's certification of the year-end obligation balance is required to be forwarded to Treasury no later than November 20. The certification to Treasury was electronically transmitted on November 10, 1998. However, as of that date, 7 of the 18 offices had not responded to the request for certification of their obligations. HUD officials stated that the certification was based

[6] SECTION 8 PROJECT-BASED RENTAL ASSISTANCE: HUD's Processes for Evaluating and Using Unexpended Balances are Ineffective (GAO/RCED-98-202, dated July 1998).

on discussions that the reviews were ongoing and would be completed. Four of these seven offices later responded with a certification of obligation balances. Three offices did not respond.

The CFO provided listings of all obligations with no disbursement activity for six months which were open as of June 30, 1998 to the program and administrative offices requesting that the status of obligations be reviewed for validity. Excluding the Section 8 programs which were reviewed separately by the program offices, the total dollar amount of obligations identified for review totaled $513 million. Of the $513 million, $74 million was identified for deobligation. We tested 23 items, representing $2.9 million of the $74 million, to determine whether the balances had been deobligated in PAS. We found that, as of January 11, 1999, 8 of the 23 items had not been deobligated in PAS.

In addition to the weaknesses found in initiating and completing the obligation reviews and the failure to adjust the financial records for invalid obligations, we found a need for increased oversight and emphasis on the obligation review process. In December 1998, we requested information on the results of the obligation reviews and the potential adjustment required for the financial statements. As a result of our request for documentation, the CFO's Office began a manual calculation of information received from the various offices to determine the dollar amount of obligations that had been identified as invalid. The CFO's Office noted that the field offices or the Field Accounting Center may have deobligated funds based on reviews but the CFO's Office was unable to determine and include these amounts in their proposed adjustment to the end of the fiscal year obligation balance. However, they felt these deobligations performed or identified by the field offices and sent directly to the Field Accounting Center for deobligation were probably limited to administrative obligations. Program related obligations were to be forwarded to Headquarters for deobligation. As a result, there was an increased risk that invalid obligations were not being deobligated in a timely manner.

HUD has made progress in identifying excess reserves in the Section 8 programs, but improvements are required in the project-based program

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

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

The Office of Housing has been hampered in its attempts to evaluate unexpended Section 8 project-based budget authority balances. Data inconsistencies between PAS and TRACS have resulted in the need for field office verification of data and has impaired HUD's ability to evaluate unliquidated balances. In December 1998, $1.3 billion in unliquidated obligation balances were recaptured in the Section 8 project-based program on expired contracts. However about 8,400 funding line items with $760 million in potential excess budget authority were excluded from the recapture analysis because the Office of Housing had determined that additional data analysis would be required by the field offices. In addition, The Office of Housing erroneously identified $50 million of the $1.3 billion for deobligation and recapture while the funds are still required for contracts not expired.

Because of delays in HUD's completing the obligation reviews, we were unable to conduct a reliability assessment of all of HUD's Section 8 project-based data. However, GAO and a contractor retained by the CFO have evaluated the documentation supporting PAS as well as TRACS. Both GAO and the contractor identified material shortfalls with the data used for the analysis of funding requirements. GAO reported on an April 1998 analysis of projected funding excesses/shortfalls and found the analysis (1) did not accurately estimate future expenditure rates (2) omitted about 1,800 contracts that should have been included, (3) did not include all funding provided in fiscal years 1997 and 1998, and (4) did not identify $517 million in excess funds no longer needed. The contractor retained by the CFO also evaluated the support for the April 1998 analysis of projected funding excesses/shortfalls. Among the problems cited in the November 1998 report were: (1) expiration dates from source documents did not agree with expiration dates in the database, (2) approximately 7,000 of the 27,000 contracts had differences in expiration dates listed between PAS and TRACS, (3) projected disbursements (burn rates) were incorrectly calculated, and (4) errors existed in the database for 13.2 percent of the contacts.

PIH has made progress in identifying excess unexpended budget authority

PIH has improved its process for identifying excess unexpended budget authority and the underlying information systems to ensure accurate data can be obtained on these balances. In July 1998, PIH performed an analysis of budget authority for all years related to the Section 8 tenant-based program and estimated that approximately $1.3 billion of excess unexpended budget authority was available for deobligation and recapture. This is funding that housing agencies received under contracts with HUD but did not expend or is not needed to make housing assistance payments. We evaluated the accuracy of the Section 8 tenant-based estimate of available budget authority and projection of requirements and believe the estimate of $1.3 billion in excess unexpended budget authority is reliable.

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

The CFO's Office is revising HUD Handbook 1900.20 Rev-2, Chapter 3 on Adjustment of Obligations. These revisions are to strengthen the internal controls and procedures for performing reviews of unliquidated obligations. Among the proposed changes are to: (1) streamline procedures for generating and transmitting reports of obligations to be reviewed, (2) require more frequent reviews of unliquidated obligations, and (3) increase the controls over completing the required obligation reviews. To address these concerns identified with the budget process, the Office of Housing has initiated two efforts to clean up the data and streamline the process for recapturing funds on Section 8 project-based contracts. HUD plans to make additional improvements to its information systems to permit automated program review and to lessen the reliance on field office input and data verification. In addition, HUD has initiated a project to have the field offices verify the database. HUD plans to perform the recapture analysis on a quarterly basis in fiscal year 1999 as a means of monitoring their clean-up effort's progress.

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

HUD's proposed actions for strengthening the internal controls for reviewing unliquidated obligations should increase the timeliness of the obligation reviews. Also, HUD has made progress in implementing a process to recapture excess budget authority. During 1998, HUD deobligated and recaptured $1.7 billion of the projected $2.7 billion excess budget authority available on expired contracts. We are encouraged by the number of initiatives underway to verify the accuracy of the database and efforts to streamline the recapture process. If completed these actions should help improve the data integrity and result in the timely recapture of all excess budget authority on Section 8 project-based contracts.

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Compliance with Laws and Regulations

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

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

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

Federal Financial Management Systems Requirements

In its *Fiscal Year 1998 Accountability Report*, HUD is reporting that 28 of its 88 financial management systems do not materially conform with the requirements of FMFIA and OMB Circular A-127. The number of reported non-conforming systems was reduced by 10[7] from the 38 reported in the *Fiscal Year 1997 Accountability Report*.

The Department reclassified five of the non-conforming systems to conforming, in part, based on the Department's plan to implement a new general ledger/financial reporting system which was planned for implementation in fiscal year 1998. However, this system, which is a series of activities to ensure that FHA transaction-level data from the Office of Housing's feeder systems are captured in such a way that the data are compliant with Credit Reform and OMB Circular A-127, is now projected to be completed by the end of fiscal year 1999. Since the actions to make the systems conforming were not in effect for fiscal year 1998, we believe these five systems should continue to be reported as non-conforming until corrective actions have been implemented.

Reviews of prior audit reports have disclosed that security over financial information is not provided in accordance with Circular A-130 *Management of Federal Information Resources*, Appendix III. The issue of security is further noted in assessments of five systems, however, based on audit reports from other sources, security should be addressed beyond those five systems.

Federal Accounting Standards

A material weaknesses was reported by KPMG LLP in FHA's budgetary and Federal basis accounting that affected HUD's ability to prepare auditable financial statements. This resulted in a need to:

[7] This reduction was based on the Department reclassifying seven systems from non-conforming to conforming, discontinuing five systems previously reported as non-conforming and reclassifying two system from conforming to non-conforming.

- review and reconcile obligations, analyze accounts that were not compliant with the SGL, translate those accounts to Federal basis accounting to prepare both the financial statements and the Report on Budget Execution (SF-133), and comply with the requirements of Statement of Federal Financial Accounting Standards (SFFAS) Number 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting;*

- reconcile cost allocations to ensure all employees were accounted for properly to comply with SFFAS Number 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*; and

- refine the methodology for calculating the liability for loan guarantees in accordance with SFFAS Number 2, *Accounting for Direct Loans and Loan Guarantees*.

Compliance with the SGL at the transaction level

During fiscal year 1998, HUD had four general ledger systems to support its core accounting needs: PAS/LOCCS, HUDCAPS, Macola Accounting System (for the Government National Mortgage Association) and the FHA General Accounting System. FHA's core financial system was not in conformance with the SGL.

HUD contracted for an OMB Circular A-127 review of the Single Family Premium Collections System (A80R-U). During fiscal year 1998, HUD program staff became aware that A80R-U was not in compliance with the SGL at the transaction level and the contractor was able to verify that non-compliance. As a result, HUD reclassified the system from conforming to non-conforming.

Compliance with submission of remediation plan to OMB

Section 803 (c) (3) of the Act requires that when the agency head agrees with the auditor's findings of noncompliance, a remediation plan shall be developed, in consultation with OMB, that describes the resources and milestones for achieving compliance. HUD submitted its fiscal year 2000 submission of information pertaining to planning, budget, and acquisition of capital assets to OMB on November 3, 1998. The remediation plans did not include the required resource information. The Department is updating the remediation plans. During the update process, the Department was unable to obtain resource information for 18 of the 28 non-conforming systems until the second quarter of fiscal year 1999 despite some actions having projected completion dates during the third quarter of fiscal year 1999.

Other Matters Under Investigation

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

PRINCIPAL FINANCIAL STATEMENTS

Introduction

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

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

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

- Consolidated Statement of Financial Position;
- Consolidating Statement of Net Cost;
- Consolidating Statement of Changes in Net Position;
- Consolidated Statement of Budgetary Resources; and
- Consolidated Statement of Financing;

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

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
CONSOLIDATED STATEMENT OF FINANCIAL POSITION
As of September 30, 1998
(Dollars in Millions)

ASSETS	
Entity Assets	
Intragovernmental	
Fund Balance with Treasury (Note 2)	$77,267
Investments (Note 4)	19,724
Interest Receivable (net)	174
Other Assets (Note 6)	417
Total Intragovernmental Assets	$97,582
Accounts Receivable (Note 5)	348
Credit Program Receivables (Note 7)	11,707
Other Assets (Note 6)	1,103
Total Entity Assets	$110,740
Non-Entity Assets	
Intragovernmental	
Fund Balance with Treasury (Note 2)	246
Other Assets (Note 6)	6
Total Intragovernmental Assets	$252
Accounts Receivable (Note 5)	407
Other Assets (Note 6)	64
Total Non-Entity Assets	$723
TOTAL ASSETS	$111,463
LIABILITIES	
Liabilities Covered by Budgetary Resources	
Intragovernmental Liabilities	
Accounts Payable	$189
Interest Payable	361
Debt (Note 8)	6,609
Other Intragovernmental Liabilities (Note 9)	5,025
Total Intragovernmental Liabilities	$12,184
Accounts Payable	913
Interest Payable	36
Liabilities for Loan Guarantees (Note 7)	9,416
Unearned Premiums	891
Debentures Issued to Claimants (Note 8)	166
Insurance Liabilities	205
Loss Reserves (Note 10)	511
Other Governmental Liabilities (Note 9)	617
Total Liabilities Covered by Budgetary Resources	$24,939
Liabilities Not Covered by Budgetary Resources	
Intragovernmental	
Debt (Note 8)	$6,784
Other Intragovernmental Liabilities (Note 9)	57
Total Intragovernmental Liabilities	$6,841
Debt (Note 8)	3,305
Other Governmental Liabilities (Note 9)	72
Total Liabilities Not Covered by Budgetary Resources	$10,218
TOTAL LIABILITIES	$35,157
NET POSITION	
Unexpended Appropriations (Note 11)	$70,377
Cumulative Results of Operations	5,929
TOTAL NET POSITION	$76,306
TOTAL LIABILITIES AND NET POSITION	$111,463

The accompanying notes are an integral part of these statements

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
CONSOLIDATING STATEMENT OF NET COSTS
For the Year Ended September 30, 1998
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Public and Indian Housing	Housing (excluding FHA)	Community Planning and Development	Other	Consolidated
COSTS:							
Unsubsidized Mortgage Insurance Programs							
Intragovernmental	$387						$387
With the Public	1,973						1,973
Total Expenses	$2,360						$2,360
Less: Earned Revenues	(2,777)						(2,777)
Net Program Costs	($417)						($417)
Subsidized Mortgage Insurance Programs							
Intragovernmental	$83						$83
With the Public	763						763
Total Expenses	$846						$846
Less: Earned Revenues	(548)						(548)
Net Program Costs	$298						$298
Government National Mortgage Association							
Total Expenses With the Public		$93					$93
Less: Earned Revenues		(767)					(767)
Net Program Costs		($674)					($674)
Section 8:							
Expenses With the Public/Net Program Costs			$8,010	$7,426	$36		$15,472
Low Rent Public Housing Loans and Grants							
Intragovernmental			$214				$214
With the Public			3,968				3,968
Total Expenses/Net Program Costs			$4,182				$4,182
Operating Subsidies:							
Expenses With the Public/Net Program Costs			$3,128				$3,128
Housing for the Elderly and Disabled							
Intragovernmental				$503			$503
With the Public				847			847
Total Expenses				$1,350			$1,350
Less: Earned Revenues				(691)			(691)
Net Program Costs				$659			$659
Community Development Block Grants:							
Expenses With the Public/Net Program Costs					$4,675		$4,675
HOME:							
Expenses With the Public/Net Program Costs					$1,292		$1,292
Other:							
Intragovernmental			$2	$44	$75	$2	$123
With the Public			545	900	968	115	2,528
Total Expenses			$547	$944	$1,043	$117	$2,651
Less: Earned Revenues			0	(115)	(19)	43	(91)
Net Program Costs			$547	$829	$1,024	$160	$2,560
Costs Not Assigned to Programs			$118	$94	$57	$29	$298
Net Cost of Operations	($119)	($674)	$15,985	$9,008	$7,084	$189	$31,473

The accompanying notes are an integral part of these statements

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
CONSOLIDATING STATEMENT OF CHANGES IN NET POSITION
For the Year Ended September 30, 1998
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Public and Indian Housing	Housing (excluding FHA)	Community Planning and Development	Other	Consolidated
Net Cost of Operations	($119)	($674)	$15,985	$9,008	$7,084	$189	$31,473
Financing Sources							
(other than exchange revenue)							
Appropriations Used	(1,838)		(15,953)	(9,173)	(7,033)	23	(33,974)
Imputed Financing	(5)					(11)	(16)
Transfers (In) / Out	2,668					(224)	2,444
Net Results of Operations	$706	($674)	$32	($165)	$51	($23)	($73)
Prior Period Adjustment (Note 2)	(9,746)						(9,746)
Net Change In Cumulative Results of Operations	($9,040)	($674)	$32	($165)	$51	($23)	($9,819)
Change in Unexpended	(1,143)		994	820	(571)	3,247	3,347
Change in Net Position	($10,183)	($674)	$1,026	$655	($520)	$3,224	($6,472)
Net Position-Beginning of Period	4,190	(5,135)	(24,391)	(21,702)	(18,202)	(4,594)	(69,834)
Net Position-End of Period	($5,993)	($5,809)	($23,365)	($21,047)	($18,722)	($1,370)	($76,306)

The accompanying notes are an integral part of these statements

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
CONSOLIDATED STATEMENT OF BUDGETARY RESOURCES
For the Year Ended September 30, 1998
(Dollars in Millions)

Budgetary Resources	
Budget Authority	$32,607
Unobligated Balance - Beginning of Year	44,853
Net Transfers Prior Year Balance, Actual	(2,300)
Spending Authority from Offsetting Collections	14,185
Adjustments	(1,627)
Total Budgetary Resources	$87,718
Status of Budgetary Resources	
Obligations Incurred	$43,454
Unobligated Balances Available	16,779
Unobligated Balances Not Available	27,485
Total Status of Budgetary Resources	$87,718
Outlays	
Obligations Incurred	$43,454
Less: Spending Authority From Offsetting Collections and Adjustments	18,217
Obligated Balance, Net - Beginning of Period	122,576
Obligated Balance Transferred, Net	(1,458)
Less: Obligated Balance, Net - End of Period	112,184
Total Outlays	$34,171

The accompanying notes are an integral part of these statements

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
CONSOLIDATED STATEMENT OF FINANCING
For the Year Ended September 30, 1998
(Dollars in Millions)

Obligations and Nonbudgetary Resources	
Obligations Incurred	$43,454
Spending Authority from Offsetting Collections and Adjustments	(18,140)
Financing Imputed for Cost Subsidies	16
Transfers In (Out)	(2,431)
Exchange Revenue Not in the Budget	(1,969)
Other	(1,520)
Total Obligations as adjusted, and NonBudgetary Resources	$19,410
Resources That do Not Fund Net Cost of Operations	
Change in Amount of Goods, Services and Benefits Ordered, but not yet Received or Provided	$10,659
Costs Capitalized on the Balance Sheet	110
Financing Sources that Fund Costs of Prior Periods	(1,224)
Other	21
Total Resources that do not Fund Net Cost of Operations	$9,566
Costs That Do Not Require Resources	
Depreciation and Amortization	$2
Bad Debts Related to Uncollectible Non-Credit Reform Receivables	109
Other	(2,015)
Total Costs Not Requiring Resources	(1,904)
Financing Sources Yet to be Provided	$4,401
Net Cost of Operations	$31,473

The accompanying notes are an integral part of these statements

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NOTES TO FINANCIAL STATMENTS
September 30, 1998

NOTE 1 - ENTITY AND MISSION

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

HUD's major programs are as follows:

The **Federal Housing Administration** (FHA) was created as a Government corporation within HUD and administers some 40 active mortgage insurance programs which are designed to make mortgage financing more accessible to the home-buying public and thereby to develop affordable housing. FHA insures private lenders against loss on mortgages which finance single family homes, multifamily projects, health care facilities, property improvements, and manufactured homes.

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

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

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

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

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

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

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

Other Programs not included above consist of other smaller programs which provide grant, subsidy funding, and direct loans to support other HUD objectives such as fair housing and equal opportunity, energy conservation, assistance for the homeless, rehabilitation of housing units, and home ownership. These programs comprise approximately 8.33 percent of HUD's consolidated assets and 7.46 percent of HUD's consolidated revenues and financing sources for fiscal 1998.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Consolidation

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

B. Basis of Accounting

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

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

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

C. Operating Revenue and Financing Sources

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

Appropriations for Grant and Subsidy Programs

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

FHA Unearned Premiums

Premiums charged by FHA for single family mortgage insurance provided by its Mutual Mortgage Insurance Fund (MMI) Cooperative Management Housing Insurance Fund (CMHI) include up-front and annual risk based premiums. Pre-credit reform up-front risk based premiums are recorded as unearned revenue upon collection and are recognized as revenue over the period in which losses and insurance costs are expected to occur. Annual risk-based premiums are recognized as revenue on a straight-line basis throughout the year. FHA's other activities charge periodic insurance premiums over the mortgage insurance term. Premiums on annual installment policies are recognized for the liquidating accounts on a straight-line basis throughout the year.

Premiums associated with Credit Reform loan guarantees are included in the calculation of the liability for loan guarantees (LLG) and not included in the unearned premium amount reported on the Balance Sheet, since the LLG represents the net present value of future cash flows.

Ginnie Mae Fees

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

D. Appropriations and Monies Received from Other HUD Programs

The General Insurance Fund (Gl) and Special Risk Insurance Fund (SRI) were not designed to be self-sustaining. As a result, the National Housing Act of 1990, as amended, provides for appropriations from Congress to finance the operations of these Funds. For post-1991 loan guarantees, appropriations to the GI and SRI Funds are made at the beginning of each fiscal year to cover estimated losses on loans to be insured during that year. For pre-1992 loan guarantees, the FHA has permanent indefinite appropriations authority to finance the cash requirements of operations.

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

E. Fund Balance with the U.S. Treasury

Substantially all of HUD’s receipts and disbursements are processed by the U.S. Treasury which, in effect, maintains HUD’s bank accounts. HUD’s fund balances with the U.S. Treasury as of September 30, 1998, were as follows (dollars in millions):

Description	Entity Assets	Non-Entity Assets
Revolving Funds	$ 8,230	$ -
Appropriated Funds	69,037	112
Escrow Fund	-	134
Total -- Fund Balance	$ 77,267	$ 246

The entity fund balances are required for payment of HUD’s commitments under its various grant, subsidy, and loan programs. Non-entity fund balances relate to transfer appropriations.

F. Investments in U.S. Government Securities

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

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

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

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

G. Credit Program Receivables and Related Foreclosed Property

HUD finances mortgages and provides loans to support construction and rehabilitation of low rent housing, principally for the elderly and disabled under the Section 202/811 program. Prior to April 1996, mortgages were also assigned to HUD through FHA claims settlement (i.e., mortgage notes assigned, MNAs). Single family mortgages were assigned to FHA when the mortgagor defaulted due to certain “temporary hardship” conditions beyond the control of the mortgagor, and when, in management's judgment, it is likely that the mortgage could be brought current in the future. In addition, multifamily mortgages were assigned to FHA when lenders filed mortgage insurance claims for defaulted notes.

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

Credit program receivables for direct loan programs and defaulted guaranteed loans assigned for direct collection are valued differently based on the direct loan obligation or loan guarantee commitment date. These valuations are in accordance with the Federal Credit Reform Act of 1990 and SFFAS No. 2, “Accounting for Direct Loans and Loan Guarantees.” Those obligated or committed on or after October 1, 1991 (post-Credit Reform) are valued at the net present value of expected cash flows from the related receivables.

Credit program receivables resulting from obligations or commitments prior to October 1, 1991, (pre-Credit Reform) are recorded at the lower of cost or fair value (net realizable value). Fair value is estimated based on the prevailing market interest rates at the date of mortgage assignment. When fair value is less than cost, discounts are recorded and amortized to interest income over the remaining terms of the mortgage or upon sale of the mortgages. Interest is recognized as income when earned. However, when full collection of principal is considered doubtful, the accrual of interest income is suspended and receipts (both interest and principal) are recorded as collections of principal. Pre-Credit Reform loans are reported net of allowance for loss and any unamortized discount. The estimate for the allowance on credit program receivables is based on historical loss rates and recovery rates resulting from asset sales and property recovery rates, net of cost of sales.

Foreclosed property acquired as a result of defaults of loans obligated or loan guarantees committed on or after October 1, 1991, is valued at the net present value of the projected cash flows associated with the property. Foreclosed property acquired as a result of defaults of loans obligated or loan guarantees committed prior to 1992, is valued at net realizable value. The estimate for the allowance for loss related to the net realizable value of foreclosed property, is based on historical loss rates and recovery rates resulting from property sales, net of cost of sales.

H. Liability for Loan Guarantees

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

The pre-Credit Reform LLG is computed using the net realizable value method. The LLG for pre-Credit Reform single family insured mortgages includes estimates for defaults that have taken place, but where claims have not yet been filed in the MMI/CMHI, GI, and SRI Funds. In addition, the LLG for pre-Credit Reform multifamily insured mortgages includes estimates for defaults which are considered probable but have not been reported to FHA in the GI, SRI, and MMI/CMHI Funds.

I. Full Cost Reporting

Beginning in FY 1998, SFFAS #4 requires that full costing of program outputs be included in Federal agency financial statements. Full cost reporting includes direct, indirect, and inter-entity costs. For purposes of the consolidated department financial statements, HUD identified each responsibility segment's share of the program costs or resources provided by HUD or other Federal agencies. These costs are treated as imputed cost for the Statement of Net Cost, and imputed financing for the Statement of Changes in Net Position and the Statement of Financing.

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

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

HUD also accrues the portion of the estimated liability for disability benefits assigned to the agency under the FECA, administered and determined by the Department of Labor. The liability is based on the net present value of estimated future payments based on a study conducted by the Department of Labor and is $57 million as of September 30, 1998. Future payments on this liability are to be funded by future appropriations. HUD offsets this unfunded liability by recording future financing sources.

K. Loss Reserves

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

L. Retirement Plans

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

A primary feature of FERS is that it offers a savings plan whereby HUD automatically contributes 1 percent of pay and matches any employee contribution up to an additional 4 percent of pay. Under CSRS, employees can contribute up to 5 percent of their pay to the savings plan, but there is no corresponding matching by HUD. Although HUD funds a portion of the benefits under FERS relating to its employees and makes the necessary withholdings from them, it has no liability for future payments to employees under these plans, nor does it report CSRS, FERS, or FECA assets, accumulated plan benefits, or unfunded liabilities applicable to its employees. These amounts are reported by the Office of Personnel Management (OPM) and are not allocated to the individual employers. HUD's matching contributions to these retirement plans during fiscal 1998 was $56 million.

M. Pension and Other Retirement Benefits

The Department's pension and other retirement benefit expenses totaled approximately $82 million for fiscal 1998. This amount includes $16 million to be funded by the OPM. Amounts funded by OPM are charged to expense with a corresponding amount considered as an imputed financing source in the statement of changes in net position.

N. Prior Period Adjustment

In prior years the consolidated financial statements did not comply with Statement of Federal Financial Accounting Standard (SFFAS) Number 2, *Direct Loans and Loan Guarantees,* as it related to the mortgage insurance programs of FHA. Had this standard been applied to FHA, FHA's net position as of September 30, 1997 would have been $9.746 billion higher than was reflected in the prior year consolidated financial statements. This amount is reflected on the statement of changes in net position as a prior period adjustment.

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

Contractual Commitments

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

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

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

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

HUD's obligations and contractual commitments under its grant, subsidy, and loan programs as of September 30, 1998 were as follows (dollars in millions):

	Commitments Funded Through		
Programs	Unexpended Appropriations	Permanent Indefinite Appropriations	Total Contracted Commitments
Section 8 Rental Assistance	20,843	39,260	60,103
Community Development Block Grants	9,016	-	9,016
HOME Partnership Investment Program	3,646	-	3,646
Operating Subsidies	1,382	-	1,382
Low Rent Public Housing Grants and Loans	7,776	29	7,805
Housing for Elderly and Disabled	3,590	-	3,590
Section 235/236	75	11,282	11,357
All Other	5,804	107	5,911
Total	$ 52,132	$ 50,678	$ 102,810

Of the total Section 8 Rental Assistance contractual commitments, $50.38 billion relates to project-based commitments, and $9.73 billion relates to tenant-based commitments. With the exception of the Housing for the Elderly and Disabled and Low Rent Public Housing Loan Programs, which have been converted to a grant program and Section 235/236, and a portion of "all other" program HUD management expects all of the above programs to continue to incur new commitments under authority granted by Congress in future years. However, estimated future commitments under such new authority are not included in the amounts above.

Administrative Commitments

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

HUD's administrative commitments as of September 30, 1998 were as follows (dollars in millions):

Program	Administrative Commitments Funded Through Unexpended Appropriations	Permanent Indefinite Appropriations	Total Reservations
Section 8 Rental Assistance Project-Based	$ 1,603	$ -	$ 1,603
Section 8 Rental Assistance Tenant-Based	922	-	922
Low Rent Public Housing Grants and Loans	1,617	-	1,617
Housing for Elderly and Disabled	2,692	73	2,765
All Other	1,594	47	1,641
Total	$ 8,428	$ 120	$ 8,548

NOTE 4 - INVESTMENTS IN U.S. GOVERNMENT SECURITIES

The U.S. Government securities are non-marketable securities. Interest rates are established by the U.S. Treasury and during fiscal 1998 ranged from 5.2 percent to 6.1 percent annually. The amortized cost and estimated market value of investments in debt securities as of September 30, 1998 was as follows (dollars in millions):

Description	Cost	Un-amortized (Premium) Discount	Net Invest-ments	Unrealized Gain	Market Value
Intragovernmental Securities:					
Non-marketable: Market-Based	$ 19,961	$ (237)	$ 19,724	$ 1,826	$ 21,550

NOTE 5 - ACCOUNTS RECEIVABLE

Section 8 Settlements

Section 8 subsidies disbursed during the year under annual contribution contracts are based on estimates of amounts due under the contracts by PHAs. At the end of each year the amount actually due under the contracts during the year is determined. The excess of subsidies paid to PHAs during the year over the amounts actually due them are reflected as accounts receivable in the statement of financial position. These amounts are "collected" by offsetting such amounts with subsidies due to PHAs in subsequent periods, and totaled $310 million at September 30, 1998.

Bond Refundings

Many of the Section 8 projects constructed in the late 1970s and early 1980s were financed with tax exempt bonds with maturities ranging from 20 to 40 years. The related Section 8 contracts provided that the subsidies would be based on the difference between what tenants could pay pursuant to a formula, and the total costs of operation of the Section 8 project, including debt service. The high interest rates during the construction period resulted in high subsidies. When interest rates came down later in the 1980s, HUD was interested in getting the bonds refunded. One method used to account for the savings when bonds are refunded (PHA's sell a new series of bonds at a lower interest rate, to liquidate the original bonds), is to continue to pay the original amount of the bond debt service to a trustee. The amounts paid in excess of the lower "refunded" debt service and any related financing costs, are considered savings. One-half of these savings are provided to the PHA, the remaining 50% is returned to HUD. As of September 30, 1998, HUD was due $407 million.

The above accounts receivable are reflected in the statement of financial position as follows: (dollars in millions):

	Entity Assets		Non-Entity Assets	
Section 8 Settlements	$	310	$	-
Bond Refundings				407
Other Receivables		38		-
Total	$	348	$	407

NOTE 6 - OTHER ASSETS

HUD's Other Assets as of September 31, 1998 were as follows (dollars in millions):

Other Entity Assets

	FHA	GNMA	Sec. 8	All Other	Total
Intragovernmental Assets:					
Receivables from unapplied disbursements	$ 213	$ -	$ -	$ -	$ 213
Sec. 312 Rehabilitation Loan Program Receivables	4	-	-	-	4
Advances against Defaulted MBS Pools	-	29	-	-	29
Borrowing Receivables from Treasury	-	-	-	149	149
Other Receivables	-	-	-	22	22
Total Intragovernmental Assets	$ 217	$ 29	$ -	$ 171	$ 417
Other Assets:					
Receivables Related to Asset Sales	$ 32	$ -	$ -	$ -	$ 32
Receivables Related to Credit Program Assets	77	-	-	-	77
Equity Interest in Multifamily Mortgage Trust 1996	60	-	-	-	60
Premiums Receivable	25	-	-	-	25
Accrued Interest and Other Receivables	-	103	-	-	103
Property and Equipment	-	-	-	24	24
Advances to the Public	-	-	663	119	782
Total Other Assets	$ 194	$ 103	$ 663	$ 143	$ 1,103

Other Non-entity Assets

	FHA	GNMA	Sec. 8	All Other	Total
Intragovernmental Assets:					
Other Receivables	$ 6	$ -	$ -	$ -	$ 6
Other Assets:					
Other Receivables	$ 64	$ -	$ -	$ -	$ 64

NOTE 7 - DIRECT LOANS AND LOAN GUARANTEES, NON-FEDERAL BORROWERS

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

Direct loan obligations or loan guarantee commitments made after fiscal 1991, and the resulting direct loans or defaulted guaranteed loans are governed by the Federal Credit Reform Act of 1990, and are recorded as the net present value of the associated cash flows (i.e. interest rate differential, interest subsidies, estimated delinquencies and defaults, fee offsets, and other cash flows). Analysis of loans receivable, loan guarantees, liability for loan guarantees, and the nature and amounts of the subsidy and administrative costs associated with the loans and loan guarantees for fiscal 1998 were as follows:

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

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

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

Direct Loan Programs	Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Direct Loans
FHA	$ 88	$ 13	$ (76)	-	$ 25
GNMA	5	-	-	1	6
Housing for Elderly and Disabled	8,143	82	(20)	1	8,206
Low Rent Public Housing Loans	38	5	(13)	-	30
All Other	1,019	58	(745)	-	332
Total	$ 9,293	$ 158	$ (854)	$ 2	$ 8,599

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

Direct Loan Programs	Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Foreclosed Property	Value of Assets Related to Direct Loans
FHA	$ 6	-	-	-	$ 6

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

Direct Loan Programs	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance for Loan and Interest Losses	Foreclosed Property, Net	Defaulted Guaranteed Loans Receivable, Net
FHA	$ 2,690	$ 640	$ (2,460)	$ 560	$ 1,430

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

Direct Loan Programs	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Foreclosed Property, Gross	Value of Assets Related to Defaulted Guaranteed Loans
FHA	$ 614	$ 21	$ (1,315)	$ 2,352	$ 1,672

F. Guaranteed Loans Outstanding (dollars in millions):

Loan Guarantee Programs	Outstanding Principal, Guaranteed Loans, Face Value	Amount of Outstanding Principal Guaranteed
FHA Programs	$ 518,069	$ 475,236
All Other	1,399	1,399
Total	$ 519,468	$ 476,635

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

Loan Guarantee Programs	Liabilities for Losses on Pre-1992 Guarantees, Estimated Future Default Claims	Liabilities for Loan Guarantees for Post-1991 Guarantees (Present Value)	Total Liabilities For Loan Guarantees
FHA Programs	$ 7,473	$ 1,931	$ 9,404
All Other	-	11	11
Total	$ 7,473	$ 1,942	$ 9,415

H. Subsidy Expense for Post-FY 1991 Loan Guarantees (dollars in millions):

Subsidy Expense for Current Year Loan Guarantees

Loan Guarantee Programs	Endorsement Amount	Default Component	Fees Component	Other Component	Subsidy Amount
FHA	$ -	$ 1,870	$ (5,169)	$ 665	$ (2,634)
All Other	-	7	-	-	7
Total	$ -	$ 1,877	$ (5,169)	$ 665	$ (2,627)

Subsidy Expense for Loan Guarantee Re-estimates for FHA

The cash flow models and financial data used to calculate the fiscal 1998 subsidy expense re-estimates for FHA are substantially different from the models used to calculate the fiscal 1997 re-estimates. These differences primarily resulted from additional refinements in the calculation process, cash flow assumptions and models, as well as additional information about the actual performance of outstanding loan guarantees.

The initial September 30, 1997, subsidy expense re-estimate was $2 billion. This re-estimate was based on the best available information and cash flow models at the time. This re-estimate, if calculated based upon revised models and financial data developed during fiscal 1998, would have resulted in a revised fiscal 1997 re-estimate of $3.4 billion, an increase of $1.4 billion in the fiscal 1997 re-estimate. As the fiscal 1997 re-estimate would have been $1.4 billion higher, the fiscal 1998 re-estimate would have been lower by that amount.

NOTE 8 - DEBT

Several HUD programs have the authority to borrow funds from the U.S. Treasury for program operations. Additionally, FHA in certain cases is authorized by the National Housing Act to issue debentures in lieu of cash to pay claims. Funds were also borrowed by PHAs and IHAs from the private sector and from the Federal Financing Bank (FFB) to finance construction and rehabilitation of low rent housing; these borrowings are being repaid by HUD on behalf of the PHAs and IHAs. HUD borrowings, and borrowings by PHAs/IHAs for which HUD is responsible for repayment, were as follows as of September 30, 1998 (dollars in millions):

Liabilities Covered by Budgetary Resources:

Description	Beginning Balance	Net Borrowings	Ending Balance
Agency Debt:			
Held by the Public	$ 68	$ 98	$ 166
Other Debt:			
Debt to the U.S. Treasury	$ 3,639	$ 2,940	$ 6,579
Debt to the Federal Financing Bank	36	(6)	30
Total Other Debt	$ 3,675	$ 2,934	$ 6,609
Classification of Debt:			
Intragovernmental Debt			$ 6,609
Debentures Issued to Claimants			166
Total Debt			6,775

Liabilities Not Covered by Budgetary Resources:

Description	Beginning Balance	Net Borrowings	Ending Balance
Agency Debt:			
Held by Government Accounts	$ 1,561	$ (70)	$ 1,491
Held by the Public	3,586	(281)	3,305
Total Agency Debt	$ 5,147	$ (351)	$ 4,796
Other Debt:			
Debt to the U.S. Treasury	$ 6,174	$ (881)	$ 5,293
Debt to the Federal Financing Bank	-	-	-
Total Other Debt	$ 6,174	$ (881)	$ 5,293
Total Debt	$ 11,321	$ (1,232)	$ 10,089
Classification of Debt:			
Intragovernmental Debt			$ 6,784
Debt held by the Public			3,305
Total Debt			$ 10,089

Interest paid during the year ended September 30, 1998, on borrowings was $598 million. The purposes of these borrowings are discussed in the following paragraphs.

Borrowings from the U.S. Treasury

HUD is authorized to borrow from the U.S. Treasury to finance Housing for Elderly and Disabled loans. The Treasury borrowings typically have a 15-year term, but may be repaid prior to maturity at the discretion of HUD. However, such borrowings must be repaid in the sequence in which they were borrowed from Treasury. The interest rates on the borrowings are based on Treasury's 30-year bond yield at the time the notes are issued. Interest is payable on April 30 and October 31. Interest rates range from 7.44 percent to 11.41 percent for fiscal 1998.

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

During the 1960s, 1970s, and 1980s, PHAs and IHAs obtained loans from the private sector and from the FFB to finance development and rehabilitation of low rent housing projects. These borrowings are being repaid by HUD on behalf of the PHAs and IHAs, through the Low Rent Public Housing program. For borrowings from the Public, interest is payable throughout the year. Interest rates range from 2.25 percent to 6 percent for fiscal 1998. The borrowings from the FFB have terms up to 40 years; the borrowings from the private sector have terms up to 30 years. FFB interest is payable annually on November 1. Interest rates range from 10.6 percent to 16.1 percent for fiscal 1998.

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

NOTE 9 - OTHER LIABILITIES

HUD's Other Liabilities as of September 30, 1998 were as follows (dollars in millions):

Other Liabilities Covered by Budgetary Resources:

Description	Non-Current	Current	Total
Intragovernmental Liabilities:			
FHA Payable from Unapplied Receipts			
Recorded by Treasury	$ -	$ 210	$ 210
GNMA Deferred Income/Revenue	-	25	25
Other Liabilities for Borrowings from Treasury			
HUD All Other	153	-	153
Resource Payable to Treasury			
Housing for the Elderly and Disabled	4,113	-	4,113
Advances Fed Other			
HUD All Other	-	5	5
Miscellaneous Receipts Payable to Treasury			
Section 8 Rental Assistance	519	-	519
Total Intragovernmental Liabilities	$ 4,785	$ 240	$ 5,025
Governmental Liabilities:			
FHA Other Liabilities	$ 14	$ 100	$ 114
FHA Escrow Funds Related to Mortgage Notes	-	204	204
GNMA Accounts Payable and Accrued Liabilities	-	21	21
Deferred Credits			
Section 8 Rental Assistance	-	164	164
Deposit Funds			
Low Rent Public Housing G/L	-	8	8
Housing for Elderly and Disabled	-	13	13
HUD All Other	-	93	93
Total Governmental Liabilities	$ 14	$ 603	$ 617

Other Liabilities Not Covered by Budgetary Resources:

Description	Non-Current	Current	Total
Intragovernmental Liabilities:			
Other Actuarial Liabilities			
HUD All Other	$ 57	$ -	$ 57
Governmental Liabilities:			
Accrued Unfunded Annual Leave			
HUD All Other	$ 72	$ -	$ 72

NOTE 10 - LOSS RESERVES

Loss reserves of $511 million were established by Ginnie Mae through a provision charged to operations and represents probable defaults by issuers of mortgage-backed securities. The reserve is relieved as losses are realized from the disposal of the defaulted issuers' portfolios. Ginnie Mae recovers part of its losses through servicing fees on the performing portion of the portfolios and the sale of servicing rights which inure to Ginnie Mae upon the default of the issuer. Ginnie Mae management believes that its reserve is adequate to cover probable losses from defaults by issuers of Ginnie Mae guaranteed mortgage-backed securities.

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

NOTE 11 - UNEXPENDED APPROPRIATIONS

HUD receives appropriations on both an annual and multiyear basis for all non-revolving fund activity. Unexpended appropriations are amounts not yet expended, which have not lapsed, been rescinded, or been withdrawn. Analysis of HUD's Unexpended Appropriations for fiscal 1998 is as follows (dollars in millions):

	Unobligated		Undelivered	Accounts Recv	
Description	Available	Unavailable	Orders	from Public	Total
FHA - Subsidized Programs	$ 43	$ 372	$ 25	$ -	$ 440
FHA - Unsubsidized Programs	-	1,264	-	-	1,264
Section 8 Rental Assistance	7,105	-	20,843	14	27,962
CDBG	845	-	9,016	-	9,861
HOME	242	-	3,646	-	3,888
Operating Subsidies	68	-	1,382	-	1,450
Low Rent Public Housing Loans and Grants	1,743	-	7,776	1,466	10,985
Section 202/811	2,798	-	3,577	-	6,375
All Other	2,236	84	5,829	3	8,152
Total	$ 15,080	$ 1,720	$ 52,094	$ 1,483	$ 70,377

Balances of Budget Authority

HUD's balances of budget authority include obligated balances for which outlays have not yet been made, along with unobligated balances. These balances are reported in the Consolidated Statement of Budgetary Resources. Unexpended appropriations reported in the Consolidated Statement of Financial Position will not agree with HUD's balances of budget authority, for the following reasons:

a) Unexpended appropriations do not include contractual commitments and reservations for which appropriations have not yet been received. As explained in Note 3, commitments and reservations funded through Permanent Indefinite Appropriations relate primarily to the Section 8 and Section 235/236 programs, resulting from contract authority provided prior to FY 1988 (contract authority is not an appropriation);

b) HUD's balances of budget authority includes FHA and GNMA activity. To the extent this activity is recorded for financial statement purposes, it is included in other net position accounts; and

c) commitments to fund future interest and principal payments relating to loans made to PHAs and IHAs for which repayment was subsequently assumed by HUD, are included in HUD's balances of budget authority, but are not reported in commitments in Note 3.

Unexpended appropriations can be reconciled to HUD's balances of budget authority as of September 30, 1998, as follows (dollars in millions):

Appropriations recorded in proprietary and budgetary records:	
Contractual commitments relating to grant, subsidy and loan programs funded through unexpended appropriations (Note 3)	$52,132
Administrative commitments relating to grant, subsidy and loan programs funded through unexpended appropriations (Note 3)	8,428
Appropriations received relating to grant, subsidy and loan programs, not yet obligated nor reserved	6,693
Accounts receivable due from the public	1,483
Unexpended appropriations relating to FHA	1,704
Other	(63)
Unexpended appropriations reported in the Consolidated Statement of Financial Position	70,377
Budgetary transactions not recorded in Proprietary records:	
Contractual commitments funded through permanent indefinite appropriations (note 3)	50,678
Administrative Commitments funded through permanent indefinite appropriations (note 3)	120
FHA unexpended balances, not included in unexpended appropriations	17,874
GNMA unexpended balances, not included in unexpended appropriations	5,857
Public and Indian Housing Loan future interest payments assumed by HUD, not included in unexpended appropriations	6,183
Contractual commitments relating to the debt service fund, not included in unexpended appropriations	1,420
Other reconciling items	3,939

Total Budgetary transactions not recorded in proprietary records	86,071
Total Balances of Budget Authority	$156,448

NOTE 12 - FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

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

A. FHA Mortgage Insurance

Unamortized insurance in force outstanding for FHA's mortgage insurance programs as of September 30, 1998 was $518 billion and is discussed in note 7F.

B. Ginnie Mae Mortgage-Backed Securities

Ginnie Mae financial instruments with off-balance sheet risk include guarantees of Mortgage Backed Securities (MBS) and commitments to guaranty MBS. The securities are backed by pools of FHA-insured, RHS-insured, and VA-guaranteed mortgage loans. Ginnie Mae is exposed to credit loss in the event of non-performance by other parties to the financial instruments. The total amount of Ginnie Mae guaranteed securities outstanding at September 30, 1998 was approximately $542 billion. However, Ginnie Mae's potential loss is considerably less because the FHA and RHS insurance and VA guaranty serve to indemnify Ginnie Mae for most losses. Also, as a result of the structure of the security, Ginnie Mae bears no interest rate or liquidity risk.

During the mortgage closing period and prior to granting its guaranty, Ginnie Mae enters into commitments to guarantee MBS. The commitment ends when the MBS are issued or when the commitment period expires. Ginnie Mae's risks related to outstanding commitments is much less than for outstanding securities due, in part, to GNMA's ability to limit commitment authority granted to individual issuers of MBS. Outstanding commitments as of September 30, 1998, was $22 billion.

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

In fiscal 1998, Ginnie Mae issued a total of $36.9 billion in its multiclass securities program.. The outstanding balance at September 30, 1998, was $83.4 billion. These guaranteed securities do not subject Ginnie Mae to additional credit risk beyond that assumed under the MBS program.

C. Section 108 Loan Guarantees

Under HUD's Section 108 Loan Guarantee program, recipients of CDBG Entitlement Grant program funds may pledge future grant funds as collateral for loans guaranteed by HUD (these loans were provided from private lenders since July 1, 1986). This Loan Guarantee Program provides entitlement communities with a source of financing for projects which are too large to be financed from annual grants. The amount of loan guarantees outstanding as of September 30, 1998, was $1.38 billion. HUD management believes its exposure in providing these loan guarantees is limited, since loan repayments can be offset from future CDBG Entitlement Program Funds and, if necessary, other funds provided to the recipient by HUD. HUD has never had a loss under this program since its inception in 1974.

NOTE 13 - CONTINGENCIES

Lawsuits and Other

HUD is party in various legal actions and claims brought against it. In the opinion of management and General Counsel, the ultimate resolution of these legal actions and claims will not materially affect HUD's financial position or results of operations for the fiscal year ended September 30, 1998. Payments made out of the Claims, Judgments and Relief Acts Fund in settlement of the legal proceedings are subject to the Department of Justice's approval.

A case was filed by owners of 43 multifamily projects regarding the Emergency Low-Income Housing Preservation Act of 1987 (ELIHPA) and the Low-Income Housing Preservation and Resident Homeownership Act of 1990 (LIHPRHA). The Court of Federal Claims has ruled that the project owners' mortgage contracts had been breached by implementation of ELIHPA and LIHPRHA, and a trial was held in November 1996 to determine damages, if any, with respect to that claim as regards four "test" properties. The court awarded $3,061,107 in damages to the Plaintiff owners of the four "test" properties. An appeal was taken by the United States from the judgment entered in this case. The United States Court of Appeals for the Federal Circuit reversed the judgement of the Court of Federal Claims, holding that ELIHPA and LIHPRHA did not breach contracts between the plaintiffs and HUD. Specifically, the Court of Appeals ruled that the requisite privity of contract did not exist between the owners and HUD with respect to prepayment of the mortgage loans so as to make HUD liable to the owners for breach of contract. The court based its holding on the fact that the contractual provision allowing prepayment appears only in the riders to the mortgage notes, to which HUD is not a party. The Federal Circuit remanded the action to the Court of Federal Claims for consideration of the plaintiffs' takings claims. The Federal Circuit's decision will govern the outcome of all the other pending actions, unless there is further review and a reversal by the Federal Circuit sitting en-banc or by the United States Supreme Court, in which event, the latter will be determinative. In several of the other LIHPRHA cases, the Court of Federal Claims Judge also held that the United States had not breached the owners' mortgage contracts by enacting ELIPHA and LIHPRHA because of a lack of privity of contract between the owners and HUD. To date, there are 23 other lawsuits involving approximately 800 multifamily projects, all of which allege the same cause of action as stated above. HUD intends to defend these matters vigorously. HUD is unable at this time to form a judgment about the likelihood of an unfavorable outcome, or to make an estimate of the amount or range of potential loss if the plaintiffs should prevail. Any adverse judgment would be paid out of the Claims, Judgments, and Relief Acts Fund administered by the Department of Justice.

NOTE 14 - INTRAGOVERNMENTAL FINANCIAL ACTIVITIES

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

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

A. Claims, Judgments, and Relief Acts Fund

Most legal actions that affect HUD and involve an amount in excess of $2,500, with the exception of on-the-job injury claims as discussed in Note 2 and legal actions pertaining to the FHA and Ginnie Mae programs, are paid from the Claims, Judgments, and Relief Acts Fund maintained by the Department of the Treasury and administered by the General Accounting Office and the Department of Justice. HUD is not required to reimburse this fund for payments made on its behalf. During fiscal 1998 no material amounts were paid to settle actions against HUD.

B. Other Interagency Transactions

HUD maintains various agreements with other federal agencies under the Economy and Efficiency Act. The revenues, expenses, receivables and payables for these agreements for fiscal 1998 are not material. HUD's two largest federal transactions are with the General Services Administration (GSA) for the use and upkeep of HUD facilities, and the Department of Agriculture's National Finance Center for the processing of payroll and related benefits.

HUD also manages transfer appropriations from the Appalachian Regional Commission (ARC) and the Department of Energy (DOE). The ARC funding is used to facilitate joint Federal and State efforts to provide basic facilities essential to economic growth in Appalachia. The DOE funding is used to fund loans and grants related to solar energy conservation improvements. These funds are included in the “All other” category in the financial statements.

NOTE 15 - EXCESS RENTAL SUBSIDIES

During fiscal 1998, HUD developed statistical estimates of the extent of unreported income and excess rental subsidies based on an analysis of a sample of assisted households nationwide that received rental assistance during calendar year 1997 (the most recent year for which data is available for computer matching purposes).

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

During fiscal 1998, the Department selected a sample of households from its automated databases containing tenant data, and computer matched household income shown in those databases to Social Security Administration (SSA)/Internal Revenue Service (IRS) data. HUD staff examined source documents for each case where differences in income from computer matching sources and tenant-reported sources exceeded a predetermined threshold. These source documents were obtained from housing agencies, owners, and agents to determine if the income differences contributed to excess rental subsidies or were caused by other reasons that would not contribute to excess subsidies. For example, the computer matching would not identify excess subsidies if erroneous income information had been entered into the databases or SSA/IRS and tenant-reported income information were reported for different time periods.

The threshold used to determine computer matching differences was $3,000 for calendar 1997 data. Use of a threshold was necessary to provide a reasonable and cost effective basis for developing estimates of unreported income.

Based on the results of the statistical sample, the Department projects, with 95 percent confidence, that during calendar year 1997 the amount of excess rental subsidies (for the 4.0 million households included in the databases, which comprised approximately 90% of all households receiving assistance during calendar 1997) was $774 million ± $191 million. Extrapolating these results to the entire universe of assisted households yields an excess rental subsidy amount of $857 million ± $211 million. This extrapolation is based on the assumption that the characteristics of the households included in the databases from which the sample was selected are similar to those households not included in the databases.

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

NOTE 16 - TOTAL COST AND EARNED REVENUE BY BUDGET FUNCTIONAL CLASSIFICATION

HUD's total cost and earned revenue by budget functional classification is as follows (dollars in millions):

Budget Functional Classification	Gross Cost	Earned Revenue	Net Cost
Commerce and Housing Credit	$ 3,832	$ (4,783)	$ (951)
Community and Regional Development	5,091	(284)	4,807
Income Security	27,394	(58)	27,336
Administration of Justice	24	-	24
Miscellaneous	257		257
Total	$ 36,598	$ (5,125)	$ 31,473

CONSOLIDATING FINANCIAL STATEMENTS (BY MAJOR PROGRAM AREA)

Department of Housing and Urban Development
Consolidating Statement of Financial Position
As of September 30, 1998
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home	Operating Subsidies	Public and Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other	Consolidating
ASSETS										
Entity Assets										
Intragovernmental										
Fund Balance with Treasury (Note 2)	$6,474	$779	$27,342	$9,879	$3,888	$1,498	$11,155	$7,774	$8,478	$77,267
Investments (Note 4)	14,108	5,448							168	19,724
Interest Receivable (net)	174									174
Other Assets (Note 6)	217	29							171	417
Total Intragovernmental Assets	$20,973	$6,256	$27,342	$9,879	$3,888	$1,498	$11,155	$7,774	$8,817	$97,582
Accounts Receivable (Note 5)	0		310			17	1		20	348
Credit Program Receivables (Note 7)	3,133	6					30	8,206	332	11,707
Other Assets (Note 6)	194	104	663	3	4		85	1	49	1,103
Total Entity Assets	$24,300	$6,366	$28,315	$9,882	$3,892	$1,515	$11,271	$15,981	$9,218	$110,740
Non-Entity Assets										
Intragovernmental										
Fund Balance with Treasury (Note 2)	$134		$112							$246
Other Assets (Note 6)	6									6
Total Intragovernmental Assets	$140		$112							$252
Accounts Receivable (Note 5)			407							407
Other Assets (Note 6)	64									64
Total Non-Entity Assets	$204		$519							$723
TOTAL ASSETS	$24,504	$6,366	$28,834	$9,882	$3,892	$1,515	$11,271	$15,981	$9,218	$111,463
LIABILITIES										
Liabilities Covered by Budgetary Resources										
Intragovernmental Liabilities										
Accounts Payable	$169						$18		$2	$189
Interest Payable							181	$180		361
Debt (Note 8)	6,579								30	6,609
Other Intragovernmental Liabilities (Note 9)	210	$25	$519					4,113	158	5,025
Total Intragovernmental Liabilities	$6,958	$25	$519				$199	$4,293	$190	$12,184
Accounts Payable	569		189	$21	$3	$65	34	7	25	913
Interest Payable							36			36
Liabilities for Loan Guarantees (Note 7)	9,404								12	9,416
Unearned Premiums	891									891
Debentures Issued to Claimants (Note 8)	166									166
Insurance Liabilities	205									205
Loss Reserves (Note 10)		511								511
Other Governmental Liabilities (Note 9)	318	21	164				9	13	92	617
Total Liabilities Covered by Budgetary	$18,511	$557	$872	$21	$3	$65	$278	$4,313	$319	$24,939
Liabilities Not Covered by Budgetary Resources										
Intragovernmental										
Debt (Note 8)							$1,491	$5,293		6,784
Other Intragovernmental Liabilities (Note 9)									$57	57
Total Intragovernmental Liabilities							$1,491	$5,293	$57	$6,841
Debt (Note 8)							3,305			3,305
Other Governmental Liabilities (Note 9)									72	72
Total Liabilities Not Covered by Budgetary							$4,796	$5,293	$129	$10,218
TOTAL LIABILITIES	$18,511	$557	$872	$21	$3	$65	$5,074	$9,606	$448	$35,157
NET POSITION										
Unexpended Appropriations (Note 11)	$1,704		$27,962	$9,861	$3,889	$1,450	$10,985	$6,375	$8,151	$70,377
Cumulative Results of Operations	4,289	$5,809					(4,788)		619	5,929
TOTAL NET POSITION	$5,993	$5,809	$27,962	$9,861	$3,889	$1,450	$6,197	$6,375	$8,770	$76,306
TOTAL LIABILITIES AND NET POSITION	$24,504	$6,366	$28,834	$9,882	$3,892	$1,515	$11,271	$15,981	$9,218	$111,463

Department of Housing and Urban Development
Consolidating Statement of Changes in Net Position
For the period ended September 1998
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home	Operating Subsidies	Public and Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other	Consolidating
Net Cost of Operations	($119)	($674)	$15,472	$4,675	$1,292	$3,128	$4,182	$659	$2,858	$31,473
Financing Sources (other than exchange revenue)										
Appropriations Used	(1,838)		(15,472)	(4,675)	(1,292)	(3,128)	(4,150)	(848)	(2,571)	(33,974)
Imputed Financing	(5)								(11)	(16)
Transfers-(In)/Out	2,668								(224)	2,444
Net Results of Operations	$706	($674)	$0	$0	$0	$0	$32	($189)	$52	($73)
Prior Period Adjustment	(9,746)									(9,746)
Net Changes in Cumulative Results of Operations	($9,040)	($674)	$0	$0	$0	$0	$32	($189)	$52	($9,819)
Change in Unexpended	(1,143)		1,694	(285)	(173)	204	245	3,123	(318)	3,347
Change in Net Position	($10,183)	($674)	$1,694	($285)	($173)	$204	$277	$2,934	($266)	($6,472)
Net Position-Beginning of Period	4,190	(5,135)	(29,656)	(9,576)	(3,716)	(1,654)	(6,474)	(9,309)	(8,504)	(69,834)
Net Position-End of Period	($5,993)	($5,809)	($27,962)	($9,861)	($3,889)	($1,450)	($6,197)	($6,375)	($8,770)	($76,306)

Department of Housing and Urban Development
Consolidating Statement of Budgetary Resources
For the Year Ended September 1998
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home	Operating Subsidies	Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other	Consolidating
Budgetary Resources										
Budget Authority	$6,488	$9	$9,383	$4,925	$1,500	$2,900	$3,132	$1,720	$2,550	$32,607
Unobligated Balance - Beginning of Year	16,751	5,607	13,462	779	210	130	434	3,893	3,587	44,853
Net Transfers Prior Year Balance, Actual			(3,826)		(13)		1,347	197	(5)	(2,300)
Spending Authority from Offsetting	12,223	858					82	779	243	14,185
Adjustments	(422)		(265)	5	7	3	(103)	(870)	18	(1,627)
Total Budgetary Resources	$35,040	$6,474	$18,754	$5,709	$1,704	$3,033	$4,892	$5,719	$6,393	$87,718
Status of Budgetary Resources										
Obligations Incurred	$15,247	$196	$11,143	$4,902	$1,475	$2,990	$3,191	$1,680	$2,630	$43,454
Unobligated Balances Available	2,459		4,719	843	236	40	1,781	2,919	3,782	16,779
Unobligated Balances Not Available	17,334	6,278	2,892	(36)	(7)	3	(80)	1,120	(19)	27,485
Total Status of Budgetary Resources	$35,040	$6,474	$18,754	$5,709	$1,704	$3,033	$4,892	$5,719	$6,393	$87,718
Outlays										
Obligations Incurred	$15,247	$196	$11,143	$4,902	$1,475	$2,990	$3,191	$1,680	$2,630	$43,454
Less: Spending Authority From Offsetting										
Collections and Adjustments	12,270	858	2,632	7	7	5	997	790	651	18,217
Obligated Balance, Net - Beginning of	700	(85)	67,229	8,793	3,511	1,525	19,166	3,475	18,262	122,576
Obligated Balance Transferred, Net			(79)		(35)	60	(1,232)	(100)	(72)	(1,458)
Less: Obligated Balance, Net - End of	1,052	(66)	60,267	9,028	3,644	1,437	15,592	3,785	17,445	112,184
Total Outlays	$2,625	($681)	$15,394	$4,660	$1,300	$3,133	$4,536	$480	$2,724	$34,171

Department of Housing and Urban Development
Consolidating Statement of Financing
For the Year Ended September 1998
(Dollars in Millions)

	Federal Housing Administration	Government National Mortgage Association	Section 8 Rental Assistance	Community Development Block Grants	Home	Operating Subsidies	Public and Indian Housing Loans and Grants	Housing for the Elderly and Disabled	All Other	Consolidating
Obligations and Nonbudgetary Resources										
Obligations Incurred	$15,247	$196	$11,143	$4,902	$1,475	$2,990	$3,191	$1,680	$2,630	$43,454
Spending Authority from Offsetting Collections and Adjustments	(12,270)	(858)	(2,632)	(7)	(7)	(5)	(997)	(790)	(574)	(18,140)
Financing Imputed for Cost Subsidies	5								11	16
Transfers In (Out)	(2,668)								237	(2,431)
Exchange Revenue Not in the Budget	(1,955)		(11)				3		(6)	(1,969)
Other			(80)		(35)		(1,233)	(100)	(72)	(1,520)
Total Obligations as adjusted, and NonBudgetary Resources	($1,641)	($662)	$8,420	$4,895	$1,433	$2,985	$964	$790	$2,226	$19,410
Resources That do Not Fund Net Cost of										
Change in Amount of Goods, Services and Ordered, but not yet Received or Provided	$91	($9)	$7,052	($220)	($141)	$143	$3,478	($215)	$480	$10,659
Costs Capitalized on the Balance Sheet	8	(50)					58	84	10	110
Financing Sources that Fund Costs of Prior Periods	(1,075)								(149)	(1,224)
Other	364						(351)		8	21
Total Resources that do not Fund Net Cost of Operations	($612)	($59)	$7,052	($220)	($141)	$143	$3,185	($131)	$349	$9,566
Costs That Do Not Require Resources										
Depreciation and Amortization									$2	$2
Bad Debts Related to Uncollectible Non-Credit Reform Receivables							$18		91	109
Other	($2,135)	$47					15		58	(2,015)
Total Costs Not Requiring Resources	($2,135)	$47					$33		$151	($1,904)
Financing Sources Yet to be Provided	$4,269								$132	$4,401
Net Cost of Operations	($119)	($674)	$15,472	$4,675	$1,292	$3,128	$4,182	$659	$2,858	$31,473

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Objectives, Scope and Methodology

Management is responsible for:

- preparing the principal financial statements in conformity with the hierarchy of accounting principles described in OMB Bulletin 97-01, *Form and Content of Agency Financial Statements*, a hierarchy which constitutes generally accepted accounting standards for the federal government;

- establishing, maintaining and evaluating internal controls and systems to provide reasonable assurance that the broad objectives of FMFIA are met; and

- complying with applicable laws and regulations.

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

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

We considered HUD's internal control over Required Supplementary Stewardship Information to be reported in HUD's *Fiscal Year 1998 Accountability Report* by obtaining an understanding of HUD's internal controls, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls as required by OMB Bulletin 98-08, *Audit Requirements for Federal Financial Statements* and not to provide assurance on these internal controls. Accordingly, we do not provide assurance on such controls.

With respect to internal controls related to performance measures to be reported in HUD's *Fiscal Year 1998 Accountability Report*, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin 98-08. Our procedures were not designed to provide assurance on internal control over reported performance measures and, accordingly, we do not provide an opinion on such controls.

To fulfill these responsibilities, we:

- examined, on a test basis, evidence supporting the amounts and disclosures in the consolidated principal financial statements;

- assessed the accounting principles used and the significant estimates made by management;

- evaluated the overall presentation of the consolidated principal financial statements;
- obtained an understanding of internal controls over financial reporting, executing transactions in accordance with budget authority, compliance with laws and regulations, and safeguarding assets;
- tested and evaluated the design and operating effectiveness of relevant internal controls over significant cycles, classes of transactions, and account balances;
- tested HUD's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin 98-08, including the requirements referred to in FFMIA;
- considered compliance with the process required by FMFIA for evaluating and reporting on internal control and accounting systems; and
- performed other procedures as we considered necessary in the circumstances.

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

Our consideration of the internal controls over financial reporting would not necessarily disclose all matters in the internal controls over financial reporting that might be reportable conditions. We noted certain matters in the internal control structure and its operation that we consider to be reportable conditions under OMB Bulletin 98-08. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect HUD's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements.

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

Our work was performed in accordance with *Government Auditing Standards* and OMB Bulletin 98-08, as amended.

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

Recommendations

To facilitate tracking recommendations in the Departmental Automated Audits Management System, this appendix lists the newly developed recommendations resulting from our audit of HUD's fiscal year 1998 financial statements. Also listed are recommendations from prior years' reports that have not been fully implemented. This appendix does not include recommendations pertaining to FHA issues because they are tracked under separate financial statement audit reports of that entity.

Recommendations from the Current Report

With respect to the material weakness that HUD needs to complete improvements to its financial management systems, we recommend that the **Chief Financial Officer**:

1.a Develop an FSI strategic plan that clearly articulates the planned approach for accomplishing the FSI vision.

1.b. Establish a moratorium on changes to the FSI project scope and strategy.

1.c. As part of the project monitoring process, define upper and lower control limits to establish the range of variation in earned value that the FSI project and tasks can reach and still be acceptable.

1.d. More closely monitor project progress using the control limits referred to in Recommendation 1.c.

We recommend that the **FSI Project Manager**:

1.e. Produce performance measurement reports (Earned Value) at both the project and task levels.

1.f. Ensure project and task level performance measurement reports are produced regularly.

With respect to the material weakness regarding excess subsidy payments, we recommend that the **Chief Financial Officer**, in consultation with the **Assistant Secretaries for Public and Indian Housing and Housing, and the Director, Real Estate Assessment Center:**

2.a. Ensure all outstanding income verification projects (both Phase I and Phase II) are completed and results reported in fiscal year 1999.

2.b. Continue activities to develop a practical and cost effective technique and methodology for large scale computer income verification matching. In the interim, develop and implement a work plan for smaller scale computer income verification matching.

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

3.a. Verify that project-based Section 8 payments are accurate and allowable by testing source documentation through verification of tenant data. Examples of procedures that do this include confirmations and on-site reviews.

In preparation for the transfer of functions to contract administrators, we recommend that the **Deputy Assistant Secretary for Multifamily Housing**, with input from PIH, REAC, and the CFO's staff:

3.b. In developing contract requirements, consider elements of HUD's controls over project-based Section 8 payments that need to be addressed by the contract administrators as part of their responsibilities for processing payments.

3.c. Analyze the impact on control risk of outsourcing oversight to contract administrators and make appropriate adjustments to the statement of work relating to the contract actions.

With respect to the material weakness that improvements are needed in multifamily project monitoring, we recommend that the **Deputy Assistant Secretary for Multifamily Housing**:

4.a. Increase efforts to conduct management reviews during fiscal year 1999 which would prioritize review of known troubled and potentially troubled projects, and projects being considered for subsidy renewal. At a minimum, the reviews should address or follow up on:

- all health and safety issues being identified by the REAC physical inspection teams,
- other known or existing concerns (e.g. poor financial history or physical condition) that can be addressed via a management review that were delayed because of the creation of the REAC and the Enforcement Center, and
- occupancy responsibilities.

4.b. Develop a comprehensive strategic plan and corresponding monitoring goal for fiscal year 2000 that will consider:

- requiring the REAC to deliver scores on audited financial statements and provide for property managers use, copies of audited financial statements until such time as the information being used by the REAC for data entry is attested to by an independent auditor;
- submitting to the REAC all remaining multifamily projects that have not yet received a physical inspection under the new REAC-developed protocols;
- completing data verification efforts in REMS utilizing the results from the efforts of the multifamily field offices, the REAC, the Enforcement Center, and the Quality Assurance Center;
- determining in the plan when information will be available for project managers' use in monitoring multifamily projects and design realistic goals which can be tracked on a monthly basis; and
- developing a strategic goal of monitoring contract administrator performance which can be tracked.

4.c. For fiscal year 1999, develop, at a minimum, mitigating controls that are not limited to, but can include:

- obtaining, reviewing and following up during management reviews any critical findings in the 1998 annual financial statements of any project where monitoring is conducted by SHFAs and HAs, or any other communication from SHFAs and HAs communicated to local HUD field offices;
- establishing in the field offices the capability to do monitoring of contract administrators; and
- determining what controls and tasks should be in the planned contract administrator contracts that will be effective October 1, 1999.

4.d. Further, we recommend that the **Deputy Assistant Secretary for Multifamily Housing**, with input as needed from the CFO, the REAC, the Office of Multifamily Housing Restructuring, and the Enforcement Center, establish the capacity to issue and maintain current criteria by establishing:

- a team to update and issue through, official Departmental channels, the required revisions to all criteria (Handbooks, Directives, guidance and policy statements) for multifamily projects, which are clear, adequate and effectively distributed; and
- a permanent capacity or division within the Office of Housing to revise criteria as needed.

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

5.a. Provide field office staff with revised guidelines and/or procedures on how to access, interpret and utilize HA information the REAC will be accumulating and disseminating on its annual HA assessments under PHAS.

With respect to the reportable condition that CPD's strategy for overseeing grantees is not fully implemented, we recommend that the **Assistant Secretary for Community Planning and Development**:

6.a. Provide written guidance and training on IDIS to grantees and field representatives.

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

7.a. Make sure security enhancement efforts receive the high level of priority that they deserve and immediately set the Top Secret Security global protection parameter to FAIL.

7.b. Ensure steps are taken to change the "started tasks command" default parameter from BYPASS to FAIL.

7.c. Prepare a cost benefit analysis of implementing the Top Secret/DB2 access control software department-wide.

7.d. Continue efforts to minimize access control weaknesses with UNISYS demand mode processing by proceeding with the UNISYS security enhancement plans.

7.e. Maintain a current written inventory of all servers. The inventory should indicate who uses the server and whether the server is considered a development or a production server.

7.f. Disable the use of the GUEST account and place passwords on all accounts (with the exception of those accounts which are used full time and have station restrictions, such as print spooling accounts). If IT does not disable the use of the GUEST account, they must, at a minimum, ensure that the account provides access only to print services. The GUEST account should be removed from the EVERYONE group. This would restrict the rights to GUEST to those specifically intended for GUEST.

Based on the Department's informal comments on our draft report, concurrent with the issuance of this report, we are recording a management decision for recommendation 7.f. with a final action target date of July 1, 1999.

7.g. Obtain a network management package that alerts staff to conditions that are questionable or unacceptable. We provided information about the weak user passwords to responsible staff. The users should be notified of their weak passwords and reminded of the importance of strong passwords.

7.h. Continue to set password encryption on Headquarters servers, and ensure that the field has set all servers to use password encryption.

Based on the Department's informal comments on our draft report, concurrent with the issuance of this report, we are recording a management decision with concurrent final action for recommendation 7.h.

7.i. Instruct the field to continue to update and test their business resumption plans. Follow-up on the directive to make sure it's accomplished.

7.j. Ensure that configuration management on the Hitachi, UNISYS, client/server and personal computer based platforms is a priority.

- Schedule and implement Hitachi critical applications under Endeavor.
- Select and procure configuration management software, and schedule and implement the software for critical UNISYS applications.
- Continue with the procurement, scheduling and implementation of client/server and personal computer based platform applications.

We recommend that the **Chief Financial Officer** ensure that the following TEVS activities are completed to meet IRS security requirements, and provide additional protection over Federal taxpayer data:

7.k. Ensure the appropriate information, as required for systems operating at a C2 level of computer security, is being captured in the audit trail. TEVS should also train at least one person to regularly generate and review audit trail reports for suspicious activities.

7.l. Develop a disaster recovery plan.

7.m. Conduct annual tests on the system security features that were implemented to prevent and detect unauthorized access to Federal taxpayer data

With respect to the reportable condition that personnel security for systems' access requires overhaul, we recommend that the **Director, Office of Information Security**:

8.a. Provide the Personnel Security Branch of the Office of Human Resources, on a periodic basis, listings of users with "demand" and "batch" access to the mainframes.

8.b. Provide the Personnel Security Branch of the Office of Human Resources, on a periodic basis, access listings of all current users.

8c. Direct the Program (System) Security Administrators to provide the Office of Information Security with names and system ID numbers for individuals whose access to program applications have been terminated by program officials.

We recommend that the **Director, Office of Human Resources**:

8.d. Periodically reconcile its database of background check statuses using listings provided by the Office of Information Security and access listings provided by the Program Security Administrators.

8.e. Provide the Office of Information Security with periodic listings of personnel name changes.

With respect to the reportable condition that additional efforts are needed to strengthen access controls over HUD's payment systems, we recommend that the **Chief Financial Officer**:

9.a. Reduce the number of HUDCAPS security profiles that allow view or data entry access to the VEND tables.

9.b. Request that a programming change be made to segregate the LOCCS "data entry" rights between bank table entry and regular voucher (non-bank table) entry.

9.c. Modify the two HUDCAPS security profiles PRTRPCSC and PRTRPCSS to exclude the ability of those users to execute VACT (vendor activation table) transactions.

9.d. Enforce the quarterly recertification requirements for HUDCAPS users, including the supervisor requirement to identify compensating controls for sole employee transaction executions.

9.e. Ensure that data entry and verifier access to LOCCS non-Section 8 programs for non–Ft. Worth accounting employees is terminated.

9.f. Consolidate the responsibility to approve the setup and change of grantee/employee bank account numbers to the Ft. Worth Accounting Office.

9.g. Request that the PAS security administrator send out periodic PAS user certification listings.

9.h. Request that the Ft. Worth Accounting Office determine the feasibility of restricting its employees with either LOCCS or PAS access.

With respect to the reportable condition that HUD needs to improve processes for reviewing obligation balances, we recommend that the **Chief Financial Officer**:

10.a. Revise the procedures used in the annual review of unliquidated obligation balances to ensure the reviews are initiated and completed in a timely manner.

10.b. Ensure that obligation balances identified as not needed are deobligated.

10.c. Revise the procedures used in the annual review of unliquidated obligation balances to ensure all obligations identified as no longer needed are recaptured for purposes of adjusting the financial statement balances.

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

10.d. Ensure that data used in reviewing unliquidated obligation balances are complete, current, and accurate.

10.e. Ensure that all contract amounts determined to have excess budget authority are deobligated and recaptured.

Unimplemented Recommendations from Prior Years' Reports

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

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

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

2.a. Establish a more systematic approach to determining staffing requirements.

2.b. Hold field offices and headquarters accountable for work accomplishments in line with available resources and established standards.

2.c. Ensure that once greater efficiencies are implemented, staffing standards are realigned to be consistent with the revised workload.

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

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

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

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

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

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

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

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

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

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

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

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

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

The issues that led to the following recommendations have not changed, as our current audit verified. However, HUD has created the REAC and the Departmental Enforcement Center which will have future responsibility over responding to the recommendations and addressing the issue. Consequently, within this context, we repeat the recommendation in unrevised form as it first appeared in our fiscal year 1995 report followed by the latest draft management decision suggested by the Office of Housing on how these recommendations should be addressed. In our fiscal year 1995 report, with respect to the material weakness on improvements needed in multifamily project monitoring, we recommend that the **Assistant Secretary for Housing-Federal Housing Commissioner**:

4.a. For the annual financial statement review contract, assure that the contractor delivers the report review packages to the respective field offices according to the delivery schedule specified in the contract terms. (Final action target date is October 1, 1997.)

4.c. Award a contract for specialized asset management services to selected properties, enabling the field offices to select the property and the necessary services for contractor assistance, based on risk to HUD and type and number of identified deficiencies. (Final action target date is April 30, 1997.)

4.d. For the working group that sets goals for the Housing Management Plan, consider adding goals pertaining to:

- SHFA monitoring, with targets that represent adherence to the policy in HUD handbooks as to the frequency and timing of such reviews.
- The timely analysis of annual financial statements by the field offices, with a target based on the timeliness of the analysis after the receipt of the statements.

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

Revised management decisions have been suggested by the Office of Housing as follows:

4.a. The REAC will be responsible for the tracking, receipt, review and analysis of annual financial statements. The REAC will begin the collection and analysis of the annual financial statements for the period ended December 31, 1998. Annual financial statements will be submitted electronically, reviewed and analyzed by REAC's Financial Analysis Subsystem and results linked electronically for immediate access by Multifamily Housing offices and the Enforcement Center through REMS. (Estimated completion date December 31, 1999.)

4.c. The REAC and Enforcement Center will contract for asset management services (e.g., inspections, project due diligence, legal services support) needed to carry out the responsibilities of their organizations. (Completed action of awarding contracts has already occurred.)

4.d. The REAC will assess and identify troubled projects which will include SHFA projects with mortgage insurance. all HUD-insured projects with subsidy will be analyzed through the REAC assessment. (Estimated completion date September 30, 2000.)

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

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

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

With respect to the material weakness that HUD needs to complete improvements to its financial management systems we recommend that the **Assistant Secretary for Housing-Federal Housing Commissioner**:

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

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

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

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

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

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

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

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

(Final action target date is September 16, 1998.)

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

6.a. Issue guidance to clarify field office responsibility with regard to performing annual on-site reviews of HOPE VI program grants pursuant to PIH's management plan and Notice 95-10 requirements, as extended. (Final action target date is December 31, 1997.)

6.b. Develop procedures for incorporating the results of the independent housing quality assessments into PIH's risk based monitoring strategy. (Final action target date is October 31, 1998.)

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

7.b. Formulate and execute a plan that will expedite disaster recovery testing of multiple critical applications and unscheduled tests. This plan must substantially reduce the current BRP testing time-table and include, but not be limited to:

- Determine what applications will be merged, replaced or deleted prior to disaster recovery testing of multiple critical applications. Any systems that are found to be in this category will not have to be part of the testing.
- Review with program representatives the criticality of BRP systems. It may be possible to eliminate some applications from the BRP.

(Final action target date is August 31, 1999.)

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

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

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

9.a. Require that security administrators and application program managers receive appropriate background investigations and request that the security administrators, in consultation with the Office of Information Technology, identify all individuals performing sensitive and/or critical system functions and require those individuals to receive appropriate background investigations. (Final action target date is October 15, 1997.)

9.b. Incorporate review of position sensitivity designations in future A-130 reviews.(Final action target date is March 31, 1998.)

9.c. Initiate action to ensure the Personnel Security Tracking System contains complete data and is updated in a timely manner. (Final action target date is August 1, 1998.)

OIG Report Number 98-FO-177-0004 (Fiscal Year 1997 Financial Statements)

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

2.a. In conjunction with development of the *HUD 2020* plan, determine the staffing requirements and organizational placement of activities necessary to carry out an ongoing income matching program. (Final action target date is March 31, 1999.)

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

3.e. Adopt a configuration management tool for the UNISYS mainframe.

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

5.a. In accordance with FFMIA, within 120 days of the issuance of this audit report, prepare the required compliance determination from the Secretary that HUD's financial management systems do not comply with FFMIA and submit the required remediation plan to OMB in accordance with OMB's September 9, 1997 FFMIA implementation guidance. (Final action target date is September 30, 1998.)

5.b. In developing the remediation plan described in recommendation 6.a., ensure that all assessments for systems determined to be in compliance with OMB Circular A-127 are adequately documented and develop corrective actions for systems determined to be non-conforming. (Final action target date is September 30, 1998.)

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

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

Federal Financial Management Systems Requirements

1. HUD's annual assurance statement issued pursuant to Section 4 of FMFIA reports 28 non-conforming systems. HUD credits the reduced number of non-conforming systems to it's FSI Project. While the Department has made accomplishments as noted in it's Accountability Report, the FSI project has suffered significant project cost increases and schedule delays which have resulted in planned actions not being actually implemented. The Department reclassified five of the non-conforming systems to conforming, in part, based on the Department's plan to implement a new General Ledger/Financial reporting system which was planned for implementation in fiscal year 1998, however, the implementation date has been revised to fiscal year 1999. Based on the revised implementation date, we believe HUD has 33 non-conforming systems.

HUD assessed its systems based on factors listed in paragraph 7 of OMB Circular A-127. HUD assessed a system as non-conforming if any one of the twelve elements was considered non-conforming. To ensure that assessments performed by program offices are adequately documented and corrective action plans are developed for systems determined to be non-conforming, the Office of the Chief Financial Officer contracted with a firm to conduct an independent review of key financial management systems to verify compliance with FFMIA an OMB Circular A-127 requirements. During Fiscal Year 1998, the contractor completed one review for which the system was reclassified from conforming to non-conforming. The organizations responsible for systems that were found not to comply with the requirements of OMB Circular A-127 are as follows:

Responsible Office	Number of Systems	Non-Conforming Systems
Office of Housing	42	18
Chief Financial Officer	21	5
Office of Administration	6	3
Office of Public and Indian Housing	7	2
Office of Fair Housing and Equal Opportunity	2	0
Government National Mortgage Association	8	0
Office of Community Planning and Development	8	0
Office of the Chief Procurement Officer	4	0
	98	28

The primary reason for the existence of non-conforming systems is that plans to replace or enhance legacy systems have not been implemented due to a combination of schedule delays and cost overruns. HUD, for the most part, plans to replace non-conforming systems with new systems or incorporate the functions of nonconforming systems into conforming systems. The following sections outline the Department's plan to correct specific system non-conformances.

Office of Housing

- **Ensure that FHA transaction-level data from Housing's feeder systems are captured in such a way that they are compliant with Credit Reform and OMB Circular A-127.**

Systems:

System Code	System Name
A43	Single Family Insurance System
A56	Mortgage Insurance General Accounting
A80G	Multifamily Mortgage Auction
A80S	Single Family Acquired Asset Management
A80N	Single Family Mortgage Notes Servicing
A80R	Single Family Premium Collection Subsystem - Upfront
F31	Cash Control Accounting Reporting System
F47	Multifamily Insurance
F75	Multifamily Claims System
R25	FHA Contract Tracking System

Plan: Design a financial data warehouse through which all feeder system's transactions pass and are posted to HUDCAPS through posting models.

Target Completion for all Phases: September 1999

Interim Milestones:	Target Date
Refine new General Ledger Chart of Accounts	Jan 98
Begin working with contractor	Feb 98
Finalize Chart of Accounts & transactions	Apr 98
Implement FHA warehouse	Jun 98
Programming and interfaces	Jul 98
Test software/Load Sep 97 balances & 98 transactions	Sep 98
Correct problems & load year-end transactions.	Dec 98
Complete final adjustment of fiscal year 98 data & test fiscal year 99 transactions	Mar 99

Resources Required: $1.4 million

- **Replace A31 with new A-80B Single Family Premium Collection System**

Plan: Replace system with A80B (Single Family Premium Collection System - Periodic and maintain A31 through 2000. A31 must be maintained one year to process premiums before they are collected by A80B.

Target Completion for all Phases: September 1999

Interim Milestones:	**Target Date**
Complete Requirements Definition	Aug 98
Complete Design, Develop, Unit Test	Dec 98
Complete Systems Test	Apr 99
Complete User Acceptance Test	Sep 99
Complete Implementation	Sep 99

Resources Required: $19,000 (maintenance) and $228,000 (operations) in fiscal year 1999

- **Replace F07 with new Multifamily Asset Development and Management System - F24A**

  Plan: FO7/Computerized Underwriting Processing System was replaced by F24A - Development Application Processing. Development Application Processing processes Multifamily applications for insurance from receipt of the application through initial closing. The first release of the Development Application Processing system was fully implemented in fiscal year 1998 and replaced F07/Computerized Underwriting Processing System in fiscal year 1999.

  Target Completion for all Phases: F07 is scheduled to be de-activated in the 3rd Quarter of fiscal year 1999.

  Resources Required: $60,000 for operations through 3rd Quarter fiscal year 1999.

- **Replace F52 with F42D - REMS**

  Plan: **F52** will be archived and officially shut down.

  Target Completion for all Phases: F52 is scheduled to be shut down as of March 1999.

  Resources Required: $45,000 for operations through 2nd Quarter fiscal year 1999.

- **Complete Users Manual for F51 - Institution Master File**

  Plan: Complete and place users manual on the web.

  Target Completion for all Phases: March 1999.

  Resources Required: $9,000

- **Convert Financial Management Center Housing ACC projects (F87 - TRACS)**

  Plan: Develop software and convert ACC projects.

  Target Completion for all Phases: September 1999.

  Resources Required: $1,535,440

- **Improve Access Controls over D64A - Single Family Housing Enterprise Data Warehouse**

  Plan: The warehouse is run on a Unix platform on a Sun Solaris using Sybase. Access is password restricted. Fire walls exist between HUD's intranet and the Sybase application. Both Social Security Number and borrower name are included in the warehouse. Access controls, while existent, an individual with access can get into individual mortgages, thus defeating the controls in the feeder systems which have more stringent access requirements because of key Social Security Number and borrower name data. A security review is underway.

  Target Completion for all Phases: Fiscal Year 2000

  Resources Required: $0.5 million in fiscal year 1999 and $1.44 million in fiscal year 2000

- **Deactivate F05 (Section 8 Management Information System) and incorporate functionality into TRACS**

  Plan: F05 will be deactivated in 3rd quarter of fiscal year 1999 and TRACS will take over functionality. The modifications have been developed and tested and are ready for release, however, there are certain reporting capabilities that are contained in F05 that are not in the new software. The user is assessing the feasibility of requiring the data entry over the Internet for these data fields, however, some legalities must be resolved before this can become definite.

  Target Completion for all Phases: Third Quarter 1999

  Resources Required: $600,000 for operations through 3rd Quarter fiscal year 1999.

- **Deactivate F45 - Multifamily Data Warehouse**

  Plan: F45 was deactivated December 1998

  Completion for all Phases: December 1998

  Resources Required: N/A

Office of the Chief Financial Officer

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

  Systems:

System Code	System Title	Replacement System
A16	SF-224 Transaction Reconciliation System	A96 PAS
A65A	Section 235 Automated Validation and Editing	A75/HUDCAPS
ATLAS	Advanced Technology Ledger Accounting System	A75/HUDCAPS
A77	Flexible Subsidy System	A21/Loan Accounting System

  Plan: Replace non-conforming systems with conforming systems - PAS, HUDCAPS, and Loan Accounting Systems

Target Completion for all Phases: September 1999

Interim Milestones:	**Target Date**
Initial Disposition Analysis	Jun 97
IT Review, cost/time estimate	Sep 97
Approval of IT estimate & TIB Funding	Oct 97
System Development and Testing	Jun 98
Implementation	Sep 99

Resources Required: Estimates being developed for HUDCAPS and PAS conversions. Operational and maintenance costs will be less than $10,000 in fiscal year 1999 for A77 - Flexible Subsidy.

- **<u>Close-out A65 Section 235 Accounting System</u>**

Plan: This system is in final closeout pending the end of 235 cases. The program has gone from 2,000 cases to a payout of $2,000/year for one case. Retroactive payments are still being processed.

Target Completion for all Phases: Pending

Resources Required: Operational and maintenance costs will be less than $20,000 in fiscal year 1999.

<u>Office of Administration</u>

- **<u>Replace A63 with the Computer Aided Facilities Management System</u>**

Plan: A63 is being replaced by the Computer Aided Facilities Management System which will integrate facilities management data with graphic representations of HUD managed and leased buildings.

Target Completion for all Phases: September 1999

Interim Milestones:	**Target Date**
Work plan fiscal year 1999	Nov 98
Functional Requirements Document	Jan 99
System/Subsystem Specification	Jan 99
Design Document	Jan 99
Operational at HQ	Apr 99
Operational at all Regions	Sep 99

Resources Required: $700,000 for fiscal year 1999

- **<u>Replace D17 with an "off-the-shelf" solution</u>**

Plan: This system is to be replaced with the enterprise edition of Project Office from Pacific Edge Software Inc. This new "front end" application will be implemented and used with Microsoft Project 98, the IT standard for project management.

Target Completion for all Phases: October 1999

Interim Milestones:	**Target Date**
Roll out replacement solution	Sep 99
Terminate PARMS	Oct 99

Resources Required: $550,000

- **Replace A76 - Funds Accounting and Status Tracking (FAST) with functions performed by the Project Cost Accounting System module of HUDCAPS**

  Plan: The principal functions performed by this system are planned for replacement by the Project Cost Accounting System module of HUDCAPS (A75) which is scheduled for development this year. A major dependency of this new module is modification of the HUD Procurement System (HPS) to include the Job Number data element. Inclusion of this critical data element in HPS will not only enable FAST replacement but will provide needed integration of the funds budgeting, contract obligation, and project management functions.

  Target Completion for all Phases: October 1999

  Resources Required: To be determined

Office of Public and Indian Housing

- **Make N07 - Regional Operating Budget and Obligations System conforming as part of subsidiary ledger implementation**

  Plan: The Regional Operating Budget and Obligations System will be made conforming as part of the subsidies subsidiary ledger implementation.

  Target Completion for all Phases: July 1999

Interim Milestones:	**Target Date**
Interface design	Jun 99
User acceptance test	Jun 99
HUD approve interface design	Jul 99

- **Request funding to correct system problems**

  Plan: PIH has asked added systems funding for fiscal year 1999 to fix the problem

  Target Completion for all Phases: To be determined

  Estimated Costs: To be determined

2. Audit procedures performed for the purpose of obtaining evidence in support of the auditor's opinion disclosed a material weakness regarding deficiencies in HUD's financial management systems and reportable conditions regarding the security over financial information. Although a reportable condition, we are including security issues as a basis for noncompliance with FFMIA because of the collective effect of the issue and noncompliance with Circular A-130, Appendix 3. The responsible office, nature of the problem and primary causes are summarized below.[8]

Responsible Office	**Nature of the Problem**
Office of the CFO	Critical systems such as PAS, CHUMS, LOCCS and others have been operational for over 15 years and becoming increasingly difficult and costly to maintain. Numerous changes to legacy systems over the years were not adequately controlled or documented, making system maintenance and enhancement more complicated and costly.

The primary cause for this occurrence is the absence of a Departmentwide Financial Systems Integration strategic plan with cost and schedule estimates detailing how HUD intends to complete its systems integration and modernization effort.

TEVS does not enforce access controls to make sure users are individually accountable for their actions through login procedures, auditing of security-relevant events, and resource isolation.

The primary causes for this occurrence are: (1) audit trail reports are not generated, (2) access controls and other security features have not been tested, and (3) data transferred from SSA to HUD may not be encrypted.

Office of Housing	FHA's automated systems are not linked and integrated, or configured to meet all financial reporting requirements. Specifically, FHA needs to improve its process for federal basis and budgetary accounting. In addition, many of FHA's financial management systems do not share a common data architecture, and not all systems provide the appropriate case level detail required for credit reform compliance.

The primary cause for FHA's system weaknesses, as cited by KPMG LLP, was that resources needed to develop state-of-the-art systems are lacking due to other critical HUD system priorities. FHA needs to improve its process for federal basis and budgetary accounting.

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

In the Hitachi environment, the primary causes of these occurrences are (1) security software is not placed in a global "fail" mode thereby resulting in vulnerabilities to critical system resources and data, (2) the TSS control parameter protecting started task command for initializing applications needs strengthening, and (3) controls over DB2 access authorizations and privileges are ineffective because there is no means to control the subsequent granting of administrative privileges. In the UNISYS environment data from many sensitive computer applications were not protected from unauthorized read access. In the Network environment, numerous user IDs existed without passwords and control settings on the LAN needed to be strengthened.

[8] The issues are discussed in greater detail in the sections of this report relating to the material weakness on the need to complete improvements to financial systems and the reportable condition on the need to improve general system security and other controls, and KPMG LLP's separate report on their audit of FHA's fiscal year 1998 financial statements.

Offices of Housing and Information Technology

FHA management must rely heavily on computerized information systems to process the large volume of data required for such a diverse insurance operation. Control weaknesses regarding FHA's general and application level security systems exist in the lack of a well designed security program, the need for improved access controls, and deficient controls over application change controls.

The primary reason for these weaknesses are that the current security program management does not assure that a consistent, centrally administered security program is in place. Inadequacies include the lack of an up-to-date Security Program Plan, enabled GUEST account on network file servers, lack of an approval process for application change requests.

Corrective Actions

On the Hitachi, HUD successfully placed the TSS global control parameter in "implement" mode in December 1998. The Department is already taking actions to implement controls to limit access to sensitive UNISYS mainframe files. With respect to the LAN environment, the Department is evaluating the results of the penetration test to determine the extent of any necessary corrective actions, and has taken steps to remove user access to the critical areas of the operating system.

Regarding Hitachi application software change control software, so far the Department has implemented the software for three Hitachi applications. The Department has revised its schedule to implement change control for the other critical Hitachi mainframe applications.

In regards to the concern over the protection of taxpayer data, the TEVS project manager intends to address each of the stated deficiencies.

Specific recommendation to correct security weaknesses are listed in Appendix B of this report and KPMG LLP's separate report on their audit of FHA's fiscal year 1998 financial statements.

Federal Accounting Standards

A material weaknesses was reported by KPMG LLP in FHA's budgetary and Federal basis accounting that affected HUD's ability to prepare auditable financial statements. This resulted in a need to:

- review and reconcile obligations and analyze accounts that were not compliant with the SGL and translate those accounts to Federal basis accounting to prepare both the financial statements and the Report on Budget Execution (SF-133) and comply with the requirements of SFFAS Number 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting;*

- reconcile cost allocations to ensure all employees were accounted for properly to comply with SFFAS Number 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*; and

- refine the methodology for calculating the liability for loan guarantees in accordance with SFFAS Number 2, *Accounting for Direct Loans and Loan Guarantees*.

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

During fiscal year 1998, HUD had four general ledger systems to support its core accounting needs: PAS/LOCCS, HUDCAPS, Macola Accounting System (for the Government National Mortgage Association) and the FHA General Accounting System. FHA's core financial system was not in conformance with the SGL.

The Single Family Premium Collections System-Up Front is a subsystem of the FHA Integrated Insurance System (A80). Single Family Premium Collection System Up-Front provides case-level reconciliation, collection, refunding and accounting processes. The system interfaces with the Computerized Homes Underwriting Management System (F17) for case validation and provides it collection information to allow for endorsement, supports collection and accounting for all Single Family up-front premiums and late charges, and supports case level detail for Credit Reform compliance.

During fiscal year 1998, the Office of Housing reclassified Single Family Premium Collection System Up-Front as a non-conforming system because it is not compliant with the SGL at the transaction level due to HUD not having implemented the SGL in compliance with federal guidance. The Office of Housing's original assessment of A80R's compliance with OMB Circular A-127 was based on a misunderstanding of the application of the SGL.

To correct the problem, HUD plans to implement a posting model between Single Family Premium Collection System - Upfront and the financial data warehouse which will then be posted to HUDCAPS. The Department asserts this will solve the problem with the application of the SGL and Credit Reform as HUDCAPS will be fully compliant.

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Agency Comments

U. S. Department of Housing and Urban Development
Washington, D.C. 20410-0100
MAR 23 1999

OFFICE OF THE CHIEF FINANCIAL OFFICER

MEMORANDUM FOR: Susan M. Gaffney, Inspector General, G

William E. Dobrzykowski

FROM: William E. Dobrzykowski, Deputy Chief Financial Officer, FF

SUBJECT: Audit of the U.S. Department of Housing and Urban Development Fiscal Year (FY) 1998 Financial Statements

The purpose of this memorandum is to provide you with official agency comments for the auditor's report on the FY 1998 Consolidated Financial Statements. As you know, for several years after the enactment of the CFO Act requirement that an annual audit be performed on the Department's consolidated financial statements, HUD continued to receive a disclaimer of opinion. The Department's financial records were in such a state of disarray that just 3 years ago, the auditor could not even provide an opinion and issued a disclaimer. During the past 2 years, under Secretary Cuomo's leadership, the Department has made management reform its number one priority. As a result of these efforts, we are very pleased that in the Inspector General's audit of the FY 1998 Consolidated Financial Statements, the Department has received its first unqualified audit opinion. This is a singularly important financial accomplishment in the history of the Department and reflective of the many reforms accomplished through the implementation of the HUD 2020 Reform Plan. HUD joins a select group of only a few cabinet level agencies with an unqualified opinion.

Nevertheless, despite HUD earning an unqualified opinion, we remain cognizant that there are still challenges to be faced in correcting the Department's remaining material weaknesses and reportable conditions. For this year, we are choosing not to provide detailed exceptions to the characterizations of various management challenges as material weaknesses and reportable conditions. We do note however, that accomplishments and reforms have continued at HUD since the closing of the audit measurement period nearly 6 months ago. We are also using many of the recommendations contained in this year's and previous audit reports to assist in developing the plans to correct these problems. The impact of these many accomplishments should have been captured and more fully described in the FY 1998 audit.

We believe that next year's audit of HUD's consolidated financial statements will show further significant improvements as the impact of the HUD 2020 Reform Plan matures and bears fruit. We look forward to working together with you and your staff in the coming year as we continue our shared goal of sound financial management for the Department.

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