Independent Auditor's Report on the Financial Statements

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[1].

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 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.

[1] This report is a condensed version of a more detailed report issued separately on March 29, 1999 by HUD, OIG entitled, "U.S. Department of Housing and Urban Development, Audit of Fiscal Year 1998 Financial Statements" (99-FO-177-0003). The report is available at HUD, OIG's Internet site at http://www.hud.gov/oig/oigindex.html.

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 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 this *Fiscal Year 1998 Accountability Report*, HUD reports 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. 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 is addressing those reporting requirements in the "Financial Management Accountability" section of this *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.

- 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 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 has presented 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 this *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 has presented consolidating statements of financial position, changes in net position, budgetary resources and financing as supplemental information in this *Fiscal Year 1998 Accountability Report*. The consolidating financial information is 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.

Additional details on our findings regarding HUD's internal control environment, verification of subsidy payments, monitoring program recipients, and system and accounting issues are summarized below and were provided in a separate report to HUD management. These additional details also augment the discussions of instances in which HUD had not complied with applicable laws and regulations; the information regarding our audit objectives, scope, and methodology; and recommendations to HUD management resulting from our audit.

Issues with HUD's Internal Control Environment

Most of the material weaknesses and reportable conditions presented 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 this *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, Computerized Homes Underwriting Management System, 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.

In our separate 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 ongoing 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. The weaknesses noted in our current audit 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 noted 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,[2] 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.

[2]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).

- ***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.

- ***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.

Objectives, Scope and Methodology

The accompanying principal financial statements are the responsibility of HUD management. Our responsibility is to express an opinion on these principal financial statements based on our audit. As part of our audit, we considered HUD's internal controls over financial reporting for the purpose of expressing our opinion on the principal financial statements and not to provide assurance on those internal controls. We conducted our audit in accordance with *Government Auditing Standards*, and the requirements of OMB Bulletin 98-08, *Audit Requirements for Federal Financial Statements*, as amended. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion on the financial statements.

We also tested HUD's compliance with laws and regulations that could have a direct and material effect on the financial statements. However, our consideration of HUD's internal controls and our testing of its compliance with laws and regulations were not designed to and did not provide sufficient evidence to express an opinion on such matters and would not necessarily disclose all matters that might be material weaknesses, reportable conditions or noncompliance with laws and regulations. Accordingly, we do not express an opinion on HUD's internal controls or on its compliance with laws and regulations.

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. 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.

Susan Gaffney
Inspector General
March 17, 1999