



Independent Auditor's Report on the Financial Statements

INDEPENDENT AUDITOR'S REPORT

To the Secretary,

U.S. Department of Housing and Urban Development:

In accordance with the Chief Financial Officers (CFO) Act of 1990, we have audited the accompanying consolidated balance sheet of the Department of Housing and Urban Development (HUD) as of September 30, 2000 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 2000 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 statements¹.

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, 2000 and the net costs of operations, changes in net position, status of budgetary resources, and reconciliation of net costs to budgetary obligations for the fiscal year then ended, in conformity with generally accepted accounting principles.

Our audit also disclosed:

- Material weaknesses in internal controls in fiscal year 2000 related to the need to:
 - complete improvements to financial systems;
 - improve oversight and monitoring of housing subsidy determinations;
 - ensure that subsidies are based on correct tenant income; and
 - enhance the Federal Housing Administration's (FHA) information technology systems to more effectively support FHA's business processes.
- Reportable conditions in internal controls in fiscal year 2000 related to the need to:
 - refine performance measures to effectively implement results management;
 - improve controls over project-based subsidy payments;
 - strengthen controls over HUD's computing environment;
 - overhaul personnel security for systems' access;
 - address risks with the reliability and security of HUD's critical financial systems;
 - improve processes for reviewing obligation balances;
 - tighten controls over Fund Balance with Treasury reconciliations;
 - enhance the design and operation of controls over FHA's information systems security and application data integrity;
 - continue to place more emphasis on early warning and loss prevention for FHA single family insured mortgages; and
 - sufficiently monitor and account for FHA's single family property inventory.

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 2000 Accountability Report*, HUD reports that it complied with Section 2 of the Federal Managers' Financial Integrity Act (FMFIA), with the exception of the material weaknesses and nonconformances specifically identified in that report. Section 2 and related guidance require that: (1) an agency's internal accounting and administrative controls provide reasonable assurance that

¹ This report is a condensed version of a more detailed report issued separately on March 1, 2001 by HUD, OIG entitled, "U.S. Department of Housing and Urban Development, Audit of Fiscal Year 2000 Financial Statements" (2001-FO-0003). The report is available at HUD, OIG's Internet site at <http://www.hud.gov/oig/oigindex.html>.

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obligations and costs are in compliance with applicable laws; (2) funds, property and assets are adequately safeguarded; and (3) revenues and expenditures are properly and reliably accounted for and reported. HUD is unable to report compliance with Section 4, which requires that accounting systems conform to the accounting principles and standards mandated by the Comptroller General of the United States. For fiscal year 1999 and prior years, we disagreed with the Department's statement of overall assurance in the Department's *Accountability Reports*. HUD's compliance determinations did not fully consider the magnitude of the problems HUD acknowledges in its own FMFIA process. As permitted by the Reports Consolidation Act of 2000 (PL 106-53 1), HUD did not prepare a separate FMFIA report for fiscal year 2000 and is addressing those reporting requirements in this *Fiscal Year 2000 Performance and Accountability Report*. Given the magnitude of the problems that still remain, we continue to believe that a FMFIA statement of noncompliance would be appropriate for HUD.

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

- HUD did not substantially comply with the Federal Financial Management Improvement Act (FFMIA). In this regard, HUD's financial management systems did not substantially comply with (1) Federal Financial Management Systems Requirements or (2) the U.S. Standard General Ledger (SGL) at the transaction level.
- HUD did not comply with the United States Housing Act of 1937, as amended by the Quality Housing and Work Responsibility Act of 1998. Specifically, HUD is not timely or properly enforcing the act's requirements for the timely expenditure and obligation by housing agencies (HA) of public housing modernization funds. As discussed later, HUD disagrees with our conclusion and we have referred the matter to the Comptroller General of the United States.
- Certain FHA contract obligations are allocated between FHA's program and liquidating funds based on the nature of the services to be provided. Limits have been set by appropriation law regarding the amount of administrative costs that may be charged to FHA's program accounts. The allocation methodology that FHA has currently applied for certain contracts may require refinement, to better reflect the relationship of the services to specific programs. Such re-allocation of obligations between funds would require additional analysis to determine if the re-allocation would result in a matter of noncompliance with the Anti-Deficiency Act, as of September 30, 2000, relating to FHA's Mutual Mortgage Insurance program account.

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 a consolidating balance sheet, and consolidating statements of changes in net position, budgetary resources and financing as supplementary information in this *Fiscal Year 2000 Performance and 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.

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Required Supplementary Information

In this *Fiscal Year 2000 Performance and Accountability Report*, HUD presents "Required Supplemental Stewardship Information," specifically, information on investments in non-federal physical property and human capital. In addition, HUD presents a (Management's) "Discussion and Analysis of Operations" and information on intra-governmental balances. This information is not a required part of the basic financial statements but is supplementary information required by the Federal Accounting Standards Advisory Board or Office of Management and Budget (OMB) Bulletin 97-01, *Form and Content of Agency Financial Statements*, as amended. We have applied certain limited procedures, which consisted principally of inquiries of management, regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Our performance of limited procedures raised doubts that we were unable to resolve regarding whether material modifications should be made to the required supplementary information relating to intra-governmental transactions to conform to guidelines required by OMB Bulletin No. 97-01. HUD requested and received a listing of all intra-governmental transactions from the U.S. Department of Treasury. However, HUD made no attempt to send confirmations to enable the reconciliation of these transactions as required by January 7, 2000 technical amendments to OMB Bulletin 97-01.

Additional details on our findings regarding HUD's internal control environment, housing assistance program delivery, verification of subsidy payments, 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 discussed in this report relate to issues discussed in prior years' reports on HUD's financial statements. HUD has been taking actions to address the weaknesses and in some instances has made progress in correcting them. For the most part, however, progress has been at a slow pace in large part because HUD needs to address issues that fundamentally impact its internal control environment. These issues are Department-wide in scope and must be addressed for HUD to more effectively manage its programs. The General Accounting Office (GAO) recently issued a January 2001 update to their *Performance and Accountability Series: Major Management Challenges and Program Risks* for HUD and, as we have reported for the past several years, concluded that HUD needs to:

- deploy a reliable financial management system that meets its program and financial management needs and complies with federal requirements, and
- continue to develop a process to identify and justify its staff resource requirements.

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

In addition to improving its financial systems, HUD will need to successfully complete and take advantage of organizational changes that have taken place during the past few years and more effectively manage its limited staff resources. Many of the weaknesses discussed in this report, particularly those concerning HUD's oversight of program recipients, are exacerbated by HUD's resource management shortcomings. Accordingly, we consider it critical for the Department to address these shortcomings through the successful completion of ongoing plans.

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

Housing Assistance Program Delivery

HUD provides housing assistance funds under various grant and subsidy programs to multifamily project owners (both nonprofits and for profit) and HAs. These intermediaries, in-turn, provide housing assistance to benefit primarily low income households. HUD spent about \$19 billion in fiscal year 2000 to provide rent and operating subsidies that benefited over 4 million households. Weaknesses exist in HUD's control structure such that HUD cannot be assured that these funds are expended in accordance with the laws and regulations authorizing the grant and subsidy programs.

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

HUD places substantial reliance upon intermediaries to ensure that rent calculations for assisted households are based on HUD requirements. Ultimately, these rent calculations determine the amount of subsidy HUD pays on behalf of the assisted household. Under project-based programs administered by the Office of Housing, this responsibility is carried out by the individual project owners or agents. Under public housing and tenant-based Section 8 programs, the HAs determine eligibility and rent for eligible households residing in public housing or at approved hous-

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ing provided by private landlords. In prior reports on HUD's financial statements, we have expressed concerns about the significant risk to HUD that these intermediaries are not properly carrying out this responsibility. HUD's control structure does not adequately address this risk due to insufficient on-site monitoring along with the absence of an on-going quality control program that would periodically assess the accuracy of intermediaries' rent determinations.

A recently completed contracted study of rent determinations under HUD's major housing assistance programs estimates that errors made by project owners and HAs resulted in substantial subsidy overpayments and underpayments. The purpose of the study was to provide national estimates of the extent, severity, costs, and sources of errors occurring in the certification and recertification procedures used by HAs and owners in calculating tenant rents. The study projected that annually, about \$1.9 billion in subsidies was overpaid on behalf of households paying too little rent and about \$0.7 billion in subsidies was underpaid on behalf of households paying too much rent based on HUD requirements.

Verification of Subsidy Payments

As discussed above, HUD provides rent and operating subsidies through a variety of programs, including public housing and Section 8. The admission of a household to these rental assistance programs and the size of the subsidy it receives depend directly on its self-reported income. HUD performed computer income matching with its assisted housing universe and estimated that housing subsidy overpayments from tenants misreporting their income totaled \$617 million during calendar year 1999. Tenants often do not report income or under report income which, if not detected, causes HUD to make excessive subsidy payments. Tenant income is a major factor affecting eligibility for, and the amount of, housing assistance a family receives, and indirectly, the amount of subsidy HUD pays. Generally, HUD's subsidy payment makes up the difference between 30 percent of a household's adjusted income and the housing unit's actual rent or, under the Section 8 voucher program, a payment standard.

HUD has developed a nationwide estimate of the amount of excess rental subsidies paid during calendar year 1999. 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 a large scale income tax data matching project. To ensure that these projects are effective, HUD has taken action to improve the accuracy of and enforce requirements for HAs to timely update information in its tenant databases.

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 and specific applications such that HUD could not be reasonably assured that assets are adequately safeguarded against waste, loss, and unauthorized use or misappropriation. Progress in improving these controls has been slow. The weaknesses noted in our current audit relate to the need to improve:

- controls over the computing environment;
- administration of personnel security operations; and
- reliability and security of critical financial systems.

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

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

Finally, we noted the need for the CFO to tighten controls over Fund Balance with Treasury reconciliations.

Results of the Audit of FHA's Financial Statements

A separate audit was performed of FHA's fiscal year 2000 financial statements by the independent certified public accounting firm of KPMG LLP. Their report on FHA's financial statements, dated February 28, 2001², includes an unqualified opinion on FHA's financial statements, along with discussions of a material weaknesses and three reportable conditions. The FHA material weaknesses is as follows:

- *FHA's information technology systems must be enhanced to more, effectively support FHA's business processes.* HUD and FHA are conducting day-to-day business with legacy based systems, several of which directly impact FHA's financial activity and necessitate financial transactions to be processed through non-integrated systems, requiring manual analysis and summary entries to be posted to FHA's general ledger. FHA's and HUD's inability to implement modern information technology adversely affects the internal controls related to accounting and reporting financial activities.

² KPMG LLP's report on FHA was incorporated in our report entitled, "Federal Housing Administration, Audit of Fiscal Year 2000 Financial Statements" (2001-FO-0002, dated March 1, 2001).

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KPMG LLP also notes three reportable conditions regarding the need for FHA and HUD to: (1) enhance the design and operation of controls over information systems security and application data integrity, (2) continue to place more emphasis on early warning and loss prevention for single family insured mortgages, and (3) sufficiently monitor and account for its single family property inventory.

KPMG LLP also notes a potential matter of noncompliance with the Anti-Deficiency Act. This relates to certain contract obligations that were allocated between FHA's program and liquidating funds.

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

Results of the Audit of Ginnie Mae's Financial Statements

A separate audit was performed of the Government National Mortgage Association's (Ginnie Mae) fiscal year 2000 financial statements by KPMG LLP. Their report on Ginnie Mae's financial statements, dated December 29, 2000,³ includes an unqualified opinion on Ginnie Mae's financial statements. In addition, the audit results indicate that there were no material weaknesses or reportable conditions with Ginnie Mae's internal controls, or material instances of non-compliance with laws and regulations.

HUD Has Made Progress in Addressing Management Deficiencies, but Much Remains to be Completed

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

³ KPMG LLP's report on Ginnie Mae was incorporated in our report entitled, "Government National Mortgage Association, Audit of Fiscal Year 2000 Financial Statements" (01-FO-177-0001, dated February 20, 2001).

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With respect to fiscal year 1999, we were unable to conclude that HUD's consolidated financial statements were reliable in all material respects. HUD has successfully addressed issues associated with a major systems conversion effort that caused us to disclaim an opinion on those financial statements. Therefore, our ability to conclude that HUD's fiscal year 2000 financial statements were reliable is noteworthy. However, because of continued weaknesses in HUD's internal controls and financial management systems, HUD continues to rely on extensive ad hoc analyses and special projects to develop account balances and necessary disclosures.

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 01-02, *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.

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Agency Comments and Our Evaluation

On February 2, 2001, we provided a draft of the internal control and compliance sections of our report to the Deputy CFO and appropriate assistant secretaries and other Departmental officials for review and comment, and requested that the Deputy CFO coordinate a Department-wide response. The Deputy CFO responded in a memorandum dated February 16, 2001. Remaining sections of the draft report were provided on February 20, 2001. The Department generally agreed with our presentation of findings and recommendations subject to detailed comments included in the memorandum and attachments. The Department's response was considered in preparing the final version of this report.

In its memorandum, the Department requested that we revise our conclusions regarding HUD's "core financial system," which is part of our material weakness relating to the need to "complete improvements to financial systems." The Department asserted that the "core" component is substantially compliant. We disagree, and provided a detailed discussion in our separate report. The Department also asked that we combine two material weaknesses relating to the need to "improve oversight and monitoring of housing subsidy determinations" and "ensure that subsidies are based on correct tenant income." While the matters are interrelated, in our judgment, it is appropriate to classify them separately.



Susan Gaffney
Inspector General

February 28, 2001