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BY THE US GENERAL ACCOUNTING OFFICE

Report To The Secretary Of Housing And Urban Development

HUD's First-Year Implementation Of The Federal Managers' Financial Integrity Act

GAO reviewed the processes used by 22 federal departments and agencies to implement the Federal Managers' Financial Integrity Act of 1982. The act was intended to help reduce fraud, waste, and abuse across the spectrum of federal government operations by requiring agencies to assess and report annually on the adequacy of their internal controls and accounting systems.

This report highlights the progress made and problems encountered by the Department of Housing and Urban Development (HUD) in its first year of experience with this new act. The report focuses on HUD's evaluation of internal controls and reviews of accounting systems and the improvements it is making as a result of identified problems.



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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

RESOURCES COMMUNITY
AND ECONOMIC DEVELOPMENT
DIVISION

B-202205

The Honorable Samuel R. Pierce, Jr.
The Secretary of Housing and
Urban Development

Dear Mr. Secretary:

This letter summarizes the results of our review of the process used by the Department of Housing and Urban Development (HUD) to implement the Federal Managers' Financial Integrity Act of 1982. Section 2 of the act requires federal executive agencies to establish internal accounting and administrative controls in accordance with the Comptroller General's standards. Section 4 of the act requires the agencies to state whether their accounting systems comply with the Comptroller General's principles, standards, and related requirements. This review was part of our government-wide assessment of how 22 federal departments and agencies implemented the act in the first year. At HUD, we worked jointly with your Office of Inspector General, which provided a report to you, as requested, on November 16, 1983.

As required by the act, the Office of Management and Budget (OMB) issued guidelines which recommend that agencies implement the act by (1) organizing the internal control evaluation process, (2) segmenting (dividing) the agency into assessable units (programs or administrative functions) which are to be the subject of vulnerability assessments, (3) conducting vulnerability assessments which are reviews of the assessable units to determine their susceptibility to waste, loss, unauthorized use, or misappropriation, (4) developing plans and schedules for internal control reviews or other actions, (5) reviewing internal controls, (6) correcting deficiencies, and (7) reporting annually by December 31 on the status of the agency's internal controls and its plans for corrective actions.

HUD has made progress in implementing its internal control evaluation process in accordance with OMB guidelines and has generally followed OMB's recommended approach. HUD's process provides a solid framework for improving the agency's internal control systems. In organizing the evaluation process, you requested top-level support and established a schedule for completing the various steps of the evaluation process. You also delegated overall responsibility for implementing the act to the

Assistant Secretary for Administration who, in turn, delegated day-to-day coordination activities to a HUD Internal Control Coordinator. Furthermore, you assigned the Inspector General responsibilities including providing technical assistance to the Office of Administration and reporting on the reasonableness of HUD's internal control evaluation process.

HUD developed overall guidance to assist managers in complying with the internal control evaluation requirements including a draft handbook covering aspects of the evaluation process. HUD plans to complete the handbook during 1984. HUD has also provided for the Office of Administration to review internal control evaluations to determine whether the evaluations meet HUD and OMB requirements.

By December 31, 1982, HUD had segmented its headquarters into 393 assessable units and had completed vulnerability assessments on these units. HUD rated 64 assessable units as being highly vulnerable, 175 as being moderately vulnerable, and 154 as having low vulnerability. In September 1983, HUD extended the segmenting and vulnerability assessment process to its 10 regional offices.

HUD also made preliminary reviews of most headquarters' assessable units that were rated as being highly vulnerable. These reviews, which are a unique step developed by HUD, were to quickly identify and correct problems which could be addressed with available knowledge and identify those units where the current knowledge was insufficient to define the problem and where internal control reviews or some other actions such as audits would be necessary. HUD plans to complete preliminary reviews of the moderately vulnerable units during fiscal year 1984. As of January 31, 1984, HUD had completed 21 internal control reviews.

HUD has taken or plans to take actions to correct weaknesses it identified through the evaluation process and has developed a tracking system to monitor the process and the planned corrective actions.

HUD's first annual statement to the President and the Congress on the adequacy of internal controls and accounting systems identified material weaknesses, planned corrective actions and the target dates for completing corrective actions, and stated that the evaluation of internal controls had not progressed to the point where full assurance that all objectives of the act have been met could be provided. The statement also said that HUD's accounting systems do not fully comply with the Comptroller General's accounting principles and standards and related requirements. In addition, the statement outlined additional actions to implement the evaluation process and indicated that the accounting systems were being redesigned. We believe the annual statement was an accurate representation of HUD's progress to date.

Although HUD has accomplished much in implementing the act, we found several areas that can be strengthened as HUD continues its internal control evaluation process. Our findings, which are summarized below, are presented in more detail in appendix I along with our objectives, scope, and methodology.

In implementing section 2 of the act, HUD performed vulnerability assessments in its headquarters and regional offices but has not extended the process to include all field office tiers. Furthermore, the vulnerability assessments did not include a separate preliminary evaluation of safeguards as recommended by OMB and cannot be easily compared because different forms were used. Also, HUD did not always develop sufficient documentation to clearly indicate the factors considered, procedures followed, or bases for answers to questions relative to its internal control evaluation process. While HUD reviewed parts of its general automatic data processing (ADP) controls and considered application controls in vulnerability assessments for a few of its 130 ADP systems, it did not emphasize ADP reviews and did not establish organizational responsibility for assessing ADP controls. Finally, HUD did not have specific guidance for performing quality assurance reviews of its internal control process.

Concerning section 4 of the act, HUD did not evaluate its accounting systems for compliance with the Comptroller General's accounting principles and standards. Rather, HUD is committing substantial resources to design new accounting systems and expects to have systems in place which will meet the principles and standards by fiscal year 1987.

To strengthen HUD's process of evaluating its internal controls and accounting systems, we proposed in a draft of this report that HUD:

- Extend the vulnerability assessment process to include all field office tiers, revise the assessment forms to require a separate preliminary evaluation of safeguards, and standardize the assessment forms used by the various HUD organizations.
- Establish guidance to ensure that sufficient documentation is developed and retained to provide a record of the procedures used, bases, and factors considered in reaching overall conclusions on segmenting, vulnerability assessments, and internal control reviews.
- Ensure that ADP controls are evaluated as part of the internal control evaluation process. To assist in accomplishing this, HUD should assign organizational responsibility and establish guidelines for evaluating ADP controls.

- Establish specific criteria on the type and extent of quality assurance procedures that HUD's Office of Administration should perform on the internal control evaluation process.
- Require documenting and testing of accounting systems as they are redesigned to help ensure their compliance with the Comptroller General's principles and standards.

In commenting on a draft of this report (see app. III), HUD generally agreed with our proposals and stated that it has taken or plans to take actions to address them. HUD did not agree with our proposal regarding vulnerability assessments. HUD's comments indicated that its vulnerability assessment process is evolving. HUD stated that its completed assessments recognized field office involvement and that, on the basis of experiences with different headquarters' forms, it had standardized the field assessment form. HUD took the position that it was desirable to develop and modify its initial internal control system before involving field operations and questioned the cost effectiveness of extending the vulnerability assessment process to all field office tiers at this time.

Because of HUD's general responsiveness to our proposals, we have not included recommendations in our report. We plan to monitor HUD's progress as part of our continuing review of federal agencies' implementation of the act.

HUD also stated that our draft report was largely negative, emphasizing perceived weaknesses rather than HUD's accomplishments, thus, giving the overall impression that HUD was not doing a good job.

Although we believe our draft report included considerable discussion of HUD's accomplishments, we have revised the report to further recognize HUD's positive efforts. Our overall purpose is to highlight HUD's accomplishments as well as discuss ways in which HUD can strengthen its internal control and accounting system evaluation efforts.

We are sending copies of this report to the House Committee on Government Operations; the Senate Committee on Governmental Affairs; the House and Senate Committees on Appropriations; the Director, Office of Management and Budget; and other interested parties.

We appreciate the cooperation extended to our staff during this review. We particularly appreciate the efforts of your Inspector General and his staff.

Sincerely yours,

A handwritten signature in cursive script, appearing to read "J. Dexter Peach".

J. Dexter Peach
Director

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ABBREVIATIONS

ADP	automatic data processing
GAO	General Accounting Office
HUD	Department of Housing and Urban Development
OMB	Office of Management and Budget

HUD'S FIRST-YEAR IMPLEMENTATION OF THE
FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT

Responding to continuing disclosures of fraud, waste, and abuse across a wide spectrum of government operations, which were largely attributable to serious weaknesses in agencies' internal controls, the Congress enacted the Federal Managers' Financial Integrity Act, 31 U.S.C. 3512(b) and (c) in 1982. The act was passed to strengthen the Accounting and Auditing Act of 1950's existing requirement that executive agencies establish and maintain systems of accounting and internal control in order to provide effective control over and accountability for all funds, property, and other assets for which the agency is responsible (31 U.S.C. 3512(a)(3)).

We believe that full implementation of the Financial Integrity Act will enable the heads of federal departments and agencies to identify their major internal control and accounting problems and improve controls essential to the development of a sound financial management structure for their agency. To achieve these ends, the act requires:

- Each agency to establish and maintain its internal accounting and administrative controls in accordance with the standards prescribed by the Comptroller General¹ to reasonably assure that: (1) obligations and costs comply with applicable law, (2) all funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation, and (3) revenues and expenditures applicable to agency operations are recorded and properly accounted for.
- Each agency to evaluate and report annually on internal control systems. The report is to state whether agency systems of internal control comply with the objectives of internal controls set forth in the act and with the Comptroller General's internal control standards. The act also provides for agency statements to identify the material weaknesses involved and describe the plans for corrective action.
- Each agency to prepare a separate report on whether the agency's accounting systems conform to the principles, standards, and related requirements prescribed by the Comptroller General.
- The Office of Management and Budget (OMB) to issue guidelines for federal departments and agencies to use in evaluating their internal accounting and administrative control systems. These guidelines were issued in December 1982.

¹The Comptroller General issued Standards for Internal Controls in the Federal Government in June 1983.

This report on the Department of Housing and Urban Development (HUD) is 1 of 22 reports on federal departments' and agencies' efforts to implement the act during the first year.

OMB GUIDELINES FOR INTERNAL CONTROLS

To provide guidance for agencies to meet the requirements of the act and an OMB circular,² OMB, in December 1982, issued Guidelines for the Evaluation and Improvement of and Reporting on Internal Control Systems in the Federal Government. The guidelines recommended a phased approach for evaluating, improving, and reporting on agencies' internal controls:

- Organize the process to make sure it is done efficiently and effectively. Primary considerations for organizing include specific assignment of responsibilities, the Inspector General's role, quality assurance over the process, internal reporting, documentation requirements, personnel and supervision, and scheduling the evaluation process.
- Segment the agency into organizational components and then into units (programs and administrative functions within each component) to be assessed. (These units are called "assessable units.")
- Assess the vulnerability (susceptibility) of each assessable unit to the occurrence of waste, loss, unauthorized use, or misappropriation. These vulnerability assessments consist of three steps: (1) analysis of the general control environment (environmental factors, such as management attitude, which could affect internal controls), (2) analysis of inherent risk (factors inherent in the unit which create potential for loss, such as a large budget), and (3) preliminary evaluation of safeguards (an evaluation of the methods used to protect the assets).
- Develop plans and schedules for performing internal control reviews and other actions such as doing audits or modifying procedures. These actions should be based on the results of the vulnerability assessments and other considerations such as management priorities and resource constraints.
- Review the internal controls for the selected areas to determine whether adequate control objectives (goals or conditions) have been established and control techniques (methods of protecting resources) exist and are functioning

²Prior to the act, OMB issued circular A-123, Internal Control Systems, which prescribed policies and standards to be followed by executive departments and agencies in establishing and maintaining internal controls in their program and administrative activities.

as intended, and then develop recommendations to correct weaknesses in either the design or functioning of the internal control system.

- Determine, schedule, and take corrective actions to improve internal controls on a timely basis and in a cost-effective manner.
- Prepare the annual statement to the President and the Congress on the status of the agency's system of internal control. This statement should include a report listing identified material weaknesses, along with plans and schedules for their correction.

HUD: CREATION, PURPOSE,
AND ORGANIZATION

HUD was established by the Housing and Urban Development Act of September 9, 1965 (79 Stat. 667; 42 U.S.C. 3531-3537). HUD's functions and authority have expanded and encompass a broad mission of providing adequate housing, promoting community and economic development, and eliminating discrimination in housing markets. HUD's major programs include:

- Housing assistance and mortgage credit. Housing assistance programs and the mortgage insurance programs provide low- and moderate-income families with home ownership opportunities and rental housing assistance.
- Community development. Community Development Block Grant Programs, the Urban Development Action Grant Program, and Rehabilitation Loan and Urban Homesteading Programs provide federal assistance to communities for improving housing conditions, conserving energy supplies, expanding business opportunities, providing jobs, and revitalizing blighted areas in the nation's cities and counties.
- Fair housing and equal opportunity. Fair housing programs provide financial assistance to state and local agencies to help them eliminate housing discrimination by promptly processing civil rights complaints, and by carrying out affirmative marketing agreements and promoting equal opportunity matters within HUD programs.

HUD administers these programs through a three-tiered organizational structure comprised of a headquarters office, 10 regional offices, and 81 field offices. During fiscal year 1983, HUD had estimated outlays of about \$14.9 billion and employed about 13,000 full-time staff.

INTERNAL CONTROL EVALUATION PROCESS

HUD has made progress in implementing its internal control evaluation process in accordance with OMB guidelines and has generally followed OMB's recommended approach.

Organizing the process

In a memorandum to all principal staff, the Under Secretary delegated overall responsibility for implementing the act to the Assistant Secretary for Administration who, in turn, delegated day-to-day coordination activities to a Departmental Internal Control Coordinator in the Office of Administration's Office of Budget. HUD issued an internal control directive prescribing policies and standards for establishing and maintaining internal controls in program and administrative activities. In a memorandum to principal staff, the Secretary requested top-level support, recognized the need for a commitment of resources, and established a schedule for completing the various steps of the evaluation process.

The Secretary has also assigned responsibilities emanating from the act to the Inspector General. The Secretary requested a report from the Inspector General on whether HUD's evaluation of internal controls was carried out according to OMB guidelines in a reasonable and prudent manner. On November 16, 1983, the Inspector General reported to the Secretary that several aspects of HUD's evaluation process must be completed before HUD could provide full assurance under the act.³ The Secretary also assigned the Inspector General the responsibility to provide technical assistance to the Office of Administration in implementing the act.

HUD developed an internal control handbook to assist managers in complying with the internal control evaluation requirements. This handbook includes a discussion of such areas as (1) assessing the relative vulnerability of HUD activities (2) performing in-depth studies of internal control systems, where appropriate, and (3) reporting on the results of this evaluation process to the Secretary. At the time of our review, this handbook was still in draft. HUD plans to issue the handbook during 1984.

Segmenting

HUD's internal control directive states that Assistant Secretaries should establish their own assessable units. For example, the Assistant Secretary for Housing established 94 assessable units to cover the programs and functions in such program areas as single-family housing, multifamily housing, and public

³Report on Review of HUD's Implementation of OMB Circular No. A-123 and the Federal Managers' Financial Integrity Act of 1982 as of September 30, 1983.

housing. Overall, by December 31, 1982, HUD headquarters had been segmented into 393 assessable units. In September 1983, HUD extended the process to its second tier, that is, regional offices. According to HUD, these assessments were not completed until November 30, 1983, making it impossible to include the results of its field work in the Secretary's first annual statement to the President and the Congress.

Vulnerability assessments

HUD assessed the vulnerability of each assessable unit to fraud, waste, and mismanagement. To accomplish these assessments, each assistant secretary used a vulnerability assessment form. The particular form used was not always the same and was selected by each assistant secretary. These forms contained questions designed to cover the three steps outlined in the OMB guidelines. The forms were also designed to rate the vulnerability of each unit. As a result of this process, HUD rated 64 units as being highly vulnerable, 175 as being moderately vulnerable, and 154 as having low vulnerability. Personnel from the assessable units being reviewed made these vulnerability assessments.

Review of internal controls and other actions

OMB guidelines provide two basic approaches to address programs and functions with the greatest vulnerability. One approach is to perform internal control reviews on highly and moderately vulnerable areas. OMB defines an internal control review as a detailed examination of internal controls to determine whether controls are sufficient and whether they are functioning as intended to prevent or detect potential risks in a cost-effective manner.

The other approach is to consider a series of options for each of the highly or moderately vulnerable program and administrative functions. OMB stated this could be done by evaluating the degree and causes of the vulnerabilities and then determining the appropriate courses of action, taking into consideration management priorities, resource availability, and other management initiatives underway. These actions might include conducting internal control reviews, requesting an audit, training staff, or modifying procedures or documents. OMB indicated that this approach helps ensure resources devoted to the internal control process are used efficiently and effectively.

HUD used both of these approaches. The Office of Finance and Accounting used the first approach and contracted with a certified public accounting firm to perform internal control reviews. As of January 31, 1984, the firm had completed 18 of these reviews. These reviews are discussed further on page 7. (See "Accounting systems evaluation.")

In the program areas and other areas of administration, HUD used the second approach and initiated a unique step in the process called preliminary reviews. This process does not constitute the comprehensive review of internal controls that would be made if an internal control review were performed. Rather, it is intended to (1) quickly identify problems which could be addressed with available knowledge and initiate corrective actions and (2) identify those areas where the current knowledge is insufficient to define the problem and where internal control reviews or some other action, such as audits, would be necessary.

HUD has completed preliminary reviews of its highly vulnerable areas in headquarters and plans to finish reviewing its moderately vulnerable areas during fiscal year 1984. According to HUD, as a result of the preliminary reviews of highly vulnerable areas, it has initiated 245 corrective actions. Furthermore, at the time of our review, HUD had completed three internal control reviews and had one in process in the program areas and areas in administration outside of the Office of Finance and Accounting.

Scheduling and tracking corrective actions

HUD established a tracking system to monitor and control the evaluation process. This system consists of (1) an Assessable Units Control Log to track the evaluation process and (2) a Promised Managers' Action Status Log to record weaknesses identified and monitor the planned corrective action.

Preparing the annual statement

On December 30, 1983, HUD issued its first annual statement to the President and the Congress on the adequacy of its internal controls. The Secretary stated that because HUD's internal control evaluation process had not been implemented in the field offices until late in the year and because other phases of the process needed further development, HUD could not provide full assurance that all of the act's objectives had been met. Although the Secretary did not state definitively whether or not HUD's internal control systems comply with the three statutory objectives and the Comptroller General's standards, we believe the year-end statement was an accurate representation of HUD's positive efforts to date.

The statement identified material weaknesses, planned corrective actions, and the target dates for completing corrective actions. Examples of reported material weaknesses follow (see app. II for additional material weaknesses):

- Because of HUD's inability to effectively validate mortgagor's submissions, false, fraudulent, or incomplete income certifications may be used to obtain housing assistance payments under the Section 235 program (a mortgage insurance and interest subsidy program for low- and moderate- income families). The corrective action planned

was to consider cross-matching of reported income with other federal agencies.

--HUD does not require public housing authorities to use competitive bidding or negotiate architectural fees. Consequently, these fees may be higher than otherwise would be charged. The corrective action planned is to require competitive selection and negotiation of architectural fees.

The Secretary's statement further outlined actions HUD plans to take to implement the evaluation process such as completing the regional office vulnerability assessments, extending the preliminary reviews to the regional offices, and completing and issuing an internal control handbook.

ACCOUNTING SYSTEMS EVALUATION

In addition to legislatively reemphasizing agency heads' responsibility and accountability for internal controls, the act also strengthened the legal requirements for federal agencies to operate effective accounting systems. Section 4 requires agency heads to report annually on whether their organizations' accounting systems conform to the principles, standards, and related requirements developed by the Comptroller General.

In his first annual statement, the Secretary concluded that HUD's accounting systems do not fully comply with our accounting principles, standards, and related requirements. He based his decision on results of various studies of HUD's accounting systems and on reports by us, the Inspector General, and others which disclosed serious problems in the accounting systems. As a result, the Secretary stated, HUD began a major project to redesign its accounting systems to bring them into compliance with our requirements. Because of these major changes underway and the known problems with the existing systems, HUD did not evaluate its accounting systems during the first year of the act for compliance with the Comptroller General's requirements.

In the interim, HUD's Office of Finance and Accounting contracted with a certified public accounting firm to perform 30 internal control reviews. These reviews were of the mostly manual controls used in accounting for HUD's various program/fund accounts and resulted in the identification of many control weaknesses and corrective recommendations. The reviews, however, were not complete reviews of HUD's accounting systems in terms either of internal controls (including automatic data processing controls) or of the systems' compliance with our accounting principles and standards. Only 1 of the 16 reviews completed in the Office of Finance and Accounting in fiscal year 1983 was directed at one of HUD's several automated accounting systems, and the report on that review described the review's scope as including only the manual aspects of the system.

As a result of these internal control reviews, the Secretary identified 108 internal control weaknesses in HUD's accounting processes. The Secretary concluded, however, that while most of the individual weaknesses were not of significant magnitude to be included in his annual statement under the act, taken as a whole, they indicated significant weaknesses in HUD's accounting processes. The Secretary identified the following as causes of the internal control breakdown:

- Use of manual procedures rather than more efficient automated procedures.
- Lack of records and documentation of methods and procedures.
- Lack of supervision and monitoring.
- Lack of fully qualified personnel.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of our review were to assess HUD's process for evaluating its internal controls and accounting systems for the purpose of reporting under the act. Because our first-year review was limited to evaluating HUD's implementation process, we did not attempt to independently determine the status of HUD's internal control system or the extent to which its accounting systems comply with the Comptroller General's principles and standards.

We conducted the review jointly with HUD's Office of Inspector General under an agreement between the Comptroller General and HUD's Inspector General. We concentrated on three of HUD's larger activities: (1) Housing, (2) Community Planning and Development, and (3) Administration. The Inspector General's staff was responsible for review work in the Office of Community Planning and Development and parts of Administration. We were responsible for the work in the Office of Housing and the Office of Finance and Accounting in Administration. We shared the information obtained. The Office of Inspector General prepared a separate report to the Secretary of HUD. We performed our audit work at HUD headquarters in Washington, D.C., and at its Chicago, Ill., field office between June 1983 and January 1984.

We interviewed HUD officials, evaluated guidelines and reports, and reviewed supporting documentation for each phase of the internal control evaluation process. We randomly sampled 45 of the 187 vulnerability assessments in Housing, Community Planning and Development, and Administration (except for the Office of Finance and Accounting). From this sample, we selected 18 vulnerability assessments to cover the major areas in these organizations. In the Office of Finance and Accounting, we randomly selected 14 of 58 vulnerability assessments. We also randomly selected seven internal control reviews for detailed review. In

the Office of Finance and Accounting, we selected three internal control reviews for detailed review and also read all 16 internal control review reports that were completed by the end of fiscal year 1983. We reviewed three of the four internal control reviews that were in process or completed in the following areas: Housing, Deputy Under Secretary for Field Coordination, and Office of Procurement and Contracts. Also, we examined how well HUD evaluated internal controls relating to automatic data processing (ADP) given the critical role ADP plays in HUD's programs.

We conducted our review in accordance with generally accepted government auditing standards.

INTERNAL CONTROL EVALUATION
PROCESS CAN BE STRENGTHENED

HUD has made progress in complying with the act and OMB guidelines. However, as it continues to develop its internal control evaluation process, HUD needs to strengthen the areas of vulnerability assessments, documentation, ADP controls, and quality assurance.

Need to improve the vulnerability
assessment process

HUD has performed vulnerability assessments in its headquarters and regional offices but has not extended the process to all field office tiers. Furthermore, the vulnerability assessments did not include a separate preliminary evaluation of safeguards as recommended by OMB. Also, the vulnerability assessments cannot be easily compared because different forms were used.

OMB guidelines require agencies to determine the vulnerability of their organizations and/or functions to waste, loss, unauthorized use, or misappropriation. These determinations are made by conducting vulnerability assessments. Although much of HUD's program activity is performed by field staff, HUD initially restricted its vulnerability assessments to the headquarters level and did not extend the process to its field offices until September 30, 1983. HUD's rationale for not performing vulnerability assessments in the field earlier was that an overwhelming workload would have been created by performing headquarters and field office reviews simultaneously and that changes--based on a reorganization--were being made to the field office structure. In September, HUD initiated vulnerability assessments at the 10 regional offices but did not extend the process to its third tier--its area and service offices, valuation, and endorsement stations. According to HUD, regional office vulnerability assessments included field office input obtained through past regional office monitoring of offices under its jurisdiction. HUD also questioned whether it would be cost effective to extend the process further at this time.

HUD's headquarters' vulnerability assessments generally addressed the inherent risk factors and the general control environment factors. However, none of the headquarters' vulnerability assessments we reviewed included a separate preliminary evaluation of safeguards. The evaluation of safeguards as outlined by OMB is intended to determine whether appropriate controls are in place in an activity to prevent or minimize waste, loss, unauthorized use, or misappropriation. Such control techniques could include separation of duties within an organizational unit, exception reporting systems, and ADP system controls.

The HUD Internal Control Coordinator told us that the preliminary evaluation of safeguards was covered under the other two aspects of the vulnerability assessment--viz., general control environment and inherent risks. Although our review of the vulnerability assessments indicates that certain questions asked under these areas may have addressed safeguards, we believe that a separate evaluation as recommended by OMB is appropriate because it would more clearly focus the evaluator's analysis on specific safeguards being used.

Additionally, HUD's vulnerability assessments were not uniform because different forms were used. According to HUD, the assistant secretaries were given the flexibility to develop their own vulnerability assessment format since the process was new and untested. As a result, the three headquarters areas we reviewed--the Offices of Housing, Community Planning and Development, and Administration--used three different vulnerability assessment formats, each asking different questions. For example, the Office of Housing's vulnerability assessment form, in addressing the inherent risk factor--impact outside the agency--asked if the subcomponent deals with outside contractors, other HUD organizations, public individuals, private sector organizations (e.g., mortgagees, public housing agencies, block grantees, etc.), other federal agencies, state and local government agencies, and the Congress. However, the Office of Community Planning and Development's form in addressing the same subject asked the following questions:

--Is the number of third-party beneficiaries extensive and/or lacking in expertise?

--Is the program delivered through third parties with a history of poor program administration?

--Does adequate monitoring of third parties take place to assure protection from fraud, waste, and mismanagement?

Although HUD's various forms addressed the vulnerability of its programs and functions, using a standardized vulnerability assessment form has advantages. A standardized form would eliminate the need for different sets of instructions. It would also facilitate department-wide quality assurance reviews by eliminating the need for the reviewers to become familiar with several different forms and evaluate their usage.

Need to improve documentation
of the evaluation process

Our review of HUD's segmenting process⁴ and a sample of vulnerability assessments and internal control reviews disclosed that documentation of the process could be improved. For example, HUD did not document the factors considered in establishing its assessable units. In this regard, we noted that HUD did not provide adequate guidance on the extent or type of documentation necessary. Complete documentation of the internal control evaluation processes would facilitate subsequent steps in the evaluation process, future years' evaluations, and independent assessments of the quality of HUD's internal control evaluation process.

OMB guidelines state that agencies should maintain adequate written documentation for activities in connection with vulnerability assessments, internal control reviews, and follow-up actions to provide a permanent record of the methods used, personnel involved and their roles, the key factors considered, and the conclusions reached. The OMB guidelines indicate that this information will be useful for reviewing the validity of conclusions reached, evaluating the performance of individuals involved in the assessments and reviews, and performing subsequent assessments and reviews. We believe that the documentation should be such that an independent reviewer could, after examining the documentation, reach the same conclusion as the original reviewer.

While HUD provided some guidance in its Draft Internal Control Handbook on the type of documentation necessary for internal control reviews, HUD did not develop agency-wide guidance on documentation requirements for the entire evaluation process. The draft handbook requires documentation of the methods used, personnel involved and their roles, and conclusions reached in internal control reviews. However, the handbook does not cover documentation requirements for the segmenting or the vulnerability assessment phases of the evaluation process.

Our review of HUD's segmentation and vulnerability assessment process disclosed weaknesses in documentation. For example, while each organizational unit went through a detailed process to determine its assessable units, the rationale for the determinations was not documented. Similarly, our random sample of vulnerability assessments disclosed inconsistencies in documenting the basis for responses to individual questions on the vulnerability assessment forms. For example, some of the Office of Housing staff who prepared vulnerability assessments told us that in answering questions on the vulnerability assessment forms, they consulted with staff in headquarters or in the field but did not prepare a record

⁴Dividing the agency into organizational components and then units, programs, and administrative functions within each component, to be assessed for vulnerability to waste, loss, unauthorized use, or misappropriation.

of these discussions. In contrast, one Housing vulnerability assessment had more than 30 pages of narrative discussion to support responses to questions on the assessment form.

Also, the Office of Community Planning and Development's and Office of Administration's vulnerability assessments did not always contain references to documentation supporting answers to questions. For example, the vulnerability assessment for the administration of the section 312 loan program (a direct federal loan program for urban rehabilitation) had a question concerning whether recordkeeping and documentation practices were adequate for the program. The response on the vulnerability assessment form was "Yes," but the form did not show the basis for the answer.

Our review of internal control reviews disclosed that the quality of documentation varied among the HUD organizations. For example, the HUD staff member performing the internal control review in the Office of the Deputy Under Secretary for Field Coordination told us he talked to regional staff and reviewed files in field offices, but he did not document this. In contrast, the Office of Administration documented the work it performed on its internal control reviews.

Need to improve evaluation of ADP internal controls

HUD relies heavily on ADP systems for its accounting and financial management operations and spends over \$30 million annually on automated systems. While HUD reviewed parts of its general ADP controls and considered application controls in vulnerability assessments for a few of its 130 ADP systems, it did not emphasize ADP reviews and did not establish organizational responsibility for evaluating ADP controls or provide guidance on how to evaluate such controls.

ADP general controls govern overall functions such as organization and management, systems development, and computer operations. General controls affect the quality of services rendered to system users and are usually evaluated by ADP managers as part of an agency's review of the general control environment. ADP application controls are part of software systems and control the quality of data input, processing, and output. Application controls are usually evaluated by the program managers who use the systems. The scope of general controls is broad, as these controls affect most ADP hardware and software systems. In contrast, application controls are narrower in scope and relate to specific ADP tasks in individual software applications.

HUD's internal control guidelines do not include clear guidance on how ADP controls should be considered. However, HUD's Office of Information Policies and Systems gave some consideration to ADP general controls. This Office is responsible for administering, coordinating, and implementing HUD's information policies

and plans, and for providing information management and ADP services. The Office made eight vulnerability assessments, three of which dealt with ADP general controls. Two vulnerability assessments addressed general controls relating to data center protection, and the other addressed systems design, development, and modification. The Office did not review application controls, although HUD recently had a contractor review the effectiveness of the security and application control features of 4 of its 130 ADP systems.

HUD did not establish organizational responsibility for assessing ADP application controls and did not identify any of its approximately 130 ADP systems as assessable units. The Deputy Director of Information Policies and Systems told us that the ADP systems were not identified as assessable units because ADP controls should have been reviewed as part of the particular program or functional assessable unit in which each ADP system is being utilized. However, this was not done. For example, neither the Office of Administration's nor the Office of Community Planning and Development's vulnerability assessments assessed ADP controls. The Housing vulnerability assessment form had only one question which addressed application controls. It asked if appropriate application controls were used. This question, however, is general and does not describe which application controls to review within an ADP system. Because HUD relies heavily on ADP systems for its accounting and financial management operations, a thorough evaluation of these system controls is an important aspect of HUD's overall internal control evaluation process.

Need to give more attention to quality assurance

HUD does not have specific guidance for performing quality assurance reviews of the internal control evaluation process. HUD's internal control handbook does not specify criteria for determining when or how quality assurance procedures should be performed in such areas as vulnerability assessments and internal control reviews. HUD also lacks a formalized process at the departmental level to ensure that individual assessments and reviews are performed adequately and consistently.

According to OMB's internal control guidelines, agencies should provide for quality control over the entire internal control evaluation process. Agencies should also develop a monitoring system to assure that assessments and reviews are performed adequately. HUD's guidance states that vulnerability assessments, preliminary reviews, and internal control reviews will be evaluated selectively by the Office of Administration to determine if the handbook requirements have been met. However, the handbook does not provide criteria for determining when or how the quality assurance reviews should be made.

The HUD Internal Control Coordinator told us that his office is trying to approach the quality assurance process from a broad standpoint--determining whether the vulnerability assessments and internal control reviews identify all major problems rather than just reviewing the adequacy of the documentation. He said that the Office of Administration performed some quality evaluations of vulnerability assessments but kept no records. A 1982 OMB review team had also determined that HUD did not perform consistent quality control reviews of its vulnerability assessments. Recently, the Office of Administration has begun to perform quality assurance evaluations of individual preliminary reviews and internal control reviews.

HUD supervisors and internal control coordinators in HUD organizational units also made some quality evaluations of vulnerability assessments. For example, in the Public Housing Program, the Office Director reviewed the vulnerability assessments performed by his staff and found some inconsistency between individual vulnerability assessment ratings and overall rankings. On the basis of his knowledge and experience in the program, he revised the rating and overall ranking of several vulnerability assessments. Also, in Community Planning and Development, the Office of Management reviewed completed vulnerability assessments. Several vulnerability assessment preparers told us that revisions resulting from this review consisted primarily of adding a narrative explanation to or citing sources of information for answers to questions on the vulnerability assessment form.

Conclusions

HUD has made progress in complying with the Federal Managers' Financial Integrity Act by creating a solid framework for improving its internal controls. However, in his first annual statement to the President and the Congress, the Secretary concluded that HUD's review of its internal controls had not progressed to the point where he could provide full assurance that the act's objectives had been met and outlined actions to complete the evaluation process. Although HUD has accomplished much in implementing the act, we found several areas that can be strengthened as HUD continues its internal control evaluation process.

Proposals, agency comments, and our evaluation

In a draft of this report, we proposed that the Secretary of HUD:

- Extend the vulnerability assessment process to include all field office tiers, revise the assessment forms to require a separate preliminary evaluation of safeguards, and standardize the various assessment forms used by the different HUD organizations.

- Establish guidance to ensure that sufficient documentation is developed and retained to provide a record of procedures used, bases, and factors considered in reaching overall conclusions on segmenting, vulnerability assessments, and internal control reviews.
- Ensure that ADP controls are evaluated as part of the internal control evaluation process. To assist in accomplishing this, HUD should assign organizational responsibility and establish guidelines for evaluating ADP controls.
- Establish specific criteria on the type and extent of quality assurance procedures that HUD's Internal Control Coordinator should perform on the internal control evaluation process.

In commenting on a draft of this report, HUD generally agreed with these proposals (except the proposal on vulnerability assessments) and stated that it had taken or planned to take action to address these proposals. HUD stated that it had initiated actions to improve its evaluation of ADP controls and planned to implement a quality assurance review during fiscal year 1984. HUD further stated that it had taken steps to improve documentation of the evaluation process, citing its revised vulnerability assessment and preliminary review guides which prescribe the documentation required to be developed and retained.

With respect to our proposal concerning vulnerability assessments, HUD indicated that the process is evolving. HUD stated that it had recognized field office involvement in its completed vulnerability assessments and that they had included a preliminary evaluation of safeguards although not as a separate category. HUD also stated that it had standardized the field assessment forms on the basis of its experience with different headquarters' forms. HUD further took the position that it was desirable to develop and modify its initial internal control system before involving its field operations and questioned whether extending the process at this time to all field office tiers would be cost effective. We share HUD's concerns relating to its vulnerability assessment process and believe that it is important to ensure that the assessments accurately reflect HUD's operations.

In view of HUD's general responsiveness to our proposals, we have not included any recommendations in this report. We plan to monitor HUD's progress as part of our continuing review of federal agencies' implementation of the act.

In its comments, HUD also stated that our draft report was largely negative, emphasizing perceived weaknesses rather than HUD's accomplishments, thus, leaving the overall impression that HUD had not done a good job. HUD further stated that the proposals contained in our draft were stated in HUD's Inspector General's report and have been accepted by HUD. HUD also stated that

our draft reflected little awareness that HUD, like other agencies, had to establish new procedures and that HUD recognized that full adherence to the act could not be accomplished in the first year and designed its strategy with this in mind.

Although we believe our draft report included considerable discussion of HUD's accomplishments, we have made several revisions to the draft to further reflect HUD's positive efforts. We recognize that many of the findings and proposals made in our draft report were similar to those contained in HUD's Inspector General's report. However, as we discussed earlier in our draft report, and as recognized in HUD's comments, we worked closely with HUD's Office of Inspector General during the review. Accordingly, it is not surprising that our findings would be similar.

We also recognize that reviewing internal controls under the act is an ongoing process. We have previously described HUD's progress and, in several instances, HUD's planned actions. We offered our proposals to augment HUD's ongoing internal control process and its planned future efforts.

ACCOUNTING SYSTEMS SHOULD BE REVIEWED FOR COMPLIANCE WITH PRINCIPLES AND STANDARDS

HUD did not evaluate its accounting systems for compliance with the Comptroller General's accounting principles and standards and related requirements. In its first-year report, HUD described serious basic problems with its accounting systems and stated that the systems are not in full compliance with these principles, standards, and related requirements. However, HUD is committing substantial resources to have systems in place by fiscal year 1987 which will meet these requirements.

Section 4 of the act requires that each annual statement prepared under section 2 of the act include a report on whether the agency's accounting systems conform to the Comptroller General's principles, standards, and related requirements. The Budget and Accounting Procedures Act of 1950 requires agencies to establish accounting and internal control systems that conform to these principles and standards, and the Comptroller General has stated that agencies should evaluate their accounting systems for compliance.

HUD's accounting organization is divided into two groups--one for general and program accounting and one for mortgage insurance accounting. Within the first group, HUD has three automated accounting systems--General Administrative, Assisted Housing, and Program. These three systems account for HUD's salary and expense appropriation, a working capital fund, and about half of HUD's housing assistance, grant, and loan program appropriations. The remainder of HUD's appropriations are accounted for manually, outside of these systems.

Seventeen independently operated automated subsystems, as well as manual processes, are located in the mortgage insurance accounting group. This group covers single-family and multifamily insured mortgages, insured home improvement and mobile home loans, repairs to HUD-owned properties, and insurance premium collections.

In his first annual statement under the act, the Secretary outlined numerous problems with the general and program accounting group's systems. He noted that these automated systems consist of independent, stand-alone applications that are cumbersome and costly to change or enhance, are error-prone because of manual interfaces, are difficult to control, and time-consuming to operate and reconcile. In our recent report entitled Increasing the Department of Housing and Urban Development's Effectiveness Through Improved Management (GAO/RCED-84-9, Jan. 10, 1984), we reported similar problems with HUD's accounting systems. We noted that these systems provided inaccurate and incomplete data and that they were labor intensive because of the many manual accounting and reporting functions.

In response to the general and program accounting group's systems' problems, HUD developed an April 1983 plan to design and implement a new system to integrate the existing systems into a single automated accounting structure. In this new system, HUD plans to provide flexible, maintainable, comprehensive, and fully automated systems capabilities. According to HUD, a major effort is underway to implement a new Federal Housing Administration mortgage insurance accounting system. For development purposes, the accounting system has been divided by programs and functions into 11 separate projects. HUD said that accounting services or software available in the private sector are being used whenever feasible to meet needs at the least cost. The 11 projects are in various stages of completion.

HUD is committing substantial resources to the design of new accounting systems and expects to have systems in place by fiscal year 1987 that will meet our accounting systems' principles and standards. However, in the past, HUD has experienced problems in developing automated systems. In our January 1984 report, we described a number of problems HUD had encountered in developing automated systems and stated that many of the problems could be traced to the need for better management of the system's development and implementation process. Additionally, in our work at other federal agencies, we have frequently found accounting systems operating differently from the manner specified in their design.

We believe a program to document and test the systems as they are redesigned would help HUD avoid the problems experienced in the past. Basically, the purpose of system documentation is to provide a clear and comprehensive description of such things as a system's objectives, methods of operations, established procedures, equipment used, operating locations, control features,

special characteristics, and end products such as accounting reports and financial statements. The documentation itself includes narrative descriptions, flowcharts, procedures manuals, schedules, and charts that are sufficiently detailed and logically organized to provide a ready understanding of a system's design, operation, and features.

Such information is needed to design the testing procedures necessary to determine if a system operates properly. Properly documented systems also have other advantages. For example, good documentation (1) provides all employees with a consistent understanding of the system's established operating procedures and requirements, (2) facilitates training of new employees, (3) provides for a permanent record of changes made to equipment and operating procedures, and (4) facilitates reviews by outside parties and lessens the need for employees to spend time explaining systems.

Effective testing can show whether systems are operating consistently, effectively, and in accordance with established policies and procedures. Generally, specific testing methods are developed on the basis of a system's particular design and features. To be economically feasible, the tests employed should be designed to focus on a system's key controls and features. For this reason, good system documentation greatly simplifies the process of designing tests because it clearly identifies the key features and operations.

Conclusions

In his first annual statement to the President and the Congress, the Secretary concluded that HUD's accounting systems do not comply with our accounting principles and standards. HUD did not evaluate its accounting systems for compliance with our principles and standards because it is redesigning the systems and expects the new systems to comply. By documenting and testing the systems as they are redesigned, HUD could determine whether the systems are operating consistently, effectively, and in accordance with established policies and procedures. This would help HUD avoid developing systems that do not comply with our principles and standards and also avoid the cost and effort required to change automated systems after they are implemented.

Proposal, agency comment, and our evaluation

In our draft report, we proposed that the Secretary, HUD, require documenting and testing of the accounting systems as they are redesigned to help ensure their compliance with our principles and standards. In commenting on our draft, (see app. III), HUD stated that it needed to document and test the accounting systems as they are redesigned. Because of HUD's responsiveness, we have not included a recommendation in our report. We plan to monitor HUD's progress as part of our continuing review of federal agencies' implementation of the act.

HUD'S MATERIAL WEAKNESSES AS REPORTED IN THE
SECRETARY'S STATEMENT, DATED DECEMBER 30, 1983

The following is a summary of material weaknesses disclosed in HUD's evaluation of its system of internal accounting and administrative control.

HOUSING AND PUBLIC AND INDIAN HOUSING

General weakness

Income Certification: Inadequate verification of program participant or recipient data may not detect false or fraudulent certifications, thus, leading to payment of benefits beyond actual eligibility limits and program participation by ineligible applicants.

Housing

Title I Property Improvement Loans: Proceeds are not always used for intended purposes after loan has been approved and borrower has received funds.

Single-Family Property Disposition (Procurement): Weaknesses in supervision and monitoring of procurement actions for property maintenance and repair have resulted in fraud.

Single-Family Valuation: Lack of field office desk and field reviews of appraisal reports during high-volume periods may lead to questionable commitments and, ultimately, inflated payoffs by HUD for defaulted mortgages.

Multifamily Financing and Preservation (Contracting): Weaknesses in HUD's field organization structure, such as lack of separation of contracting duties and in supervision and monitoring of property disposition procurement functions, may lead to fraud and waste.

Multifamily Financing and Preservation (Management and Sales): Rental delinquencies have limited the ability to manage debt collection by reducing cash flow.

Multifamily Financing and Preservation (HUD Servicing): Workout agreements are not processed in a timely manner and have not been adequately monitored to ensure compliance with terms because of a lack of established monitoring requirements and techniques for use in monitoring agreements.

Public and Indian housing

Administration of Contract Award: Projects are approved which require amendment funding because of undetected poor initial design or nonconformance with minimum standards.

Lead-Based Paint Abatement: HUD has not developed an adequate system to ensure that 24 CFR Part 35, which requires each Assistant Secretary to develop and implement procedures to verify, inspect, and eliminate lead-based paint in any residential structure which receives federal funds, is effectively and efficiently administered.

Technical Policy and Procedure Implementation (Pre-Construction): Projects are approved that may not be designed for the intended use, or overfunded with little or no consideration for cost constraints because of a lack of management goals, performance and monitoring standards, or staff training.

Technical Policy and Procedure Implementation (Post-Construction): Processing is not completed in a timely manner, and projects are not efficiently moved through development, construction, and post-construction phases because of a lack of trained and skilled staff.

Turnkey III (Homeownership Program): Homeownership selection criteria for incoming program participants and provisions of the Turnkey III Homebuyer Agreement are not enforced.

Comprehensive Improvement Assistance Program (Modernization): Public Housing Agencies funded for modernization have experienced delays in construction programs and mismanagement of funds because of a lack of monitoring by HUD. An Office of Inspector General audit also revealed that field offices need to improve monitoring of public housing authorities' comprehensive modernization plans, need to reduce excess modernization advances, and need to ensure that the authorities have obtained required energy audits.

Public Housing Financial Management: Some public housing authorities have received overpayments of the Performance Funding System operating subsidy by understating projections of local income used in subsidy calculations. Problems go undetected through weaknesses in monitoring of income projections.

Architectural Fees: Architectural services are required primarily for design and inspection of public housing projects. HUD does not require public housing authorities to select architects on a competitive basis or negotiate architects' fees when hiring architects in the development of low-income housing. Thus, the fees may be higher than would otherwise be charged.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION

Reconciliation of Guaranty Fees: Discrepancies between fees reported and fees collected have not been detected in a timely fashion, adversely affecting cash flow.

Fiscal Procedures of Federal National Mortgage Association: Monitoring of operations conducted by Federal National Mortgage Association for Government National Mortgage Association (funds collection, safekeeping, remittance, and payments) has not always been timely and comprehensive, potentially allowing income losses to go undetected.

Final Certifications: Final Certifications may not be carried out properly, leading to questionable assurances that mortgages are federally underwritten.

COMMUNITY PLANNING AND DEVELOPMENT

Community Development Block Grant Program (Lump-Sum Draw-downs): Lump-sum drawdown provisions raise the possibility of community development block grant recipients drawing down amounts in excess of need, violating program regulations, and causing additional interest cost to the Treasury.

Section 312 Rehabilitation Loan Program (Program Requirements): Inadequate or improper loans are approved and properties are rehabilitated with excessive rehabilitation costs because of poor comprehension by HUD local staff and locality personnel of program requirements.

Section 312 Rehabilitation Loan Program (Monitoring): HUD's lack of monitoring private mortgage banking firms under contract poses a potential problem in detecting irregularities in the handling of cash for Section 312 loan repayments.

Community Development Block Grants (Administrative Expenses): Unclear procedural requirements and regulation definitions have allowed community development block grants grantees to exceed the 20-percent limit on administrative and planning expenses, reducing the amount available for actual community development block grant activities.

Community Development Block Grants (Program Income): Grantee income derived from interest, repayments, and other program activities may only be used for certain purposes by recipients per law and regulation. Inadequate monitoring and procedural controls may permit unallowable expenditures to go undetected.

ADMINISTRATION

Office of Finance and Accounting: To fully comply with Circular A-123 and to continue the work initiated under a joint review of the internal control of accounting systems by the Office of Finance and Accounting and the Office of Inspector General, the Office of Finance and Accounting contracted with a certified public accounting firm to perform internal control reviews to assess the adequacy of and identify weaknesses in HUD's accounting processes. As of September 30, 1983, 17 of the scheduled 32 internal control reviews had been completed which identified 108 weaknesses requiring corrective actions. While most of the individual weaknesses are not of a significant magnitude to be included in the response to the President, taken as a whole, the reviews indicate the existence of significant procedural and systemic weaknesses in a number of HUD's accounting processes.

Personnel Management: Changes in duties, responsibilities, and organizational structures over time, along with fragmentation of functions, may have resulted in the misclassification of positions. This could lead to overgrading in higher graded and supervisory positions. Moreover, new classification standards and policies issued by Office of Personnel Management may result in misclassification of some of HUD's current staff.



U S DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
THE SECRETARY
WASHINGTON, D C 20410

May 17, 1984

Honorable Charles A. Bowsher
Comptroller General of the United States
General Accounting Office
Washington, DC 20548

Dear Mr. Bowsher:

Your staff has sent to us the draft report on the "Department of Housing and Urban Development's First Year Implementation of the Federal Managers' Financial Integrity Act." My staff has prepared a detailed response and a copy of it is enclosed for your information.

While I appreciate the modifications to the draft letter as a result of discussions between your staff and our Inspector General's staff, I want you to know of my general disappointment at the lack of balance in the report and for its total emphasis on perceived weaknesses. Indeed, my own report to the President last December acknowledged recommendations made by my Inspector General and indicated that we had more to do to fully achieve the objectives of the Act or OMB Circular A-123. As you are aware, the recommendations contained in your report were stated in our Inspector General's report of November 16, 1983 and have been accepted by the Department. On the other hand, my report, as well as that of the Inspector General, also fairly presented the real accomplishments we had made in the first year of implementation.

It is the recognition of what we had achieved that is sadly lacking in the GAO draft report. While the draft transmittal letter has been modified to be more balanced, our concern is that the report will be used by itself by many and project the wrong image of our accomplishments. The draft stresses procedural inadequacies as perceived by GAO staff but with little regard to what our results were, leaving an overall impression that we had not really done a good job. We are damned with faint praise in a statement that HUD "is making progress" or by a reference to our "positive but unfinished work."

The report reflects little awareness that HUD, like other Federal agencies, had to install brand new procedures under the Act, develop internal instructions, inform managers, institute training programs and provide active direction. This Department showed leadership and innovation in doing so, developing internal guidelines and procedures which were pointed out to other agencies by the OMB and the GAO itself as models. We knew that full adherence to the Act could not be accomplished within the first year and designed our strategy with that in mind. The GAO's report furnishes no hint that it understood our approach, and it expends much effort in identifying things to be done of which we already knew. I understand that, based upon subsequent meetings, this tone will be changed in order to give a more balanced picture of our accomplishments.

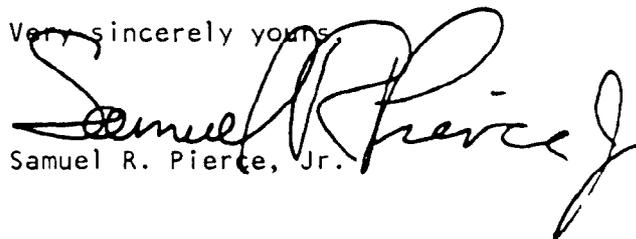
I am sure you are aware that the success of the Federal Managers' Financial Integrity Act requires the support of managers. Implementation of the Act is time consuming and requires considerable resources, and compels us to focus on the most significant areas of vulnerability. A report of this kind reflects little awareness of what we have tried to do or the burdens placed upon managers who are not auditors. As such it threatens to undermine our efforts. We need support from the GAO, not a listing of relatively minor findings which are not reflective of results. Our managers will not find such support in this report. We are also concerned about the adverse impact on other agencies of such a negative report on an agency which both the OMB and you have called a leader in implementation of the Act. If all our effort to be a leader is treated in such a negative fashion, the incentive of other agencies to aspire to our levels of accomplishment will be seriously undermined.

[GAO Comment: The act's successful implementation is of utmost importance. In our report, we have tried to highlight HUD accomplishments in implementing the act as well as discussing ways in which implementation efforts can be enhanced. Our intent is to help assure achievement of the legislation's goal--to reduce fraud, waste, and abuse and improve management of federal government operations.]

Although the report notes that the GAO's effort was a joint undertaking with our Office of Inspector General, evidence of such partnership is not found in the GAO's draft. I was appreciative of GAO's cooperation with our Office of Inspector General in conducting a joint audit of the internal control program in order to save the time of our program managers and our internal control coordinators. I would like to suggest to you formally (as my staff has already discussed with your staff informally) that serious consideration be given to the preparation of a joint report on any future joint audit. The Department would then receive one set of comments and one report on its activities and thereby eliminate the need to review and respond to two different audit reports on the same set of facts and findings at different times. While I recognize there are many reasons why GAO and OIG cannot do joint reviews and reports in all cases, it would seem to me that FMFIA implementation is an area where a joint report could be feasible and result in savings and efficiencies to all parties concerned.

I earnestly hope that the final report will present the efforts of this Department in a more balanced fashion.

Very sincerely yours,



Samuel R. Pierce, Jr.

Enclosure



U S DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON D C 20410

OFFICE OF THE ASSISTANT SECRETARY
FOR ADMINISTRATION

May 17, 1984

Mr. J. Dexter Peach
Director
Resources, Community and
Economic Development Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Peach:

We have reviewed your proposed report entitled "Department of Housing and Urban Development's First Year Implementation of the Federal Managers' Financial Integrity Act" (RCED-84-140). Our detailed comments are enclosed.

I appreciate the draft modifications to the cover letter which you have discussed with our Inspector General. These changes in tone respond to our disappointment with the negativism of the original letter, particularly in view of the fact that both the Office of Management and Budget (OMB) and GAO have indicated to us that we are one of the leaders in the Federal Government in implementation of the Federal Managers' Financial Integrity Act (FMFIA) and OMB Circular A-123. The draft report, however, is still remains largely negative in tone, concentrating on our "unfinished work" rather than our positive accomplishments. Since the report will stand on its own, separate from the letter, we believe the draft will need changes in the tone to correspond with the revised letter. We understand that, based of subsequent meetings, this tone will be changed in order to give a more balanced picture of our accomplishments. Further, the revised letter and the draft report contain inaccuracies. Both require significant modification in order to accurately reflect our efforts.

Our enclosed detailed comments concern your revised cover letter, which we have received informally, and the original draft report. They are written with the following concepts in mind:

- The OMB guidelines were provided to each agency as guidance in the development of its own specific plan in the most efficient and effective manner consistent with each agency's unique mission and organizational structure. OMB stressed the newness of the internal control process, and agencies were encouraged to innovate. Training "from the bottom up," in which agencies shared unique experiences and approaches, was the basis for OMB's training efforts. The GAO draft emphasizes a rigid adherence to the guidelines rather than a portrayal of the agency activity and the results achieved.

[GAO Comment: Our draft discussed HUD's internal control evaluation activities and accomplishments. This final report has been revised to give further recognition to these accomplishments.]

- The Department's submission to the President and the Congress on the FMFIA went into a detailed explanation of our implementation methodology and rationale including the focus on national programs, accountability of top management, experimentation and innovation, development of needs, skills, and knowledge in managerial staff and decisions for a staff-level support structure. The GAO draft apparently ignores our extensive explanation and instead includes random, episodic comments from interviews with "housing staff" as support for its conclusions.

[GAO Comment: We attempted to recognize HUD's methodology and rationale and have revised our report to reflect additional information provided by HUD in its comments.

- The draft also ignores the broad range of managerial involvement in the process, particularly at the initial stage, when OMB and GAO guidelines were still in draft. Many of the remarks in the draft are not relevant because the guidance quoted was not available at the time the work was accomplished. For example, the GAO standards for internal controls were not issued until June 1, 1983 or four months prior to completion of the first cycle of evaluations. Moreover, GAO has previously stated publicly that the process of implementation is a multi-year effort. In addition, the significant activity by HUD under preliminary reviews has been all but ignored.

[GAO Comment: We recognize that the implementation process is a multi-year effort, and we made proposals in our draft report to enhance HUD's future internal control evaluation efforts. We believe HUD's future efforts will need to better address OMB guidelines and GAO standards. Furthermore, while we believe our draft report did recognize HUD's preliminary reviews, this final report has been revised to further recognize them.]

- The HUD Office of Inspector General report issued November 11, 1983 as a result of the joint audit with GAO was discussed extensively with management and represents a fair picture of the accomplishments and weaknesses in our initial effort. The Office of Inspector General report was written in a manner which would enable a third party to get an accurate picture of the FMFIA activity in HUD. The GAO draft, five months later, did not capture the same balance.

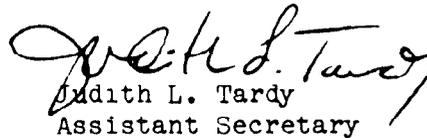
We would appreciate your further review of the GAO draft report and its modifications to include the more balanced description of the internal control process conducted in HUD. While the transmittal letter has been revised as noted above, we are concerned that the letter and the report can and will be read separately and, in fact, will present a different view of the work conducted within this Department on internal control implementation.

Finally, I was appreciative of GAO's cooperation with our Office of Inspector General in conducting a joint audit of the internal control program in order to save the time of our program managers and our internal control coordinators. I would like to suggest to you formally (as my staff has already discussed with your staff informally) that serious consideration be given to the

preparation of a joint report on any future joint audit. The Department would then receive one set of comments and one report on its activities and thereby eliminate the need to review and respond to two different audit reports on the same set of facts and findings. While I recognize there are many reasons why IAO and Office of Inspector General cannot do joint reviews and reports in all cases, it would seem to me that FMFIA implementation is an area where a joint report could be feasible and result in savings and efficiencies to all parties concerned.

Should your staff have any questions regarding our comments, please direct them to Albert J. Kliman, Director, Office of Budget, on 755-7296.

Sincerely,


Judith L. Tardy
Assistant Secretary

Enclosure

DETAILED COMMENTS ON PROPOSED GAO REPORT ENTITLED
 "DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
 FIRST YEAR IMPLEMENTATION
 OF THE
 FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT"

LETTER TO THE SECRETARY

<u>LETTER REFERENCE</u>	<u>COMMENT</u>
Page 1, paragraph 2	The draft letter is inconsistent in its reference as to whether the Office of Management and Budget (OMB) guidelines recommend action or require compliance. We believe, along with OMB, that OMB guidelines are for the agencies to use and modify as necessary. Guidelines do not require compliance. Hence, the reference in paragraphs 3 and 4 to "compliance" and "required" should be eliminated.
Page 4, paragraph 3	<p>The draft letter suggests that HUD's field vulnerability assessments did not include our Area Office activity. The letter and report do not recognize that both Headquarters and Regional Office vulnerability assessments were to consider Field Office activities. The fact that forms may not have been completed by personnel in those offices separately from those prepared by Regional Office personnel is a matter of agency judgment on how to efficiently perform the process. Regional Office staff have in the past monitored offices within their jurisdiction and are competent to judge their vulnerability. Moreover, some major Regions and Field Offices are co-located for operating efficiency as well as providing insight to Regional Vulnerability Assessments preparers on actual program operating problems. The concept of reasonable assurance (GAO General Standards) does not require that every location and activity be evaluated without consideration of the costs or benefits involved.</p> <p>In addition, safeguards were evaluated as part of our vulnerability assessment process, although not as a separate category of activity as suggested by OMB guidelines.</p>

[GAO Note: Page references which referred to our draft report have been revised to correspond with the page references in this final report.]

Page 2, paragraphs 3 & 4

The letter states that we initiated three internal control reviews, when in fact we only initiated two internal control reviews in our program offices, Housing and the Office of the Deputy Under Secretary for Field Coordination. The Office of the Government National Mortgage Association (GNMA) incorrectly labeled their preliminary review efforts as internal control reviews. This misunderstanding has been corrected and our tracking system has been revised. The draft letter should eliminate any reference to GNMA's efforts, including its use as an example.

In addition, limiting your comments to our program internal control reviews results in a biased and unbalanced report. For example, as of January 31, 1984 we had 136 highly and moderately vulnerable administrative and staff functions and we had completed 34*internal control reviews in these areas. Highlighting only our program efforts severely understates our true internal control review efforts. The draft letter should include all of our internal control review efforts.

Page 3, paragraph 2

The use of the term "all" regarding our evaluation of our ADP systems is unfair since HUD has so many ADP systems that all of them could not be reviewed in a single year. The draft overlooks that (a) all of HUD's ADP systems are not equally significant; (b) parts of the general controls were reviewed (see page 17 of the draft report; and (c) parts of the application controls were reviewed in the vulnerability assessments, preliminary reviews and internal control reviews.

Again the report highlights weaknesses and does not recognize our accomplishments. In our view, data systems need to be reviewed as the programs are reviewed and not in isolation. The draft letter should be revised to include our positive efforts.

Page 4, paragraphs 3 & 4

We already have started implementing several of your recommendations and would like to receive credit for these actions.

*[GAO Note: Subsequently, HUD informed us that it had completed 21 internal control reviews as indicated in this report.]

DRAFT REFERENCECOMMENT

Page 4, paragraphs 5 & 6

The negative tone of your draft letter is highlighted in your phrase ". . . HUD's positive but unfinished work". The words "unfinished work" emphasize our weaknesses without accurately acknowledging our accomplishments.

[GAO Comment: Report has been revised as appropriate.]

Page 2, paragraph 2

OMB guidelines are not requirements. The seven-phase approach described in your draft is only a suggested approach. The OMB guidelines states that each Executive Agency is expected to use this guidance to assist in the development of its own specific plans in order that management can perform a self-evaluation of needed improvements, and report on its internal control system in the most efficient and effective manner consistent with its own missions and organizational structure. The draft should be revised to include the word "suggested" in reference to OMB's approach.

Page 4, paragraph 1

Again your draft implies that OMB guidelines are a requirement. The OMB approach is a suggested approach and your draft should be revised to reflect this fact.

[GAO Comment: Report has been revised as appropriate.]

Page 4, paragraph 2

HUD's internal control coordinator is located in the Office of Budget within the Office of Administration. We suggest you revise your draft to more accurately reflect the placement of the coordinator in the Office of Budget. The draft should also reflect our February 23, 1982 memorandum from the Under Secretary to the principal staff which initiated the process.

[GAO Comment: Report has been revised.]

Page 4, paragraph 5

Your draft accurately states that we extended our vulnerability assessment process to our Regional Offices in September 1983. However, you fail to mention that the vulnerability assessments were not completed until November 30, 1983, making it impossible to include the Regional Offices' results in our

first annual statement. Your draft language alludes to some motive other than the lack of time as the reason for excluding the field results from our letter.

[GAO Comment: Report has been revised to include HUD's reasons for excluding field results.]

Page 6, paragraph 1

Since OMB guidelines cannot require any action, why state that our preliminary reviews were not required by OMB? Instead, your draft should give us credit for accomplishing something above and beyond OMB's suggested approach.

Since we are currently performing preliminary reviews on our moderately vulnerable units, the draft should be revised to indicate our actual efforts, rather than what was planned prior to the end of your audit period. Also, it should be noted in your draft that our preliminary reviews on the highly vulnerable areas resulted in over 245 corrective actions being initiated.

Page 5, paragraph 5 and
page 6, paragraph 1

In this paragraph you accurately include all the internal control reviews that we completed by January 31, 1984. This paragraph supports our objection to your early statement on page 2, first paragraph, of the letter to the Secretary. As discussed earlier in our comments, you limited yourself to our program internal control reviews, gives the impression that we did not have a serious internal control review effort during 1983. We suggest that this inconsistency between the letter and the report be corrected by acknowledging all the internal control reviews that we initiated and completed.

[GAO Comment: Report has been revised as appropriate.]

Page 6, paragraph 6

The draft inaccurately paraphrases our reported material weakness identified under the Section 235 Program as a weakness for all housing assistance payments. The draft must be revised to accurately reflect that the weakness only exists in our Section 235 Program.

Page 9, paragraph 1

As discussed earlier in our comments, GNMA mistakenly labeled its preliminary review activity as an internal control review. The error was corrected by both GNMA and the Office of Budget prior to the end of your

audit period. The draft should eliminate all references to a GNMA internal control review.

[GAO Comment: Report has been revised as suggested.]

Page 9, paragraphs 4 & 5

Since the OMB guidelines cannot require compliance, the word "required" should be replaced with "suggested" when referring to the OMB guidelines.

Page 9, paragraph 5

As stated earlier in our comments, the draft does not recognize that both Headquarters and Regional Offices vulnerability assessments included Field Office activity. In addition, believed it was desirable to develop and modify our initial internal control system in Headquarters prior to involving our field operations. Further extending the internal control process to all field tiers, as recommended in your draft, may not be cost effective at this time.

[GAO Comment: Report has been revised as appropriate.]

Page 10, paragraphs 1 & 2

The draft states that we did not perform complete vulnerability assessments as defined by OMB because we did not have a separate evaluation of safeguards. The draft lists three techniques that could be included in this evaluation, all of which were included in our vulnerability assessments. The draft further states that our method "may have addressed safeguards." The draft clearly focuses on procedures and not on substance. The OMB approach is not a requirement, but a suggested approach. The draft does not even attempt to identify the effect of not including a separate evaluation of safeguards. Hence, since we followed the intent of OMB's guidelines, we believe this finding should be excluded from the draft.

In any event, the draft does not clearly distinguish between the techniques for the evaluation of safeguards and the techniques for evaluation of the general control environment. Separation of duties is used as an example for both techniques.

[GAO Comment: We discuss on page 10 HUD's position that the safeguards were addressed under the evaluation of the general control environment and inherent risk. However, we continue to believe that a separate evaluation of safeguards would more clearly focus the evaluator's analysis of the specific safeguards being used.]

Page 10, paragraph 3

The draft discusses the different vulnerability assessment forms used by our Headquarters program offices. Nowhere in the draft does it give our reasons for using different forms, even though we discussed this with your auditors on several occasions.

Since this was a new and untested process, we decided that each Assistant Secretary should have the flexibility to design an instrument that made sense for his/her organization, drawing on basic formats and extensive technical assistance provided by the internal control coordinator. As discussed with your auditors, we required a standardized format for the field assessments based on our experience with the different Headquarters assessment forms. We believe our reasons for using the different forms should be included in the draft.

[GAO Comment: Report has been revised as appropriate.]

The draft implies that vulnerability assessments are better with specific questions compared to general risk options. We disagree with this view. Also, the instructions to the Office of Housing vulnerability assessment form provided for adding specific questions unique to the assessable unit.

[GAO Comment: We did not evaluate the relative merits of the assessment forms and have revised the report to make this clear.]

The draft lists three "advantages" for using a standardized and complete vulnerability assessment form. As discussed earlier in our comments, our assessments contained all the elements suggested by OMB, but we used a different format. Hence, the draft should eliminate any reference to an incomplete form.

[GAO Comment: Report has been revised to delete reference to incomplete forms.]

Page 5, paragraphs 3-5

The draft lists two OMB approaches to address programs and functions with the greatest vulnerability: internal control reviews and a series of options to develop plans for corrective actions. The draft correctly states that HUD chose the second approach, to develop plans for corrective actions for our program offices, with some internal control reviews as an element of these plans. However, the draft does not note that the first approach was used for HUD's accounting systems.

[GAO Comment: The draft and final reports state that the first approach was used by the Office of Finance and Accounting.]

The ensuing discussion centers on the internal control reviews done by the program offices, as if we had chosen only the first OMB approach. Since the draft introduces the second approach, it should discuss how this approach was implemented. As it is written, the draft is confusing because it explains the internal control review approach when the development of plans for corrective actions approach should be discussed.

[GAO Comment: Report has been revised as appropriate.]

In addition, the draft incorrectly compares the two approaches, when they are two separate ways of accomplishing the same goal. The approaches used are dependent on whether the causes and extent of the vulnerabilities are known. The management approach assumes the problems are known and that another evaluation is not needed.

[GAO Comment: Our intention was to explain the approaches used by HUD. The report has been revised to clarify our intention.]

The draft incorrectly implies that OMB guidelines recommend internal control reviews for all highly and moderately vulnerable areas.

We suggest that this section be rewritten to correctly describe how we implemented both approaches.

[GAO Comment: We did not intend to imply that internal control reviews were recommended for the highly and moderately vulnerable areas. We recognized in the draft that the second approach is also applicable to these areas.]

Page 9, paragraph 1

As stated earlier in our comments, GNMA incorrectly labeled its preliminary review activity as an internal control review. The draft should exclude the reference to GNMA when discussing internal control reviews.

[GAO Comment: On the basis of HUD comments, the references to GNMA have been deleted from the report.]

Page 6, paragraphs 1 & 2

The draft states that our internal control reviews are not scheduled based on the vulnerability assessment results. However the draft fails to say how our internal control reviews are scheduled. Our internal control reviews are based on our preliminary reviews, which are based on the vulnerability assessments. The draft should be revised to correctly state this fact.

Since we are currently completing preliminary reviews on our moderately vulnerable areas, the draft should be revised to fully recognize our ongoing efforts.

[GAO Comment: The draft report stated that the purpose of HUD's preliminary reviews was to develop a plan to address problems highlighted during the vulnerability assessments and determine whether to do an internal control review; thus, we indicated that internal control reviews were based on the preliminary review. The report has been revised to reflect HUD's ongoing efforts.

Page 6, paragraph 1

The draft incorrectly compares our preliminary reviews with internal control reviews. Our preliminary reviews were never intended to be a substitute for the internal control reviews. The preliminary review process was intended to evaluate the degree and causes of vulnerability, and then, considering management priorities, resource availability and other management initiatives underway, determine the appropriate courses of action. These actions might include conducting internal control reviews, requesting an audit, training staff, etc.

The draft specifically describes this process as the second approach suggested by OMB guidelines. Instead of giving us credit for implementing OMB's second approach, the draft incorrectly tries to show that we are substituting preliminary reviews for internal control reviews. The draft should be revised

to show the proper relationship between the preliminary and internal control reviews and give HUD credit for implementing both suggested approaches.

[GAO Comment: Our draft stated that HUD used both approaches and described these approaches. The report has been revised to eliminate any implication that HUD was using the preliminary review as a substitute for internal control reviews.]

Page 6, paragraph 1

The draft discusses several reasons that HUD staff gave for not recommending internal control reviews and Administration's efforts to increase the number of internal control reviews initiated by the program offices. However, the reasons for these two paragraphs are missing from the draft. Because we chose OMB's second option to address programs and functions with the greatest vulnerability, internal control reviews were not required. Administration encouraged appropriate consideration of internal control reviews as an option for action. The draft needs reflect the reasons for these actions.

[GAO Comment: Report has been revised as appropriate.]

Page 9, paragraph 1

As discussed earlier in our comments, please eliminate the reference to GNMA's internal control review. However, we believe Chapter 5 of the draft and March 1984 handbook versions include OMB's recommended steps such as identifying internal control objectives and techniques. Also, the draft used in the pilot internal control review, "A Guide to Internal Control Reviews," prepared by a contractor also contains tasks related to control objectives and control techniques.

The report states that the Office of Housing internal control review did not meet OMB Guidelines. This conclusion is based on a review of an internal control review report which did not state that all event cycles of the assessable unit were identified and reviewed. The internal control review team identified all event cycles within the assessable unit and performed the appropriate work to make an evaluation of the assessable unit.

To criticize the internal control review because of an inadequately written scope in the report is inappropriate. Also, page V-2 of the OMB Guidelines indicates that not all event cycles must be reviewed to adequately evaluate the unit.

[GAO Comment: As noted on page 35, reference to GNMA has been deleted. Also, a subsequent discussion with a HUD staff member participating in the Office of Housing's internal control review indicated that all event cycles were considered although this fact was not clearly indicated in either the report on the internal control review or in documentation supporting the review. Because HUD has stated that it will strengthen its documentation of the review processes, we have deleted references to Housing's internal control review. As a result of these revisions, we have also deleted a proposal contained in our draft report related to strengthening the internal control review process.]

Pages 11 & 15

We agree that we need to improve documentation of the evaluation process and have already taken steps to correct this deficiency. Our revised vulnerability assessment and preliminary review guides prescribe the type and amount of documentation to be developed and retained by program managers. We believe that the draft should reflect our efforts to correct this deficiency.

Pages 12, 13, & 15

We agree that we need to improve the evaluation of ADP controls. We have initiated actions to correct this deficiency. Please revise the draft to reflect our current activity in this area.

Pages 13-15

We agree that we need to give more attention to quality assurance and have plans to implement a quality assurance review during FY-1984. We would like to see the draft reflect our planned efforts.

[GAO Comment: Report has been revised as appropriate.]

Pages 14-16

Based on our earlier comments, the following draft conclusions should be deleted or modified:

- The vulnerability assessment process should be extended to all Field Office tiers;
- HUD did not perform complete vulnerability assessments as defined by OMB because a separate preliminary evaluation of safeguards was not included;

- Vulnerability assessments were not in a standard, comparable format because several different forms which addressed different questions were used by the various HUD organizations;
- HUD initiated three internal control reviews in its program areas such as the Office of Housing although it identified 103 highly and moderately vulnerable areas in these programs;
- The preliminary review process does not employ the specific review processes of the internal control review which should identify control problems that would otherwise go undetected; and
- Those internal control reviews completed in program areas did not meet OMB guidelines because control objectives, control techniques, and event cycles were not always identified.

Pages 14-16

We believe the recommendations should recognize the corrective steps we have already taken. Since we have taken some actions on each of the recommendations, the draft should be revised to reflect our efforts.

[GAO Comment: Report has been revised as appropriate.]

Pages 16-19

We agree that we need to document and test our accounting systems as they are redesigned to help ensure their compliance with GAO principles and standards.

Appendix II

Both HUD's first annual letter to the President and the Congress on internal controls and the Office of Inspector General's report on the Department's Implementation of the Federal Managers' Financial Integrity Act are public information. The paraphrasing of these documents serves no useful purpose in your draft and should be deleted.

[GAO Comment: We have included information from HUD's first annual letter to the President and the Congress to provide further insight into the material weaknesses HUD reported. We have deleted an appendix summarizing the Inspector General's report as HUD suggested.]

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