Federal Housing Administration, Washington, DC

Audit of FHA's Fiscal Years 2021 and 2020 Consolidated Financial Statements

Office of Audit
Financial Audits Division
Washington, DC

Audit Report Number: 2022-FO-0003
December 09, 2021

OFFICE OF INSPECTOR GENERAL
U.S. Department of Housing and Urban Development

To:	Lopa P. Kolluri Principal Deputy Assistant Secretary for Housing and the Federal Housing Administration, H
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From:	Kilah S. White Assistant Inspector General for Audit, GA
Subject:	Independent Public Accountant's Audit Report on the Federal Housing Administration's Fiscal Years 2021 and 2020 Consolidated Financial Statements

Attached are the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) results of the audit of the Federal Housing Administration's (FHA) consolidated fiscal years 2021 and 2020 financial statements and reports on internal control over financial reporting and compliance with laws, regulations, contracts, and grant agreements and other matters.

We contracted with the independent public accounting firm of CliftonLarsonAllen LLP (CLA) to audit the financial statements of FHA as of and for the fiscal years ended September 30, 2021 and 2020,[1] and to provide reports on FHA's 1) internal control over financial reporting; and 2) compliance with laws, regulations, contracts, and grant agreements in its financial reporting. Our contract with CLA required that the audit be performed in accordance with U.S. generally accepted government auditing standards, Office of Management and Budget audit requirements, and the Financial Audit Manual of the U.S. Government Accountability Office and the Council of the Inspectors General on Integrity and Efficiency.

In its audit of FHA, CLA reported:

- The consolidated financial statements as of and for the fiscal year ended September 30, 2021, are presented fairly, in all material respects, in accordance with U.S. generally accepted accounting principles.
- One material weakness[2] and one significant deficiency[3] in internal control over financial reporting, based on the limited procedures that it performed.

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[1] The accompanying consolidated financial statements as of and for the fiscal year ended September 30, 2020, were audited by other auditors, whose Independent Auditor's Report was issued on November 12, 2020.

[2] A material weakness is a deficiency or a combination of deficiencies in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of FHA's financial statements will not be prevented or detected and corrected on a timely basis.

[3] A significant deficiency is a deficiency or combination of deficiencies in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

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    - A material weakness existed related to FHA controls over financial accounting and reporting.
    - A significant deficiency existed related to FHA econometric modeling activities used to estimate the agency's loan guarantee liability.
- No reportable noncompliance issues for fiscal year 2021 with provisions of applicable laws, regulations, contracts, and grant agreements tested and no other matters.

In connection with the contract, we reviewed CLA's reports and related documentation and inquired of its representatives. Our review, as differentiated from an audit of the financial statements in accordance with U.S. generally accepted government auditing standards, was not intended to enable us to express, and we do not express, opinions on FHA's financial statements or conclusions about the 1) effectiveness of FHA's internal control over financial reporting and 2) FHA's compliance with laws, regulations, contracts, and grant agreements and other matters in its financial reporting. CLA is responsible for the attached Independent Auditors' Report, dated December 6, 2021, and the conclusions expressed therein. Our review disclosed no instances in which CLA did not comply, in all material respects, with U.S. generally accepted government auditing standards.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, appendix 8M, requires that OIG post its reports on the OIG website. Accordingly, this report will be posted at https://www.hudoig.gov.

If you have any questions or comments about this report, please call Thomas McEnanly, Audit Director, at (202) 402-8216.

Independent Auditors' Report

Inspector General
U.S. Department of Housing and Urban Development

Assistant Secretary for Housing – Federal Housing Commissioner
Federal Housing Administration

In our audit of the fiscal year 2021 consolidated financial statements of the Federal Housing Administration (FHA), a component of the U.S. Department of Housing and Urban Development (HUD), we found:

- FHA's consolidated financial statements as of and for the fiscal year ended September 30, 2021, are presented fairly, in all material respects, in accordance with United States of America (U.S.) generally accepted accounting principles;
- A material weakness and a significant deficiency for fiscal year 2021 in internal control over financial reporting based on the limited procedures we performed; and
- No reportable noncompliance for fiscal year 2021 with provisions of applicable laws, regulations, contracts, and grant agreements we tested and no other matters.

The following sections discuss in more detail (1) our report on the consolidated financial statements, which includes an emphasis-of-matter paragraph related to the loans receivable and related foreclosed property, net, and loan guarantee liability line items and the required supplementary information (RSI)[1] and other information[2] included with the financial statements; (2) our report on internal control over financial reporting; (3) our report on compliance with laws, regulations, contracts, and grant agreements and other matters; and (4) FHA's response to our findings and recommendations.

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of FHA, which comprise the consolidated balance sheet as of September 30, 2021; the related consolidated statements of net cost, changes in net position, and the combined statement of budgetary resources for the fiscal year then ended; and the related notes to the consolidated financial statements.

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[1]The RSI consists of Management's Discussion and Analysis section and Schedules A (Intragovernmental Assets), B (Intragovernmental Liabilities), C (Comparative Combining Statement of Budgetary Resources by FHA Program for Budgetary), and D (Comparative Combining Statement of Budgetary Resources by FHA Program for Non-Budgetary) included as RSI within the Principal Financial Statements section of the Annual Management report for fiscal year 2021.
[2]Other information consists of the Message from the Principal Deputy Assistant Secretary for Housing and Federal Housing Administration section; Systems, Controls and Legal Compliance discussion within the Management's Discussion and Analysis section; Message from the Deputy Assistant Secretary for Finance and Budget and Other Accompanying Information within the Principal Financial Statements section; and the FHA Organizational Chart section of the Annual Management Report for fiscal year 2021.

We conducted our audit in accordance with U.S. generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 21-04, *Audit Requirements for Federal Financial Statements* (OMB Bulletin 21-04). We believe that the audit evidence we obtained is sufficient and appropriate to provide a basis for our audit opinion.

Management's Responsibility

FHA management is responsible for (1) the preparation and fair presentation of these consolidated financial statements in accordance with U.S. generally accepted accounting principles; (2) preparing, measuring, and presenting the RSI in accordance with U.S. generally accepted accounting principles; (3) preparing and presenting other information included in documents containing the audited financial statements and auditors' report, and ensuring the consistency of that information with the audited financial statements and the RSI; and (4) maintaining effective internal control over financial reporting, including the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. *Government Auditing Standards* require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement. We are also responsible for applying certain limited procedures to the RSI and other information included with the consolidated financial statements.

An audit of financial statements involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the auditors' assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit of financial statements also involves evaluating the appropriateness of the accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit also included performing such other procedures as we considered necessary in the circumstances.

Opinion on Financial Statements

In our opinion, the Federal Housing Administration's consolidated financial statements present fairly, in all material respects, FHA's financial position as of September 30, 2021, and its net cost of operations, changes in net position, and budgetary resources for the fiscal year then ended in accordance with U.S. generally accepted accounting principles.

Emphasis of Matter

As discussed in notes 1, 7, and 13 to the financial statements, FHA has loans receivable, net, and negative loan guarantees of $49,072 million and $17,908 million, respectively, as of September 30, 2021, the majority of which are issued under the *Federal Credit Reform Act of 1990*. FHA values its Credit Reform direct loans and loan guarantees and related receivables from assigned notes and property inventories at the net present value of their estimated future cash flows associated with these assets. Anticipated cash outflows primarily include lender claims arising from borrower defaults, premium refunds and costs to maintain and sell foreclosed properties. Anticipated cash inflows primarily include insurance premium receipts, proceeds from asset sales and principal and interest collections on Secretary-held notes. The valuation estimates are developed using econometric models that integrate historical loan-level program and economic data with regional house price appreciation forecasts to develop assumptions about future portfolio performance. Subsidy costs are intended to estimate the long-term cost to the U.S. Government of its direct loan and loan guarantee programs. A subsidy re-estimate is performed annually and any adjustment resulting from the re-estimate is recognized as subsidy expense when net cash outflows are expected or subsidy surplus when net cash inflows are expected. Actual results may differ from the estimates. Our opinion on FHA's financial statements is not modified with respect to this matter.

Other Matters

Accompanying Prior Year Financial Statements

The accompanying consolidated FHA financial statements as of and for the year ended September 30, 2020, were audited by other auditors, whose Independent Auditor's Report thereon dated November 12, 2020, expressed an unmodified opinion on those financial statements and included an emphasis of matter paragraph on the loan guarantee liability estimate. We were not engaged to audit, review, or apply any procedures to FHA's fiscal year 2020 consolidated financial statements and, accordingly, we do not express an opinion or any other form of assurance on the fiscal year 2020 consolidated financial statements.

Required Supplementary Information

U.S. generally accepted accounting principles issued by the Federal Accounting Standards Advisory Board (FASAB) require that the RSI be presented to supplement the consolidated financial statements. Although the RSI is not a part of the consolidated financial statements, FASAB considers this information to be an essential part of financial reporting for placing the consolidated financial statements in appropriate operational, economic, or historical context. We have applied certain limited procedures to the RSI in accordance with *Government Auditing Standards*, which consisted of inquiries of management about the methods of preparing the RSI and comparing the information for consistency with management's responses to the auditors' inquiries, the consolidated financial statements, and other knowledge we obtained during the audit of the consolidated financial statements, in order to report omissions or material departures from FASAB guidelines, if any, identified by these limited procedures. We did not audit and we do not express an opinion or provide any assurance on the RSI because the limited procedures we applied do not provide sufficient evidence to express an opinion or provide any assurance.

Other Information

FHA's other information contains a wide range of information, some of which is not directly related to the consolidated financial statements. This information is presented for purposes of additional analysis and is not a required part of the consolidated financial statements or the RSI. We read the other information included with the consolidated financial statements in order to identify material inconsistencies, if any, with the audited consolidated financial statements. Our audit was conducted for the purpose of forming an opinion on FHA's consolidated financial statements. We did not audit and do not express an opinion or provide any assurance on the other information.

Report on Internal Control over Financial Reporting

In connection with our audit of FHA's consolidated financial statements, we considered FHA's internal control over financial reporting, consistent with our auditors' responsibility discussed below. We performed our procedures related to FHA's internal control over financial reporting in accordance with *Government Auditing Standards*.

Management's Responsibility

FHA management is responsible for (1) maintaining effective internal control over financial reporting, including the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error; (2) evaluating the effectiveness of internal control over financial reporting based on the criteria established under 31 U.S.C. 3512 (c), (d) (commonly known as the Federal Managers' Financial Integrity Act (FMFIA)); and (3) providing an assurance statement on the overall effectiveness of internal control over financial reporting included in management's discussion and analysis (MD&A), as Systems, Controls, and Legal Compliance section.

Auditors' Responsibility

In planning and performing our audit of FHA's financial statements as of and for the year ended September 30, 2021, in accordance with *Government Auditing Standards*, we considered FHA's internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the consolidated financial statements, but not for the purpose of expressing an opinion on the effectiveness of FHA's internal control over financial reporting or on management's assurance statement on the overall effectiveness on internal control over financial reporting. Accordingly, we do not express an opinion on FHA's internal control over financial reporting or on management's assurance statement on the overall effectiveness of internal control over financial reporting. We are required to report all deficiencies that are considered to be material weaknesses or significant deficiencies. We did not consider or evaluate all internal controls relevant to operating objectives as broadly established by the FMFIA, such as those controls relevant to preparing performance information and ensuring efficient operations.

Definition and Inherent Limitations of Internal Control over Financial Reporting

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, the objectives of which are to provide reasonable assurance that (1) transactions are properly recorded, processed, and summarized to permit the preparation of consolidated financial statements in accordance with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition, and (2) transactions are executed in accordance with provisions of applicable laws, including those governing the use of budget authority, regulations, contracts, and grant agreements, noncompliance with which could have a material effect on the consolidated financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements due to fraud or error.

Results of Our Consideration of Internal Control over Financial Reporting

Our consideration of internal control was for the limited purpose described above and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies or to express an opinion on the effectiveness of FHA's internal control over financial reporting and therefore, material weaknesses or significant deficiencies may exist that have not been identified. Given these limitations, during our audit, we did identify certain deficiencies in internal control over financial reporting that we consider to be a material weakness and a significant deficiency, described below and in Exhibit A and Exhibit B, respectively.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.

A *material weakness* is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. We consider the deficiency described below and in Exhibit A to be a material weakness.

Weaknesses in Controls over Financial Accounting and Reporting

> In fiscal year 2021, FHA recorded a series of erroneous loan endorsements and associated negative subsidy for its Home Equity Conversion Mortgage (HECM) program, which led to misstatements of approximately $3,303 million in its accounting records and borrowing and investment transactions that would otherwise not occur. In addition, FHA management did not adequately review and implement OMB Circular A-136, *Financial Reporting Requirements-Revised*, which resulted in the improper presentation of the loan guarantee liability as a negative liability in the initial version of the financial statements as of September 30, 2021 and 2020.

A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiency described below and in Exhibit B to be a significant deficiency.

Weaknesses in Controls over Econometric Modeling Activities

> FHA's econometric modeling activities used to estimate the agency's loan guarantee liability need improvements to minimize the precision risks or the susceptibility to error associated with estimating FHA's largest liability on its balance sheet. Further, we identified areas of needed improvement regarding documentation used to support FHA management's current modeling practices.

During our fiscal year 2021 audit, we identified deficiencies in FHA's internal control over financial reporting that we do not consider to be material weaknesses or significant deficiencies. Nonetheless, these deficiencies warrant FHA management's attention. We have communicated these matters to FHA management and, where appropriate, will report on them separately.

Purpose of Report on Internal Control over Financial Reporting

The purpose of this report is solely to describe the scope of our consideration of FHA's internal control over financial reporting and the results of our procedures, and not to provide an opinion on the effectiveness of FHA's internal control over financial reporting. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering internal control over financial reporting. Accordingly, this report on internal control over financial reporting is not suitable for any other purpose.

Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements and Other Matters

In connection with our audit of FHA's consolidated financial statements, we tested compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements consistent with our auditors' responsibility discussed below. We caution that noncompliance may occur and not be detected by these tests. We performed our tests of compliance in accordance with *Government Auditing Standards*.

Management's Responsibility

FHA management is responsible for complying with laws, regulations, contracts, and grant agreements applicable to FHA.

Auditors' Responsibility

Our responsibility is to test compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements applicable to FHA that have a direct effect on the determination of material amounts and disclosures in FHA's consolidated financial statements, and perform certain other limited procedures. Accordingly, we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to FHA.

Results of Our Tests for Compliance with Laws, Regulations, Contracts, and Grant Agreements and Other Matters

Our tests for compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements disclosed no instances of noncompliance or other matters for fiscal year 2021 that would be reportable under *Government Auditing Standards*. However, the objective of our tests was not to provide an opinion on compliance with laws, regulations, contracts, and grant agreements applicable to FHA. Accordingly, we do not express such an opinion.

Purpose of Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements and Other Matters

The purpose of this report is solely to describe the scope of our testing of compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements, and the results of that testing, and not to provide an opinion on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering compliance. Accordingly, this report on compliance with laws, regulations, contracts, and grant agreements is not suitable for any other purpose.

Status of Prior Year's Control Deficiencies and Noncompliance Issues

We have reviewed the status of FHA's corrective actions with respect to the findings and recommendations included in the prior year's Independent Auditors' Report, dated November 12, 2020. The status of prior year findings is presented in Exhibit C.

FHA's Response to Audit Findings and Recommendations

FHA's response to the findings and recommendations identified in our report is described in Exhibit D. FHA's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

CliftonLarsonAllen LLP

CliftonLarsonAllen LLP

Greenbelt, MD
December 6, 2021

EXHIBIT A
Material Weakness

1. Weaknesses in Controls over Financial Accounting and Reporting

A. Erroneous Recording of HECM Subsidy Expense and Underlying Obligations

Background:

The Financial Analysis and Controls Division (FACD) is responsible for calculating the Home Equity Conversion Mortgage (HECM) program subsidy. In addition, FACD staff review the reconciliations of the data sources used to calculate the subsidy and records the accounting transactions into FHA's source systems and the general ledger. Procedures require the FACD staff to review the reconciliations prepared by the Single Family Insurance Operations Division (SFIOD), which compares the daily Computerized Home Underwriting Management System (CHUMS) file activity to the monthly Home Equity Reverse Mortgage Information Technology (HERMIT) Cohort Summary report. Further, FACD staff runs the Credit Subsidy Control System (CSCS) Transaction Summary report and compares the year-to-date endorsement amounts to the HERMIT Cohort Summary report on a monthly basis. Manual journal entries are recorded in CSCS to bring the cumulative endorsements in CSCS in line with the HERMIT Cohort Summary report and to record the related subsidy expense and underlying obligations.

CSCS is the subsidiary system used to calculate the subsidy expense and underlying obligation amounts, and CSCS subsequently transfers the calculated subsidy amounts into the general leger through an automated interface. Because the CSCS Transaction Summary report reconciliation to the HERMIT Cohort Summary report takes place after the monthly close, the endorsement variance is processed in CSCS in the month following the reconciliation period. Therefore, FHA records an accrual entry into the general ledger for the month impacted by the reconciling difference to ensure the subsidy expense and underlying obligations are complete and accurate for the current month. The general ledger accrual entry is reversed the following month, as the actual transactions are recorded through the automated CSCS interface.

Condition:

In May 2021, FHA's FACD identified a $3,303 million error with its calculation of the HECM program subsidy and underlying obligations. This error had been undetected since at least September 2020. Once the error was detected, FACD attempted to reverse the erroneous entries in CSCS. However, FACD could not reverse the erroneous transactions due to system limitations and functionality within CSCS. A system solution could not be developed before the end of the fiscal year and a number of manual journal entries were needed to correct the general ledger balances impacted by the erroneous HECM subsidy expense and obligations entries. As part of the September 2021 closing activities, FACD corrected the subsidy expense balance and related proprietary transactions, but could not correct the over-estimate of underlying obligations and the related budgetary entries in the general ledger before year end due to the lack of budgetary resources. Working with the U.S. Department of the Treasury and Office of Management and Budget (OMB), FHA was able to correct the transactions in October 2021 to properly reflect accurate balances in the published September 30, 2021 financial statements.

During the year end audit procedures, we requested that FHA perform a complete review of the HERMIT to CHUMS to CSCS reconciliation process to determine the root cause of the error. At that time, FHA management discovered that FACD staff recorded the monthly HECM subsidy expense and obligations adjusting entries for the difference between the endorsements on the HERMIT Cohort Summary report versus the CSCS Transaction Summary report, without determining whether this difference increased or decreased the cumulative endorsement balance in CSCS. Further, FHA did not use the HERMIT to CHUMS reconciliation as a reasonableness check for the adjusting entry that was recorded in CSCS. As a result of the erroneous monthly adjustments, the cumulative endorsement amount and the related HECM subsidy expense and obligations increased significantly in fiscal year 2021. Specifically, as the reconciling difference between HERMIT and CSCS grew more negative, the adjustment in CSCS continued to be processed as a positive amount. In contrast, the associated monthly accrual to capture the CSCS adjustment in the general ledger was recorded as a negative amount. Although the monthly accrual offset some of the error impact on the CSCS calculated subsidy expense and obligations, it resulted in an abnormal balance in budgetary account 4901, *Delivered Orders, Unpaid*.

Criteria:

The Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* states that effective documentation assists in management's design of internal control by establishing and communicating the who, what, when, where, and why of internal control execution to personnel. Documentation also provides a means to retain organizational knowledge and mitigate the risk of having that knowledge limited to a few personnel, as well as a means to communicate that knowledge as needed to external parties, such as external auditors.

In addition, GAO's standards state that management should design the entity's information system and related control activities to achieve objectives and respond to risks. Further, GAO's standards state that management should internally communicate the necessary quality information to achieve the entity's objectives. Management communicates quality information throughout the entity using established reporting lines. Quality information is communicated down, across, up and around reporting lines to all levels of the entity. Management communicates quality information down and across reporting lines to enable personnel to perform key roles in achieving objectives, addressing risks, and supporting the internal control system.

Cause:

The erroneous monthly entries occurred because of misinterpretation of reconciliation procedures and input values by a new FACD accountant and a new branch chief who were not adequately trained and monitored. Also, the standard operating procedures were not sufficiently detailed and did not provide a sufficient description of the steps or actions required to perform the reconciliation and prepare the accrual entries. Further, FACD management did not timely assess the impact that the erroneous CSCS entries had on various facets of FHA operations and financial accounting and reporting. Once identified, the issue was not adequately analyzed and communicated to the Office of Financial Accounting and Reporting (OFAR). According to FHA, senior leadership was not fully aware of the magnitude of the error.

Effect:

The lack of adequate procedures, proper reconciliations, staff training, and management reviews resulted in a $3,303 million error in the initial version of the September 30, 2021 financial statements. In addition, these control deficiencies led to a risk of noncompliance with laws and regulations, such as the Antideficiency Act.

EXHIBIT A
Material Weakness

Recommendations:

We recommend that the Deputy Asssitant Secretary for Finance and Budget:

1A. Request an opinion from HUD's Office of the Chief Financial Officer's Appropriation Law Division on whether the abnormal balance in account 4901 constitutes a violation of the Antideficiency Act.

1B. Enhance standard operating procedures around system and account reconciliations to ensure that they cover all possible scenarios and are easy to follow.

1C. Appropriately train and monitor new personnel to ensure that they understand and execute the procedures and controls.

1D. Update procedures to clearly define error thresholds that require followup and the communincation process for elevating errors to supervisors, managers, and senior leadership.

1E. Establish clear lines of comminication within and between divisions to ensure that all personnel become aware of issues that may impact their duties and responsibilities.

1F. Strengthen controls over the preparation of HECM-related reconciliations, reviews, and oversight by ensuring that (1) program personnel preparing such reconciliations understand how such reconciliations impact financial accounting and reporting and (2) financial personnel sufficiently understand programs and systems to determine their general ledger impact.

1G. Enhance the quarterly variance analysis to identify the business reasons for changes in account balances and pay specific attention to abnormal balances and activity.

B. <u>Improper Presentation of the Loan Guarantee Liability</u>

Background:

The net potential future losses related to FHA's central business of providing mortgage insurance are reflected in the Loan Guarantee Liability (LGL) in the consolidated balance sheet. As required by SFFAS [Statement of Federal Financial Accounting Standards] No. 2, *Accounting for Direct Loans and Loan Guarantees,* the LGL includes the Credit Reform-related Liabilities for Loan Guarantees (LLG) and the pre-Credit Reform Loan Loss Reserve (LLR).

The LLG is calculated as the net present value of anticipated cash outflows and cash inflows. Anticipated cash outflows include lender claims arising from borrower defaults (i.e., claim payments), premium refunds, property costs to maintain foreclosed properties arising from future defaults and selling costs for the properties. Anticipated cash inflows include premium receipts, proceeds from asset sales and principal and interest on Secretary-held notes.

FHA uses cash flow model assumptions associated with loan guarantee cases subject to the Federal Credit Reform Act to estimate the cash flows associated with future loan performance. To make reasonable projections of future loan performance, FHA develops assumptions based on historical data, current and forecasted programs, and economic forecasts.

EXHIBIT A
Material Weakness

Condition:

During our review of FHA's initial version of the year-end financial statements, we found that the abnormal negative LGL balances in the amount of $17,908 million and $6,184 million at September 30, 2021 and 2020, respectively, were improperly presented within the liabilities section of FHA's balance sheet. FHA's credit program econometric model calculates the present value of net cash flows. When the models predict that future estimated cash inflows will exceed the future estimated cash outflows for FHA's programs in their entirety, the LGL is negative. The abnormal LGL should be classified as an asset in FHA's financial statements in accordance with OMB financial reporting guidance. Once we brought the matter to FHA management's attention, the LGL balances were reclassified to the appropriate asset financial statement line item on FHA's published financial statements and related footnotes.

Criteria:

OMB Circular A – 136, *Financial Reporting Requirements-Revised* states that when the net LGL for all credit programs of a reporting entity is negative, it should be reported as an asset. In addition, the components of the line item must be disclosed.

Cause:

FHA's OFAR Division did not adequately review and implement OMB Circular A-136, *Financial Reporting Requirements-Revised,* to ensure compliance with the financial reporting guidance issued by OMB.

Effect:

The inadequate review and implementation of OMB Circular A-136 increases the risk of improper presentation of the financial statements and material misstatement. By reclassifying the negative LGL as an asset:

- FHA's total assets increased from $158,676 million to $176,584 million at September 30, 2021, and from $131,732 million to $137,916 million at September 30, 2020.
- FHA's total liabilities increased from $55,832 million to $73,740 million at September 30, 2021, and from $50,798 million to $56,982 million at September 30, 2020.

Recommendations:

We recommend that the Director of OFAR:

1H. Strengthen the financial statement review controls by completing a compliance matrix to ensure all balances that are presented and disclosed reflect the most up-to-date finanicial accounting and reporting guidance.

EXHIBIT B
Significant Deficiency

2. Weaknesses in Controls over Econometric Modeling Activities

A. <u>Model Inputs</u>

Background:

The Federal Housing Administration (FHA) is responsible for administering programs that provide mortgage insurance for three primary programs: Single Family, Multifamily, and Healthcare, that have mortgages financed by FHA-approved lenders throughout the United States (U.S.) and its territories, backed by the full faith and credit of the U.S. Government. FHA uses complex econometric modeling techniques to estimate the future cash flows over the life of these loans and determine the cost of the loan guarantees on a present value basis. The program components principally impacted by these activities are the Single Family Forward (SF), Home Equity Conversion Mortgage (HECM), [3] Multifamily, and Healthcare Facilities. [4] The FHA offices principally responsible for the econometric modeling activities for the SF, HECM, and the MF programs are the Office of Evaluations and the Office of Risk Management.

Condition:

During our examination of FHA's econometric models, we found that the controls related to modeling activities need improvements to minimize the precision risks associated with estimating FHA's largest liability on its balance sheet. The accuracy and precision of FHA's LGL estimate is highly dependent upon the use of the most up-to-date, accurate, and complete data as well as the reasonableness of the assumptions. Also, the reliability and completeness of the data inputs are essential to assisting FHA management in predicting the Federal Government's future economic loan guarantee obligations for its programs. During our review of FHA's econometric models, we identified the following:

- The SF credit risk estimation process uses the scheduled Unpaid Principal Balance (UPB), instead of the current UPB, to run credit models. The current UPB represents actual value, whereas the scheduled UPB qualifies as an imprecise estimate that is not adjusted for additional payments of principal. This process is not consistently applied because FHA management uses the current UPB for its MF and HECM econometric models.

- The MF cash flow model inputs contained a loan with a different attribute than the source document. The final source document was accurate, but FHA incorrectly processed the transaction in its Development Application Processing (DAP) feeder system, which resulted in an erroneous input into the MF cash flow model.

- The SF Technical Note states FHA's rationale for routinely estimating the fourth quarter (July through September) loan origination volume as equal to the third quarter (April through June). However, the basis for the decision is not adequately analyzed and reviewed on a regular basis. Further, our review of FHA's SF model identified that FHA's assumption related to the fourth quarter loan volume lacks historical data support. We found that the fourth quarter endorsement volume, on average, was higher than third quarter in the last 5,10, and 29 years through year 2020. In addition. we found significant fluctuations in the loan volume between the fourth quarter and third quarter. In the last 5, 10, and 29 years, the mean percentage

[3] HECM is a program within Single Family.
[4] Healthcare Facilities is a program within Multifamily (herein after, collectively referred to as "MF").

change in loan volume between the fourth quarter and the third quarter was 14%, 8%, and 7%, respectively. In addition, the maximum percentage change between the fourth quarter and the third quarter in the last 5, 10, and 29 years was 25%, 25%, and 41%, respectively.

Criteria:

Federal Financial Accounting and Auditing Technical Release 6: *Preparing Estimates for Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act – Amendments to Technical Release No. 3 Preparing and Auditing Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act,* states that agencies must accumulate sufficient, relevant and reliable data on which to base cash flow projections. It is important to note that the agencies should prepare all estimates and reestimates based upon the best available data at the time the estimates are made. Agencies should prepare and report reestimates of the credit subsidies in accordance with SFFAS No. 2, 18, and 19 to reflect the most recent data available as discussed in the reestimate section of this technical release.

The GAO *Standards for Internal Control in the Federal Government* states that effective documentation assists in management's design of internal control by establishing and communicating the who, what, when, where, and why of internal control execution to personnel. Documentation also provides a means to retain organizational knowledge and mitigate the risk of having that knowledge limited to a few personnel, as well as a means to communicate that knowledge as needed to external parties, such as external auditors.

Cause:

FHA management believes the current data inputs used for each of the models provide the best available data, and are reliable and complete for estimation purposes. Further, FHA management's position is that the data inputs are consistently executed within the models and achieve the agency's modeling objectives for estimating future cash flows and financial reporting purposes. In certain instances, management did not have a documented process in place which provides evidence that certain control activities, such as training, periodic reviews, or management decisions support the current modeling practices, are performed.

Effect:

The use of inappropriate or inaccurate data inputs may impact reliability of estimates and result in errors or a less precise estimated LGL.

Recommendations:

All recommendations for Model Inputs are provided at the end of Exhibit B.

B. <u>Model Documentation</u>

Background:

FHA management is responsible for establishing a process to prepare the LGL estimate and maintain adequate documentation to support its current econometric modeling control activities. The established process should include control activities that assist management in mitigating modeling risks in order to meet the specific estimation and financial reporting objectives. Some examples of control activities include actions such as approvals, reconciliations, performance reviews, verification reviews as well documented policies and procedures. These activities are preventive or detective in nature and should be performed at all levels of the agency. The econometric models used by FHA produce an estimate that is reported as the largest component of the LGL in FHA's balance sheet.

Condition:

The econometric modeling documentation includes various types of documents, such as flowcharts, policy and procedure manuals, narrative descriptions and PowerPoint presentations. The importance of the documentation is paramount to ensuring that a specific process is followed or executed in a consistent manner. In addition, the details within these documents can help users understand the nuances or rationale used to modify or update a current practice. Further, the modeling activities require sufficient and descriptive documentation that is clear and consistent to ensure that appropriate steps are followed to achieve FHA management's intended objective. During our examination of FHA econometric models, we found that:

- A MF loan valued at approximately $7.7 million was excluded from the cash flow results file. FHA management could not provide sufficient evidence that documented the rationale or justification used to exclude the loan.

- Model documentation contained obsolete and inaccurate information, or omitted information. The errors were noted in the following documents:

    - Single Family Budget Model Technical Note
    - Single Family Budget Model User Guide
    - HECM Budget Model Technical Note
    - HECM Single Family Data Warehouse Datamart Dictionaries
    - RMCAP Platform Data Dictionary
    - Multifamily FY 2021 Commercial LLG and LLR Regression Analysis Memo

The consistent application of the appropriate econometric model inputs and the use of the most current documentation are critical to ensuring a more precise estimation of FHA's future cash flows is achieved for its loan guarantee programs.

Criteria:

Federal Financial Accounting and Auditing Technical Release 6: *Preparing Estimates for Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act – Amendments to Technical Release No. 3 Preparing and Auditing Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act states* that documentation must be provided to support the assumptions used by the agency in the subsidy calculations. This documentation will not only facilitate the agency's review of the assumptions, a key internal control, it will also facilitate the auditor's review. Documentation should be complete and stand on its own, i.e., a knowledgeable independent person could perform the same steps and replicate the same results with little or no outside explanation or assistance. If the documentation were from a source that would normally be destroyed, then copies should be maintained in the file for the purposes of reconstructing the estimate.

EXHIBIT B
Significant Deficiency

Cause:

In certain instances, management did not have a documented process in place that provides evidence that certain control activities, such as periodic reviews or management decisions that support the current modeling practices, are performed. Also, FHA management does not regularly update its documentation to reflect the current practices used for its modeling activities.

Effect:

The lack of documented procedures, management's rationale, or justification used for specific events creates the risk that the execution of modeling activities will be performed inconsistently and lead to errors or misstatements in FHA's LGL and related accounts.

Recommendations:

We recommend that the FHA Director of the Office of Evaluation:

2A. Perform a comprehensive analysis for all cohort years and assess the impact that the use of the scheduled UPB instead of the current UPB has on the LGL. If significant based on a quantitative threshold, update the SF cash flow model to incorporate the current UPB data.

2B. Develop and implement a new process to require the annual validation of the fourth quarter endorsement volume estimation method for the SF Forward model. The process should include a management review and approval control component. The process should be documented and should demonstrate that management's estimate is based on the analysis of past experiences, current policy, and market considerations, and, if necessary, incorporate improvement recommendations.

2C. Perform a comprehensive review of the SF and HECM model documentation and update the specific sections with the current practices and procedures required to execute the model activities.

2D. Establish a process that requires the timely review and update of model documentation. The process should include tracking the dates and nature of the revisions.

We recommend that the FHA Director of the Office of MF Production:

2E. Provide training and periodic reminders to field staff and management to ensure that the data fields in DAP and on the final Form HUD-290 are accurate and consistent.

We recommend that the FHA Director of the Office of Risk Management:

2F. Develop and implement written procedures that provide guidance or best practices that should be followed to address data anomalies. At a minimum, these written procedures should include the following: (1) a process for identifying key data attributes that significantly impact the results, (2) the determination of preset thresholds for analyst and management attention, (3) the treatment of data anomalies, such as null values or values that exceed preset thresholds, (4) a process for providing feedback to the upstream data provider(s) for corrective and preventive actions when data integrity issues are detected and management concludes the issue is significant, and (5) a process for preparing documentation to support management decisions.

EXHIBIT C
Status of Prior Year Findings and Recommendations

The Independent Auditors' Report dated November 12, 2020, identified three unimplemented recommendations from the prior-year report 2019-FO-0002, *Federal Housing Administration's Fiscal Years 2018 and 2017 Financial Statements Audit*, and report 2018-FO-0003, *Federal Housing Administration's Fiscal Years 2017 and 2016 Financial Statements Audit*. The Office of Inspector General (OIG) – prior independent auditors – originally made these recommendations to management to correct material weaknesses or significant deficiencies included in the Report on Internal Control Over Financial Reporting; however, the OIG concluded that the deficiencies in internal control no longer met the definition of a material weakness or significant deficiency individually or in combination in fiscal year 2020. Therefore, the OIG recommended that FHA should continue to track and resolve the recommendations under the prior-year report numbers in the Audit Resolution and Corrective Action Tracking System (ARCATS) in accordance with departmental procedures.

Our assessment of the status of the findings and recommendations related to the prior year audits is presented below:

Prior Audits' Findings and Recommendations	***Tracking***	***Fiscal Year 2021 Status***
With respect to FHA's not having effective monitoring and processes in place for its unliquidated obligation balances and to ensure the accuracy of data reported in the financial statements, the OIG recommended that the Deputy Assistant Secretary for Finance and Budget: 1.a. Ensure that $399.1 million identified as invalid obligations in fiscal year 2018 is deobligated as appropriate.	ARCATS 2019-FO-0002-002-I (Final action target date was October 31, 2019)	Repeat. We issued a similar finding as a management letter comment.
With respect to FHA's weaknesses in processing recorded HECM [home equity conversion mortgage] assignments, the OIG recommended that the Director of the Office of Single Family Asset Management: 1.b. In conjunction with the loan-servicing contractor, determine what actions can be taken to ensure that recorded assignments are reviewed in a timely manner after receipt.	ARCATS 2019-FO-0002-002-M (Final action target date was December 31, 2019)	Closed
With respect to FHA's not having effective monitoring and processing controls over its unliquidated obligation balances and using inaccurate data to report on its loan guarantees, the OIG recommended that the Deputy Assistant Secretary for Finance and Budget: 2.a. Ensure that the $270.7 million identified as invalid obligations in fiscal year 2018 is deobligated as appropriate.	ARCATS 2018-FO-0003-002-A (Final action target date was August 31, 2018)	Repeat. We issued a similar finding as a management letter comment.

EXHIBIT D
FHA's Response to Audit Findings and Recommendations

OFFICE OF HOUSING

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

December 6, 2021

MEMORANDUM FOR: CliftonLarsonAllen, LLP

FROM: Susan A. Betts, Housing, Deputy Assistant Secretary for Finance and Budget, HW

SUBJECT: Response to Draft Audit Report on FHA's Fiscal Years 2021 and 2020 Financial Statements

On behalf of the Federal Housing Administration (FHA), thank you for the opportunity to respond to FHA's Independent Auditors' Report. We are pleased to have obtained an unmodified opinion on our financial statements and appreciate the efforts of the independent auditors in conjunction with the Office of the Inspector General (OIG) to provide us with actionable recommendations. FHA is committed to making the changes necessary to strengthen controls over financial reporting and modeling activities and has prioritized this work amongst our staff. Working collaboratively with the auditors, we will continue to identify improvements and implement changes needed to address the internal control findings identified.

Report on Internal Control – Material Weakness

Finding 1: Weaknesses in Controls over Financial Accounting and Reporting

FHA agrees with this finding and recommendations. FHA has already begun implementing several of the recommendations identified in the finding and will continue to implement the changes necessary to address the remaining recommendations in FY 2022. To address control weaknesses surrounding financial reporting, FHA will:

- Finalize communications with HUD's Appropriation Law Division
- Review and update standard operating procedures, with a particular focus on systems and reconciliations identified during the financial statement audit.
- Enhance training for new and existing personnel as well as improve management's review and monitoring processes.
- Review error thresholds that require follow up and communicate the process for elevating errors to supervisors, managers, and senior leadership. We have issued preliminary error thresholds and communication protocols, when those errors are discovered. These preliminary thresholds and protocols will be further reviewed and updated as necessary.

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- Provide additional training and review sessions to all staff and managers involved in HECM-related reconciliations, reviews, and oversight to ensure understanding of analytical procedures and financial tie points as they relate to accounting and reporting as well as enhance their understanding of the programs and systems involved in the HECM process and its impact on the general ledger.
- Implement additional variance analyses at lower levels of the organization, in addition to existing FHA-wide quarterly variance analysis and OFAR's General Ledger Division quarterly variance analysis.
- Implement a compliance matrix and formal review process of new and existing financial accounting and reporting guidance, and its impacts on FHA's financial reporting.

Report on Internal Control – Significant Deficiency

Finding 2: Weaknesses in Controls over Econometric Modeling Activities

FHA agrees with the findings and associated recommendations. To address control weaknesses surrounding the model inputs and documentation, FHA will:

- Perform a comprehensive analysis for all cohort years and assess the impact of the use of the scheduled UPB instead of the current UPB has on the LGL. We will document management's determination of significance and materiality of the differences and, subsequently have FHA's Model Risk Governance Board decide on the use of current UPB data to update the SF cash flow model or approve the use of scheduled UPB data.
- Update the annual Single Family Model Risk Governance model assumption review process and documentation to include the Fiscal Year fourth quarter endorsement volume estimate methodology.
- Perform a comprehensive review of the SF and HECM model documentation and update the specific sections with the current practices and procedures required to execute the model activities.
- Proceed with the timely review and update of model documentation to include date tracking and capture revision descriptions.
- Implement the written procedure developed to address data anomalies.