U.S. Department of Agriculture

Office of Inspector General
Midwest Region

Audit Report

Rural Development Compliance with the Improper Payments Information Act Of 2002

Report No. 04601-0010Ch
January 2005

UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

WASHINGTON, D.C. 20250

DATE: January 27, 2005

REPLY TO
ATTN. OF: 04601-0010-Ch

SUBJECT: Rural Development Compliance with the Improper Payments Information Act of 2002

TO: Gilbert Gonzalez
Acting Under Secretary
Rural Development

THROUGH: John M. Purcell
Director
Financial Management Division

This report presents the results of our audit of Rural Development (RD) mission area's compliance with the Improper Payments Information Act (IPIA) of 2002,[1] and the requirements and implementing guidance issued by the Office of Management and Budget (OMB) and the Office of the Chief Financial Officer (OCFO). The audit was conducted as part of a Department-wide audit of USDA's implementation of the IPIA. We initially intended to evaluate the actions taken by the Rural Housing Service (RHS). However, during the audit we expanded the scope of our audit to include a limited review of the implementation of the IPIA by the other agencies of RD – the Rural Business-Cooperative Service (RBS) and the Rural Utility Service (RUS). Our audit disclosed that RD had not taken sufficient action to comply with the IPIA and the guidance provided by OMB and OCFO.

BACKGROUND

The IPIA requires the head of each agency to annually review all programs and activities the agency administers to identify those that may be susceptible to significant improper payments. For each program or activity identified, the agency is required to estimate the annual amount of improper payments and, if the estimate is over $10 million, report the estimate to Congress along with the actions the agency is taking to reduce those improper

[1] Public Law (P.L.) 107-300, November 26, 2002.

payments. OMB issued implementing guidance on May 21, 2003. This guidance required each agency to report the results of its estimates for improper payments, and corrective actions, in the Management Discussion and Analysis (MD&A) section of the U.S. Department of Agriculture's (USDA) Performance and Accountability Report (PAR) for fiscal years ending on or after September 30, 2004. OMB also defined significant improper payments[2] and specified that if programs or activities exceeded this threshold, the estimate developed and reported to Congress was to be statistically valid.

The OCFO, designated as the lead agency for coordinating and reporting the Department's efforts to implement the IPIA, provided instructions to agencies in August and October 2003. The August memorandum transmitted Departmental policy and instructions for implementing program reviews to identify erroneous payments. The instructions included the detailed guidance from OMB regarding implementation and requirements for the IPIA.[3] The guidance from OMB provided that agencies examine the risk of erroneous payments in all programs and activities they administer. In a memorandum, dated October 9, 2003, OCFO provided additional guidance to RD on implementing the requirements of the IPIA and requested that all agencies provide an IPIA implementation status report.[4] The memorandum required that all programs with outlays of $10 million or more annually must undergo a risk assessment to determine if there is significant risk of erroneous payments. A template was provided which listed five categories of risk factors: internal control, documentation, potential fraud, programmatic, and financial. The memorandum also requested: (1) A chart detailing dates for risk assessments that have been completed; (2) planned dates for completion of remediation plans for programs with significant erroneous payments; and (3) planned dates when the agency will have determined its baseline plus improvement targets for the next 3 fiscal years (FY).

RD reported 33 programs with outlays of $7.6 billion that met OCFO's threshold for performing risk assessments. These programs included, among others, the Single Family Housing and Multi-Family Housing Loan Programs, Rental Assistance, Business and Industry Loan Program, and Electric Programs.

OBJECTIVE

The objective of the audit was to evaluate the actions taken by RD to assess the susceptibility of its programs to improper payments in accordance with the IPIA and the implementing guidance of OMB and OCFO.

SCOPE AND METHODOLOGY

We performed an audit of RHS compliance with the Improper Payments Information Act at RD headquarters in Washington, D.C. During the audit, we revised our scope to also

[2] OMB defined significant improper payments as annual erroneous payments exceeding both 2.5 percent of program payments and $10 million. See OMB Memorandum M-03-13, dated May 21, 2003.

[3] OCFO Guidance, Requirements for Implementing IPIA, August 11, 2003.

[4] OCFO Guidance, Update on Requirements for Implementing the IPIA, Public Law 107-300, dated October 9, 2003.

include contacting RBS and RUS to determine how they initially assessed their programs with the view to comparing their procedures with RHS.

We conducted our fieldwork from March through May 2004. The audit was performed in accordance with Government Auditing Standards.

We judgmentally selected 6 of 12 applicable RHS programs based on total outlays for FY 2004, and evaluated the risk assessments using guidance set forth by OMB and the OCFO for implementing the Act. We also evaluated the documentation used to support and rank the risk factors. For those programs designated as high risk to improper payments, we reviewed the agency's efforts to reduce the improper payments. To accomplish our audit objectives, we reviewed:

- Risk assessments and methodologies used
- The IPIA, OMB guidance, and OCFO directives
- FY 2004 budget summaries in comparison to agency information
- RD's Management Control Reviews and State Internal Reviews
- RHS' FMFIA Reports for 2002 and 2003
- Prior Government Accountability Office (GAO) and OIG reports
- GAO's Internal Control Management and Evaluation Tool

We also conducted interviews with RHS Acting Deputy Administrators, directors, and program officials. In addition, we reviewed risk assessments that RBS and RUS submitted to the OCFO. We conducted interviews with the staffs of those agencies to determine their process for conducting risk assessments since they had not developed a formal process to guide the assessments.

FINDING AND RECOMMENDATION

RD Agencies Need To Improve Their Program Assessments

The agencies within the RD mission area had not performed effective assessments of their programs to identify where they were susceptible to significant amounts of improper payments. The risk assessments performed were generally limited in scope, not adequately documented, and based primarily on empirical data. According to RD officials, this occurred because they did not have a clear understanding of the implementation requirements for assessing their programs. As a result, risk assessments that were performed may not accurately reflect RD programs' susceptibility to improper payments and there was reduced assurance that information to be reported in the FY 2004 PAR would fulfill the requirements of the IPIA.

RD responded to OCFO in November 2003 that all of its applicable programs had been assessed and reported that the RD mission area had only one program, RHS' Section 521 Rental Assistance, identified as potentially being susceptible to significant improper payments and meeting the requirements for a statistically valid estimate of improper payments.

Rural Housing Service

RHS officials prepared risk assessments for 12 programs because their outlays exceeded $10 million. The officials said they were unclear on how to assess their programs by following the OMB and OCFO guidance. Employing the suggested format provided by OCFO, RHS officials used their program knowledge and information on financial systems controls obtained from their Finance Office to develop risk factors for the five categories the OCFO suggested. Program managers then discussed the factors and some of the controls in place, and rated their programs' susceptibility to improper payments based upon their knowledge of the programs. We judgmentally selected 6 of the 12 completed assessments to evaluate the agency's process in determining program vulnerability to improper payments. We noted that RHS performed risk assessments of each program individually; however, our evaluation of the assessments disclosed that the ranking (high, medium, low) of risk factors identified in the assessments was not always supported by the documentation provided, specifically to include controls that would tend to obviate the risk. Further, the risk factors identified did not encompass all known areas of vulnerability, although some had been reported in RHS internal reviews or OIG audit reports.

We discussed the results of our audit with RHS officials and they generally concurred with our findings. RHS officials stated that they did their best to properly assess their programs but stated that OCFO did not instruct them to develop a risk assessment process and they believed OMB's guidance was not clear regarding how to perform risk assessments.

The following examples illustrate the conditions found.

Rental Assistance (RA) Program

RHS' initial assessment of the Multi-Family Housing (MFH) RA program determined that there was a risk of significant improper payments and that the program met the threshold to perform a statistical estimate. However, the risk assessment performed by the agency did not support this conclusion. We noted that only one of the 20 risk factors identified by RHS in the initial risk assessment was rated as a high risk and the overall risk rating of the program was listed as low. During our audit, MFH officials completed a revised assessment that better supported the program's designation as high risk, but the assessment as reported to OCFO still rated the overall risk of improper payments to the program as low. When we pointed this out, MFH officials confirmed that the overall risk to the program should have been reported as high. We found that of the nine risk factors used in the revised assessment, four were rated as moderate risk, three as low risk, and 2 as a high risk for improper payments. The two rated as high risk were essentially the same. The two factors – Tenant Income Verification and Applicant/Borrower Failure To Estimate Income Correctly - related to the same issue; that tenant certifications were incorrect due to inaccurately reported income and management companies were not properly verifying income and adjustments reported by tenants resulting in both overstated and understated rental subsidies being paid by RHS.

The assessment mentioned a recent (2003) OIG audit for the State of Florida,[5] stating that it disclosed false reporting of tenant income. The audit report also noted that RHS had not fully implemented controls over the tenant certification process to monitor and improve the quality of certifications. RHS officials had not included an earlier (1999) OIG audit[6] in the assessment that had projected erroneous rental subsidies in six States in excess of $14 million for the same reasons. At this time, the 12 recommendations of this (1999) report remain open and as reported in the 2003 OIG audit, controls over the tenant certification process recommended in the earlier audit had not been fully implemented.

RHS officials stated they knew this program was high risk due to GAO and OIG audit reports and their own internal reviews but by the end of our fieldwork they had not developed corrective actions to address the improper payments. They were in the process of developing a statistical sampling plan for use in estimating the error percentage and amount of improper payments in RA for reporting in the PAR and have since initiated the fieldwork. The RHS plan based the sample on the universe of multifamily properties that receive rental assistance, selecting a 2 percent sample of the properties. However, as 12 recommendations from our 1999 audit remain open, it is questionable how RHS can address corrective actions for the RA improper payments in the PAR.

Other Multi-Family Housing Programs

RHS' initial risk assessments for both direct and guaranteed Rural Rental Housing (RRH) loan programs determined they were not susceptible to significant improper payments. The programs were assessed again during our audit and RHS officials again rated them as having low risk for improper payments. We noted that the risk assessment performed for MFH direct loans included other programs, the Farm Labor Housing (FLH) Loan and FLH Grant Programs, and the Housing Preservation Grant Program. The programs were rated as one, with the same risk factors being applied to each. The IPIA, and OMB and OCFO guidance, state that each program or activity must be reviewed to determine those which may be susceptible to significant improper payments. Each of these programs should have been assessed separately.

Our audit of the program assessments as completed by RHS officials found that known vulnerabilities were not always identified as risk factors and support for the ranking of risk factors that were identified was not always adequate. As an example, a joint OIG/RHS initiative[7] was conducted to identify owners and management agents that

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[5] Audit Report 04004-3-At, Rural Rental Housing Program, Tenant Income Verification, June 2003.

[6] Evaluation Report 04801-0004-Ch, Rural Rental Housing Program, Tenant Income Verification Process, February 1999.

[7] Evaluation Report 04801-0006-Ch, Rural Rental Housing Program, Uncovering Program Fraud and Threats to Tenant Health and Safety, March 1999.

misused Government funds. The initiative targeted 32 suspect RRH owners and management companies in 13 States. Each of the 32 owners and management companies also used identity-of–interest companies to provide services or supplies and 18 were found to have improperly withdrawn over $4.2 million from apartment complex accounts. The risk assessments completed for both the Direct and Guaranteed Loan Programs included identity of interest as a program risk factor. However, in each assessment, it was rated as a low risk for improper payments. The only support provided for this ranking was a reference to a 1994 OIG Fraud Alert Bulletin, which did not support the low risk rating given to this risk factor. In addition, neither assessment identified the charging of unallowable or unsupported costs to apartment complexes, but the joint initiative had identified that over $3 million in unallowable or unsupported costs had been charged.

At the exit conference, RD officials questioned whether misuse of RRH project funds constituted an "improper payment" of Federal funds. The Act defines a payment as being derived from Federal funds or other Federal resources. The funds misused by owners and management agents relating to apartment complexes are indirectly derived from the Federal funds provided by RHS. The owners of the complexes receive a subsidy in the form of interest credit as an incentive to provide housing for tenants in rural areas. Although there is no actual payment to the owners, RHS is obligated to pay Treasury the difference in the going rate of interest at the time funds are borrowed and the subsidized payment they receive from the owners. RHS may also provide rental assistance to the project to further subsidize the rent of eligible tenants. In return for interest credit and rental assistance subsidies, the owners contractually agree to use those funds in the manner prescribed in the contract. The owners are prohibited from charging unallowable and unsupported costs, or making unapproved withdrawals for return on equity and from the reserve accounts.

The aforementioned joint study, coauthored by OIG and RHS, states, in part:

> "The misuse of funds jeopardizes the integrity of the RRH Program in several ways. First, sufficient funds are not always available to repair physical deterioration of apartment complexes. As a result, tenants may be living in housing that is not maintained or repaired in a timely manner which, if left unchecked, could result in housing with health and safety deficiencies. The deterioration, if unabated, also threatens the Government's security interests in the properties. Misuse may also burden low-income and elderly tenants with higher rents. <u>Finally, it increases the Government's rental assistance subsidy costs</u>" (emphasis added).

As a result, we concluded the linkage of misuse of RRH project funds to an improper payment of Federal funds had been adequately established (and formally agreed to by RD).

At the time of our audit, RHS had been working on regulatory and policy changes since 1999 and plan to issue new program regulations soon to address 13 of the 20 measures they had committed to. However, until the new program regulations are issued and implemented, the risks to the program will continue. These measures are critical to preventing abuse, as discussed above, and improving the integrity of the RRH Program.

Single Family Housing

RHS' initial risk assessments for both Single Family Housing (SFH) Direct and Guaranteed Loan programs determined that they were not susceptible to significant improper payments. However, we found that RHS officials had included several programs in one risk assessment. The SFH Direct Low Income Housing Loans, Housing Repair Loans, Housing Repair Grants, and Self-Help Technical Assistance Grants programs were combined into one assessment; however, these programs each had different objectives and should have been assessed separately. RHS officials should have identified specific risk factors needed to assess vulnerabilities applicable to those programs and to provide a valid indicator of the programs susceptibilities to improper payments.

We also noted that SFH officials did not always provide support to justify the ranking of risk given to risk factors. For instance, they identified income miscalculations as a risk factor in the assessment for the SFH Direct Loan Program, ranking it as a low risk. The support provided for this ranking were program regulations that included nothing to justify the low ranking. However, we noted that the Nationwide State Internal Review (SIR) Summary Report for FY 2002 had reported that income/repayment ability for SFH loan applicants was not properly calculated or verified in 55 percent of the States reviewed. SIRs procedures consider any deficiency that occurs in at least 20 percent of the States reviewed to be a nationwide weakness. The determination of the ranking of this factor should have reflected this.

Rural Business – Cooperative Service and Rural Utilities Service

RBS and RUS were not within the original scope of our audit: however we decided to contact these agencies to determine if either had established a process to assess their programs that could be adopted by RHS. Our interviews with officials in these agencies disclosed that the implementation of the OCFO guidance by RUS and RBS was extremely limited. For instance, an official with RUS's Waste and Water Program calculated 2.5 percent of their programs funding and determined that if that amount was under $10 million, those programs had no risk. This type of calculation, and the resulting determination of the risk of improper payments the programs may be susceptible to, do not meet the intent of the IPIA nor the OMB and OCFO guidance. The IPIA requires all agencies to annually review all programs and activities to identify those that may be susceptible to significant improper payments. OMB and OCFO guidance requires agencies to base their decisions regarding program susceptibility to improper payments on a systematic review of their programs with outlays exceeding $10 million dollars. The OMB definition for significant improper payments sets a minimum threshold, which after being met requires specific actions by the agencies and the reporting of those actions to Congress.[8] Determining that 2.5 percent of a program's funding does not exceed $10 million has nothing to do with the level of risk that the program may have to improper payments.

RBS officials told us they did not understand OMB's and OCFO's guidance and were unclear how to assess their programs. The officials stated they reviewed the sample list of risk factors provided by OCFO and, taking those exact factors, determined those that were applicable to their programs. They then ranked the sample risk factors as having a low or medium risk of improper payments based on their knowledge of the programs and reported this to the OCFO. As with RUS, RBS had not assessed their programs on an individual basis, identifying risks associated with them. Instead, they used the sample risk factors provided by OCFO, many of which were not applicable to the programs.

By not properly conducting these required risk assessments, the agencies' management has not identified the risks that could impede the efficient and effective achievement of the goals and objectives for each of its program. Identification of risks would allow management to decide upon the internal control activities required to mitigate those risks and achieve the internal control objectives of efficient and effective operations, reliable financial reporting, and compliance with laws and regulations.

Agencies have been required for many years to assess the internal controls over their programs and financial management activities pursuant to the Federal Managers' Financial Integrity Act (FMFIA) of 1982 and other legislative and administrative initiatives. The FMFIA requires ongoing evaluations of the adequacy of the systems of internal accounting and administrative control of each agency and requires the head of each agency to issue an annual report that identifies material weaknesses identified through the assessment process and the actions planned to correct those weaknesses. With this knowledge and experience, agencies should be able to assess their programs and activities for improper payments, and determine those that are susceptible to significant improper payments, and meet the reporting requirements imposed by the IPIA.

Summary

RD agencies had not performed risk assessments that would be effective in identifying all programs susceptible to improper payments. Although RHS officials had performed risk assessments to identify factors unique to their programs, they had not included all known program risks and had not always properly supported their ranking of the risk of each factor to improper payments. RBS and RUS did not develop risk factors specific to their

[8] OMB Memorandum M-03-13, Improper Payments Information Act of 2002.

programs; thus, the assessments they provided to OCFO did not represent the status of programs with respect to the risk of improper payments. Because of the manner in which programs were assessed, there is reduced assurance that programs susceptibility to improper payments was identified and the requirements of the IPIA met.

In order to provide the insights needed to evaluate program's susceptibility to improper payments, RD needed to conduct a risk assessment employing a methodology such as:

- Identification of program risk factors;
- Identification of the control measures prescribed to mitigate those risks and an evaluation as to their adequacy; and
- Tests of transactions to ensure the controls are functioning as prescribed; the results of this examination would yield the estimated degree of noncompliance.

As a result of our evaluation of the implementation of the OCFO guidance by RD and the other agencies included within our overall scope, we concluded that the requirements and instructions issued by the Department need to be made more prescriptive, detailed, and clarified. We have made a recommendation to that effect to OCFO in our rollup report to the Department.

RECOMMENDATION

Conduct more thorough risk assessments of all programs with outlays of $10 million or more by: developing criteria to identify program vulnerabilities, determining acceptable risk levels, ranking the risk factors, evaluating the design and the functionality of the internal controls in place to mitigate improper payments, and establishing controls to ensure the timely and accurate completion of the assessments.

AGENCY POSITION

RD concurred with the recommendation in their response, dated December 29, 2004 (see exhibit A). RD agreed to conduct risk assessments for their programs in accordance with the issued OCFO guidance and to complete all risk assessments by April 30, 2005. However, also in the response, RHS disputed which specific risk factors are to be considered when applying the IPIA, stating that a multi-family development that has no rental subsidy is not subject to review under the IPIA because RHS makes no direct payment of Federal funds to a multi-family property that does not receive rental assistance.

OIG POSITION

We concur with the management decision. To achieve final action, RD needs to comply with the effective OCFO guidance and complete corrective action in accordance with the specified timeframes.

Regarding the matter of the IPIA's applicability to projects which do not receive rental assistance, those projects receiving interest credit would be nonetheless impacted, as interest credit is a rental subsidy. RHS asserts that it is not a risk factor based upon its "interpretation of the IPIA." We suggest that RHS obtain an opinion from the Office of the General Counsel to resolve this issue.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing the corrective action taken or planned and the timeframes for implementation. Please note that the regulation requires management decision to be reached on the finding and recommendation within a maximum of 6 months from report issuance, and final action be taken within 1 year of management decision.

We appreciate the courtesies and cooperation extended to our staff during this review.

/s/
ROBERT W. YOUNG
Assistant Inspector General
for Audit

EXHIBIT A-AGENCY RESPONSE

United States
Department of
Agriculture

Rural Development

Operations and
Management

Washington, DC
20250

DEC 29 2004

SUBJECT: Rural Development Compliance with the Improper Payments Information Act-Official Draft (Audit No. 04601-001-CH)

TO: Robert W. Young
Assistant Inspector General for Audit
Office of Inspector General
U. S. Department of Agriculture

The following is Rural Development's response to the recommendation in the subject audit:

Recommendation No. 1

Conduct more thorough risk assessments of all programs with outlays of $10 million or more by: (1) developing criteria to identify program vulnerabilities, (2) determining acceptable risk levels, (3) ranking the risk factors, (4) evaluating the design and the functionality of the internal controls in place to mitigate improper payments, and establishing controls to ensure the timely and accurate completion of the assessments.

Response:

Rural Development concurs with the recommendation.

Rural Development will be following the guidance provided by the Office of the Chief Financial Officer (OCFO) regarding the conducting of risk assessments.

Risk assessment for programs with less than $200 million in outlays will be completed by January 28, 2005, and reviewed by OCFO.

Risk assessments of programs with over $200 million in outlays will be reviewed and discussed in OCFO's monthly Improper Payments Information Act Working Group meetings.

All risk assessments will be completed by April 30, 2005.

Rural Housing Service's (RHS) review of the report raised an issue with respect to the application of the Improper Payments Information Act (IPIA) to the operations of a multi-family property. The Office of the Inspector General (OIG) stated in the report that a precedent was set when RHS and the Office of Inspector General (OIG) jointly issued a statement in a prior audit that misuse of funds for operations could lead to higher rental subsidy costs. While OIG believes this to be an indirect link, it is considering it a risk factor for IPIA for the multi-family loan programs.

Multi-Family Housing agrees that the misuse of funds for operations could lead to higher rental subsidy costs. This is an appropriate risk factor for the Section 521 Rental Assistance Program, which is the U. S. Department of Agriculture's (USDA) rental subsidy program. However, a multi-family development financed under Sections 514, 515, or 516 that has no rental subsidy is not subject to this risk factor with respect to the IPIA. RHS makes no direct payment of federal funds to a multi-family property that does not receive rental assistance. The IPIA defines a payment as "…any payment made by a federal agency… AND derived from federal funds…" (emphasis added). The only payments made to multi-family properties by RHS are in the Rental Assistance program, and those payments are subject to the IPIA.

RHS has instituted a number of controls to address issues raised by OIG regarding identity of interest contractors and property management fee payments. OIG has recognized RHS's attempts to mitigate risks associated with the operations of the multi-family program. Stretching the applicability of the IPIA to the operations of a multi-family property creates an unnecessary duplication of oversight, monitoring and accountability on the part of the owner and the Agency. RHS has systems and tracking in place to address multi-family operational issues without being subject to the IPIA requirements.

Finally, RHS concurs that program vulnerabilities and risk factors do exist in the various multi-family programs, and it continues to design and implement measures to reduce USDA's risk in these areas. However, based on RHS's interpretation of the IPIA, those risk factors are not related to an improper payment.

This information is being presented in order to reach management decision on the subject audit. If you have any questions or need additional information, please contact Walter Wright of my staff at (202) 692-0089.

John Lussmann

FOR JOHN M. PURCELL
Director
Financial Management Division

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