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Office of Inspector General
Midwest Region
Audit Report

# Rural Development Compliance With Federal Managers' Financial Integrity Act Reporting Requirements

OFFICE OF INSPECTOR GENERAL • USDA •

**Report No.**
**85401-4-CH**
**MARCH 2002**

UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250

DATE: March 20, 2002

REPLY TO
ATTN OF: 85401-4-Ch

SUBJECT: Compliance With Federal Managers' Financial Integrity Act Reporting Requirements

TO: Michael E. Neruda
Deputy Under Secretary
Rural Development

ATTN: Sherie Hinton Henry
Director, Financial Management Division
Rural Development

This report presents the results of our audit of Rural Development's Compliance with the Federal Managers' Financial Integrity Act (FMFIA) in fiscal year 2001. Rural Development's response to the official draft, dated February 26, 2002, is included in its entirety as exhibit B, with excerpts and the Office of Inspector General's position incorporated into the Findings and Recommendations section of the report.

Based on the information contained in the response, we have reached a management decision on Recommendation No. 6. Please follow your agency's internal procedures in forwarding documentation for final action to the Office of the Chief Financial Officer. We have not reached management decisions on Recommendations Nos. 1, 2, 3, 4, 5, 7, 8, 9, and 10. Management decisions can be reached when Rural Development provides the additional information outlined in the report section, OIG Position.

In accordance with Department Regulation 1720-1, please furnish a reply within 60 days describing the corrective actions taken or planned and the timeframes for implementation of those recommendations for which management decisions have not yet been reached. Please note that the regulation requires a management decision to be reached on all findings and recommendations within a maximum of 6 months from report issuance.

/s/
RICHARD D. LONG
Assistant Inspector General
for Audit

# EXECUTIVE SUMMARY

## RURAL DEVELOPMENT
## COMPLIANCE WITH FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT REPORTING REQUIREMENTS

## REPORT NO. 85401-0004-CH

## RESULTS IN BRIEF

This report presents the results of our audit of Rural Development's (RD) compliance with the reporting requirements of the Federal Managers' Financial Integrity Act (FMFIA). Our objective was to determine whether RD conducted effective internal control reviews to identify material internal control weaknesses and reported those weaknesses through the FMFIA process.

Although the agency had made an effort to comply with the FMFIA, we found that RD's process does not ensure that all material weaknesses would be identified and reported. In the past 10 years, RD found only 3 of the 23 (13 percent) material internal control weaknesses identified in Section 2 of the FMFIA report. (The vast majority had been reported by OIG.) RD developed and implemented a detailed process to identify and report internal control weaknesses, but the effectiveness of its reporting process was diminished since it employed a definition of a material weakness that did not include quantitative or sufficient qualitative characteristics. Specifically, RD used the broad definition of a material weakness put forth by the Office of Management and Budget, which stated that an agency should report "a deficiency that the agency head determines to be significant enough to be reported outside the agency." This indefinite guidance allowed RD's senior managers to dismiss an internal control weakness, identified by program staff, that could result in a serious shortfall in funding available to adequately repair and maintain the Multi-Family Housing portfolio. RD estimated that by fiscal year 2005, $850 million could be necessary to ensure safe and sanitary housing for low-income residents.

We also found that RD did not identify a level of risk for individual controls within each program, but instead assessed an overall risk level for each program being reviewed. RD's lack of risk assessment for individual controls meant that high risk areas would not be reviewed as often as needed. Conversely, RD would be diverting valuable agency resources in reviewing controls that had a low risk of not achieving a control objective.

Finally, we found that RD, through its Financial Management Division (FMD), had not provided adequate guidance over the FMFIA process. Program staff were allowed to identify and review key internal controls without ensuring that they would fulfill FMFIA reporting requirements. Furthermore, RD did not utilize a key component of the FMFIA process, State Internal Reviews, in identifying and reporting nationwide trends of internal control problems.

## KEY RECOMMENDATIONS

We recommend that RD develop and implement a definition of a material weakness that contains both qualitative and quantitative characteristics and properly reflects the relative risk and significance of deficiencies. In addition, we recommend that the agency include the $850 million finding from its review of the Multi-Family Housing Program in the next FMFIA report. RD needs to develop clear and comprehensive control objectives and techniques, and accompanying review guides for their programs, that will adequately monitor their effectiveness. Furthermore, RD should establish risk level assessments for individual control objectives, and use those risk assessments to determine the scope of RD's internal control reviews.

## AGENCY RESPONSE

In their response to the official draft report, dated February 26, 2002, RD officials agreed with the majority of the findings and recommendations as presented, and are in the process of taking corrective actions. Agency officials did, however, express some disagreements with Recommendations. Nos. 1 and 2, and the actions being taken on these did not fully address the problems noted.

## OIG POSITION

Based on RD's response, we have reached a management decision on Recommendation No. 6. We will continue to work with the agency on the corrective actions needed to address Recommendations Nos. 1 and 2. Management decisions can be reached on the remaining recommendations once RD has provided us with the information specified in the OIG Position sections of the report.

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# INTRODUCTION

## BACKGROUND

In 1982 Congress passed the Federal Managers' Financial Integrity Act, or FMFIA (31 U.S.C. 3512), that requires agencies to develop cost-effective internal accounting and administrative controls to ensure that Federal programs are operated efficiently, effectively, and in compliance with relevant laws. The FMFIA also requires that the head of each agency evaluate internal controls annually and report to the President and the Congress on whether the agency's system of internal controls complies with standards prescribed by the Comptroller General. An agency's internal control systems should provide reasonable assurance that the following objectives are met: (1) Obligations and costs comply with applicable laws; (2) funds, property, and other assets are safeguarded from waste, loss, or mismanagement; and (3) revenues and expenditures are properly recorded and accounted for to permit the preparation of reliable financial and statistical reports and to maintain accountability over assets.

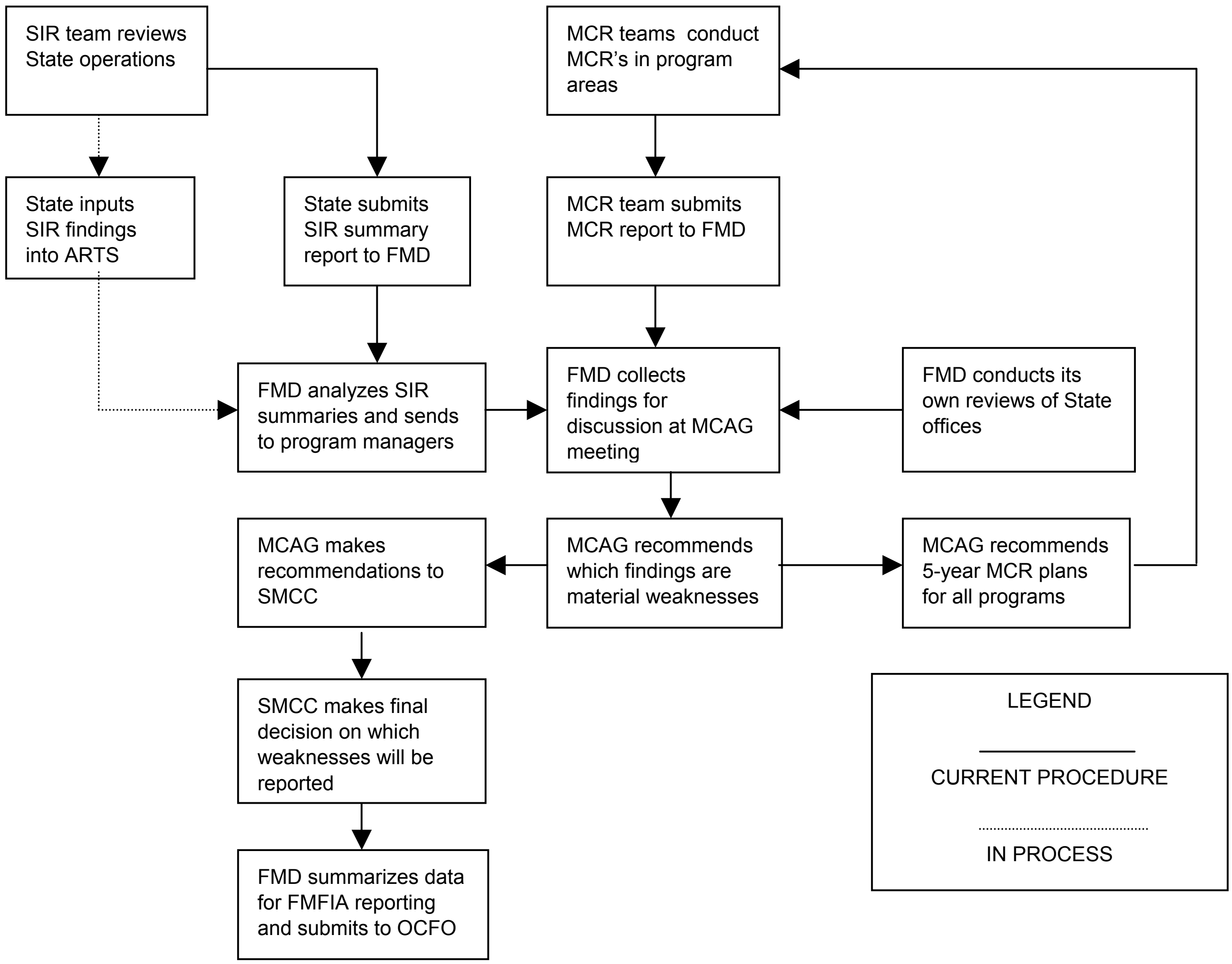
The FMFIA has two sections that describe reporting procedures for executive agencies. Section 2 of the Act requires each agency to establish internal accounting and administrative controls in accordance with standards prescribed by the Comptroller General, and to report to Congress and the President annually on the agency's compliance with the requirements cited above. Section 4 requires each agency to report on whether its accounting system conforms to the principles and standards prescribed by the Comptroller General. For any material internal control weaknesses identified in the FMFIA report, a schedule for corrective action must be included.

The FMFIA delegates responsibility for guidance on reviewing the internal controls to the Office of Management and Budget (OMB). OMB developed Circular A-123 to provide guidelines on improving the accountability and effectiveness of Federal programs and operations by establishing, assessing, correcting, and reporting on management controls. Circular A-123 places the responsibility on each agency to identify its internal controls and establish a system to review and report on the effectiveness of those controls.

In an attempt to comply with OMB Circular A-123, each division within Rural Development (RD) documented its key internal controls, called control objectives and techniques (COTS). The COTS identify key internal control objectives, the associated risks to those objectives, and the techniques used to ensure the objectives were met. Additional guidance on the establishment of an internal control framework is provided by the Treadway Commission Report, Internal Control – Integrated Framework. This report provides both the public and private sectors with a standard to assess internal control systems. It defines internal control as a process designed to provide reasonable assurance for achievement of objectives in: (1) Effectiveness and efficiency of operations; (2) reliability of financial reporting; and (3) compliance with applicable laws and regulations.

The Financial Management Division (FMD) of RD is responsible for overseeing the entire FMFIA reporting process. The FMD ensures that each division within RD reviews key internal controls. Using the COTS as a guide, each RD division reports the existence of any material internal control weaknesses, through the Management Control Review process. In addition, the FMD compiles data from audit and investigative findings from outside agencies, such as the Office of Inspector General (OIG) and the General Accounting Office (GAO), State Internal Reviews (SIR), and its own FMD reviews. The findings disclosed from all reviews are discussed at meetings of the Management Control Advisory Group (advisory group). Below is a flowchart of RD's FMFIA compliance process.

## FLOWCHART FOR THE FMFIA REPORTING PROCESS IN RD




An advisory group was established for each agency division in order to discuss the results of the MCR and FMD reviews. Each advisory group is composed of a designated Management Control Officer (the FMD Director), an RD division representative, and one State director. In addition, there are representatives from the administrative area within Operations and Management, policy and planning, the Office of Community Development, and field offices. Each advisory group hears presentations of findings from their MCR and FMD reviews in order to develop a 5-year MCR plan and decide whether the internal control weaknesses identified need to be elevated to the Senior Management Control Council (SMCC). The SMCC includes the Deputy Under Secretary for Operations and Management, the three Agency Administrators, and three State Directors (on a rotational basis). The SMCC meets twice a year and makes recommendations concerning material weaknesses that warrant disclosure in the FMFIA report.

## OBJECTIVES

The objectives of this audit were to evaluate whether RD was conducting effective internal control reviews in order to identify any material internal control weaknesses, and also to evaluate the sources and methods RD used in identifying and disclosing material internal control weaknesses through the FMFIA reporting process.

## SCOPE

We performed our fieldwork at the RD National Office in Washington, D.C., and interviewed staff from both the National Office and the Information Resources Management (IRM) Division in St. Louis, Missouri. Our audit covered RD's reporting process for Section 2 of the FMFIA for FY 2000 in three agencies: Rural Business Service (RBS), Rural Housing Service (RHS), and Rural Utilities Service (RUS). Preliminary audit results required that we expand our scope. As a result, we reviewed FMFIA reports for fiscal years 1991 through 2000 relating to RD programs. We coordinated the audit with the Midwest Region audit of the RD financial statements to supplement coverage of the agency's SIR's conducted at State offices.

The audit was conducted in accordance with Government Auditing Standards established by the Comptroller General of the United States.

## METHODOLOGY

We reviewed FMD's procedures for identifying and assessing internal controls and collecting data and summarizing the results for the annual FMFIA report. FMD collects this data from MCR's, the audit tracking system, SIR's, and FMD reviews. We reviewed Federal regulations, OMB guidance, Departmental regulations, and RD instructions. In addition, we conducted interviews with Headquarters officials from FMD, RHS, RBS, and RUS, as well as the IRM division in St. Louis, Missouri, and with officials from OMB. We reviewed RD's management control system including FMD reviews, MCR reviews, SIR reviews, the Audit Reports Tracking System (ARTS), and obtained and reviewed RD's COTS. Based on our findings in these areas, we expanded our work. We reviewed and summarized the FMFIA reports for the past ten years and the FY 2000 annual SIR results to assess the materiality of identified weaknesses.

# FINDINGS AND RECOMMENDATIONS

| CHAPTER 1 | RD NEEDS TO IMPROVE ITS SYSTEM FOR COMPLYING WITH FMFIA REQUIREMENTS |
|---|---|

RD's process in complying with the FMFIA does not ensure that all material internal control weaknesses would be identified and reported. Each agency is required to review its system of internal controls and report any material internal control weaknesses. We found that although RD made an effort to comply with the FMFIA, the agency's definition of what constitutes a "material" internal control weakness lacked all utility. In addition, the internal controls identified for each unit did not ensure that all significant areas were covered or distinguish between high and low risk areas for individual internal controls. As a result, a known internal control weakness that would be considered material went unreported, and the existence of other material internal control weaknesses may not be detected.

## FINDING NO. 1

### RD'S DEFINITION OF MATERIAL INTERNAL CONTROL WEAKNESSES IS INADEQUATE

RD did not establish clear parameters for determining whether an identified weakness was sufficiently material to be included in the agency's FMFIA report. This occurred because agency officials relied on the very broad definitions issued by the Office of Management and Budget (OMB), without adding supplemental definitions that were more relevant to RD's own operations. As a result, the agency did not report a material weakness that could require the agency to determine how to fund between $850 million and $1 billion in repairs to the Multi-Family Housing portfolio. According to RD officials, failure to perform these repairs could cause 25 percent of the agency's $12 billion Multi-Family Housing portfolio to become unsafe or unsanitary within the next 3 years (initially reported in FY 2000). Even though RD officials were aware of this problem, they did not adjust their 5 year review plan to monitor this potentially critical situation. In addition, the lack of a clear definition of a material weakness may have contributed to the fact that out of the 23 material control weaknesses reported by RD over the last 10 years, only 3 were identified through the agency's review process; the remainder were disclosed by OIG and/or GAO audits.

OMB defines a material weakness as a deficiency that the agency head determines significant enough to be reported outside the agency (i.e., included in the annual FMFIA report to the President and Congress)[1], and requires judgment by agency managers as to the relative risks and significance of deficiencies. OMB staff stated that the definition is intentionally broad to give agency heads some discretion in what they report. However, they stated that it is also the intent of A-123 to make sure agency management understands that they are responsible for establishing and reviewing internal controls. Agency managers and staff should be encouraged to identify and report deficiencies, as this reflects positively on the agency's commitment to recognizing and addressing management problems. Failing to report a known deficiency would reflect adversely on the agency. In addition, RD's management control system, mandated by the FMFIA, consists of four major components: (1) General Accounting Office (GAO) audits and OIG audits and investigations; (2) Management Control Reviews (MCR); (3) State Internal Reviews (SIRS); and (4) Financial Management Division (FMD) reviews[2].

Departmental Regulations (DR) 1110-2, Management Accountability and Control; augmented OMB's definition by including qualitative criteria to guide the determination of the materiality of weaknesses. The regulation listed seven material weakness categories, one of which stated that a weakness is material if it significantly weakens safeguards against waste, loss, or unauthorized use of funds, property, or other assets[3]. In addition, quantitative criteria, specifically monetary thresholds, are the primary indicator of materiality. In our conduct of the annual financial statement audit of the mission area, OIG computed most recently the overall materiality level of RD to be $181 million. This level represents the aggregate amount of misstatements, which make the financial statements unreliable. For RD's FMFIA purposes, a more meaningful quantitative criterion would be to compute the materiality level on a program-by-program basis. A quantitative criterion should be used in conjunction with qualitative criteria to determine what constitutes a material weakness.

We found that in FY 2000 RD identified a known material internal control weakness, but failed to include this problem in its FMFIA report to the Secretary of Agriculture. The MCR Final Report stated that 25 percent of the program's portfolio will physically deteriorate to the point of being unsafe or unsanitary within the next 5 years. One of the reasons cited was the lack of adequate funding in the reserve accounts. This percentage of the portfolio accounts for 4,250 properties (85,000 units), and RD estimates that in order to fund the necessary repairs it will cost $850 million ($10,000 per unit). This same problem had been pointed out by an RD internal report from 1999, which projected that a property with a

[1] OMB Circular A-123; Attachment III; Assessing and Improving Management Controls; revised June 21, 1995

[2] RD Instruction 2006-M, Sections 2006.601 (a) and 2006.607; dated March 10, 1999

[3] USDA Departmental Regulation DR 1110-2, Management Accountability and Control; February 23, 1999

fully funded reserve account after 10 years would have only one-fourth of what is needed for repairs. However, since RD has never established the criteria for determining materiality they considered the $850 million needed for repairs as not material enough to include in the FMFIA report.

In order to fulfill its fiduciary responsibilities, RD should err on the side of conservatism and fully disclose all potential weaknesses. Employing only the qualitative criteria, as set forth in the Department regulations, we submit that the issue regarding the deterioration of the Multi-family Rural Rental Housing clearly would significantly weaken safeguards against waste and loss. In addition, several other qualitative criteria listed in the regulations as criteria for materiality would indicate that this issue constitutes a material weakness. Quantitatively, the value of the portfolio at risk and the cost to repair the projects, initially estimated at $850 million, should clearly be identified as being material.

The estimated cost of repairing the portfolio was elevated during discussions at the October 2000 senior managers' meeting, where program staff stated to the committee that $1 billion was necessary to properly rehabilitate the portfolio. They also told the committee that only $53 million had been available for that purpose the previous year. In spite of the seriousness of the problem, the committee voted that it was not material for FMFIA reporting purposes. Program staff stated that they did not believe that reporting the problem would result in the agency receiving the additional funds needed to address the problem. Subsequently, in a memorandum to the Secretary of Agriculture dated September 27, 2001, RD stated that their internal controls are generally in compliance with Section 2 of the FMFIA.

RD's senior management also agreed with the RHS advisory group that the Multi-Family Housing Program would not be reviewed again until fiscal year 2005. Each division within RD has its own advisory group, made up of program and administrative staff, that discusses MCR results and makes recommendations to the senior committee (the SMCC) regarding internal control weaknesses and the MCR's 5-year plan. The SMCC makes the final decisions in these matters. Program staff stated that they do not have the budget to do MCR reviews more than once every 5 years. However, the management committees have scheduled reviews in other areas when serious problems or risks were found. For example, in FY 2000 the Operations and Management Division's advisory group recommended that the next review of civil rights in RBS be scheduled in FY 2004, a 4-year span. The SMCC then overrode the advisory group's decision and scheduled the next MCR for FY 2002, only a 2-year span. Due to the magnitude of the problem with the RHS portfolio, the MCR of the Multi-Family Housing Program should have been rescheduled for a more timely review in addition to including this problem in their FMFIA report.

It is not surprising that from fiscal year 1991 through 2000, RD reported only 3 material internal control weaknesses from a total of 23 identified during that same period, 2 of which were reported by RD in fiscal year 1990 and the third in fiscal year 2000. Eighteen of the 23 material control weaknesses reported by RD were actually identified by GAO or OIG, and 2 were identified jointly by GAO, OIG, and RD. (See exhibit A.) When asked why RD had not reported more internal weaknesses over the past 10 years, FMD and RD program officials explained that the reviews they performed looked at a cross-section of program activities and they did not have the resources to focus on a specific area as OIG and GAO did. However, according to OMB officials, agency management is responsible for establishing and reviewing a system of internal controls and reporting on the effectiveness of those controls. RD did not meet that level of responsibility when it recently reported that its internal controls are generally in compliance with the FMFIA for fiscal year 2001, ignoring the $850 million finding reported by its own program staff.

During the exit conference, RD officials stated that they did not consider the upcoming repairs needed for the Multi-Family Housing portfolio to be the result of an internal control weakness, but rather a result of normal wear and tear. If this were the case, then the greater the urgency to identify and report the internal control that caused the funding shortfall of close to $1 billion. Failure to identify and correct the internal control weakness could result in future funding shortfalls. The officials also stated that they followed OMB's definition on materiality, and since they believed they had the repair and maintenance problem under control, they did not need to include it in the FMFIA report. They stated that in addition to proposing new regulations, part of the agency's response to address the lack of available funding was to make $53 million available for any needed repairs. However, an agency is required to both document the existence of a material internal control weakness and provide a time-phased action plan to correct the weakness. OMB guidance encourages agencies to identify and report weaknesses, as this reflects positively on the agency's commitment to recognizing and addressing management problems and failure to report a known weakness would reflect adversely.

In summation, we found that RD did not fully comply with the intent of the FMFIA in identifying and reporting material internal control weaknesses. RD did not have any specific guidance in place to differentiate between material internal control weaknesses, which must be reported under FMFIA, and non-material internal control weaknesses. In order for RD to be in compliance with the FMFIA, the agency needs to develop and issue new guidance for its managers to use in determining whether an identified internal control weakness is sufficiently material to include in the FMFIA report. In addition, the agency needs to amend its recent report to the Secretary and include the finding from the Multi-Family Housing review as a material internal control weakness, as well as revising its 5-year plan to review this issue before serious problems occur.

## RECOMMENDATION NO. 1

Develop and implement a definition of a material weakness that contains both qualitative and quantitative characteristics and properly reflects the relative risk and significance of deficiencies. In addition, report in the next FMFIA report the already identified weakness relating to the extensive work needed to repair the buildings used in the Multi-Family Rural Rental Housing Program.

**Agency Response**

In its response, RD officials stated that they currently use the definition of a material weakness issued by the Department in Departmental Regulation 1110-2. Until RD receives revised regulatory guidance from the Department, it would be imprudent to include the already identified weaknesses relating to the extensive work needed to repair the buildings used in the multi-family Rural Rental Housing Program in a revised FMFIA report.

**OIG Position**

RD's response did not address the central issue of this recommendation, the need to develop the necessary qualitative and quantitative criteria to guide managers in determining what is or is not a material weakness. Such measures are not provided in the existing guidance from either the Department or OMB, and are a necessary first step in ensuring that weaknesses identified through RD's various review processes are properly reported if they are in fact material.

The response stated that it would be imprudent to include the cited weakness involving RD's Multi-Family Housing portfolio in a revised FMFIA report until RD received revised regulatory guidance from the Department. We are working with the Department on this issue, but we believe RD needs to establish better procedures to enable it to identify a material problem. We cited in the finding that for financial reporting in 2001, a level of $181 million was considered the indicator of materiality. Based on RD's estimate, they identified a potential problem of between $850 million to $1 billion. The Departmental Regulation states that a weakness is material if it significantly weakens safeguards against waste, loss or unauthorized use of funds, property, or other assets. We believe that, based on RD's reviews, a material weakness was identified but not reported because RD's SMCC determined that the problem was not material. We continue to recommend that RD expand its criteria so that material weaknesses as described are recognized and reported. We cannot reach management decision based on this response.

## RECOMMENDATION NO. 2

Amend the recent informational memorandum (dated September 27, 2001) for the Secretary to include the finding from the Multi-Family Housing review as a material internal control weakness, and revise the MCR 5-year plan to include a followup review on the pertinent areas of the Multi-Family Housing program before FY 2005.

**Agency Response**

In its response, RD stated the projected severe need for financial resources ($850 million) to address the repair and maintenance of the existing Multi-Family Housing portfolio has been elevated through the Under Secretary for Rural Development to the Office of the Deputy Secretary for the Department in the form of proposed regulatory changes. The proposed regulation, consisting of curative measures, is still in the clearance process.

In addition, RD stated that the persistent lack of financial resources to repair and maintain the Multi-Family Housing portfolio will necessitate the property owners to use funding from the reserve accounts, increased rents, third party loans and Federal Home Loan Bank loans and grants. Low Income House Tax Credits (LIHTC) and subsequent loans from the agency will be used to collectively offset the $850 million projected costs.

**OIG Position**

While we do not disagree with RD's proposal for regulatory changes and other actions needed to deal with the potential funding shortfall for needed repairs to the agency's MFH portfolio, the response does not address either the need to amend the informational memorandum to the secretary or to provide more timely followup reviews of this area than are specified by the MCR's currently existing 5-year plan. To reach a management decision on this recommendation, RD needs to provide us with its proposals for corrective actions to address these issues, including timeframes.

## FINDING NO. 2

### RD'S IDENTIFICATION OF KEY INTERNAL CONTROLS DID NOT COVER ALL MAJOR AREAS

The Control Objectives and Techniques (COTS) that were established by RD's divisions to identify material internal control weaknesses did not include coverage of all significant areas. We found, for instance, that the COTS developed for RHS' Multi-Family Housing division did not include any controls to ensure the adequacy of funding for the reserve account, and for Single Family Housing there were no controls to ensure accurate area designations or income verifications. RD's FMD and program division staffs were not aware of the standards used in developing and documenting an internal control system and the procedures needed to review those controls. As a result, the existence of some material internal control weaknesses would not be detected and reported in the agency's compliance with the FMFIA. Furthermore, our review of previous OIG audits found about $5.4 million in questioned costs in program areas that do not receive adequate coverage in RD's COTS or review guides.

According to officials at the OMB, the intent of the FMFIA was to ensure that agency management understood that they were responsible for setting up a system and reviewing an internal control framework[4]. In addition, the GAO has issued advisories of an internal control framework based on the results of the Treadway Commission report titled "Internal Control – Integrated Framework," published in September 1992 by the Committee of Sponsoring Organizations of the Treadway Commission. This report provided both the private and public sectors with a standard to use in assessing their control systems. The report stated that the internal control process is designed to provide reasonable assurance regarding: (1) the achievement of objectives relating to effectiveness and efficiency of operations; (2) the reliability of financial reporting; and (3) compliance with applicable laws and regulations[5].

The COTS developed by RD staff did not identify all major internal controls. In addition, some of the internal control objectives were inappropriate and did not have a clear goal or risks associated with a particular internal control. Some of the internal controls not identified by RD program staff included known problem areas previously reported by OIG.

**CONTROL OBJECTIVES**

Some control objectives were vague, and did not have a clear goal. For example, one control objective was to "Assess physical status

4 Federal Managers' Financial Integrity Act of 1982, Public Law 97-255; September 8, 1982

5 Internal Control-Integrated Framework, Committee of Sponsoring Organizations of the Treadway Commission; September 1992

of Farm Labor Housing Properties and how the properties are safe from criminal and drug activities." However, this vague objective was actually a description of actions to be taken without explicitly stating that RD should be ensuring that the properties are safe from criminal and drug activities. Another control objective was to "determine training needs of State office staff." This objective was unclear since we were unable to ascertain whether the objective was to determine what training State office staff needed or whether their training was adequate. The Treadway Commission report notes that objectives are what an entity strives to achieve, while control activities (techniques) are what the entity must do to achieve those objectives. Although "determine training needs of state office staff" was an objective that RD was striving to achieve; a better control objective would have been to ensure that state office staff are properly trained for their duties, with "determining training needs" as one of the associated control techniques.

**CONTROL TECHNIQUES**

The internal control techniques we reviewed would not ensure that the associated control objective would be met if the techniques were followed. Again, the Treadway Commission report's definition of control technique is what an entity must do to achieve its objectives. However, we found that the control objective "eligibility compliance and proper utilization of rental assistance (RA)" had as one of its control techniques "review RA usage." This control technique does not explain what RA usage is being reviewed for, or require the reviewer to address the issue of whether RA is properly utilized. Another control technique for the same control objective is "review routine responsive and preventive maintenance contained in the management plan." As with the technique noted above, it should explain why the responsive and preventive maintenance is being reviewed.

**CONTROL RISKS**

We found that some risks identified by RD in the COTS seemed unclear, and did not really appear to be risks. The Treadway Commission report defines risk assessment as "the identification and analysis of relevant risks to achievement of the objectives." It further notes that the process of identifying and analyzing risk is a critical component of an effective internal control system. (See finding 3.) However, for the control objective "eligibility compliance and proper utilization of RA," two of the associated risks are "maintenance of waiting list and how tenants are selected" and "plans for RA usage." Although the waiting list and RA are important program components, these items, as written, are more the control techniques and do not describe any risk to the program.

> Risks should be associated with specific internal controls and the level of risk of those controls failing that would prevent the completion of the agency's control objective. For example, inherent risks to the objective *proper utilization of RA* would be that a waiting list is not completed or maintained, tenants were selected based on improper criteria, or tenant income not verified annually by project managers.

In a related issue, RD developed procedures to review its internal controls and report on their effectiveness. Through their Management Control Reviews (MCR), each RD division developed review guides to ensure the internal controls listed in COTS were reviewed. Although we found that the review guides generally covered all internal controls listed in COTS, omitting key internal controls from COTS meant that those controls would not be reviewed.

We compared the COTS to the MCR review guides to determine how the steps in the review guide addressed the control techniques listed in COTS. For example, we found that the steps in the Farm Labor Housing review guide generally conformed to the control objectives and techniques listed in the COTS. One discrepancy we noted was that the COTS stated that the reviewer should ensure that projects have properly maintained reserve, tax and insurance, and security deposit accounts as part of a control objective of assessing housing costs. However, the review guide, while containing steps dealing with this objective, does not mention monitoring these accounts. In addition, we found that a key internal control that covered area designations for Single Family Housing Direct Loan, the reserve account funding, and the identity of interest relationships for the Multi-Family Housing Program were not listed in COTS or the review guide. Similarly, we found that the area designations for the Rural Business Enterprise Grants (RBEG program) were not listed in COTS or the review guide.

In a discussion with RD program staff, we informed them that the COTS we reviewed did not include all significant areas where OIG has identified that vulnerabilities exist. Some of the areas not included were reviews of reserve account funding, identity of interest relationships, and management plans. An RD official stated that because the COTS have to be broad enough to cover a wide area, there cannot be a separate line item for each item to be checked. While we agree with that concept, it is also important that all significant program areas need to have coverage in the review guide. In addition, there should be a connection between COTS and the review guide that can be followed.

**BETTER OVERSIGHT NEEDED IN THE DEVELOPMENT OF COTS**

We reviewed the role of FMD in establishing COTS and related review guides. Although FMD provided comments to program staff, they did not provide specific direction in developing COTS or review guides. An FMD official told us that they do review COTS and review guides to see if there is consistency between the two, and if the steps in the review guide are consistent with the techniques in COTS. He stated that FMD provided its comments on COTS to program staff. However, we found that the COTS included inappropriate objectives and inadequate techniques. It indicates that FMD needs to be more involved in the MCR process to ensure that the COTS and review guides established for RD programs will sufficiently address each program's important internal controls. We cited some specific examples such as "conduct physical inspections" in order "to ensure all agency plan reviewers and/or construction inspectors are fully trained," to the acting director. He agreed that the technique would not achieve the objective.

Another item not included in any of the COTS or review guides were steps to review the SIR results. We discussed it with program staff, who told us that SIR results are looked at as part of the MCR process. We also discussed it with FMD staff, and asked why a review of SIR results would not be included in the review guides. An FMD official told us that it should be automatic that the MCR review team would take a look at whatever State staff had found in their review. However, the FMD official further stated that they had no procedures to ensure that this was done, and he agreed that it should be included in the review steps.

The objectives and techniques listed in the COTS should, at a minimum, provide coverage of known problem areas, including findings by OIG. However, we found no control objectives or techniques that would have covered the following key internal controls identified in OIG audits from recent years:

- Correct area designations in the RBS' RBEG program - One of the findings reported in a previous OIG audit was that RD approved funds to a corporation located in an ineligible area. It was found that RD relied on the State's flawed method for classifying rural areas.

- Protection against the use of an identity of interest company in the RHS program - OIG reported that one company withdrew $4.3 million to pay insurance premiums through an identity of interest company, which subsequently failed to provide adequate coverage.

- <u>Adequate funding of reserve accounts for Multi-Family Housing projects</u> - In a previous audit, we reported that a management company had under funded the reserve accounts for 12 projects by over $100,000. In other audits, we reported that management companies had misused and improperly converted funds from the reserve accounts.

These are just some of the examples of known problem areas within RD programs that OIG has reported over the years, which should have been reviewed during the MCR process. In just these cases alone, over $5 million in program funds were not used in accordance with program regulations. However, the FMD and program staff did not document any control objectives or techniques that would have identified the failed internal controls that allowed the above problems to continue. Although each incident OIG reported may not be considered material, identification and review of key internal controls is critical to determining if there is a problem.

With the considerable amount of reference material available to the agency, including the Treadway Commission report, Departmental guidance, and OMB guidance, RD should be able to develop COTS that will show a clear relationship between control objectives and associated techniques and that will require review of all key controls for each of its programs. After the COTS have been developed, RD needs to develop review guides that will adequately monitor the effectiveness of the controls outlined in the new COTS.

## RECOMMENDATION NO. 3

Develop new comprehensive COTS to ensure that RD has a clear and comprehensive set of control objectives, and techniques that will mitigate the risks associated with the control objectives. In addition, perform a formal review of all COTS to ensure that those developed by program staff are appropriate and that techniques will achieve corresponding objectives.

**<u>Agency Response</u>**

In its response, RD stated that a task force of RD managers/staff would be convened by July 31, 2002, to evaluate the current Management Control Review (MCR) processes. The task force will make recommendations on the development of the new comprehensive COTS, as appropriate. The COTS that are developed will be reviewed by the Financial Management Division (FMD) on an ongoing basis to ensure that they remain current in order to achieve their intended objectives.

**OIG Position**

To reach management decision, RD needs to provide us with its planned timeframes for completing the task force's review process and having the revised COTS in place.

## RECOMMENDATION NO. 4

Develop review guides that adequately monitor the effectiveness and operation of the new COTS when these are developed, and ensure they include an analysis of the results of State Internal Reviews.

**Agency Response**

In its response, RD stated that a task force of RD managers/staff would be convened by July 31, 2002, to evaluate the current Management Control Review (MCR) processes. The RD managers/staff will develop review guides that adequately monitor the effectiveness and operation of the new COTS when these are developed, and ensure they include an analysis of the results of the SIRs.

**OIG Position**

To reach management decision, RD needs to provide its timeframes for when the new review guides will be developed and in place.

## FINDING NO. 3

### RD'S MANAGEMENT CONTROL REVIEWS ARE NOT TARGETED AT HIGH RISK ACTIVITIES WITHIN EACH PROGRAM

Current RD procedures do not distinguish between high and low risk internal control areas to be reviewed within a particular program. Because RD assesses risk at the program level, all control objectives and techniques (COTS) within a program receive equal focus regardless of the relative degrees of risks involved in each. RD has not established risk-level assessments for individual controls for any of its programs. As a result, high-risk areas of RD programs may not be reviewed as often as needed. In addition, valuable agency resources may be used ineffectively in reviews of low-risk areas that have little significance or a low probability of deficiencies occurring.

USDA Departmental regulations define risk assessment as the identification and analysis of possible risks in meeting the agency's objectives and forming a basis for how these risks should be managed or controlled and the deterrents that should be implemented[6]. In addition, GAO issued advisories on internal control systems based on criteria found in the Treadway Commission's report "Internal Control–Integrated Framework." The report stated that risk assessment should be done both entity-wide and at activity levels[7]. Entity-wide risk assessment is similar to what RD performed in identifying a risk level for each assessable unit, such as Multi-Family Housing. In addition to identifying risk at the entity level, risks should be identified at the activity level dealing with specific business units or functions. All RD's risk assessments are done at the assessable unit, or what the Treadway report referred to as the "entity-wide" level.

In assessing risk based on an entire program, RD is placing the same amount of emphasis on every aspect of that program, even though there can be varying levels of risk within a given program. In the Multi-Family Housing Program, there is one control objective to "define and maintain a working relationship with sources of leveraged financing" and another control objective to "assure that the State maintains a system to assess the portfolio and determine which properties are in good condition, fair condition, and poor condition." Based on the results of past OIG audit reports of the Multi-Family Housing Program, and the review conducted by RD (see finding 1), these two areas should not be receiving the same amount of emphasis. It is much more likely that problems will occur with the physical condition of the portfolio than with financing sources, but both areas will be reviewed with the same frequency. For another example, an MCR would spend equal time on reviewing the controls to ensure compliance with disability access requirements, which could be considered a low-risk area; as it would with the adequate level of reserve funds to maintain the physical structure of a property, which has been found to be a high-risk area.

The objective of performing risk analysis is to determine what the high-risk areas are and what level of attention they might need. From our review of the Treadway Commission's Internal Control-Integrated Framework report, we determined that considerable attention should be given to significant risk areas. The report stated that a risk that does not have a significant effect and that has a low likelihood of occurrence generally does not warrant serious concern. However, a significant risk with a high likelihood of occurrence usually demands considerable attention. However, RD did not assess any risks at the activity level dealing with specific program objectives. Dealing with risk at this level helps focus risk assessment on major business units or functions and helps narrow a review to ensure key objectives and controls assessed at a high risk are reviewed more often.

[6] USDA Departmental Regulation DR 1110-2, Management Accountability and Control; February 23, 1999

[7] Internal Control-Integrated Framework, Committee of Sponsoring Organizations of the Treadway Commission; September 1992

Furthermore, after risks have been identified at both the entity and activity levels, a risk analysis needs to be performed. This analysis should include the significance of a risk, the likelihood of occurring, and how the risk should be managed.

We discussed the issue with RD program officials, who told us they thought that trying to assess risk at the control level would dilute their efforts. This is contrary to the findings of the Treadway Commission, however, and does not take into account the dilution of resources that results from their diversion to low-risk areas within an assessable unit. The officials also said that the MCR is only part of their process of program review. However, the other elements of the review process referenced by RD officials are not directly connected with the FMFIA process, and may not result in the reporting of any weaknesses which they might disclose.

## RECOMMENDATION NO. 5

Establish risk level assessments for individual control objectives and techniques, and use those risk assessments to determine the scope of the internal control review.

**Agency Response**

In its response, RD stated that a task force of RD managers/staff would be convened by July 31, 2002, to evaluate the current Management Control Review (MCR) processes. The task force will make recommendations to RD MCAGs. The MCAGs and Senior Management Control Council (SMCC) will establish risk levels for individual control objectives and techniques. These risk level assessments will then be utilized to determine the scope of the internal control review.

**OIG Position**

To reach management decision, RD needs to provide the timeframes within which the task force will complete its evaluation and the risk level assessments for individual control areas will be in place.

## CHAPTER 2 — RD's IDENTIFICATION AND REPORTING OF NATIONWIDE TRENDS NEEDS IMPROVEMENT

We found that RD did not utilize a key tool, State Internal Reviews (SIR), in order to identify nationwide trends, even though their instructions identify SIR's as a major component in the FMFIA reporting process. From FY 1998 through FY 2000, the FMD staff did not perform the required nationwide compilation and analysis of the findings disclosed during the SIR process. In addition, RD did not provide adequate oversight of the MCR process to ensure compliance with the FMFIA. There was no coordination of the method or form in which RD program staff reported MCR findings, and how the States reported the annual SIR results to ensure those findings were placed in proper perspective. FMD, the lead division in complying with FMFIA reporting requirements, did not take a proactive part in ensuring that RD program staff adequately reviewed, identified, and reported any material internal control weaknesses. Because of this, there was reduced assurance that the MCR and SIR review processes would clearly identify a material internal control weakness that would need to be included in the FMFIA report

### FINDING NO. 4

**SIR RESULTS NOT USED TO IDENTIFY NATIONWIDE TRENDS OR MATERIAL CONTROL WEAKNESSES**

We found that RD did not use the results of the State Internal Reviews (SIR) to identify nationwide trends, even though their instructions identify SIR's as a major component in the FMFIA reporting process. RD officials stated that due to staffing shortages they had to divert resources to the new MCR process and were unable to perform the required nationwide compilation and analysis of the findings disclosed during the SIR process. As a result, material weaknesses identified by nationwide trends that would have been noted in a SIR summary, may go undetected for inclusion in the FMFIA report.

RD's instructions for FMFIA compliance state that the purpose of the SIR process is to determine if policies and procedures for making and servicing loans/grants are being implemented according to RD regulations, to identify weaknesses in program and administrative operations, and to inform senior agency management of the effectiveness of the States' oversight. In addition, they require the FMD Director to analyze the fiscal year-end State Summary Report of SIR findings for all States, distribute annually to all offices a nationwide compilation,[8] and advise RD agency administrators of the results of States' reviews[9].

According to RD instructions, the FMD staff is responsible for compiling and analyzing the SIR data on an annual basis. However, we found that FMD officials did not compile SIR results or perform an analysis of SIR results for FY's 1998 through 2000. An FMD official told us this was because of staffing shortages and the startup of the MCR process. The last time FMD compiled SIR results were in FY 1997. Trends identified then included failure to determine eligibility within 30 days of a completed application in Single Family Housing, failure to properly verify income, and inadequate maintenance of reserve accounts in Multi-Family Housing.

Although FMD did perform the analyses of SIR's data in FY 1997, they did not use this information to identify internal control weaknesses based on nationwide trends, even though RD's instructions that define the SIR process clearly indicate that its purpose is for FMFIA compliance. An FMD official agreed that this is an area they will have to address.

We performed our own analysis of SIR's data, using FMD's method for identifying nationwide trends, which is to report any program deficiency that was found in at least 20 percent of the States that reviewed that program. From our analysis of FY 2000 SIR data, we found that a total of 23 out of 39 states (59 percent) reported as an internal control weakness the failure to make eligibility determination within 30 days under the Single Family Housing Direct Loan Program. In addition, under the same program we found that 16 of 39 states (41 percent) reported a deficiency regarding improper income verification. Because FMD did not compile this data and distribute it to the advisory groups, these potentially material internal control weaknesses were not even discussed for possible inclusion in the FMFIA report. As discussed earlier, these trends were also present in Single Family Housing in 1997 when FMD performed its last compilation of nationwide SIR results.

For FY 2000, we were able to identify other nationwide trends from SIR data relating to the Rural Business Enterprise Grant (RBEG), Intermediary Relending Program (IRP), and Business and Industry (B&I) programs. In the RBEG program, 5 out of 13 states (38 percent) reported problems in "lack of documentation." In the IRP, 2 out of 10 states (20 percent) acknowledged an internal control weakness in "IRP funds not dispersed." In the B&I program, 4 out of 13 states (31 percent) reported an internal control weakness in "lack of documentation."

[8] RD Instruction 2006-M, Section 2006.605 (e) (7); dated March 10, 1999

[9] RD Instruction 2006-M, Section 2006.607 (c) (3); dated March 10, 1999

We found that even though RD's instructions required summarizing SIR data as part of the FMFIA process, the FMD staff failed to compile a nationwide summary for three years. The existence of nationwide trends that we identified in our review of SIR's, which went undetected by RD staff, could have been considered material and required inclusion in the agency's FMFIA report to the Secretary. RD needs to ensure that nationwide SIR results are compiled annually, identify nationwide trends of control weaknesses and distribute those results to all offices. In addition, the agency needs to ensure that RD instructions require the use of SIR results by review teams and committees to determine whether a material internal control weakness exists.

## RECOMMENDATION NO. 6

Institute controls to ensure that SIR's are a major component of the FMFIA process, and that nationwide SIR results are compiled annually and the results distributed to all offices.

**Agency Response**

In its response, RD concurred with our recommendation and agreed to include SIRs findings in the FMFIA process based upon findings noted in the Audit Report Tracking System. Results will be shared with all offices no later than December 31, 2002.

**OIG Position**

We accept RD's management decision.

## RECOMMENDATION NO. 7

Institute controls to ensure that the nationwide SIR's analysis is distributed to all advisory groups to be used for determining whether material internal control weaknesses exist.

**Agency Response**

In its response, RD stated that the SIR analysis will be shared with all MCAGs and if a determination of materiality is made, it will be forwarded to the SMCC.

**OIG Position**

We agree with the proposed corrective action. To reach a management decision, RD needs to provide us with its timeframes for implementing these actions.

## FINDING NO. 5

### RD NEEDS TO IMPROVE ITS OVERSIGHT OF THE MCR AND SIR REPORTING PROCESS

The FMD needs to strengthen its coordination of the methods or form in which RD program staff reports MCR findings and how the States reported the annual SIR results to ensure those findings are placed in proper perspective. FMD, the lead division in complying with FMFIA reporting requirements, did not take a proactive part in ensuring that RD program staff adequately reported findings to include information on the extent of their testing and the number of deficiencies found. As a result, there was reduced assurance that RD's review process would clearly identify whether a material internal control weakness should be included in the FMFIA report.

RD's instructions state that the FMD Director, in conjunction with the SMCC, develops, implements, and administers management control policies that will provide reasonable assurance of RD's compliance with the intent of the FMFIA and OMB Circular A-123[10]. Although the FMD did provide a format for RD program staff to follow in reporting a material internal control weakness, it lacked specific criteria on placing any findings in their proper perspective or in determining the extent of the problem. In addition, FMD did not ensure that States reported SIR's results in a manner consistent with each other or with MCR reporting.

**SPECIFIC CRITERIA NEEDED FOR MCR REPORTS**

We found that RD's reporting of MCR findings did not include enough information to describe the extent of the testing done or the problem discovered. The reports submitted to FMD on the results of the MCR reviews do not place findings in proper perspective. We reviewed the MCR review report for four programs including the Intermediary Relending Program (IRP), Single Family Housing Loans, Multi-Family Housing Loans, and Environmental & Technical Assistance programs. In the MCR of the IRP, RD staff found that "in many cases," there was no evidence of agency approval of forms used for relending purposes, and "in most cases" there was not enough information in the file to comprehend the nature of the project. The report did not mention the number of cases in which they found the internal control weaknesses.

Similar language was found in the MCR reports for Single Family Housing

[10] RD Instruction 2006-M, Section 2006.605 (e) (1); dated March 10, 1999

and Multi-Family Housing loans. In the MCR of Single Family Housing loans, RD staff found that, in a few cases, loans were being made for unauthorized purposes, but there was no mention of how many loans were reviewed, how many had this problem, or the dollar amount of the loans. The same MCR noted that "in many cases, documentation of having checked the debarment and suspension lists at application and closing is not provided." In the MCR of the Multi-Family Housing loans, RD staff found that "many States do not monitor construction costs." There was no mention of how many States or the dollar value of those States' portfolios. In the same MCR, staff noted "in some rehabilitation cases, cosmetic items were given priority over health, safety, and accessibility issues." As before, there was no mention of how many cases, or how much money they represented.

An FMD official stated that they do not require program staff to use any particular report format, even though FMD developed an MCR report format. FMD allows the program staff to decide how they want to present the information, and report it accordingly. However, to make informed and balanced decisions, findings in the MCR report should include universe and scope data that allows the reader to put findings in proper perspective. If advisory group members are going to be able to make key decisions on whether findings are material they need to know things like: how many loans were reviewed; how many had a given problem; the dollar value of the loans; and the dollar value of loans with the problem. This type of support data should be included in the report.

**FMD DID NOT ENSURE STATE REPORTS WERE CONSISTENT**

The deficiencies in report formatting were also found in the SIR reports, where States did not always report SIR findings in a consistent manner. As an example, some states reported findings for Single Family Housing and Multi-Family Housing loans without differentiating between direct and guaranteed loans, which were identified by FMD to be separate assessable units. This also happened to another three programs involving Rural Business Enterprise Grants (RBEG), Intermediary Relending Program (IRP), and Business & Industry (B&I). When reporting internal control weaknesses, the States did not identify in which specific program the internal control weaknesses occurred. RD instructions require States to include a list of offices reviewed, program operations reviewed, and identification of trends with frequency rates in their SIR summary reports to FMD[11].

However, RD instructions do not differentiate among programs for reporting purposes in the same way that FMD identifies assessable units. For example, in its instructions for the SIR State Summary Report, RD

11 RD Instruction 2006-M, Exhibit B, Part III (c); dated March 10, 1999

lists as one example of Areas Reviewed, “Single Family Housing (Direct and Guaranteed).” Since FMD has identified Single Family Housing Direct and Guaranteed Loans as two distinct assessable units, the results from the SIR summaries would not be compatible with results from MCR reviews of the same programs.

We discussed this problem with an FMD official, who stated that they have given training to the Management Control Officers on what and how to report. However, the official agreed that the current report format would not be very useful. In addition, we found that most States failed to provide universe data that explained the number of cases reviewed and the frequency of the internal control weakness identified. The FMD official agreed that it would be helpful if universe data were provided in order to place findings in their proper perspective.

During the exit conference, RD officials stated that a standardized report format was available for review teams to use, even though the MCR reports did not contain specific universe data. In addition, details of the review, including justification sheets, were made available to MCAG and SMCC members when deciding what to include in the FMFIA. Although we agree that the agency provided a standard report format, it was not a requirement that MCR teams use the template; further, the report format needs to be amended to ensure that review teams describe the universe of what was reviewed, and whether any disclosed control weaknesses are isolated or systemic problems. Finally, since both the MCR and SIR results are used to identify material internal control weaknesses, standardized reporting should be required of both reports.

Overall, FMD needs to take a more proactive part in its oversight of the agency’s FMFIA process. The FMD needs to ensure that data collected from all reviews, like SIR’s and MCR’s, include all support data to assist committee members in making informed decisions. Finally, RD needs to amend instructions concerning SIR reporting so the results can be used in conjunction with the findings from other RD reviews.

## RECOMMENDATION NO. 8

Require FMD to ensure that MCR reporting procedures place findings in the proper perspective by including universe data on total number and value of grants/loans reviewed and number and value of grants/loans with deficiencies.

**Agency Response**

In its response, RD states that a task force of RD managers/staff will be convened by July 31, 2002, to evaluate the current Management Control Review (MCR) processes. Controls will be established to ensure that findings include universe data on total number and value of grants/loans reviewed and number and value of grants/loans with deficiencies.

**OIG Position**

We concur with RD's proposed corrective actions. To reach a management decision RD needs to provide us with its proposed timeframes for having the cited controls in place.

## RECOMMENDATION NO. 9

Require the FMD to ensure that all States report the annual SIR findings in a standardized manner, and that the SIR reporting procedures place findings in the proper perspective by including universe data on total number and value of grants/loans reviewed and number and value of grants/loans with deficiencies.

**Agency Response**

In its response, RD state that a task force of RD managers/staff will be convened by July 31, 2002, to evaluate the current Management Control Review (MCR) processes. Controls will be established to ensure all States report their annual SIR findings in a standardized manner and that findings include universe data.

**OIG Position**

We concur with RD's proposed corrective actions. To reach a management decision RD needs to provide us with its proposed timeframes for having the cited controls in place.

## RECOMMENDATION NO. 10

Require RD to amend its instructions on the SIR process to require States to identify findings/trends based on the same assessable units as those used in MCR reporting.

**Agency Response**

In its response, RD stated that the SIR process is a separate, comprehensive process and to do this is not possible as the process is now. A task force of RD managers/staff will be convened by July 31, 2002, to evaluate the current Management Control Review (MCR) processes, including SIRs. Controls will be established to ensure consistency in assessable units, related findings and trends.

**OIG Position**

This recommendation was intended to have each State review its SIRs results to identify trends within the State for corrective actions. It would entail a review of the SIRs performed in a given year. We believe that each State director would benefit from this analysis. We continue to recommend that this action be implemented.

## EXHIBIT A – SUMMARY OF MATERIAL INTERNAL CONTROL WEAKNESSES REPORTED FROM FY'S 1991-2000

| TITLE OF MATERIAL INTERNAL CONTROL WEAKNESS | SOURCE | FISCAL YEAR IDENTIFIED | FISCAL YEAR CORRECTED |
|---|---|---|---|
| Automated Credit Management. | OIG | 1986 | 1995 |
| Farmers Program Loan-making criteria should be strengthened. | GAO | 1989 | 1997 |
| Farmer Programs Guaranteed Loan Making. | GAO | 1989 | 1997 |
| Farmer Programs Account Servicing | OIG | 1989 | 1992 |
| Housing Preservation Grants. | OIG | 1989 | 1993 |
| Farmer Program Borrower Responsibilities. | GAO | 1990 | 1992 |
| Multi-Family Housing Tenant Certification. | OIG | 1990 | 1993 |
| Rural Community Assistance. | OIG | 1990 | 1992 |
| Guaranteed Loans Accounting System - Farmer Program guaranteed loan making. | GAO & RD | 1990 | 1994 |
| Farmer Programs Direct Loans. | RD | 1990 | 1993 |
| Single Family Housing loan servicing. | RD | 1990 | 1997 |
| Farmer Program Debt Restructuring. | OIG | 1991 | 1994 |
| Single Family Housing Interest Credit. | OIG | 1991 | 1995 |
| Automation Data Processing Modernization. | GAO & OIG | 1992 | 2000 |
| Oversight of the Multi-Family Housing Program. | OIG | 1992 | Correction In progress |
| Accounting and Financial System: Automated Multi-Housing Accounting System (AMAS). | RD & OIG | 1992 | 1994 |
| Contracting. | OIG | 1993 | 1993 |
| RD: FMFIA review process needs improvement. | OIG | 1993 | 1998 |
| Single Family Housing Loan Servicing. | OIG | 1995 | 1997 |
| Graduation of Community Program Loans. | OIG | 1995 | 1997 |
| RUS: Testing or review elements of the internal control structure. | OIG | 1996 | 1997 |
| RUS: Strengthen internal controls to ensure that commercial credit is sought for water and waste disposal projects. | OIG | 1996 | 1998 |
| Business Programs Compliance with All Applicable Civil Rights Laws, Executive Orders and Program Requirements. | RD | 2000 | Correction In progress |
| **TOTAL WEAKNESSES REPORTED: 23** | **14 by OIG<br>3 by GAO<br>3 by RD<br>3 by OIG/GAO/RD** | | |

# EXHIBIT B – RD'S RESPONSE TO THE DRAFT REPORT

USDA

FEB 26 2002

United States
Department of
Agriculture

Rural Development

Operations and
Management

Washington, DC
20250

SUBJECT: Rural Development Compliance with Federal Managers' Financial Integrity Act Reporting Requirements-Official Draft (Audit No. 85401-004-CH)

TO: Richard J. Davis
Director
Administration and Finance Division
Office of Inspector General, USDA

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

**Recommendation No. 1**

Develop and implement a definition of a material weakness that contains both qualitative and quantitative characteristics and properly reflects the relative risk and significance of deficiencies. In addition, report in the next FMFIA report the already identified weaknesses relating to the extensive work needed to repair the buildings used in the Multi-Family Rural Rental Housing Program.

**Response:**

Rural Development (RD) currently uses the definition of a material weakness issued by the Department in Departmental Regulation 1110-2. Until RD receives revised regulatory guidance from the Department, it would be imprudent to include the already identified weaknesses relating to the extensive work needed to repair the buildings used in the Multi-Family Rural Rental Housing Program in a revised FMFIA report.

**Recommendation No. 2**

Amend the recent informational memorandum (dated September 27, 2001) for the Secretary to include the finding from the Multi-Family Housing review as a material internal control weakness, and revise the MCR 5 year plan to include a followup review on the pertinent areas of the Multi-Family Housing program before FY 2005.

**Response:**

The projected severe need for financial resources ($850 million) to address the repair and maintenance of the existing Multi-Family Housing portfolio has been elevated through the Under Secretary for Rural Development to the Office of the Deputy Secretary for the Department in the form of proposed regulatory changes. The proposed regulation, consisting of curative measures, is still in the clearance process.

The persistent lack of financial resources to repair and maintain the Multi-Family Housing portfolio will necessitate the property owners to use funding from the reserve accounts, increased rents, third party loans and Federal Home Loan Bank loans and grants. Low Income House Tax Credits (LIHTC) and subsequent loans from the Agency will be used to collectively offset the $850 million projected cost.

**Recommendation No. 3**

Develop new comprehensive COTS to ensure that RD has a clear and comprehensive set of control objectives and techniques that will mitigate the risks associated with the control objectives. In addition, perform a formal review of COTS to ensure that those developed by program staff are appropriate and that techniques will achieve corresponding objectives.

**Response:**

A task force of RD managers/staff will be convened by July 31, 2002, to evaluate the current Management Control Review (MCR) processes. The task force will make recommendations on the development of the new comprehensive COTS, as appropriate. The COTS that are developed will be reviewed by the Financial Management Division (FMD) on an ongoing basis to ensure that they remain current in order to achieve their intended objectives.

**Recommendation No. 4**

Develop review guides that adequately monitor the effectiveness and operation of the new COTS when these are developed, and ensure they include an analysis of the results of the State Internal Reviews (SIRs).

**Response:**

A task force of RD managers/staff will be convened by July 31, 2002, to evaluate the current Management Control Review (MCR) processes. The RD managers/staff will develop review guides that adequately monitor the effectiveness and operation of the new COTS when these are developed, and ensure they include an analysis of the results of the SIRs.

**Recommendation No. 5**

Establish risk level assessments for individual control objectives and techniques, and use those risk assessments to determine the scope of the internal control review.

**Response:**

A task force of RD managers/staff will be convened by July 31, 2002, to evaluate the current Management Control Review (MCR) processes. The task force will make recommendations to RD MCAGs. The MCAGs and Senior Management Control Council (SMCC) will establish risk level assessments for individual control objectives and techniques. These risk level assessments will then be utilized to determine the scope of the internal control review.

**Recommendation No. 6**

Institute controls to ensure that SIRs are a major component of the FMFIA process, and that nationwide SIR results are compiled annually and the results distributed to all offices.

**Response:**

We agree to include SIR findings in the FMFIA process based upon findings noted in the Audit Report Tracking System. Results will be shared with all offices no later than December 31, 2002.

**Recommendation No. 7**

Institute controls to ensure that the nationwide SIR's analysis is distributed to all advisory groups to be used for determining whether material internal control weaknesses exist.

**Response:**

The SIR analysis will be shared with all MCAGs and if a determination of materiality is made, it will be forwarded to the SMCC.

**Recommendation No. 8**

Require FMD to ensure that MCR reporting procedures place findings in the proper perspective by including universe data on total number and value of grants/loans reviewed and number and value of grants/loans with deficiencies.

**Response:**

A task force of RD managers/staff will be convened by July 31, 2002, to evaluate the current Management Control Review (MCR) processes. Controls will be established to ensure that findings include universe data on total number and value of grants/loans reviewed and number and value of grants/loans with deficiencies.

**Recommendation No. 9**

Require the FMD to ensure that all states report the annual SIR findings in a standardized manner, and that the SIR reporting procedures place findings in the proper perspective by including universe data on total number and value of grants/loans reviewed and number and value of grants/loans with deficiencies.

**Response:**

A task force of RD managers/staff will be convened by July 31, 2002, to evaluate the current Management Control Review (MCR) processes. Controls will be established to ensure all states report their annual SIR findings in a standardized manner and findings include universe data.

**Recommendation No. 10**

Require RD to amend its instructions on the SIR process to require States to identify findings/trends based on the same assessable units as those used in MCR reporting.

**Response:**

The SIR process is a separate, comprehensive process and to do this is not possible as the process is now. A task force of RD managers/staff will be convened by July 31, 2002, to evaluate the current Management Control Review (MCR) processes, including SIRs. Controls will be established to ensure consistency in assessable units, related findings and trends.

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 692-0089.

Sherie Hinton Henry

SHERIE HINTON HENRY
Director
Financial Management Division

## ABBREVIATIONS

| | |
|---|---|
| **ARTS:** | Audit Reports Tracking System |
| **COTS:** | Control Objectives and Techniques |
| **CSC:** | Centralized Service Center |
| **FMD:** | Financial Management Division |
| **FMFIA:** | Federal Managers' Financial Integrity Act |
| **GPRA:** | Government Performance and Results Act |
| **IRM:** | Information Resources Management |
| **MCAG:** | Management Control Advisory Group |
| **SMCC:** | Senior Management Control Council |
| **MCR:** | Management Control Review |
| **OCD:** | Office of Community Development |
| **RBS:** | Rural Business Service |
| **RD:** | Rural Development |
| **RHS:** | Rural Housing Service |
| **RUS:** | Rural Utility Service |
| **SIR:** | State Internal Review |