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U.S. Department of Agriculture

Office of Inspector General
Midwest Region

Audit Report

Rural Housing Service's Progress To Implement the Improper Payments Information Act of 2002

Report No. 04601-0011-Ch
February 2006

USDA

UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

WASHINGTON, D.C. 20250

DATE: February 24, 2006

REPLY TO
ATTN. OF: 04601-0011-Ch

TO: Russell Davis
Administrator
Rural Housing Service

THROUGH: John Dunsmuir
Acting Director
Financial Management Division

FROM: Robert W. Young /s/
Assistant Inspector General
for Audit

SUBJECT: Rural Housing Service's Progress to Implement the Improper Payments Information Act of 2002

This report presents the results of our audit of the Rural Housing Service's (RHS) fiscal year (FY) 2005 efforts to implement the Improper Payments Information Act (IPIA) of 2002.[1] Our audit of RHS was conducted as part of a Departmentwide effort to evaluate the progress to implement the IPIA through additional guidance issued by the Office of the Chief Financial Officer (OCFO). Our review of the risk assessments for two of the six RHS programs with estimated outlays of $50 million or more disclosed that RHS had not compiled sufficient evidence to support its conclusion of low risk of improper payments. As a result, we were unable to independently determine if the RHS ranking was supportable.

BACKGROUND

In November 2002, the President signed the IPIA, Public Law (P.L.) 107-300, which 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.

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

If the estimate is over $10 million, the agency must report the estimate to Congress along with the actions the agency is taking to reduce those improper payments. In May 2003, the Office of Management and Budget (OMB) issued guidance to agencies for estimating and reporting improper payments.

As the lead agency for coordinating and reporting the Department's efforts to implement the IPIA, OCFO provided additional instructions to USDA agencies in August and October 2003.

In FY 2004, we performed audits of six agencies' programs, including RHS,[2] to determine whether the agencies performed risk assessments in compliance with the OMB and OCFO guidance for implementing the IPIA. Our review of RHS' risk assessments disclosed that the agency's ranking of risk factors was not always supported by the documentation provided, specifically to include controls that would tend to obviate the risk. We also performed an audit of OCFO[3] in FY 2004, to evaluate its actions to implement the IPIA—specifically, its effort to assess the Department's programs for the risk of improper payments. Based on the results of that audit and the conditions reported in the agency audit reports, we recommended that OCFO strengthen its guidance to agencies for performing risk assessments.

OCFO issued more prescriptive guidance in November and December 2004. The revised OCFO guidance included specific instructions for agencies to follow in order to meet IPIA requirements, focusing on those programs most likely to be at significant risk of improper payments. The guidance divided programs into six categories, ranging from programs with less than $10 million in outlays to programs exceeding $400 million in outlays. The guidance required that program vulnerabilities to improper payments, to include program, financial, budget, and performance management issues, be identified along with the internal controls in place to prevent the improper payments. In addition, the OCFO guidance included instructions for the testing of transactions in each program. This was a key provision of the guidance in that the test of transactions process provides quantitative evidence of the adequacy of the design and functionality of the internal controls. The guidance states that a judgmental sample of transactions should be taken that is sufficiently large to support the agency's assertion that internal controls are working. To support their conclusions regarding programs' susceptibility to improper payments, agencies were to include the results of these tests in their risk assessments. The guidance also included key milestones for agencies to submit information so that OCFO and OMB could assess the agencies progress in completing all risk assessments by the established deadline of April 30, 2005.

OBJECTIVE

The objective of the audit was to assess the adequacy of RHS's implementation of OCFO's revised guidance regarding improper payment reporting requirements, including (1) agency efforts to conduct risk assessments of selected programs and report results to OCFO, and (2) agency conclusions that the programs were at low risk of improper payments.

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[2] Rural Development Compliance with the Improper Payments Information Act of 2002, Audit No. 04601-10-Ch, dated January 2005.

[3] USDA Compliance with the Improper Payments Information Act of 2002, Audit No. 50601-8-Ch, dated January 2005.

SCOPE AND METHODOLOGY

We performed our audit of RHS compliance with the IPIA at RHS Headquarters in Washington, D.C. We conducted our fieldwork from July through August 2005. The audit was performed in accordance with *Government Auditing Standards*.

Of the risk assessments submitted to OCFO, as of April 30, 2005, we judgmentally selected two RHS programs: Single Family Housing (SFH) Direct 502 Loan Program and Community Facilities (CF) Direct Loan Program, with total estimated outlays of $1.4 billion. We based our selection on our preliminary analysis of vulnerability criteria, outlay dollars, and the extent and adequacy of information contained in the risk assessment documentation provided to OCFO. The SFH and CF direct loan programs represented 80 percent of the estimated outlays of the 6 RHS programs that fell into OCFO's top 3 categories for program outlays.

To accomplish our audit objectives, we interviewed the appropriate officials and reviewed the following documents:

- the IPIA, OMB guidance, and OCFO directives,
- regulations, program procedures, and handbooks,
- prior Government Accountability Office (GAO) and Office of Inspector General (OIG) audit reports,
- FY 2005 budget summaries, and
- risk assessments.

FINDINGS

RHS Did Not Collect and Analyze Sufficient Information to Determine the Extent of Improper Payments

Although RHS had improved its process from FY 2004 for performing risk assessments by identifying major vulnerabilities and internal control measures needed to mitigate those vulnerabilities, our review of the supporting documentation for assertions included in each program's risk assessment for FY 2005 disclosed that the agency had not fully adhered to OCFO's guidance on conducting risk assessments. We attributed this to RHS not adequately conducting tests of transactions for either the SFH or CF direct loan programs nor considering program risks, like CF program eligibility as required. The tests of transactions were inadequate because the agency did not test a complete universe of loans or evaluate test results to determine if they impacted improper payments (i.e., analyzing the number and dollar value of the deficiencies noted to determine the adequacy of internal controls). RHS officials stated that they believed their review process over the tests of transactions as performed was adequate. However, once we provided them with our results, they agreed that they needed to strengthen the review process, which is a control function, to ensure sufficiency, adequacy, and accuracy of transaction testing. As a result, RHS could not support its conclusion that the programs are at low risk for improper payments.

According to OCFO guidance,[4] agencies must, as part of their program risk assessments, test a judgmentally selected sample of transactions "to determine the effectiveness of program design and internal controls in the prevention of improper payments." The guidance states that "the sample should be sufficiently large to support the agency's assertion that internal controls are working." The OCFO guidance[5] also states that agencies "may need to work with your agency's program, financial, internal review, budget, and performance management staff to complete these risk assessments."

Single Family Housing Direct Loan Program

The RHS risk assessment process did not include sufficient tests of transactions to support the conclusion that the SFH direct loan program was at low risk for significant improper payments. SFH officials substituted loans reviewed as part of a routine underwriting review of eligibility and an annual review of payment subsidy renewals as tests of transactions required by OCFO. Although OCFO's guidance allows for substituting tests that are part of a program's quality assurance process, our review disclosed deficiencies in the testing process which impaired the utility of the results substituted. For example, although the underwriting reviews identified errors with 8 of 22 loans (36 percent), officials did not establish the impact those errors had on eligibility. Similarly, errors detected in the subsidy renewal reviews were not quantified to assess their potential impact on improper payments.

Of 18,709 new loans made nationwide between May 2003 and May 2004, 490 loans had become delinquent within the first year. SFH officials conducted loan underwriting reviews of 22 of these delinquent new loans (attributable to 4 States), as part of their ongoing monitoring efforts to ensure adherence to the SFH program's underwriting standards.[6] SFH officials also used these underwriting reviews as part of the test of transactions to support their risk assessment determination. However, due to only a subuniverse (delinquent new loans) being tested, the results would not necessarily reflect the overall adequacy of eligibility controls for SFH loans.

Furthermore, program officials failed to obtain the information necessary to assess the adequacy of controls for even this limited sample of underwriting reviews used as a test of transactions. The reviewing officials determined, among other things, that of the 22 loans: (1) 8 (36 percent) did not meet credit standards, based on a review of applicants' credit history, (2) 6 (27 percent) did not have support to justify waivers for deficient credit histories, and (3) 8 (36 percent) had verification and calculation errors of various types including expired or missing income verifications and erroneous income calculations. If these errors resulted in loan applicant ineligibility, the loans would constitute improper payments. However, SFH officials told us that

[4] USDA FY 2005 Tests of Transactions Guidance, dated December 8, 2004.
[5] USDA FY 2005 Risk Assessment Guidance, dated November 10, 2004.
[6] The States were selected for review because they had new loan delinquency rates well above the national average and/or a high percentage of new loans on foreclosure and/or bankruptcy.

they did not follow up with the loan approving officials to determine if the errors found would have impacted the loan eligibility, but reported to OCFO that no loan was made to an unqualified borrower. Without fully evaluating the results of the underwriting reviews, RHS should not have used the information as a basis for evaluating the adequacy of the internal controls over loan eligibility. Furthermore, examining only delinquent borrowers provides no insight in identifying loans made to borrowers who had income in excess of program requirements (and thus were ineligible) but who were current on their loan payments.

SFH officials also offered a second test of transactions for the FY 2005 risk assessment, specifically, the annual interest credit subsidy review conducted by the Centralized Servicing Center (CSC).[7] Annually, the CSC selects a minimum of 1 percent of all subsidy renewals completed during the year and audits them for program compliance and accuracy.

CSC provided the overall number of subsidy renewals tested and unauthorized assistance found, however CSC did not break down the dollar figure and determine whether the errors found would have resulted in the granting of improper payment subsidies. CSC officials agreed that they should have compiled information relating to the annual subsidy review and its results in order to use it as a test of transactions. The officials stated they will provide the breakdown and impact on improper payments in subsequent years. Without information to show the number of renewals found in error and whether they resulted in improper payments, RHS did not have a basis for determining if this control measure was effective in detecting improper payments.

Based on RHS' use of these two reviews, we could not verify that the low risk ranking for the SFH Direct 502 Loan Program is appropriate.

We discussed our findings with SFH and CSC officials, who acknowledged that the tests of transactions were not conclusive. SFH officials told us they had believed the tests, as performed, were adequate to measure the effectiveness of internal controls to prevent improper payments. However, based on our discussions, they understood the need to improve the tests for future risk assessments.

Community Facility Direct Loan Program

CF officials did not fully adhere to guidance from OCFO in completing the risk assessment for the direct loan program in FY 2005. Our evaluation of the program's risk assessment disclosed it did not include eligibility as a risk, as required, and the test of transactions did not involve an assessment of how errors impacted improper payments, thus negating their utility. Thus, we questioned whether RHS' low ranking for the CF direct loan program was supported by the risk assessment.

In the risk assessment, officials only listed vulnerabilities related to CF's financial systems; they did not include any risks related to program eligibility. The program official that prepared the

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[7] The CSC provides oversight and monitors interest subsidies on loans for the SFH direct loan program. The subsidies reduce loan interest rates paid by borrowers to an effective interest rate as low as 1 percent, depending on the adjusted family income.

assessment acknowledged that improper payments could occur from eligibility errors or omissions. However, the official decided to exclude vulnerabilities associated with eligibility as a program risk because he did not believe there were any.

Further, RHS relied on its State Internal Review (SIR) report summary for FY 2003 to serve as its test of transactions for the CF direct loan program. RHS' Financial Management Division (FMD) randomly selected 146 deficiencies that were identified during reviews of both the direct and guaranteed loan programs. However, the universe for the direct loans was not known and the deficiencies FMD selected were not linked to only the CF direct loan program. We noted the SIR guide did address program risk issues, such as eligibility, but CF officials did not have the review results of the loans tested to evaluate their impact on loan eligibility and whether improper loans or payments had occurred. They only received a summary listing of the deficiencies and an assurance from FMD that it had determined there was no impact on improper payments. Without a total universe of direct loans or program-specific results to assess, CF officials could not identify problems found in the SIRs and determine their impact on improper payments. Therefore, the test of transactions was not adequate to support the program's low risk ranking.

During our review, program officials stated they had found a code in the SIRs that would distinguish direct loans from guaranteed loans. The officials stated that this would permit the agency to determine the direct loan universe and obtain results of the reviews to enable them to assess the impact of the review results on improper payments for FY 2006. The program official also stated that the FY 2006 risk assessment would include program risks and appropriately link them to specific internal controls.

SUMMARY

Based on our evaluation of the risk assessments and the available supporting documentation, we concluded that RHS had not collected and analyzed sufficient information to perform adequate tests of transactions for the two programs reviewed, nor had it considered all potential significant vulnerabilities. Without accurate tests of transactions to determine whether the programs' internal controls were effective in preventing improper payments, RHS could not support its conclusion that the programs were at low risk for improper payments.

RECOMMENDATIONS

Recommendation 1

Strengthen the review process over the tests of transactions to ensure that sufficient information is obtained and analyzed to provide reasonable assurance that OCFO's guidance is met.

Agency Response

RD concurred with the recommendation. In their response dated December 21, 2005 (see exhibit A), RD stated they would conduct risk assessments for the CF and SFH direct loan programs in accordance with OCFO guidance and would complete the test of transactions simultaneously with the Management Control Review (MCR), scheduled for February 13 through May 5, 2006. In their response, RD also stated that the results of their transaction testing for the CF Direct Loans, Section 502 Direct Loans, and payment subsidies, would be reported to include the universe of transactions, the number of transactions selected, how the selections were made, and the results of the transaction tests. RD would also conclude whether the testing supported a low risk determination for each program.

OIG Response

We concur with the management decision. For final action, RD needs to provide documentation to OCFO of the tests of transactions completed in accordance with the plan proposed in their response and within the specified timeframes.

Recommendation 2

Include eligibility determinations when assessing the risk of improper payments in the CF program.

Agency Response

RD concurred with the recommendation and in their response stated they would include eligibility determinations when assessing the risk of improper payments in the CF direct loan program and otherwise adhere to OCFO instructions in completing the risk assessment in FY 2006.

OIG Response

We concur with the management decision. For final action, RD needs to provide evidence to OCFO that eligibility determinations were included in the risk assessment of the CF direct loan program in FY 2006.

For both recommendations, please follow your agency's internal procedures in forwarding documentation for final action to OCFO. Final action on management decision should be completed within 1 year of the date of management decision to preclude being listed in the Department's annual Performance and Accountability Report.

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

Exhibit A – Agency Response

USDA Rural Development

United States Department of Agriculture
Rural Development

DEC 21 2005

TO: John M. Purcell
Director
Financial Management Division

THROUGH: Walter Wright
Financial Management Division

FROM: Russell T. Davis
for Administrator
Rural Housing Service

SUBJECT: Rural Development
Response to Audit Recommendations
Report No. 04601-0011-Ch

Upon the request of the Office of Inspector General (OIG), we are providing responses to the following audit recommendations specifying the corrective actions planned for implementing the Improper Payments Information Act of 2002:

1. **Strengthen the review process over the tests of transactions to ensure that sufficient information is obtained and analyzed to provide reasonable assurance that OCFO's guidance is met.**

   CP plans to strengthen the review process over the tests of transactions by completing the test of transactions simultaneously with the Management Control Review (MCR), which is scheduled for February 13, 2006 through May 5, 2006. This National Office review will consist of three percent or more of the CF direct loan files and projects.

   Single Family Housing (SFH) will also take advantage of the MCR scheduled this fiscal year to conduct the test of transactions. The SFH Direct Loan Division will conduct an in-house file review of 150 Section 502 loan dockets from five States that geographically represent the nation as a whole.

Accompanying the Direct Loan Division's in-house test of transactions will be the annual payment subsidy review conducted by the Centralized Servicing Center (CSC). CSC will report on the overall number of subsidy renewals tested, provide the unauthorized assistance found including a dollar breakdown, and state whether errors resulted in improper payments.

Every internal control listed in Section V of the risk assessment will be tested. Documentation of the methodology used to determine the sample, the universe of transactions and how the sample was selected will be summarized in the risk assessment. Documentation of the testing will include the following items at a minimum; the universe of transactions; the number of transactions that were tested; how the transactions were selected for testing; the results of testing; and a statement of whether the testing supports a low risk determination. The Agency plans to fully adhere to guidance from the Office of the Chief Financial Officer in completing the risk assessment for both the SFH and CP direct loan programs in FY 2006.

2. **Include eligibility determinations when assessing the risk of improper payments in the CF program.**

CP will include eligibility determinations when assessing the risk of improper payments in the CF program. Considerations will be given to program vulnerabilities and control measures for those risks.

Informational copies of this report have been distributed to:

Administrator, Rural Housing Service	
Through: Director, Financial Management Division	
Operations and Management	4
U.S. Government Accountability Office	1
Office of the Chief Financial Officer	
Director, Planning and Accountability Division	1
Office of Management and Budget	1