



United States Department of Agriculture
Office of Inspector General





United States Department of Agriculture
Office of Inspector General
Washington, D.C. 20250



DATE: September 28, 2012

AUDIT
NUMBER: 04703-0002-Hy

TO: Dallas Tonsager
Under Secretary
Rural Development

Tammy Trevino
Administrator
Rural Housing Service

ATTN: John Dunsmuir
Acting Director
Financial Management Division

FROM: Gil H. Harden
Assistant Inspector General for Audit

SUBJECT: Rural Development's Controls Over Eligibility Determinations for the Rural
Community Facilities Program's Direct Loan and Grant Recovery Act
Activities—Phase 2

This report presents the results of the subject audit. Your written response to the official draft report, dated August 21, 2012, is included in its entirety at the end of this report. Excerpts from your response and the Office of Inspector General's position are incorporated into the relevant sections of the report. Based on the written response, we are accepting your agency's management decision for all audit recommendations in the report, and no further response to this office is necessary.

Please follow your internal agency procedures in forwarding final action correspondence to the Office of the Chief Financial Officer. Please note that Departmental Regulation 1720-1 requires that final action be reached on all recommendations within 1 year of report issuance.

We appreciate the courtesies and cooperation extended to us by members of your staff during our audit fieldwork and subsequent discussions.

Table of Contents

Executive Summary	1
Background and Objectives	4
Section 1: Use of Recovery Act Funds for One Project Was Not in Accordance With Internal Agency Guidance	6
Finding 1: Rural Development Used Recovery Act Funds for a Project with a Swimming Pool	6
Recommendation 1	8
Section 2: Disbursement of Funds	9
Finding 2: Rural Development Disbursed Funds Before Recipients Met the Matching Requirements.....	9
Recommendation 2	10
Recommendation 3	10
Section 3: Required Insurance for Grant and Loan Projects	12
Finding 3: Rural Development Needs to Ensure that Grantees Purchase Insurance Needed to Protect the Government’s Interest	12
Recommendation 4	14
Scope and Methodology	15
Abbreviations	17
Exhibit A: Sampling Methodology for Recovery Act Audit of Rural Development Community Facilities Direct Loan and Grant Program	18
Agency’s Response	21

Rural Development's Controls Over Eligibility Determinations for the Rural Community Facilities Program's Direct Loan and Grant Recovery Act Activities—Phase 2

Executive Summary

Of the \$28 billion in loans, loan guarantees, and grants the American Recovery and Reinvestment Act of 2009 (Recovery Act) provided to the Rural Development mission area,¹ Congress set aside \$1.1 billion for direct loans and \$61 million for grants as part of the Rural Housing Service's (RHS) Community Facilities Direct Loan and Grant Program. This program provides loans and grants designed to build essential community facilities for public use in rural areas such as schools, libraries, childcare facilities, hospitals, medical clinics, assisted living facilities, fire and rescue stations, police stations, and community centers. As mandated by the Recovery Act, the Office of Inspector General (OIG) is responsible for monitoring agency activities and ensuring that funds were expended in a manner that minimized the risk of improper use.² OIG initiated this audit—the second related to the controls over the funds provided under the Community Facilities Direct Loan and Grant Program—to determine if program participants and project purposes met eligibility requirements and if RHS properly monitored the use of funds to ensure that Recovery Act funds were disbursed and used in accordance with project specifications.

Based on our review of a statistically selected sample of 81 loans and grants, totaling \$18.3 million, we generally found that program participants and project purposes met eligibility requirements and that Rural Development's internal controls were adequately designed and operating as prescribed. However, we identified three instances where Rural Development could enhance its controls over these grants and loans:

- We found that Rural Development approved both a loan and a grant, totaling \$13.1 million, to construct a multi-function community center that featured a swimming pool,³ a use which was not in accordance with guidance provided by RHS.⁴ National office officials are required to provide concurrence to the State and area offices for loan and grant requests over \$3 million. Although the Rural Development officials who approved the project stated that they were not aware of the pool's existence when they made the decision to obligate Recovery Act funds for the project, we found that other personnel at both RHS Headquarters and the responsible Rural Development State office were, in fact, aware that at the time of loan approval, the borrowers planned to include a swimming pool as part of the project's overall design. However, neither the State office nor the national office took steps to determine whether the pool—which was, in fact, built using

¹ Public Law 111-5, dated February 17, 2009.

² Office of Management and Budget M-09-15, *Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009*, dated April 3, 2009.

³ Loan amount of \$12,609,600 and grant in the amount of \$500,000.

⁴ The Administrator's unnumbered letter, dated September 1, 2009, further prohibited the use of Recovery Act funds for projects that were associated with swimming pools and other specified purposes, even where these were not directly funded under the Recovery Act.

non-Rural Development funding—was still included as part of the project at the time of fund obligation. As a result, this project received \$13.1 million in Recovery Act loan and grant funds that was not in accordance with RHS’ updated guidance at that time.

- Rural Development offices in two States disbursed two Recovery Act Community Facilities Program grants before the recipients had contributed the matching funds for their projects, as required by the agency’s guidance. This occurred because Rural Development did not have adequate controls in place to ensure that recipients had contributed their matching funds before they received grant funds. Based on the results of our statistical sample, we project that a total of 24 loans or grants, representing \$712,000 in funds, were disbursed to recipients who had not met their matching fund requirement.⁵
- Rural Development disbursed Recovery Act funds to three⁶ recipients who did not have required insurance coverage at the time of loan closing. Although Rural Development had controls in place to ensure that the recipients obtained appropriate and adequate liability coverage, area officials did not adequately implement these controls. If these recipients were to default on the loans, Rural Development could ultimately be responsible for the amount of the loans. Based on the results of our statistical sample, we project a total of 59 loans and grants, representing \$5.8 million in Recovery Act funds, did not have the required coverage to protect the Government’s interest.⁷

By addressing the weaknesses in the Community Facilities Direct Loan and Grant Program identified in this report, Rural Development would put in place a more robust system of controls for disbursing loans and grants and thereby ensure that Federal funds are spent in ways that further the goals of the program.

Recommendation Summary

We recommended that RHS develop and implement additional controls to ensure that approving officials receive all relevant information affecting the loan and grant approval process for Community Facilities projects over \$3 million. In addition, we recommended that RHS strengthen its controls to verify that matching fund requirements have been met and recipients have appropriate insurance coverage before they close on grants or loans.

⁵ We are 90 percent confident that between 3 and 51 loans and grants did not satisfy this condition. Based on our sample results, the associated amount obligated for loans and grants with this exception ranges from a low of the \$60,010 found in the sample to a projected upper limit (90 percent confidence level) of \$1.7 million. See Exhibit A for sampling information.

⁶ These three recipients received a total of two loans and three grants totaling \$493,010.

⁷ We found five loans and grants with insurance exceptions. We are reporting five as the minimum number of loans and grants with insurance exceptions because the calculated lower boundary of a one-sided 90 percent confidence interval is lower than the actual number of exceptions found. The associated amount obligated for loans and grants with this exception ranges from a low of the \$493,010 found in the sample to a projected upper limit (90 percent confidence level) of \$15 million. See Exhibit A for sampling information.

Agency Response

In their written response to the official draft report dated August 21, 2012, RHS officials agreed with the findings and recommendations as presented. We have incorporated the response in the Findings and Recommendations section of this report, along with our comments in the applicable OIG Position sections. The agency's response to the official draft is included in its entirety at the end of this report.

OIG Position

Based on the agency's response, we accept management decisions for all recommendations listed in this report.

Background and Objectives

Background

Rural Development's Rural Housing Service (RHS) is responsible for distributing Recovery Act funds through the Community Facilities Direct Loan and Grant Program. These loans and grants are designed to build essential community facilities for public use in rural areas with a population of 20,000 or less. The facilities include schools, libraries, childcare facilities, hospitals, medical clinics, assisted living facilities, fire and rescue stations, police stations, and community centers. Eligible applicants include public entities, units of local government, Federally-recognized Indian tribes, and nonprofit organizations. The program is administered by Rural Development through RHS' State and area offices.

In response to the economic downturn, Congress passed the American Recovery and Reinvestment Act of 2009 (Recovery Act), which the President signed into law on February 17, 2009, with the purpose of preserving and creating jobs, promoting economic recovery, and assisting those most impacted by the recession.⁸ The Recovery Act authorized approximately \$28 billion in loans, loan guarantees, and grants to the Rural Development mission area to assist in achieving the purposes of the Recovery Act. The Community Facilities Direct Loan and Grant Program received \$1.1 billion for direct loans and \$61 million for grants. This funding was in addition to the annual appropriations for this program.

Congress, in enacting the Recovery Act, emphasized the need for accountability and transparency in the expenditure of funds. The Office of Management and Budget (OMB) issued guidance that required Federal agencies to establish rigorous internal controls, oversight mechanisms, and other approaches to meet the accountability objectives of the Recovery Act.⁹ Our role, as mandated by the Recovery Act, was to oversee agency activities and to ensure agencies expended funds in a manner that minimizes the risk of improper use.

Rural Development's national office coordinates, plans, and maintains control of the Community Facilities Direct Loan and Grant Program. In addition, the national office provides concurrence to the State and area offices for loan and grant requests over \$3 million. Rural Development's State and area offices process the direct loan and grant applications. The area offices accept loan and grant applications, process them, and serve as a point of contact for the applicant during and after the application process. Based on the area office reviews of the applications and supporting documentation, they provide recommendations to the State offices to approve the loans and grants. The State offices monitor loan and grant activities and provide assistance to area offices.

With the implementation of the Recovery Act, the Secretary issued guidance, dated March 23, 2009, to ensure that the funds received under the Recovery Act are expended responsibly and in a transparent manner. As part of this guidance, the Office of the Secretary required Rural Development to submit all Recovery Act funding requests to the Secretary's office for

⁸ Public Law 111-5, Division A, Title XVI, Section 1604, dated February 17, 2009.

⁹ *Initial Implementing Guidance for the American Recovery and Reinvestment Act of 2009*, February 18, 2009, and *Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009*, April 3, 2009.

review. State offices were required to submit all requests for direct loans and grants funded with Recovery Act funds to the national office. The national office reviewed and submitted the Recovery Act applications to the Office of the Secretary for concurrence before obligating funds.¹⁰ In addition, the Office of the Secretary submitted these data to OMB for its review and further concurrence with Rural Development's approval of each application. Once the Office of the Secretary and OMB concurred, Rural Development officials announced the projects selected to receive Recovery Act funding through press releases. The funds for the approved projects were transferred from the national office to the State offices' accounts.

We used a multi-phase approach in performing our review of the Community Facilities program Recovery Act activities. In Phase 1, we evaluated the agency's policies, procedures, and internal controls for distributing Recovery Act funds.¹¹ Our review found that Rural Development's national, State, and area offices had adequate controls in place to ensure the proper review and approval of the projects receiving Recovery Act funding.

Objectives

Our audit objective was to test compliance with the provisions of the Recovery Act and with RHS' regulations and procedures, and to evaluate the effectiveness of RHS' internal controls over the Community Facilities Direct Loan and Grant Program. This included determining if (1) program participants and project purposes met eligibility requirements, (2) RHS properly monitored the use of Recovery Act funds to ensure that they were disbursed and used in accordance with approved project specifications; and (3) Rural Development implemented an effective outreach program in order to ensure that the goals of the Recovery Act were met. Our assessment of Rural Development's outreach program determined that it likewise was effective in addressing the goals in the Recovery Act.

¹⁰ Rural Development officials refer to this as the clearance process, which consists of reviews by both the Office of the Secretary and the Office of Management and Budget.

¹¹ *Controls Over Rural Community Facilities Direct Loan and Grant Program Recovery Act Activities—Phase I* (04703-0001-Hy, July 23, 2010).

Section 1: Use of Recovery Act Funds for One Project Was Not in Accordance With Internal Agency Guidance

Finding 1: Rural Development Used Recovery Act Funds for a Project with a Swimming Pool

Both Federal regulations and Rural Development guidelines prohibit the use of Recovery Act funds for community facilities projects that include swimming pools; however, we found that Rural Development approved both a loan and a grant, totaling \$13.1 million, to construct a multi-function community center that featured a swimming pool.¹² Although Rural Development officials stated that they were not aware of the pool's existence when they made the decision to obligate Recovery Act funds for the project, we found that personnel at both RHS Headquarters and the responsible Rural Development State office were aware that the project's original design included a swimming pool, and did not take steps to determine whether these plans had changed before obligating Recovery Act funds. As a result, \$13.1 million in Recovery Act loan and grant funds was used for a project that was not in accordance with guidance provided by the Administrator in an unnumbered letter prior to the date that the agency obligated Recovery Act funds for the project.

The Recovery Act states that funding may not “be used by any State or local government, or any private entity, for any casino or other gambling establishment, aquarium, zoo, golf course, or swimming pool.”¹³ The Administrator for Housing and Community Facilities Programs further required on September 1, 2009, that “[p]rojects receiving [Recovery Act] funds cannot have any association with the aforementioned ineligible purposes, *even when the ineligible portion was not funded from the [Recovery Act] allocation*” (emphasis added by OIG).

Since funding requests for loans and grants of over \$3 million must be reviewed at the RHS national office before State officials approve the projects, we reviewed¹⁴ 26 of the 30 approved loan and grant funding requests over \$3 million in order to evaluate the effectiveness of this review.¹⁵ Totalling over \$393 million in Recovery Act funds, these projects included hospitals, assisted living facilities, schools, and community centers. We found that one of these applications requested grants and loans, totaling \$13.1 million, for a multi-purpose community center which would house administrative offices, a fitness center with locker rooms, and a swimming pool.¹⁶

In June 2009, during the loan review, the national office loan specialist advised the State office that the cost of constructing the pool needed to be removed from the total project cost in order

¹² Loan amount of \$12,609,600 and grant in the amount of \$500,000.

¹³ Public Law 111-5, Division A, Title XVI, Section 1604, dated February 17, 2009.

¹⁴ We did not conduct site visits for these projects.

¹⁵ As of April 30, 2010.

¹⁶ The original funding request on the recipient's application was \$14 million. However, the loan review document showed a request for an \$11.4 million direct loan and \$200,000 grant. In June 2010, RD obligated an additional \$1.5 million in direct loan funds to the recipient to cover construction change orders from the contractors, resulting in a total award amount of \$13.1 million.

for Rural Development to approve the funding. The State office notified the applicant of this on June 22, and on July 10, 2009, the State office resubmitted the amended project budget with the cost of the swimming pool deducted. On July 13, 2009, the Rural Development national office concurred with the State office approval of the project. Based on the guidance available at that time—the wording of the Recovery Act itself, which prohibited the use of funds made available under the Act for swimming pools and other specified purposes—Rural Development officials believed that the decision to approve the loan and grant after deducting the amount applicable to the construction of the swimming pool was reasonable. However, between that time and the actual obligation of funds for the project on September 29, 2009, the Administrator issued an unnumbered letter,¹⁷ under which guidance this project should not have received Recovery Act funding. We interviewed officials of RHS’ national office to determine why they did not, at this point, either reconsider the project’s eligibility or take steps to fund the project out of their regular appropriated funds, rather than Recovery Act funds. The officials who approved the obligation of funds in September 2009 stated that they were not aware of the pool’s existence. They said that the State’s regular annual appropriation could not have supported the large dollar value of the project; however, they also confirmed that if they had had information showing that the project included a swimming pool, they would not have approved the obligation of Recovery Act funds.

RHS approving officials stated that they did not become aware of the pool’s existence until the project was first inspected on January 6, 2010, more than 3 months after the funds were obligated. Therefore, RHS believed that there was no reason for them not to proceed with the September 29, 2009, obligation of Recovery Act funds. Although the State office did provide the national office with project documents, such as the application, letter of conditions,¹⁸ project financials, and construction documents, neither office followed up to determine whether or not the recipient still intended to include the swimming pool as part of the project, following RHS’ June 2009 determination not to fund the pool itself. During our review of the communications between the recipient and the national and State offices, we found that there were no stipulations that the pool could not be built, only that it could not be directly funded under the Recovery Act. Nor was there any indication that the recipient’s construction plans had changed as a result of the reduction in funding.

Under the guidance that was in effect at the time of the original agreement in June 2009, Rural Development and RHS officials believed at that time that they could approve the use of Recovery Act funds as long as Recovery Act funds were not used to build the swimming pool. However, when the Administrator’s unnumbered letter was issued in September 2009, it changed the criteria that RHS officials were to use in determining whether a project could receive Recovery Act funds; however, there was no process in place to ensure that the continued suitability of this loan and grant—or that of other loans and grants requiring Headquarters-level approval— was re-evaluated for compliance with the updated requirement, and that responsible officials would receive all relevant information needed to make such

¹⁷ The Administrator’s unnumbered letter, dated September 1, 2009, further prohibited the use of Recovery Act funds for projects that were associated with swimming pools and other specified purposes, even where these were not directly funded under the Recovery Act.

¹⁸ The letter of conditions is given to recipients as a tentative approval, provided they satisfy all of the requirements contained in the letter within a prescribed timeframe.

determinations. Based on the position of National Office officials that they would not have approved the obligation of Recovery Act funds if they had been aware that the project included a swimming pool, we believe that Rural Development needs to strengthen its controls to ensure that funds are not being used for projects not in accordance with program guidance, and that responsible officials have sufficient information available to them to make these determinations.

Recommendation 1

Develop and implement additional controls to ensure that approving officials receive and review all relevant information affecting the loan and grant approval process for Community Facilities projects over \$3 million, particularly in circumstances where eligibility requirements are changed before funds are obligated.

Agency Response

In the response dated August 21, 2012, agency officials stated that they will develop additional controls to ensure that all information affecting loan/grant approvals are reviewed. The guidance will be provided in the form of an unnumbered letter addressing the requirements specific to this finding and compliance for the program. The estimated completion date for this action is October 31, 2012.

OIG Position

We accept management decision for this recommendation.

Section 2: Disbursement of Funds

Finding 2: Rural Development Disbursed Funds Before Recipients Met the Matching Requirements

Based on our review of 81 statistically selected loans and grants in 11 States, we found that Rural Development offices in 2 States disbursed 2 Recovery Act community facilities grants before the recipients had contributed the required matching funds for their projects. This occurred because Rural Development did not have adequate controls in place to ensure that recipients had spent their matching funds before they received grant funds. Unless Rural Development adequately monitors grant recipients' compliance with matching requirements, it cannot ensure that the recipients are following the terms of their grant agreements or are using Recovery Act funds as required. Based on the results of our statistical sample, we project that a total of 24 loans and/or grants, representing \$712,000 in Recovery Act funds, were disbursed before the recipients met their matching requirement.¹⁹

Rural Development's requirements state that "[g]rant funds will not be disbursed until they are actually needed by the applicant and all [matching] funds are expended."²⁰ Likewise, the letter of conditions signed by each grantee states that the applicant's contribution of funds toward the project cost shall be considered the first funds expended. In addition, the letter of conditions requires that recipients provide invoices supporting the amount of funds requested.²¹ In two States, however, we found that Rural Development area offices disbursed Recovery Act funds before the recipients' matching funds were used for 2 of the 81 grants we sampled.

In California, we found that Rural Development disbursed \$50,000 of Recovery Act funds to one recipient, even though the recipient had only contributed \$42,000 of its \$57,450 in required matching funds. State and area officials agreed that the procedures for disbursing matching funds were not followed. OIG concluded that the area officials did not adequately review the recipient's supporting documentation and released funds on invoices that the grant recipient had been billed, but had not yet paid. When we spoke to the recipient of this grant, he stated that Rural Development urged him to request the grant funds, even though he informed them that he had not yet spent the full amount of his matching funds. He stated that area officials replied that they were under pressure to disburse funds, and that, as a result, he provided them with copies of unpaid invoices. We discussed this issue with Rural Development State officials, who stated that they were unaware of any urging by area office personnel to disburse project funds prior to the recipient's having spent the required matching funds.

In Missouri, Rural Development approved a disbursement of \$10,010 in Recovery Act funds, but required that the grantee contribute \$8,190 for a project that involved purchasing and installing

¹⁹ We are 90 percent confident that between 3 loans and grants and 51 loans and grants did not satisfy the condition. Based on our sample results, the associated amount obligated for loans and grants with this exception ranges from a low of the \$60,010 found in the sample to a projected upper limit (90 percent confidence level) of \$1.7 million. See Exhibit A for sampling information.

²⁰ Rural Development Instruction 3570.80(f).

²¹ Not all letters of conditions stipulate that the recipient must provide invoices and other financial verification before funds are disbursed.

an emergency warning siren. We found that, although Rural Development disbursed grant funds to the recipient more than 90 days before the recipient needed the funds to pay for the equipment, the recipient had not first contributed its matching funds, as required by Rural Development's requirements. In August 2010, we visited the recipient to verify the purchase of the approved equipment, and found the equipment uninstalled and in its original packaging. The recipient stated that the siren was not installed because the town was waiting for the final architectural plans for a new fire engine barn. When we discussed this issue with Rural Development area officials, they stated that they believed the project was underway and had disbursed the funds under that assumption; their decision was also based, in part, on the belief that the recipient did not have the financial resources to purchase the siren and wait for a reimbursement. Rural Development officials at both the State and national offices agreed that the premature disbursement of funds was an error.

We concluded that Rural Development needs to strengthen its controls over the disbursement process to ensure that grant funds are not provided to recipients until all matching funds stipulated by their grant agreements have been used.

Recommendation 2

Develop and implement written requirements that all letters of conditions stipulate that funds will not be disbursed until the recipient is able to provide evidence, such as paid invoices and other financial verification, that the matching fund requirements have been met.

Agency Response

In their response dated August 21, 2012, agency officials stated that the letter of conditions presently includes the appropriate language regarding applicant contributions. However, Community Facilities officials can strengthen the oversight procedures used by field staff by implementing additional processing procedures to ensure that recipients are compliant with matching fund requirements prior to the disbursing of funds. RHS will provide guidance in the form of an unnumbered letter addressing the requirements specific to this finding and compliance with program requirements. The estimated completion date for this action is October 31, 2012.

OIG Position

We accept management decision for this recommendation.

Recommendation 3

Strengthen the oversight procedures used by field staff to verify recipients' compliance with the matching fund requirements before disbursing grant funds.

Agency Response

In their response dated August 21, 2012, agency officials stated that they would strengthen the oversight procedures used by field staff by implementing additional processing procedures to ensure that recipients are compliant with matching fund requirements prior to the disbursing of funds. RHS will provide guidance in the form of an unnumbered letter addressing the requirements specific to this finding and compliance with program requirements. The estimated completion date for this action is October 31, 2012.

OIG Position

We accept management decision for this recommendation.

Section 3: Required Insurance for Grant and Loan Projects

Finding 3: Rural Development Needs to Ensure that Grantees Purchase Insurance Needed to Protect the Government's Interest

Rural Development disbursed Recovery Act funds to three recipients who either did not have insurance coverage or fidelity bonds,²² or who did not provide proof of insurance at the time of loan closing.²³ Although Rural Development had controls in place to ensure that the recipients obtained appropriate and adequate liability coverage, area officials did not adequately implement these controls. If these recipients were to default on the loans (or if projects were to be damaged), Rural Development could ultimately be responsible for the amount of the loans. Based on the results of our statistical sample, we project a total of 59 loans and grants, representing \$5.8 million in Recovery Act funds, which did not have the required coverage to protect the Government's interest.²⁴

To ensure that the Government's financial interest is protected, Rural Development requires that all borrowers and grantees obtain and maintain adequate insurance coverage by loan closing or the start of construction, whichever occurs first. Additionally, loan recipients are required to obtain fidelity bond coverage. Adequate coverage must be maintained for the life of the loan, and borrowers and grantees must provide evidence of the policies to the area offices.²⁵ In order to ensure that these requirements are met, each recipient file contains a processing checklist to ensure that the recipient fulfills the necessary requirements to receive a disbursement of awarded loan and grant funds.

During our review at agency area offices in two States, we found that Rural Development closed on loans and grants to three different recipients who did not have adequate insurance or fidelity bond coverage at the time of closing.²⁶

- In Tennessee, one recipient was awarded a loan in the amount of \$166,000 and a grant in the amount of \$75,000 to purchase and renovate an existing building. During our review of the recipient files, we found that, although closing occurred in July 2010, the recipient did not purchase liability insurance until August of the same year and did not provide a valid copy of its fidelity bond.²⁷ Although the letter of conditions required the recipient to submit proof of a fidelity bond in an amount at least equal to the total annual debt

²² Fidelity bonds cover all persons with access to the funds, in the event of unauthorized use and theft of the funds.

²³ Grantees are required to purchase property insurance; liability and property damage insurance, which include vehicle coverage; malpractice insurance; flood insurance; and worker's compensation insurance.

²⁴ We found five loans and grants with insurance exceptions. We are reporting five as the minimum number of loans and grants with insurance exceptions because the calculated lower bound of a one-sided 90 percent confidence interval is lower than the actual number of exceptions found. The associated amount obligated for loans and grants with this exception ranges from a low of the \$493,010 actually found in the sample to a projected upper limit (90 percent confidence level) of \$15 million. See Exhibit A for sampling information.

²⁵ Rural Development Instruction 1942.17 (j) (3).

²⁶ Rural Development defines the closing date as when the recipient signs a Promissory Note or a Grant Agreement. Prior to closing, the recipient must also satisfy all requirements in the letter of conditions.

²⁷ The fidelity bond went into effect in February 2008, but was not submitted at the time of closing.

requirements for the loan, there were no markings or notations on the letter to indicate that the area officials verified that the borrower had obtained the required insurance and fidelity bonds prior to closing. Officials at the Rural Development area office were unable to provide an explanation for the missing documents, simply citing an oversight on their part. Additionally, the area officials stated that they took the recipient's word that insurance had been purchased. The recipient was unable to explain why the property was not adequately insured, and stated during our visit that it was in the process of being insured.

- Also in Tennessee, a recipient was awarded a loan in the amount of \$192,000 and a grant in the amount of \$50,000 to construct a new building, but did not have proof of insurance coverage or a fidelity bond at the time of closing. The recipient's file at the area office contained insurance documents which we determined were for an entity other than the recipient. When we visited the recipient, however, we learned that the recipient had both insurance and a fidelity bond in place at the time of loan closing, but Rural Development did not have the documents in the file.

Area officials indicated that they contacted the recipient's fidelity bond holder in order to verify the recipient's coverage and did not require the recipient to provide these documents at the time of closing. OIG also brought to area officials' attention that the liability insurance on file was incorrect and, in September 2010, the area office received the correct insurance documents from the recipient. OIG also noted that the processing checklist in the recipient's file was incomplete, and had not been used to ensure that the recipient provided this documentation.

- In Missouri, a recipient received a grant in the amount of \$10,010, in March 2010, to acquire and install an emergency warning siren,²⁸ but we found that proof of insurance coverage was not in the file. During our site visit to the recipient, we verified that the recipient did not have insurance.

OIG inquired with area officials as to what controls exist to ensure that all documents were obtained at closing. We learned that the area officials use a checklist to certify that recipients provide all required documentation. In this particular case, the checklist shows the dates for all other required documentation, except for evidence of insurance coverage. OIG asked why area officials did not verify insurance coverage at closing. Area officials disclosed that they did not conduct a closing meeting prior to the grant disbursement.²⁹ If area officials had conducted a closing meeting, they would have discovered that the recipient had not provided insurance coverage. As a result of our inquiry, the recipient immediately contacted its insurance company to have the project insured. The project was insured in August 2010, after the funds were disbursed in March 2010 and the single payment for the project was made in July 2010.

²⁸ This is the same grant identified in Finding 2, for which funds were disbursed before the recipient needed them.

²⁹ The closing meeting is conducted to ensure all the required documents were obtained to ensure the project is still in compliance and to disburse funds.

OIG concluded that, although Rural Development area officials are provided with checklists to ensure that recipients meet all of the requirements outlined in the regulations in order to receive loan and grant funds (including procuring insurance and fidelity bonds), area office staff did not consistently use the checklists to ensure that all the required information was submitted prior to loan and grant closing. The agency needs to develop and implement additional controls to ensure that loan and grant funds are not disbursed until recipients satisfy all program requirements. Rural Development national office officials agreed that more controls are needed regarding insurance coverage. They stated that, during their Management Control and State Internal Reviews, they have noted similar problems with insurance coverage; they stated that they have issued an unnumbered letter which should address the problem.

Recommendation 4

Develop and implement an additional level of review to ensure that area officials complete the processing checklist as intended prior to loan and grant closing.

Agency Response

In their response dated August 21, 2012, agency officials stated that Rural Development field staff must ensure that the borrower/grantee provides evidence of adequate insurance including fidelity bond coverage prior to loan closing or at the start of construction as required. RHS officials agreed to implement additional controls to ensure that verification of adequate insurance is provided and that coverage is maintained by the borrower/grantee. The guidance will be provided in the form of an unnumbered letter addressing the requirements specific to these findings and compliance for the program. The estimated completion date for this action is October 31, 2012.

OIG Position

We accept management decision for this recommendation.

Scope and Methodology

Our audit examined Community Facilities Direct Loan and Grant activity under the Recovery Act from April 1, 2009, through April 30, 2010. We examined applicable regulations and policies and evaluated the effectiveness of RHS' internal controls relating to the approval, obligation, and disbursement of Community Facilities direct loans and grants. We conducted our review at the RHS national office in Washington, D.C., and at statistically selected Rural Development area offices in 11 States.³⁰ We reviewed loan and grant application dockets in the State and area offices for projects in our statistical sample and loan review documents for projects over \$3 million at the national office. We also reviewed loan and grant monitoring procedures. However, we did not review the IT system or assess the integrity of the data in the system since the information system controls were reviewed by other OIG audit teams. Lastly, we reviewed Rural Development's outreach procedures.

Loan and Grant Universe

We obtained a list of 1,126 Recovery Act loans and grants that were obligated between April 1, 2009, and April 30, 2010, from the Rural Development Information Technology staff. These loans and grants represented a total of 901 projects. We generated an audit sample based on the area office that processed the application. As a result, we obtained a sample of 81 loans and grants, representing 65 projects, totaling \$18.3 million in obligations and \$2.2 million in disbursements, located in 15 service areas.³¹ We visited the area offices to review the loan and grant files to determine if program participants and project purposes met eligibility requirements. As of September 30, 2011, disbursements totaled almost \$8.3 million on 62 projects.³²

We also reviewed a total of 26 loan and grant requests within our universe from applicants requesting Recovery Act funds exceeding \$3 million. Our purpose was to determine the process used by the national office to review these projects for consideration of Recovery Act funding, as well as to determine whether the purposes of the approved projects met the intent of the Recovery Act and otherwise complied with program requirements outlined in Rural Development instructions.

Rural Development National Office

At the Rural Development national office, in addition to reviewing the eligibility procedures for projects over \$3 million, we reviewed laws, regulations, and directives of the Community Facilities Program, as well as Recovery Act laws and regulations. We also reviewed Rural Development's directives and guidance for Recovery Act implementation within the agency.

³⁰ OIG performed fieldwork in California, Colorado, Georgia, Illinois, Indiana, Maryland, Minnesota, Mississippi, Missouri, Tennessee, and Virginia. See Exhibit A.

³¹ The service areas represent one or more area offices within a State. Although our sample selected 15 service areas, we learned this encompassed 18 area offices. These offices were located in Alturas, California; Yreka, California; Redding, California; Elk Grove, California; Oroville, California; Bent County, Colorado; Sandersville, Georgia; Champaign County, Illinois; North Vernon, Indiana; Muncie, Indiana; Hagerstown, Maryland; Baxter, Minnesota; Batesville, Mississippi; St. Joseph, Missouri; Farmington, Missouri; Cookeville, Tennessee; Union City, Tennessee; and Courtland, Virginia.

³² Funds to three projects have been deobligated since the beginning of our audit work.

We reviewed the agency's tracking and reporting process and reviewed funding reports to determine if the agency was meeting the Recovery Act performance goals. Lastly, we evaluated the Community Facilities Program Recovery Act obligations to determine whether all Community Facilities Program Recovery Act funds would be obligated by the end of fiscal year 2010.

Rural Development State Offices

At the Rural Development State offices, we reviewed and tested eligibility controls for the Community Facilities Program to determine if the program was executed in accordance with regulations and policies, and if loan and grant recipients met eligibility requirements. In order to test eligibility, we reviewed the loan and grant files to verify applicant eligibility factors. We also reviewed the State's administrative funding plan to ensure that it adhered to national office guidance. We reviewed how the State orchestrated outreach for the Recovery Act. Lastly, we evaluated the State's obligation of Recovery Act funds to ensure that projects met the intent of the Recovery Act.

We conducted these tests by examining Community Facilities Program projects where funds were obligated as of April 30, 2010, and either fully or partially disbursed at the time of our site visits. For those projects for which Rural Development disbursed funds, we visited the recipient to review its files to determine if funds were used in accordance with Rural Development regulations and the related loan and grant agreements. Additionally, we inspected the final projects.

We conducted our review in accordance with Generally Accepted Government Auditing Standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions.

Abbreviations

FIPS.....	Federal Information Processing Standard
OIG	Office of Inspector General
OMB	Office of Management and Budget
Recovery Act	American Recovery and Reinvestment Act
RHS.....	Rural Housing Service

Exhibit A: Sampling Methodology for Recovery Act Audit of Rural Development Community Facilities Direct Loan and Grant Program

Objective:

This sample was designed to support the audit of Recovery Act funding awarded to the Community Facilities Direct Loan and Grant Program. We chose a random sample of Rural Development loan and grant servicing areas to test whether loans and grants for Community Facilities Program projects awarded Recovery Act funds complied with applicable laws and agency procedures.

Audit Universe:

Our audit universe consisted of 1,126 loans and grants awarded under the Recovery Act as of April 30, 2010. The total amount obligated for these 1,126 loans and grants was \$638 million at that time. The universe list was provided by Rural Development. The loans and grants were spread over a total of 47 States and were serviced by total of 178 servicing areas, which are identified by State and county key codes defined in the Federal Information Processing Standard (FIPS).³³

Sample Design:

We prepared a cluster sample with simple random selection of servicing areas. In this design, all Recovery Act projects within a servicing area formed a cluster. We used the “randbetween”³⁴ function in Microsoft[®] Excel to select 15 clusters, spread among 11 States, for review from the 178 clusters in the audit universe. For the clusters selected, all loans and grants were reviewed. This resulted in 81 loans and grants in the sample.

³³ A standardized set of numeric or alphabetic codes issued by the National Institute of Standards and Technology to ensure uniform identification of geographic entities through all Federal Government agencies.

³⁴ This is a Microsoft[®] Excel function that returns a random number in a specified range.

Exhibit A: Sampling Methodology for Recovery Act Audit of Rural Development Community Facilities Direct Loan and Grant Program

This sample design is summarized in the table below, which identifies the specific servicing areas selected and their corresponding number of loans and grants:

Design Summary	Number of Servicing Areas (Clusters)	Number of Loans & Grants (Total for Clusters)
Universe	178	1,126
Sample	15	81
Servicing Areas Selected		
Servicing Area FIPS code	Servicing Area Location (City, State)	Number of Loans & Grants
06089	Alturas, CA/ Yreka, CA/ Redding, CA	6
06007	Elk Grove, CA/ Oroville, CA	5
51175	Courtland, VA	12
18079	North Vernon, IN	2
18035	Muncie, IN	3
08011	Bent County, CO	2
13303	Sandersville, GA	5
24043	Hagerstown, MD	1
28107	Batesville, MS	16
27035	Baxter, MN	1
47131	Union City, TN	2
47141	Cookeville, TN	11
17019	Champaign County, IL	2
29021	St. Joseph, MO	6
29187	Farmington, MO	7

Results:

When a criterion did not apply to a specific loan or grant, we considered the criterion met, i.e., no exception. Direct projection of exceptions (numbers or dollars) using cluster sample formulae yielded the results summarized in this section.³⁵ Even with a total of 81 loans and grants in the sample, the selection of only 15 clusters resulted in wide confidence intervals, caused by variability between the clusters.³⁶

³⁵ Scheaffer, Mendenhall, Ott, Elementary Survey Sampling, Duxbury Press, c. 1990, Chapter 8, particularly equations 8.8 through 8.10.

³⁶ We tested several scenarios to determine whether reviewing additional clusters might improve precision. From those tests, we concluded that, even with a sample of 28 clusters (137 FIPS), there was not enough change to warrant the large increase in fieldwork. We concluded that a much larger sample size, and, possibly, a sample redesign with stratification on cluster size, would be needed to significantly improve precision.

Exhibit A: Sampling Methodology for Recovery Act Audit of Rural Development Community Facilities Direct Loan and Grant Program

Criterion for Finding 2: Recovery Act funding was disbursed before recipients had contributed the matching funds for the projects.

We found two exceptions to this criterion. As a result, we projected a total of 24 loans or grants for which the applicant had not contributed matching funds. We are 90 percent confident that at least 3 loans and grants did not satisfy the condition.

Based on our sample results, the associated amount obligated for loans and grants with this exception ranges from a low of the \$60,010 found in the sample to a projected upper limit (90 percent confidence level) of \$1.7 million. The point estimate is \$712,000.

Criterion for Finding 3: Recovery Act funding was disbursed to recipients who did not have required insurance coverage at the time of loan closing.

We found five exceptions to this criterion. As a result, we projected a total of 59 projects for which the recipients did not have required insurance coverage prior to funds being disbursed. The logical lower bound is the five exceptions found, because the calculated lower bound of a one-sided 90 percent confidence level is lower than the actual number of exceptions in the sample.

Based on our sample results, the associated amount obligated for loans and grants with this exception ranges from a low of the \$493,010 found in the sample to a projected upper limit (90 percent confidence level) of \$15 million. The point estimate is \$5.8 million.

**USDA'S
RURAL HOUSING SERVICE
RESPONSE TO AUDIT REPORT**



United States Department of Agriculture
Rural Development

August 24, 2012

TO: Gil Hardin
Assistant Inspector General
for Audit
Office of Inspector General

FROM: John Dunsmuir
Acting Director
Financial Management Division

SUBJECT: Official Draft Report # 04703-002-HY: Controls over Eligibility Determinations
for Rural Community Facilities Program Direct Loan and Grant Activities

Attached, please find Rural Housing Service's response to the subject official draft report.

If you have any questions, please contact Debby Shore of my staff at (202) 692-0191.

/s/ John Dunsmuir

Attachment

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August 21, 2012

TO: Gil Hardin
Assistant Inspector General
for Audit

FROM: Tammye Treviño
Administrator
Housing and Community Facilities

THRU: John Purcell
Director
Financial Management Division

SUBJECT: Audit Number 04703-2-HY
Controls over Eligibility Determination for Rural
Community Facilities Program, Direct Loan and
Grant Recovery Act Activities- Phase 2

The Community Facilities Program (CF) has reviewed the official draft report on the subject audit. We appreciate the opportunity to provide responses on the findings and the suggested recommendations. We have included the proposed corrective actions to be implemented, including timeframes for completion.

Finding 1:

Rural Development Used Recovery Act Funds for a Project with a Swimming Pool.

Recommendation 1:

Develop and implement additional controls to ensure that approving officials receive and review all relevant information affecting the loan and grant approval process for Community Facilities projects over \$3 million, particularly in circumstances where eligibility requirements are changed before funds are obligated.

CF Response to Recommendation 1:

CF staff determined that the program participant and project purposes met eligibility requirements. Recovery Act Funds were not used to finance a swimming pool, which is prohibited under the American Recovery and Reinvestment Act of 2009, Section 1604.

The Agency's loan/grant approval procedures are generally as follows:

- In accordance with RD Instruction 1942-A, the State Director or designee requests an obligation of loan and/or grant funds via the Commercial Program Application System after signing Form RD 1940-1, "Request for Obligation of Funds".
- The State Director or designee executes the "Request for Obligation of Funds," thereby certifying that all of the committee and administrative determinations and certifications required by regulations prerequisite to providing assistance of the type indicated on the form have been made and the evidence thereof is in the loan and/or grant docket. The approval official is also certifying that all requirements of pertinent regulations have been complied with.
- When all requirements have been met, the approval official may approve the assistance in the amount requested. By executing Form RD 1940-1, and subject to the availability of funds, the Government agrees to advance such amount to the applicant for the purpose of and subject to the availability prescribed by regulations applicable to the type of assistance.

To strengthen this process the National Office will develop additional controls to ensure that all information affecting loan/ grant approval is reviewed. The National Office will provide guidance in the form of an Unnumbered Letter (UL) addressing the requirements specific to this finding and compliance for the program. The estimated completion date is October 31, 2012.

Finding 2:

Rural Development Disbursed Funds before Recipients Met the Matching Requirements.

Recommendation 2:

Develop and implement written requirements that all letters of conditions stipulate that funds will not be disbursed until the recipient is able to provide evidence, such as paid invoices and other financial verification, that the matching fund requirements have been met.

Recommendation 3:

Strengthen the oversight procedures used by field staff to verify recipients' compliance with matching fund requirements before disbursing grant funds.

CF Response to Recommendation 2 and 3:

In accordance with RD Instruction 3570-B, Section 3570.80 (f), grant funds are not disbursed until they are actually needed by the applicant and until all awardee/borrower, Agency, or other funds are expended, except when:

- Interim financing of the total estimated amount of loan funds needed during construction is arranged;
- All interim funds have been disbursed; and
- Agency grant funds are needed before RHS or other loan can be closed.

The Letter of Conditions presently includes the appropriate language regarding applicant contributions. However, CF can strengthen the oversight procedures used by field staff by implementing additional processing procedures to ensure that recipients are compliant with matching fund requirements prior to the disbursing of funds. The National Office will provide guidance in the form of an UL addressing the requirements specific to this finding and compliance with program requirements. The estimated completion date is October 31, 2012

Finding 3:

Rural Development needs to ensure that grantees purchase insurance needed to protect the government's interest.

Recommendation 4:

Develop and implement an additional level of review to ensure that area officials complete the processing checklist as intended prior to loan and grant closing.

CF Response to Recommendation 4:

RD field staff must ensure that the borrower/grantee provides evidence of adequate insurance including fidelity bond coverage prior to loan closing or at the start of construction as required in RD Instruction 1942-A, Section 1942.17 (j) (3) (i). Compliance with RD's Insurance and bond requirements is necessary to protect the government's interest in the facility financed. To strengthen oversight procedures, the National Office will implement additional controls to ensure that verification of adequate insurance is provided and coverage is maintained by the borrower/grantee. The National Office will provide guidance in the form of an UL addressing the requirements specific to these findings and compliance for the program. The estimated completion date is October 31, 2012.

If you have any questions, please contact Rich Davis of my staff at (202) 720-1500.

Informational copies of this report have been distributed to:

Government Accountability Office

Office of Management and Budget

Office of the Chief Financial Officer
Director, OCFO, Planning and Accountability Division

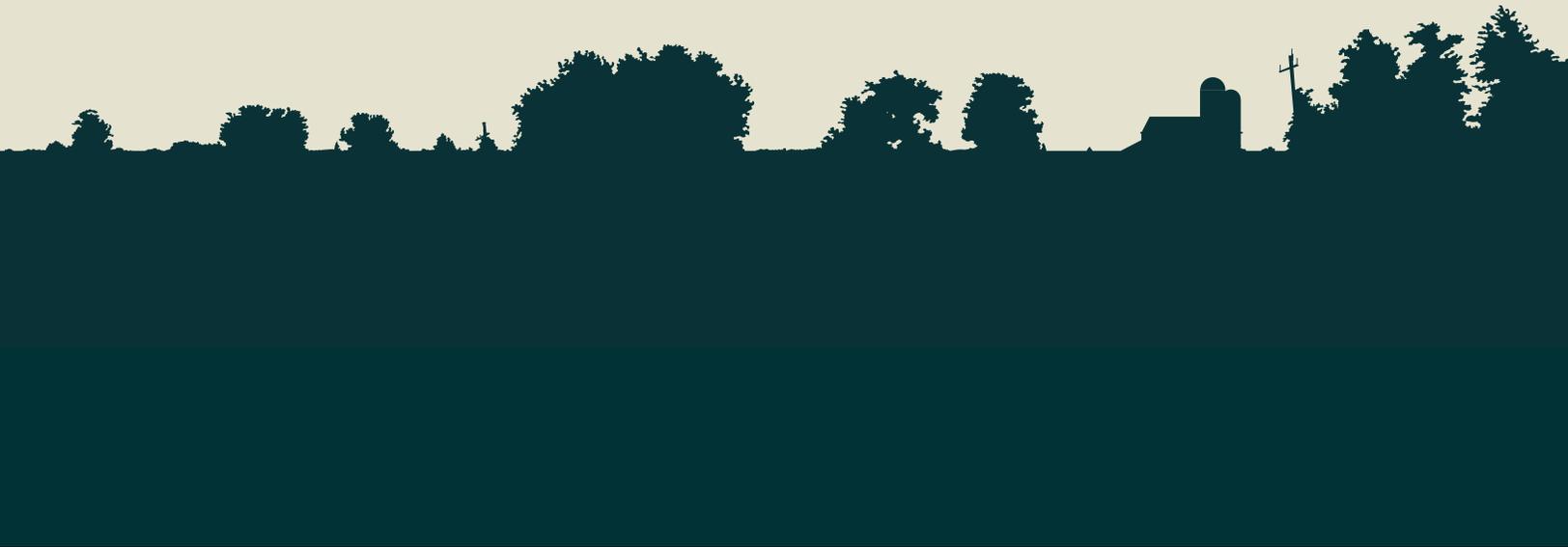
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