

GAO

Report to the Ranking Minority Member,
Subcommittee on Agriculture, Rural
Development, and Related Agencies,
Senate Committee on Appropriations

March 2004

RURAL HOUSING SERVICE

Standardization of Budget Estimation Processes Needed for Rental Assistance Program



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RURAL HOUSING SERVICE

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Highlights of [GAO-04-424](#), a report to the Ranking Minority Member, Subcommittee on Agriculture, Rural Development, and Related Agencies, Senate Committee on Appropriations

Why GAO Did This Study

The Rural Housing Service's (RHS) Section 521 Rental Assistance Program provides rental subsidies to about 250,000 rural tenants. With an annual budget of over \$700 million, the program is RHS's largest line-item appropriation, accounting for approximately 70 percent of the agency's budget. In early 2003, RHS reported hundreds of millions of dollars in unexpended balances, primarily tied to 5- and 20-year contracts issued from 1978 through 1982. Concern has arisen that these unexpended balances may be the result of the agency's budget practices, especially its procedures for estimating funding needs. GAO was asked to assess the accuracy of RHS's budget estimates for the rental assistance program, the activity level of rental assistance contracts issued from 1978 through 1997, and the activity level of rental assistance contracts issued from 1998 through 2002 and the accuracy of RHS's estimates of the rate at which these funds would be used.

What GAO Recommends

To more accurately estimate rental assistance budget needs, GAO recommends that the Secretary of Agriculture require program officials to use and correctly apply the inflation rates provided by the Office of Management and Budget (OMB) in its annual budget estimation processes. The Department of Agriculture and OMB commented on a draft of this report.

www.gao.gov/cgi-bin/getrpt?GAO-04-424.

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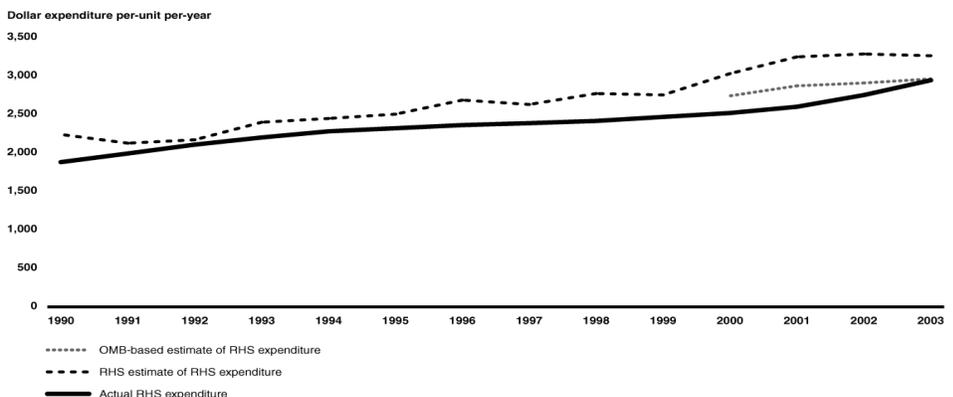
What GAO Found

RHS is overestimating its budget needs for 5-year rental assistance contracts in three ways. First, the agency uses inflation factors that are higher than those OMB recommends for use in the budget process. Second, RHS does not apply its inflation rate separately to each year of a 5-year contract, but instead compounds the rate to reflect the price level in the fifth year and applies that rate to each contract year. Using these first two methods, RHS overestimated its 2003 budget needs by \$51 million (6.5 percent). Third, RHS bases its estimates of future expenditure rates on recent maximum expenditures, rather than on the average rates at which rental assistance funds are expended. RHS has begun the process of automating its budget processes and certain aspects of its new model promise improvements over the current estimating methods. However, the agency continues to use its own inflation rates and incorrectly calculates those rates in such a way that would cause the agency to actually underestimate its budget needs.

At current spending rates, it will take another 7 years for all the active contracts that were issued from 1978 through 1982 to expend their funds, 8 years after the last of the 20-year contracts were expected to expire. Contracts issued from 1983 through 1997 should expend their remaining funds in 2004. GAO calculated that RHS overestimated its funding needs for contracts issued from 1998 through 2002 by an average of about 8 percent each year. GAO analysis of rental assistance payment data showed that the agency has overestimated its budget needs almost every year since 1990, the earliest year for which GAO gathered data. Where GAO had sufficient data from the agency, the analysis also shows that if RHS had used and correctly applied OMB inflation rates to its base per-unit rates, its estimates would have been closer to actual expenditures.

Standardizing the agency's budget estimation processes would help the agency more accurately estimate its rental assistance needs and curtail future unexpended balances or budget shortfalls.

Actual v. Estimated Rental Assistance Expenditures Per-Unit Per-Year, from 1990 through 2003



Source: GAO analysis of RHS data.

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Abbreviations

AMAS	Automated Multi-Housing Accounting System
AMI	Area Median Income
OMB	Office of Management and Budget
RHS	Rural Housing Service
USDA	United States Department of Agriculture

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United States General Accounting Office
Washington, D.C. 20548

March 25, 2004

The Honorable Herbert Kohl
Ranking Minority Member
Subcommittee on Agriculture, Rural Development
and Related Agencies
Committee on Appropriations
United States Senate

Dear Senator Kohl:

Each year, the Rural Housing Service (RHS) of the Department of Agriculture (USDA) provides rental subsidies through the Section 521 Rental Assistance Program to about 250,000 rural tenants living in federally subsidized properties. With an annual budget of over \$700 million, the program is RHS's largest line-item appropriation, accounting for approximately 70 percent of the agency's budget. In early 2003, RHS reported hundreds of millions of dollars in unexpended balances, primarily tied to 5- and 20-year contracts issued from 1978 through 1982. Concern has arisen that these unexpended balances may be the result of the agency's budget practices, especially its procedures for estimating funding needs.

To help with your oversight of the Section 521 Rental Assistance Program, you asked us to assess (1) the accuracy of RHS's budget estimates for the rental assistance program, (2) the activity level of rental assistance contracts issued from 1978 through 1997 that have unexpended balances and the possibility of deobligating¹ these unexpended balances, and (3) the activity level of rental assistance contracts issued from 1998 through 2002 and the accuracy of RHS's estimates of the rate at which these funds would be used.

To respond to these objectives, we collected written information from RHS, interviewed their representatives, and received oral verification from Office of Management and Budget (OMB) staff on RHS's budget estimation processes. We reviewed federal guidance on program budget preparation and on internal controls that apply to the process. Also, we collected and analyzed raw data from RHS's accounting database to determine rental

¹An agency's cancellation or downward adjustment of previously recorded obligations.

assistance program activity. Details about our scope and methodology appear at the end of this letter.

We conducted our work from January 2003 through February 2004 in Washington, D.C. and St. Louis, Missouri, in accordance with generally accepted government auditing standards.

Results in Brief

Using its current processes, we found that RHS has overestimated its budget needs for 5-year rental assistance contracts in three ways. First, the agency has used inflation factors that are higher than those OMB has recommended for use in the budget process. Second, RHS does not apply its inflation rate separately to each year of a 5-year contract, but instead compounds the rate to reflect the price level in the fifth year and applies that rate to each contract year. In 2003, for example, RHS started with an inflation rate that was high relative to OMB's rates and then compounded it, resulting in a budget overestimation of over \$51 million, or 6.5 percent. Third, RHS bases its estimates of future expenditure rates on recent maximum expenditures, rather than on the average rates at which rental assistance funds are expended. We also found that the budget estimation and allocation processes are largely managed by a single employee, which suggests a problem with RHS's internal controls for the program. RHS is developing an automated budget forecasting and allocation model that shows more promise than the current methods it will replace, because it will allow the agency to use more accurate data to establish per-unit costs. RHS has also taken steps to address the weaknesses in its internal controls and has reported that three or four employees, rather than one, will administer the new budget forecasting and allocation processes. However, the agency plans to continue using its own inflation rates and, in contrast to its current methods, will calculate those rates in such a way that would cause the agency to actually underestimate its budget needs.

About 18 percent of the rental assistance contracts issued from 1978 through 1997 are still active—even though the agency estimated that they would expire by 2002—and together they account for \$605 million in unexpended balances. Almost 84 percent of this amount, or \$510 million, involves the 5- and 20-year contracts issued from 1978 through 1982. Nearly one-third of those contracts are still active. At current average spending rates, it will take another 7 years for all the active contracts to expend their funds—8 years after the last of the 20-year contracts were expected to expire. USDA stated that the unexpended balances cannot be deobligated, since every rental assistance contract RHS has

executed contains a provision stating that the agreement expires only when the assistance runs out.²

Ninety percent of the 5-year contracts issued from 1998 through 2002 are still active, and RHS's estimates of the contracts' expenditure rates were inaccurate to varying degrees. Seventy-four percent of the total number of contracts issued in 1998 are still active, even though RHS expected these contracts to run out during 2003, suggesting that these contracts may have been overfunded. About 25 percent, or \$114 million, of the funds remain from the 1998 contracts, and about 35 percent, or \$208 million, remain from the 1999 contracts. Furthermore, only 11 percent of the funds from the contracts issued in 2002 were spent during the contracts' first 1½ years, suggesting that many of the contracts from this time period are expending their funds more slowly than RHS anticipated. Our analysis of RHS data found that these contracts will run an average of over 6 rather than 5 years each.

To more accurately estimate rental assistance needs and curtail future unexpended balances—or budget shortfalls—we recommend that the Secretary of Agriculture require program officials to use and correctly apply the inflation rates provided by OMB in their annual budget estimation and allocation processes.

Background

The Section 521 Rental Assistance Program, started in 1978, is administered by RHS's Multifamily Housing Division of Portfolio Management. The program provides rental assistance for tenants living in units created through RHS's Multifamily Direct Rural Rental Housing Loans and Multifamily Housing Farm Labor Loans programs.³ Under the program, eligible tenants pay no more than 30 percent of their income

²We will issue a separate legal opinion on this issue.

³The Section 515 Multifamily Direct Rural Rental Housing Loans program provides loans, subsidized as low as 1 percent interest, to developers to build rental housing. The Section 514 Multifamily Housing Farm Labor Loans program provides grants and loans subsidized at 1 percent interest to build rental housing for farm laborers either off or on the farmer's property. Only "off-farm" labor housing is eligible for rental assistance subsidies. All projects must be established on a nonprofit or limited profit basis to receive rental assistance.

toward the rent, and RHS pays the balance to the project owner.⁴ As of January 2003, approximately 53 percent of tenants in the program's 464,604 housing units were receiving rental assistance. According to program officials, the program has a waiting list of approximately 80,000 eligible tenants.

RHS provides the subsidies through 5-year contracts with project owners; 20-year contracts were also issued to units in newly constructed properties from 1978 through 1982. The contracts specify that owners will receive payments on behalf of tenants in a designated number of units at the project. Contracts may be renewed as many times as funds are made available, and additional units may be covered if funds are available. According to program officials, about 96 percent of the Rental Assistance Program's budget is used to renew expiring rental assistance contracts. The remaining funds are used to provide rental assistance for units in newly constructed properties and additional rental assistance at existing properties. Budget needs are estimated assuming a 5-year rental assistance contract life, although a contract's actual life is determined by how long its funds last and could run far beyond its estimated life if the funds are expended slowly enough.

Each month, project owners or their management companies must certify the number of rental assistance units that are occupied. If a unit is empty and rental assistance is not being used, the project owner assigns a new tenant from the waiting list. If there are no tenants eligible for the rental assistance, the rental assistance may be transferred to another property.

RHS's national, state, and local offices manage the rental assistance program. The national Office of Multifamily Housing Portfolio Management develops and implements the program regulations, estimates program budgets, allocates funds, and tracks nationwide program statistics. State and local offices work directly with property owners, property management companies, and tenants to monitor the program. State and local responsibilities include conducting financial, management, and physical reviews of the properties; executing rental assistance contracts with property owners; approving rent increases; and processing

⁴Eligible tenants are persons with very low and low incomes, the elderly, and persons with disabilities who are unable to pay the basic monthly rent within 30 percent of their adjusted monthly income. Very low income is defined as below 50 percent of the area median income (AMI); low income is between 50 and 80 percent of AMI.

rental assistance payments. State and local staff also collect and maintain property and tenant data for their areas. Support for the program is also provided through two offices in St. Louis. The Information Resources Management Office's Rural Housing Service Branch maintains the automated databases used to manage program data. The Office of the Deputy Chief Financial Officer uses the program data to generate and maintain the general ledger and financial statements for the program.

In 1982—the fourth year of the program—RHS reported in an internal position paper that rental assistance funds were being substantially underused. The agency found that approximately \$100 million of the rental assistance funds obligated for 5-year contracts would be lost between 1983 and 1985, because the contracts would expire before all the obligated funds were used.⁵ The study found that rental assistance contracts set to expire at the end of 5 years still had funds available for an average of 5 additional years. The agency noted that if contract terms were extended until the funds ran out, the tenants could receive benefits twice as long without any further appropriation of funds. Alternately, the agency noted that terminating contracts at the end of their terms and returning the unexpended funds would save federal funds, assuming the contracts would not be replaced. The paper recommended the indefinite extension of rental assistance contracts, and the recommendation was adopted as agency policy in 1983. Contract language was changed at that time, and previously written contracts were amended.

RHS's Current Methods Have Overestimated the Agency's Budget Needs by as Much as 7 Percent, or \$51 Million Per Year

Using its current methodology, RHS has overestimated its budget needs for 5-year rental assistance contracts in three ways. First, the agency has used inflation factors that are higher than those projected by OMB for use in the budget process. Second, RHS compounds the inflation rate to reflect the price level in the fifth year and applies that rate to each contract year, rather than using an appropriate rate for each year. Third, the expenditure rates RHS uses to estimate budget needs may also overstate the need for rental assistance. Furthermore, RHS budget processes do not adhere to certain internal control standards. While a new budget forecasting model shows promise, it is, at present, flawed.

⁵The study did not consider 20-year contracts, likely because the first of these would not expire until 1998.

Current Processes for Estimating Budget and Allocation Needs

RHS's processes for estimating its budget and allocation needs have evolved over time. An agency official who worked on the program's initial budgets from 1978 through 1982 told us that RHS intentionally overfunded the contracts in an effort to subsidize the poorest possible tenant by basing tenant contributions on minimum Social Security payments. Agency documents suggest that the agency was using inflation rates of 10 to 20 percent to estimate future spending rates for the life of the contracts.⁶ After this time period, the agency made a series of changes to its processes, including increasing tenant contributions from 25 percent to 30 percent, and differentiating per-unit costs for rural rental housing and farm labor housing properties.

The current method for estimating budget needs was developed by two agency officials, between 1995 and 1997, and is based on a formula that consists of multiplying estimates for the number of expiring rental assistance units by a national average per-unit cost and by an inflation factor. The need for rental assistance for units in newly constructed properties and additional rental assistance at existing properties is also calculated. Since 1996, one official has largely managed the process with oversight from the Rural Development Budget Office, OMB staff, and RHS supervisors.

OMB Circular A-11, *Preparation, Submission, and Execution of the Budget*, provides guidance to agency officials, stating that preparation of agency budgets must be consistent with the economic assumptions provided by OMB. These assumptions are listed each year in the President's Budget, though they are made available to agencies prior to that time for their budget preparations. However, neither OMB staff nor the Rural Development Budget Office official we spoke with required RHS to use these rates or objected to the agency determining its own inflation rates. Although OMB policy does permit agencies to consider other factors in developing their budget estimates, it does not allow agencies to automatically apply these factors to their budget requests. Also, although OMB staff and a Rural Development budget official review and approve RHS's budget requests each year, neither has ever required nor sought a justification for the rates chosen.

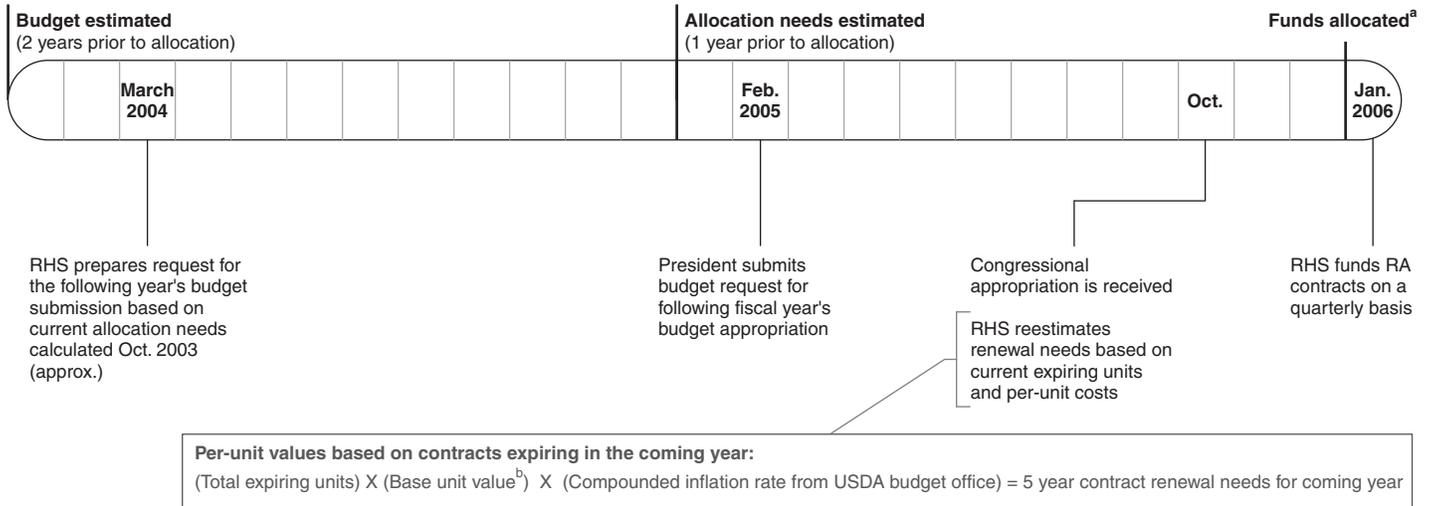
⁶The actual inflation rate, as measured by the Consumer Price Index, ranged from 8.9 percent to 13.3 percent from 1978 through 1981, and fell to 3.8 percent in 1982.

RHS considers its annual rental assistance needs through two different processes prior to funding the contracts. First, the agency prepares the submission for the President's Budget about 2 years prior to the budget year, based on previous renewal needs, average per-unit costs, and a compounded inflation rate. Agency officials explained that in recent years they used 2.7 percent when preparing estimates to submit with the President's Budget. By the time Congress appropriates a budget based on this information, the data used by the agency are about 2 years old. Therefore, after receiving the fiscal year budget, and before allocating the rental assistance funds, RHS rechecks the estimated number of expiring units and average per-unit costs, based on more current data.

For this second process, the agency prepares a report using the Automated Multi-Housing Accounting System database (AMAS) on the contracts expected to expire in the coming year. This report is sent to the local offices for verification and then returned to the national office. The agency establishes average per-unit values, based on the contracts expiring in the coming year, by inflating the maximum per-unit cost from the prior 3 months by a compounded inflation rate. According to agency officials, RHS adjusts the inflation rate to more closely approximate the level of funding received. If the original budget estimate and the allocation estimate differ, RHS distributes any rental assistance funds remaining after the expiring contracts are renewed among states to create new rental assistance units.⁷ These allocation figures then become the basis for future submissions for the President's Budget.

⁷In 2002, for example, there was a difference of \$30 million (overestimation) between the agency's budget request and actual allocation needs.

Figure 1: Example of RHS Budget and Allocation Estimation Processes



Source: GAO.

^aFunds for contracts expiring January-March may be allocated in last quarter of previous year.

^bMaximum per-unit cost from prior 3 months based on contracts expiring in coming year.

RHS's Current Methods Have Overestimated Its Budget Needs

Because it has not followed OMB procedures, RHS has overestimated its future budget needs. For example, although OMB's fiscal year 2003 published rates varied between 2.2 and 2.4 percent for 2003 through 2007, RHS used a rate of inflation of 2.7 percent when preparing its budget for 5-year contracts that would be renewed in 2003. Applied to the average per-unit, per-year base rate of \$3,264, the 2.7 percent rate created a difference of \$203 per unit over the 5-year contract period. Since RHS planned to issue 5-year contracts for 44,652 units that year, it overestimated its budget needs by more than \$9 million. RHS did not keep documentation of the inflation rates it used prior to 2000 but, as table 1 shows, the agency's inflation rates have been higher than OMB's rates for every year for which it has documentation.

Table 1: Differences between RHS and OMB Inflation Rates, 2000-2003

Budget year	RHS: for President's budget	RHS: prior to allocations	OMB
2000	2.7%	2.5%	2.3%
2001	2.7	3.0 ^a	2.5
2002	2.7	3.0 ^b	2.6
2003	2.7	2.4	2.2

Source: GAO analysis of RHS and OMB data.

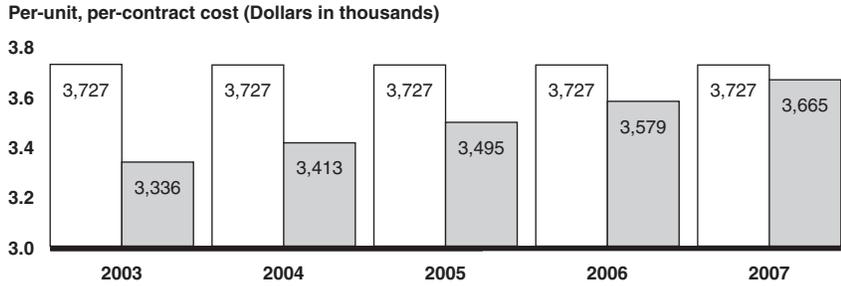
^aThe 2001 budget documents RHS provided show that RHS used different inflation rates when reestimating its budget needs for family (3 percent compounded to the fourth year) and elderly replacement units (3 percent compounded to the fifth year) and new construction units (2.7 percent compounded to the fourth year). When asked, RHS reported that this is not a standard practice.

^bAgency officials told us, and agency documents state, that RHS used a rate of 2.7 percent for its 2002 allocation estimates. However, upon review of the data provided, we determined that they used a rate of 3 percent and RHS concurred.

However, it is not so much the inflation rates RHS uses as how it uses them that has caused the agency to significantly overestimate its budget needs. As we have seen, OMB's economic assumptions provide inflation rates for each year, and agencies are expected to use these individual rates for each year they are projecting, compounding the rates separately for each subsequent year based on the previous year's rate. But RHS uses one inflation rate for all 5 years of the contract, compounds that rate to the fifth year, and then applies the compounded rate to each year of the contract. This practice results in the agency using a rate that is more than five times the rate it started with for the first year.

For example, rather than applying its 2003 inflation rate of 2.7 percent to each year, RHS compounded this rate to the fifth year and applied the resulting value (14.2 percent) back to each year of the contract (fig. 2). Spending was thus assumed to be 14.2 percent higher for each of the subsequent 5 years, although its stated inflation projection was that prices would be only 2.7 percent higher in the next year, about 5.4 percent higher in the following year, and so on. Thus RHS multiplied the annual per-unit base rate of \$3,264 by over 14 percent, rather than the 2.7 percent it started with, or the 2.2 to 2.4 percent projected by OMB. Compared with OMB's rates and procedures for calculating future spending, RHS's method created a difference of \$1,147 per unit. Again, as RHS estimated it would fund contracts for 44,652 units in 2003, it actually overestimated its budget needs by over \$51 million (6.5 percent).

Figure 2: Comparison of RHS and OMB-Based Budget Estimation Methods



2003 per-unit base rate X	RHS inflation rate (1.027 ^{^5})	\$3,264 x 1.142	= \$18,635 per-unit, per-contract				
	OMB economic assumptions	\$3,264 x 1.022	\$3,336 x 1.023	\$3,413 x 1.024	\$3,495 x 1.024	\$3,579 x 1.024	= \$17,488 per-unit, per-contract

RHS estimate
 OMB-based estimate

Source: GAO analysis of RHS and OMB data.

The expenditure rates RHS uses to estimate budget needs may also overstate the need for rental assistance. RHS officials claim that the expenditure rates they use—equal to the maximum amount of monthly rental assistance used over the previous 3 months—account for vacant units at the properties. However, using this method treats vacant units as if they were occupied and ignores the impact that a property’s vacancy rate has on rental assistance usage. For example, a property with 10 units (receiving \$200 of rental assistance for each unit) may have no vacant units during the first month, one vacant unit during the second month, and 2 vacant units during the third month. During an average month, one of the property’s units will be vacant, and the property will require \$1,800 in rental assistance (\$200 from each of the nine occupied units). However, using the maximum of 3 months, it would appear the property has no vacant units and that rental assistance needs are \$2,000 a month. The estimation rate would be 10 percent higher than it should be, because the impact of the vacant units on rental assistance usage was ignored. We believe using a 3- or 12-month average could produce a more accurate picture of usage. We discussed this practice with RHS officials, and they replied that they used the maximum monthly rate because they did not believe averages were accurate for their purposes.

RHS Is Not Adhering to Internal Control Standards

Finally, RHS is not adhering to internal control standards regarding segregation of duties. A single employee within the agency is largely responsible for both the budget estimation and allocation processes for the rental assistance program. Furthermore, this employee's work is not afforded a deliberative review by the Rural Development Budget Office, OMB staff, or RHS supervisors. While the office has assigned staff to support this employee, the employee told us that due to staff turnover, there was no one available to help with the budget estimation and allocation processes.

Internal control is a major part of managing an organization. Our *Standards for Internal Control in the Federal Government* provide the overall framework for establishing and maintaining internal control and for identifying and addressing major performance and management challenges and areas at greatest risk of fraud, waste, abuse, and mismanagement.⁸

Internal control activities are the policies, procedures, techniques, and mechanisms that enforce management's directives and help ensure that actions are taken to address risks. Control activities are an integral part of an entity's planning, implementing, reviewing, and accountability for stewardship of government resources. One very basic but essential example of a control activity is the segregation of duties. According to the standards, key duties and responsibilities need to be divided or segregated among different people to reduce the risk of error or fraud. This should include separating the responsibilities for authorizing transactions, processing and recording them, reviewing the transactions, and handling any related assets. No one individual should control all key aspects of a transaction or event. Based on our analysis of RHS's budget estimation and allocation processes, and our *Standards for Internal Control*, it is our view that the autonomy of this employee is not consistent with internal control standards.

Automated Process Is an Improvement, but Problems Remain

In March 2003, RHS began the process of automating its budget estimation and allocation processes by developing a forecasting model that it will use to estimate future budget needs, starting in 2006. A team consisting of staff from the national office, state offices, and the Information Resources

⁸U.S. General Accounting Office, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: Nov. 1, 1999).

Management Office's Rural Housing Service Branch created the model. RHS also used contractors and consulted with numerous internal experts. The model was designed to automatically calculate rental assistance by projecting renewal needs on a property-by-property basis and calculating future rental assistance usage estimates using a combination of factors, including prior actual usage, inflation, the potential for rate increases, and rental assistance volatility. These last two factors were dropped from the model when the agency determined that their impact on future spending was negligible. The forecasting model is currently in the testing phase.

RHS demonstrated its new forecasting model to us in late 2003. Certain aspects of the model promise improvements over the current estimating methods. For example, the model (1) allows RHS to use property-level data rather than the national averages that are currently used to establish per-unit rates and (2) determines each property's per-unit rate based on the average usage over the prior 12 months, rather than the maximum usage of the previous 3 months that is currently used. These improvements should allow for more accurate replacement estimates based on actual rental assistance usage at each property. Furthermore, the model properly applies the inflation rate to each of the 5 years for which the agency is forecasting. Program officials also told us that three to four staff members will be trained to use the model and develop the budget and allocation estimates for the agency, which should mitigate the segregation of duties concern.

However, the inflation calculation in the model is flawed. RHS continues using its own inflation rates rather than those provided by OMB, and the agency is incorrectly calculating the rates it plans to use. RHS officials explained that they are using historical rates of change to determine future spending rates rather than OMB's rates, which are based on future projections of inflation. This means that RHS is looking to past activity to determine what will happen in the future, whereas OMB asks agencies to use projections of future change.

Furthermore, RHS is incorrectly calculating its historical rates of change in a way that could cause the agency to underestimate its budget needs. RHS calculates the average per-unit expenditures for each year over 3 years, then calculates the change from the first year to the third and divides that number by 3. The agency should divide by 2, since it is estimating an annual rate of change from 2 years of changes. By dividing by a larger number than appropriate, RHS's method will cause it to underestimate the rate of change and thus to underestimate its budget needs. For example, if

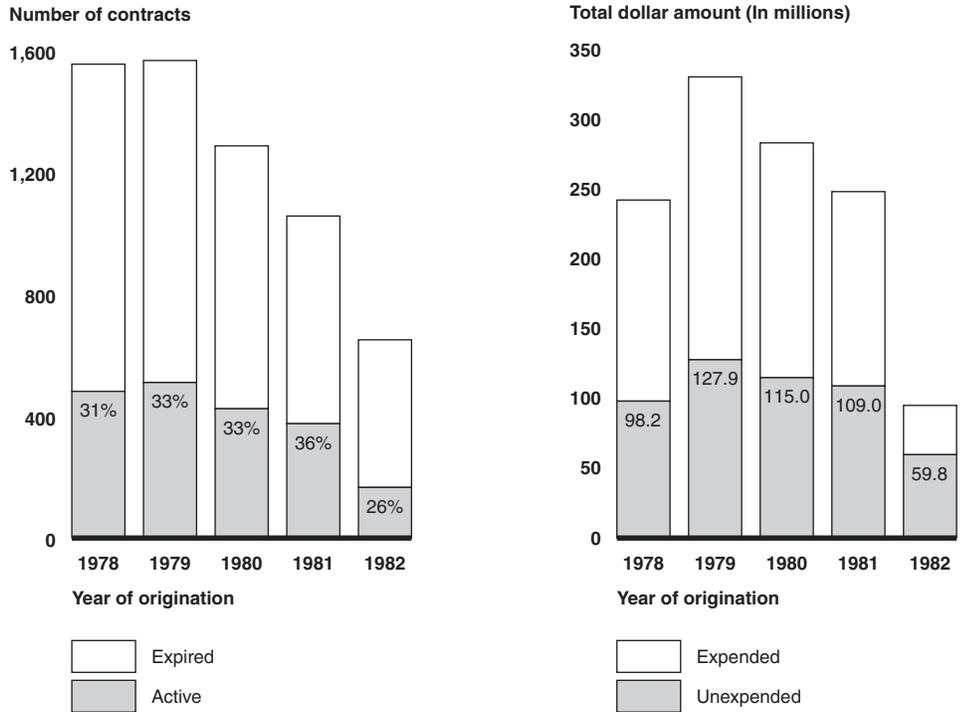
prices increased 3 percent from 2000 to 2001, and 2 percent—of the year 2000 level—from 2001 to 2002, then the average annual increase is 3 plus 2, divided by 2, which equals 2.5. If RHS divides by 3, it will come up with an inflation rate of 1.67— lower than the average inflation rate of the recent past.

Unexpended Funds Primarily from Contracts Issued from 1978 through 1982 Will Not Be Exhausted until 2011

Contracts issued from 1978 through 1982 account for the majority of unexpended balances and are expending their funds at a relatively slow rate. Based on current average expenditures, these contracts likely will not expend their funds completely until 2011. USDA has concluded that these funds cannot be deobligated. Contracts issued from 1983 through 1997 also have unexpended balances; based on our analysis, these funds likely will be expended in 2004.

Based on their age, contracts issued from 1978 through 1997 (both 5 and 20 year), should have expired by the end of 2002. As of June 2003, approximately 18 percent of these contracts were still active, accounting for \$605 million in unexpended balances. Most of this amount (\$510 million or 84 percent) involved the 32 percent of the contracts from 1978 through 1982 that were still active (see fig. 3). Contracts issued from 1983 through 1997 accounted for the remaining \$95 million.

Figure 3: Active v. Expired Contracts and Expended v. Unexpended Amounts from Contracts Issued from 1978 through 1982

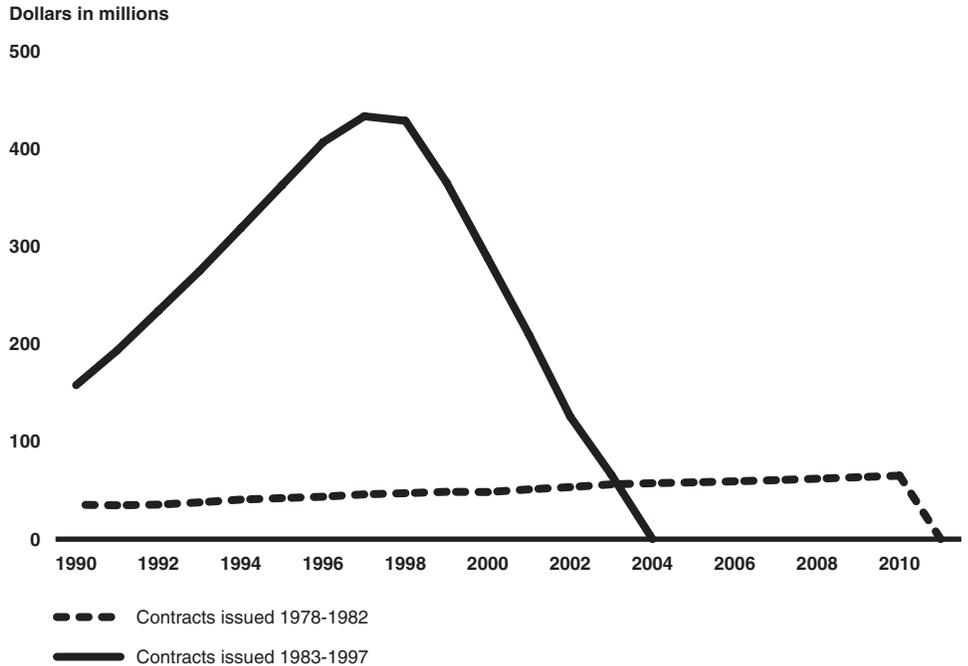


Source: GAO analysis of RHS data.

Note: Data are current as of June 2003.

Based on average current spending rates calculated from AMAS data and projected forward using OMB inflation rates, RHS will not exhaust all the unexpended balances from these contracts until at least 2011. In 2002, approximately \$179 million in rental assistance funds was paid to project owners from contracts issued from 1978 through 1997, \$53 million of it from contracts issued from 1978 through 1982, and \$126 million from contracts issued from 1983 through 1997. At this rate, contracts from the 1983 to 1997 period will likely expend their remaining \$95 million during 2004. The 1978 to 1982 contracts, which were funded based on inflation projections of 10 to 20 percent, will not expend their \$510 million in unexpended balances until 2011 on average—8 years after the last of the 20-year contracts should have expired.

Figure 4: Projected Expenditures from Contracts Issued from 1978 through 1997



Source: GAO analysis of RHS and OMB data.

Note: Contracts issued from 1978 through 1982 include 20- and 5-year contracts.

USDA Stated that Deobligating Unexpended Balances Would Result in Breach of Contract

The USDA regulations state that rental assistance contracts are effective for, depending on the contract, 5 or 20 years from the effective date of the agreement. These same regulations, however, make it clear that the expiration date of a contract is at complete disbursement of the funds obligated to the contract. This date, as the USDA regulations state, may be "before or after" the 5- or 20-year term.

The rental assistance contracts that implement this policy explicitly tie their expiration to the disbursement of rental assistance amounts listed in the contracts. In practice, this has resulted in many of the contracts extending beyond (in some instances, far beyond) the contemplated 5- or 20-year term. According to USDA, any effort to recapture the remaining unexpended funds associated with rental assistance agreements entered into from 1978 through 1982 would result in a breach of those contracts and would subject USDA to liability.

The Activity of Contracts Issued in 1998 through 2002 Is Consistent with Earlier Years

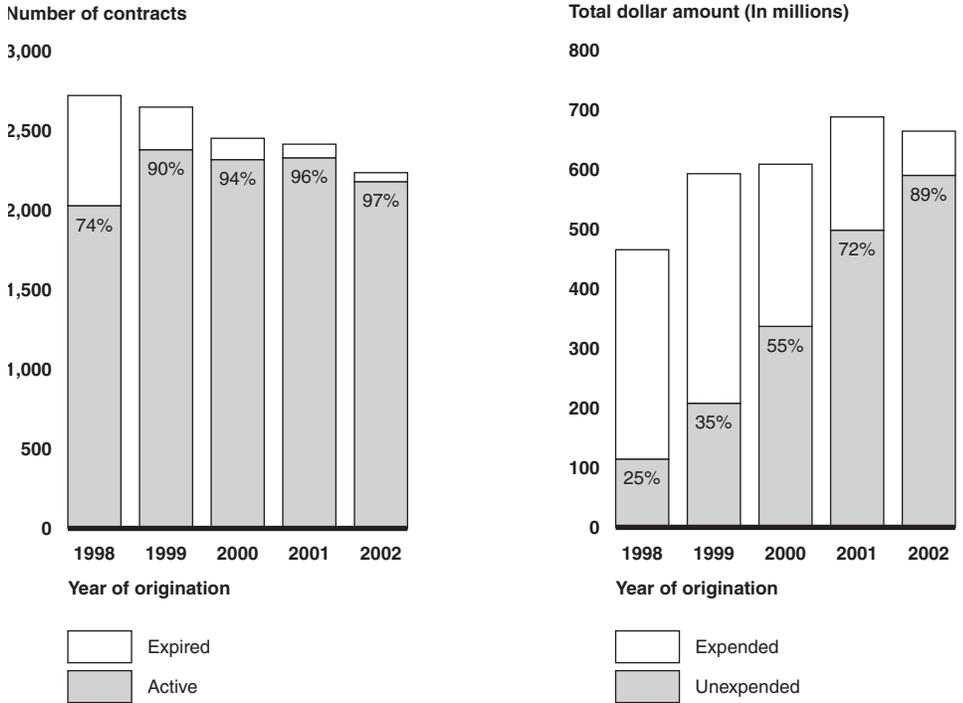
Ninety percent of the contracts issued from 1998 through 2002 are still active and appear to be expending their funds at a slower rate than RHS anticipated. Based on current expenditure rates, these contracts likely will run an average of over 6 years each. These findings are consistent with our analysis of RHS data, which shows that RHS has overestimated its spending needs most years since 1990.

The Majority of Contracts Issued from 1998 through 2002 Are Still Active and Expending Their Funds at a Slower Rate than RHS Anticipated

According to RHS data, and illustrated in figure 5, a relatively small percentage of contracts have expired. As of June 2003, 74 percent of the contracts issued in 1998 were still active, although the average contract should have expired by this date.⁹ The fact that so many were still active suggests that the majority of the 1998 contracts may have been overfunded. Furthermore, about 25 percent of the funds remained from the contracts issued in 1998, and about 35 percent of the funds remained from the contracts issued in 1999; only 11 percent of the funds allocated in 2002 were spent during the contracts' first 1½ years. This suggests that the contracts are also expending their funds more slowly than the 5 years on which RHS bases its budget needs.

⁹Contracts are funded quarterly, based on their estimated renewal needs between January and December. Therefore, the average contract is funded based on a June renewal time frame, and an average contract lifetime would run from June of the first year to June of the fifth year (e.g., June 1998 to June 2003).

Figure 5: Active v. Expired Contracts and Expended v. Unexpended Amounts from Contracts Issued from 1998 through 2002



Source: GAO analysis of RHS data.

Note: Data are current as of June 2003.

A document provided by the agency indicates that, since 1992, contracts have been spending on average 3 percent in their first year, 14 to 18 percent in the second through sixth years, 8 percent in the seventh year, and tapering off around the twelfth year. According to the agency, this tapering indicates that overfunding of contracts is moderate. However, it should be noted that the document projects, for example, that about 1.7 percent of the funds allocated in 2000 will remain by the tenth year—a balance of \$10.8 million from the \$640 million originally allocated.

Using RHS rental assistance payment data, we calculated that RHS overestimated its funding needs for these contracts by an average of about 8 percent each year. Between 1998 and 2002, almost \$1.2 billion in rental assistance payments were made from contracts originating in those years, at an average rate of \$2,808 per-unit per-year. However, RHS budgeted

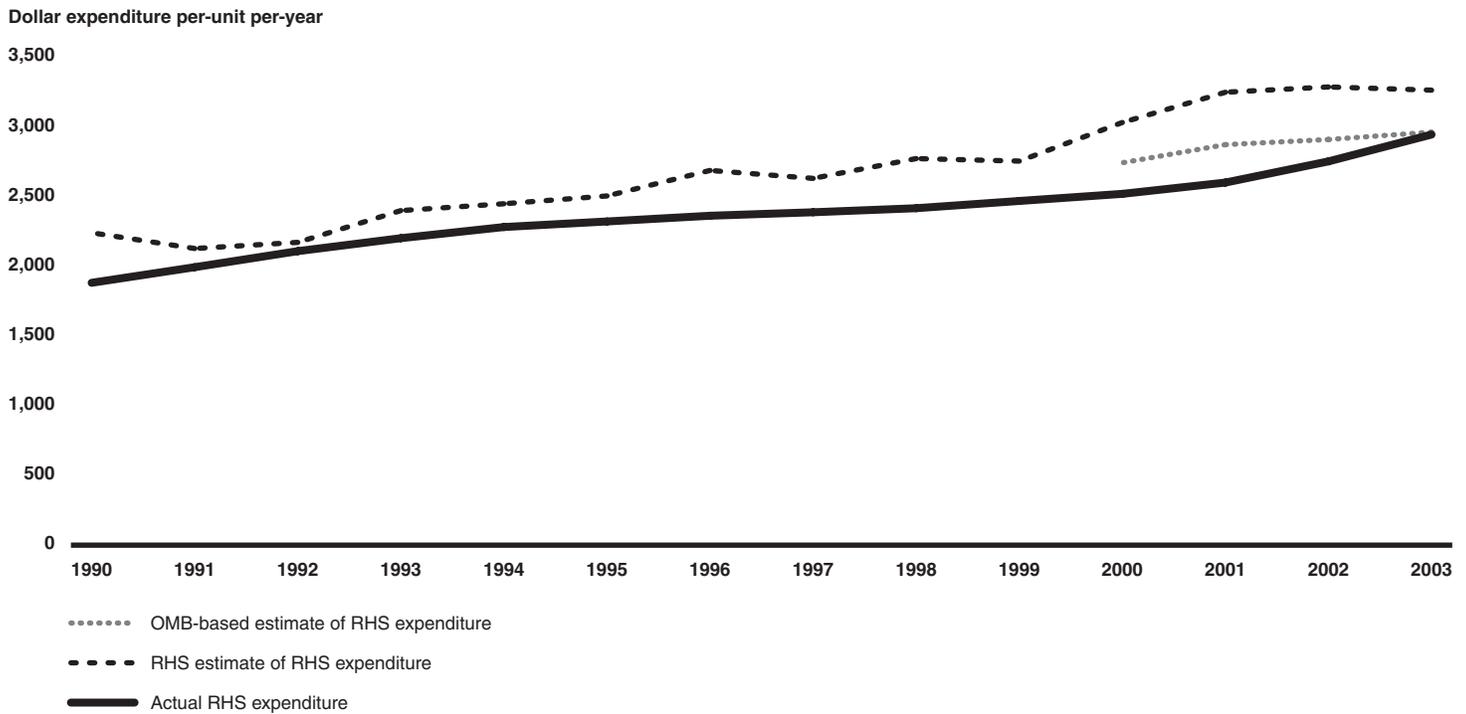
these units at an average annual rate of \$3,019—a difference of \$211 per-unit per-year (7.5 percent), or \$1,055 per-unit per 5-year contract.

RHS Has Overestimated Its Spending Needs in Most Years Since 1990

Our analysis of rental assistance payment data showed that the agency has been overestimating its budget needs since at least 1990, the earliest year for which we gathered data. Importantly, where we had sufficient data from the agency, our analysis also shows that if RHS had used and correctly applied OMB inflation rates to its base per-unit rates, its estimates would have been closer to actual expenditures.

Figure 6 below provides an example of the difference between RHS's actual and estimated expenditures. The actual expenditures are averaged from the entire portfolio of 5-year contracts issued from 1989 through 2002, while the estimated expenditures are averaged from only those units for which renewal, new construction, or servicing contracts originated in the corresponding year. Furthermore, the RHS estimated expenditure for a given year shows the effect of the 5-year estimate in the first year only. Due to RHS's method for calculating its estimated expenditures over a 5-year period, the difference is largest in the first year and declines over time as inflation raises the actual expenditure (or more accurate estimation) closer to the estimated expenditure (see fig. 2). The declining differentials of the second to fifth years are not reflected in figure 6 below. Nonetheless, while the estimated expenditures for any given year represent about 20 percent of the portfolio, they represent almost the entire portfolio over any 5-year period in the figure. RHS estimates are above actual expenditures in each of the years. In addition, the corresponding estimated expenditures using OMB inflation rates also helps to illustrate the degree to which the RHS method has lead to overestimation. Sufficient information was not available from the agency to extend our OMB-based estimate of RHS expenditure prior to 2000. Our scope and methodology section contains a discussion of the data limitations we faced in our assessment of activity levels.

Figure 6: Actual v. Estimated Rental Assistance Expenditures Per-Unit, Per-Year, from 1990 through 2003



Source: GAO analysis of RHS data.

Note: (1) RHS estimated expenditures for 1990 to 2002 are based on the agency's allocation estimates prior to obligation of appropriated funds; complete data of original estimates for the President's Budget were not available from the agency. As noted, in some years RHS's allocation amounts were smaller than the original submitted budgets; therefore, the RHS estimated numbers depicted may be smaller than the per-unit per-year amounts the agency actually received through appropriations. The 2003 estimated expenditures are based on the request submitted for the President's Budget. (2) RHS estimated expenditures show the effect of the 5-year estimate in the first year. Over time, the difference will decline as inflation raises the actual expenditures closer to the estimated expenditures. (3) Actual expenditures are for 5-year contracts issued 1989 to 2002; 2003 actual expenditures are estimated based on 10 months of available data. (4) RHS did not keep documentation of the inflation rates it used prior to 2000; therefore, we did not have sufficient information to estimate the impact of using OMB rates in its estimates prior to that time.

Between 1998 and 2002, RHS planned to fund 5-year contracts for an average of 42,000 units each year; the difference between the actual rate of expenditure and what RHS budgeted may mean that the agency had a surplus of approximately \$43 million per year during this period, or more than \$220 million total over the last 5 years.

Based on current spending rates, and allowing for inflation, the average contract issued during these years will likely run out of funds during its

sixth year. That is, the average contract issued in 2000 or 2001 will completely expend its funds during 2006 or 2007, respectively, and the average contract issued in 2002 will completely expend its funds during 2008.

Conclusions

RHS provides subsidized rental housing to almost half a million people each year. The rental assistance program, with an annual budget of over \$700 million, provides further subsidies to about half this number. RHS budget estimating processes have caused the agency to overstate its spending needs over the life of the rental assistance program, resulting in hundreds of millions of dollars in unexpended balances. Consistently overstating funding needs for one program also undermines the congressional budget process by not allowing those funds to be available for other programs. RHS is updating and automating its budget estimation process, and its new forecasting model shows some improvements over past and current processes. However, there are some flaws with the model. The agency plans to use its own inflation rates, which are based on historic rates of change, rather than the inflation rates provided by OMB, which predict future rates of change. Furthermore, RHS is incorrectly calculating the rates it plans to use, which may cause the agency to underestimate its future contract needs. A simple modification to the agency's planned budget estimation process would help the agency more accurately estimate its rental assistance needs and curtail future unexpended balances—or budget shortfalls as the case may be.

Recommendation for Executive Action

To more accurately estimate rental assistance budget needs, we recommend that the Secretary of Agriculture require program officials to use and correctly apply the inflation rates provided by OMB in its annual budget and allocation estimation processes.

Agency Comments and Our Evaluation

We provided USDA and OMB with a draft of this report for their review and comment. The Acting Undersecretary for Rural Development for USDA raised several concerns about our analysis of RHS's budgeting practices and rental assistance expenditure data. In particular, the Acting Undersecretary argued that OMB's Circular A-11 encourages the use of a per-property microscale rate of change, rather than a blanket national rate. OMB's Circular A-11 states that all budget materials must be consistent with the economic assumptions provided by OMB. While OMB policy

permits consideration of certain factors in developing out-year estimates, this does not mean that an agency should automatically use its own economic assumptions without providing documentation and justification. As we note in our report, neither OMB staff nor the Rural Development Budget Office required a justification for the agency's inflation rates.

Furthermore, according to the Acting Undersecretary, we did not demonstrate that using inflation rate projections from the President's Budget would provide a more accurate budget estimate. We believe that figure 6 in this report illustrates that using the inflation projections from the President's Budget would have brought the agency's budget estimates closer to its actual expenditures, without running the risk of underfunding the rental assistance contracts.

USDA also disagreed with our finding that RHS's budget estimates were too high. As stated in this report, we believe RHS overestimates its budget needs by using inflation factors that are higher than those projected by OMB for use in the budget process, improperly compounding the inflation rates, and using expenditure rates that may overstate the need for rental assistance. Our estimates reflect the extent to which RHS may have overestimated its budgets when compared with estimates based on OMB budget guidance documents and appropriate application of a compounding formula. USDA's complete written comments and our responses appear in appendix I.

We received oral comments from OMB. OMB representatives did not have comments on the specific findings or conclusions of this report. They did, however, note that they are always open to suggestions that would help the Administration provide more accurate budget projections along with the related oversight.

Scope and Methodology

To assess the accuracy of RHS's budget estimates for the rental assistance program, we collected written and testimonial information from agency officials on current budget estimation methods and the budget automation plan that is being developed. We reviewed OMB guidance on preparing agency budgets and the inflation rates provided by OMB for agency use, and interviewed OMB staff that oversee the rental assistance program. Finally, we consulted our *Standards for Internal Control in the Federal Government* to review control activities that apply to RHS's budget estimation processes. In describing RHS's current process for estimating its budget needs, we faced the problem that the agency has no official

written documentation for that process. Most information was provided verbally, and the information the agency did provide outlined only its elementary budget processes.

To assess the activity level of rental assistance contracts issued from 1978 through 1997 with unexpended balances, we reviewed rental assistance data from the agency's Automated Multi-Housing Accounting System (AMAS) from January 1990 through October 2003 to determine the extent of the unexpended balances. We also used these data to determine the rate at which those balances were currently being expended; by applying OMB inflation rates for future years to the current rates of expenditure, we estimated when the funds will expire. We acquired OMB inflation rates for future years from the fiscal year 2004 and 2005 President's Budgets.¹⁰

To assess the activity level of rental assistance contracts issued from 1998 through 2002 and the accuracy of RHS's estimates of the rates at which these funds would be used, we reviewed rental assistance data from AMAS from January 1998 through October 2003 to determine the activity level of the unexpended balances. We also used these data to determine the rate at which those balances were currently being expended; by applying OMB inflation rates for future years to current rates of expenditure we estimated when the funds will expire. We assessed the accuracy of RHS's estimates of the rate at which the funds would be used by comparing RHS's estimated rental assistance expenditures to actual program expenditures. We determined RHS's estimated expenditures based on data provided by the agency. We determined actual program expenditures using payment data from AMAS.

We faced limitations in our assessment of actual program expenditures using AMAS data. We had compared actual expenditures averaged from the entire portfolio of contracts issued from 1978 through 2002 with estimated expenditures averaged from only those units for which renewal, new construction, or servicing contracts originated in the corresponding year. In response to agency concerns, we eliminated contracts issued prior to 1989 because they represented a mix of contracts that were expending funds normally and contracts that exhibited unusual behavior resulting in abnormally low expenditures. The agency opined that the annual

¹⁰Table S-11: Comparison of Economic Assumptions from the Budget for Fiscal Year 2005, lists inflation rates for 2005 to 2009. For any projections 2010 and beyond, we used the rate for 2009.

expenditures from these abnormal contracts could not be compared with their estimates. Due to the structure of AMAS data, we were unable to isolate the abnormal behaving contracts. However, the resulting figure (fig. 6), based on their comments, looks very similar to the original figure.

For the AMAS data we used, we requested and received the most current data available from the system. We assessed the reliability of the data by (1) reviewing existing information about the systems and the data, (2) interviewing agency officials knowledgeable about the data, and (3) examining the data elements (fields) used in our work by comparing known and/or anticipated values. When inconsistencies were found, we discussed our findings with agency officials to understand why inconsistencies could exist. We determined that the data were sufficiently reliable for the purposes of this report.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies of this report to interested Members of Congress and congressional committees. We also will send copies to the Secretary of the Department of Agriculture and the Director of the Office of Management and Budget and make copies available to others upon request. In addition, this report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

Please contact me at (202) 512-4325, or Andy Finkel at (202) 512-6765, if you or your staff have any questions concerning this report. Key contributors to this report are listed in appendix III.

Sincerely yours,



William B. Shear
Director, Financial Markets and
Community Investment

Comments from the U.S. Department of Agriculture

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



United States Department of Agriculture

Office of the Secretary
Washington, D.C. 20250

MAR 8 2004

Mr. William B. Shear
Director, Financial Markets and Community Investment
United States General Accounting Office
441 G Street, NW
Room 2A10
Washington, DC 20548

Dear Mr. Shear,

Thank you for providing the United States Department of Agriculture (USDA), Rural Development, with your draft report on Standardization of Budget Estimation Processes Needed for Rental Assistance Program, Audit No. GAO-04-424. I would like to offer the following comments for your consideration and ask that a copy of this response be included in your final report.

USDA provides affordable multifamily housing to almost a half-million residents in rural America. One of the most important tools available is the Rental Assistance (RA) program, which enables eligible very low and low-income residents to pay only 30 percent of their income towards rent. USDA takes very seriously its stewardship of this program.

While USDA acknowledges that there is evidence that we have inadvertently overestimated the cost of RA contracts in the past, we do not believe that the report supports an estimation of \$51 million a year in over funding in Fiscal Year (FY) 2003. It should be noted that at no point were government funds at risk and there has been no loss of funds due to the Agency's RA budget estimation policy. Funds appropriated for RA contracts have allowed any balance remaining at the end of the five-year contract period to be used for the extension of those contracts. Otherwise, these contracts would have required additional funds for renewal.

The General Accounting Office (GAO) found that contracts are now expected to exhaust funds in the sixth year. USDA believes this validates the method of estimating that Rural Housing Service (RHS) has used in recent years. RHS has succeeded in narrowing down estimated expenditure rates without the benefit of complete automation. RHS's estimating methods have evolved. Over time, assumptions, factors and circumstances require us to re-evaluate and change our methods. Multifamily property and health insurance costs, taxes and operating expenses all increase over time. Given the dynamic nature of our portfolio, we believe it is inconclusive to determine at this time that active contracts within their renewal period are over funded.

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See comment 1.

See comment 2.

See comment 3.

Appendix I
Comments from the U.S. Department of
Agriculture

GAO identified three ways that overestimating occurs: inflation rate, compounding rate and expenditure rate.

Inflation Rate

See comment 4.

GAO notes that RHS has not used the Office of Management and Budget (OMB) inflation rate or followed OMB procedures. However, USDA would argue that OMB Circular A-11 actually encourages the use of a per property micro-scale rate of change rather than a blanket national rate. We believe our budgeting is in accordance with OMB budget planning guidance as required by OMB Circular A-11.

OMB is currently consulted but we will implement a more formal process. As in the past, USDA will work with OMB to develop a mutually acceptable rate. USDA will also continue to evaluate use of the per project rate of change as an indicator of future RA use because we believe it is the best method of determining what is happening in a specific property.

See comment 5.

GAO attempts to show in Figure 6 that RHS estimates have exceeded actual expenditures for 1990-2003. However, Figure 6 is flawed for two reasons: (1) it presents only Year 1 of a five-year contract to compare estimates to expenditures. A truer picture of any overestimation claim would follow a contract through its life span and compare the estimate against actual expenditures. Showing only the first year gives a distorted view, and (2) as noted by GAO, RHS budget estimation process data was not available for years prior to 2000. We were unable to trace the per unit values shown back to any source.

See comment 6.

Inflation Rate Compounding Calculation

USDA agrees that the compounding calculation used most recently may have resulted in contracts outliving their expected renewal term by three to six months. Similarly, the proposed RA Forecasting Tool has been revised to address GAO's preliminary tool review concerns.

Expenditure Rate

See comment 7.

The third factor cited by GAO for overestimation of the RA budget needs is the expenditure rate that RHS used in its calculations. It is important to note that RHS developed the average rate in an effort to balance out the high and low vacancy rates; vacancies were not ignored as claimed in the report. It should also be noted that RA is only paid on occupied units and not on vacant units. USDA believes that using the most recent 3 months' history represented a more realistic picture of occupancy going forward vs. the occupancy 12 months previous, absent the availability of historic property data, now available with the proposed automated Forecasting Tool. Also through this process, RHS instilled quality control by investigating any abnormally high or low rates prior to calculating the contract amount; we did not automatically renew without examination.

Appendix I
Comments from the U.S. Department of
Agriculture

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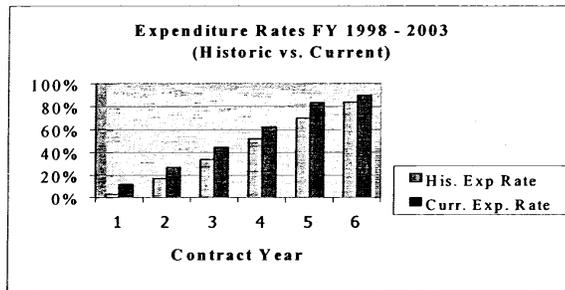
USDA believes the discussion in the report does not convey RHS's attempts to achieve balance in its estimating calculations.

See comment 8.

USDA reiterates that GAO has not demonstrated that use of OMB's inflation rate would result in exact five-year contracts or that use of the OMB rate matches the RA needs at our multifamily properties. To require use of a blanket national rate as a basis for funding RA contracts jeopardizes the property and the tenants. Under funding contracts is as equally serious a problem as over funding. One of the major reasons RHS developed the proposed automated RA Forecasting Tool is to have the ability to drill down to a property level and determine that specific property's RA needs. USDA is committed to protecting tenants and the financial viability of the housing they occupy.

See comment 9.

USDA disagrees with GAO's assertion that the 1998-2003 contracts are expending funds at a level consistent with contracts funded in 1978-1997. The following chart reflects that the contracts funded in the last six years (1998-2003) are expending their funds at a faster rate than the historic rate.



Note: Year 1 represents FY 2003 contracts in their 1st year of renewal; Year 2 represents FY 2002 contracts in their 2nd year of renewal, etc. through FY 1998 contracts in 6th year). Data as of March 4, 2004.

See comment 10.

RHS, through a number of methods, monitors the appropriate use of RA, guards against fraud, waste and abuse, and continues to improve and revamp its procedures and processes. USDA believes it would be an error to base any budgetary decisions on the claim of \$51 million in over funding for FY 2003 simply because we did not use the OMB inflation rate. FY 2003 contracts have just started their five-year renewal cycle.

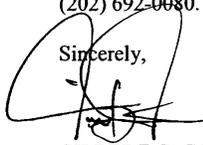
Appendix I
Comments from the U.S. Department of
Agriculture

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USDA is committed to the future of rural communities and we continue to work toward improving our rental assistance program.

Thank you for this opportunity to comment on the report. If you have any questions, please contact John M. Purcell, Director, Financial Management Division, at (202) 692-0080.

Sincerely,



GILBERT G. GONZALEZ
Acting Under Secretary
Rural Development

The following are GAO's comments on the U.S. Department of Agriculture's letter dated March 8, 2004.

GAO Comments

1. Our \$51 million figure is based on data provided by the U.S. Department of Agriculture (USDA), analyzed in a manner consistent with the Office of Management and Budget (OMB) budgetary guidance, correcting for the areas where we believe USDA overestimates its budgetary requirements. As we state in the report, this number is an estimate of the extent to which the Rural Housing Service (RHS) may have overestimated its budget when compared with an estimate based on OMB budget guidance documents and appropriate application of a compounding formula.
2. Although we concur that a budget estimation process, by itself, will not necessarily put government funds at risk, consistently overstating funding needs undermines the congressional budget process. In addition, without performing a detailed internal controls review, we cannot state that the current process for allocating budget funds has not put government funds at risk or led to a loss of funds. We do note that RHS is not adhering to internal control standards regarding segregation of duties for both its estimation and allocation processes, and such an internal control lapse could introduce a risk of error or fraud.
3. We agree that RHS's contracts are not lasting as long as they did in the past, however, a 6-year average life contract is still 20 percent greater than the intended contract life.
4. Circular A-11 states that "all budget materials, including those for out-year policy and baseline estimates, must be consistent with the economic assumptions provided by OMB. OMB policy permits consideration of price changes for goods and services as a factor in developing [outyear] estimates. However, this does not mean that you should automatically include an allowance for the full rate of anticipated inflation in your request." If the agency has evidence that a property will perform above or below the Consumer Price Index, which is the basis for OMB's economic assumptions, we would agree that this evidence should be used. OMB guidance indicates that the agency should document this evidence and justify that its proposed budget-estimation methodology would create a more accurate budget estimate.

5. We note in our report that the difference declines over time. Figure 2 shows this decline and shows that RHS is still overestimating its budget needs in the fifth year, albeit by less than in years 1 through 4.
6. As stated in the note in figure 6, RHS's estimated expenditures are based on data provided by the agency. Actual RHS expenditures are based on data from RHS's Automated Multi-Housing Accounting System (AMAS). As noted in the report, RHS did not document the inflation rate it used in its budget and allocation estimates prior to 2000. This is the lack of data to which we refer. It only affected our OMB-based estimate of RHS expenditures by preventing us from backing out agency rates and replacing them with the inflation projections from the President's Budget for years prior to fiscal year 2000. We clarified the text on this point.
7. Our concern centers on the fact that the agency is using the highest of the most recent 3 months instead of an average of all 3 months, not on the use of 3 months of data versus 12 months of data.
8. We concur that these rates are, in fact, an estimate, but as figure 6 illustrates, using these rates would have brought the agency's estimates closer to its actual expenditures. Furthermore, as shown in figure 6, budget estimates based on the inflation projections from the President's Budget would still have been higher than actual program expenditures, which should alleviate USDA's concern that using this method would underfund contracts.
9. Our report does not make this assertion. We state that the activity of contracts issued from 1998 through 2002 is consistent with earlier years, and in particular, that RHS has overestimated its spending needs in most years since 1990.
10. The \$51 million overestimate does not stem from the inflation rate only. It also stems from RHS compounding the rate to the fifth power and then applying that rate back to each year of the contract. We concur that we will not know the outcome of the contracts issued in 2003 until 2008 or later. This is our best estimate based on data provided by the agency and following OMB budgetary guidance.

GAO Contacts and Staff Acknowledgments

GAO Contacts

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Staff Acknowledgments

In addition to those named above, William Bates, Emily Chalmers, Jamila Jones, Austin Kelly, Marc Molino, and Julie Trinder made key contributions to this report.

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