



Issue Date March 7, 2012

Audit Report Number 2012-FW-1005

TO: Yolanda Chavez
Deputy Assistant Secretary for Grant Programs, DG

//signed//

FROM: Gerald R. Kirkland
Regional Inspector General for Audit, Fort Worth Region, 6AGA

SUBJECT: The State of Texas Did Not Follow Requirements for Its Infrastructure and Revitalization Contracts Funded With CDBG Disaster Recovery Program Funds

HIGHLIGHTS

What We Audited and Why

We audited the U. S. Department of Housing and Urban Development's (HUD) Community Development Block Grant (CDBG) 2008 Disaster Recovery assistance for Hurricane Ike and other disasters, administered by the Texas Department of Rural Affairs (the State). Our objective was to determine whether the State administered HUD's Disaster Recovery funds used for infrastructure and revitalization contracts in compliance with the supplemental appropriations requirements, HUD's policies, and the State of Texas' Disaster Recovery action plan. This is the fifth audit of Texas' administration of Disaster Recovery funds, and it was conducted as part of the Office of Inspector General's (OIG) commitment to HUD to implement oversight of Disaster Recovery funds to prevent fraud, waste, and abuse.

What We Found

The State did not follow Federal and State requirements and best practices for its infrastructure and revitalization professional services and project management services contracts. It failed to do so because it disregarded various requirements.

Specifically, the State (1) improperly procured its professional services and project management services contracts, (2) improperly increased the project management services company's contract, (3) included ineligible contract provisions, (4) failed to ensure the contract payment type was consistent, (5) failed to prevent questionable charges, (6) did not ensure its budgets clearly assigned costs according to HUD CDBG cost categories, and (7) did not ensure its project management services contract contained specific and quantifiable performance measures. As a result, the State paid \$9.06 million in questioned costs.

In addition, the State failed to adequately monitor its professional and project management services contracts due to staffing cutbacks and disagreements in the department originally responsible for overseeing the funds. Therefore, it did not review the contractor's performance or its accounting for, allocation of, or support for the eligibility of its costs.

The Texas General Land Office recognized that the project management services contract had problems and terminated it during our audit, which will prevent the State from improperly spending more than \$75.01 million in Disaster Recovery funds.

What We Recommend

We recommend that HUD's Deputy Assistant Secretary for Grant Programs require the State to (1) repay \$919,570 in ineligible markup costs, (2) support or repay an estimated \$7.59 million in unsupported inflated costs, (3) repay \$542,477 in unreasonable and unnecessary inflated costs, and (4) document its termination of the professional services contract and its deobligation of the funds, which will result in \$75.01 million in Disaster Recovery funding being put to better use. In addition, HUD should require the State to adopt and follow sound agency business procedures for its Disaster Recovery-funded procurements and payments to ensure they comply with Federal and State policies.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-4. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided our discussion draft to the Texas General Land Office and HUD on February 13, 2012. We held an exit conference with them on February 27, 2012. The General Land Office provided its written response dated February 28, 2012, on March 2, 2012, and it generally agreed with the findings. The complete text of

the auditee's response, along with our evaluation of its response, can be found in appendix B of this report. In addition, HUD provided written comments dated March 6, 2012, which agreed with the findings. HUD's written response can be found in appendix C of this report.

TABLE OF CONTENTS

Background and Objective	4
Results of Audit	
Finding 1: The State’s CDBG Disaster Recovery-Funded Services Contracts Did Not Follow Federal and State Requirements	6
Finding 2: The State Failed To Adequately Monitor Its Professional and Project Management Services Contracts	14
Scope and Methodology	17
Internal Controls	20
Appendixes	
A. Schedule of Questioned Costs and Funds To Be Put to Better Use	22
B. Auditee Comments and OIG’s Evaluation	23
C. HUD Comments	25

BACKGROUND AND OBJECTIVE

Congress enacted the Consolidated Security, Disaster Assistance, and Continuing Appropriations Act, 2009 (Pub. Law 110-329), on September 30, 2008. The Act appropriated \$6.1 billion through the Community Development Block Grant (CDBG) program for “necessary expenses related to disaster relief, long-term recovery, and restoration of infrastructure, housing, and economic revitalization in areas affected by hurricanes, floods, and other natural disasters occurring during 2008 for which the President declared a major disaster.” In 2008, Texas’ gulf coast was severely impacted by three hurricanes and a tropical storm. Texas cited preliminary unreimbursed damages of \$29.4 billion for the 2008 hurricane season. In 2009, Texas received more than \$3 billion in CDBG Disaster Recovery funding authorized by the Act through two allocation rounds. In the first round of allocations, the U. S. Department of Housing and Urban Development (HUD) awarded the State \$1.3 billion for disaster recovery from Hurricane Ike.

The Governor of Texas appointed the Texas Department of Rural Affairs (the State) as the overall responsible agency for the Disaster Recovery funds. It had responsibility over the administration of nonhousing projects. The State had budgeted \$661 million for nonhousing activities as of June 30, 2011. Of that amount, it awarded \$591 million to 230 communities.

In October 2008, the State solicited for engineering services for its Disaster Recovery-funded nonhousing activities. It awarded a contract to HNTB Corporation (contractor) in December 2008 to conduct damage assessments and evaluate the eligibility of approximately 2,300 nonhousing projects. The contract totaled approximately \$16.6 million. In July 2009, the State solicited for a project management services firm for its Disaster Recovery-funded nonhousing projects. In August 2009, it contracted again with HNTB Corporation to administer the State’s CDBG Disaster Recovery program and work with its staff, grantees, grant administrators, environmental service providers, and design engineers involved in the project management of more than 2,000 nonhousing projects at a contract price not to exceed \$68.9 million. In April 2011, the State increased the contract to \$144 million, added additional project management services, and increased the contractor’s oversight duties to approximately 6,000 projects.

On July 1, 2011, the Governor of Texas changed the State agency responsible for the administration of the Disaster Recovery funds to the Texas General Land Office. The General Land Office cancelled the professional management services contract on September 1, 2011.

Our objective was to determine whether the State administered HUD’s Disaster Recovery funds used for infrastructure and revitalization contracts in compliance with the supplemental appropriations requirements, HUD’s policies, and the State of Texas’ Disaster Recovery action plan. Specifically, we wanted to determine whether the State (1) used the appropriate procurement method for soliciting the project management services contractor, (2) awarded contracts with ineligible contract provisions, (3) ensured its contracts contained specific and quantifiable performance measures, (4) ensured its project management services contract included contract budgets which included cost categories as defined by State CDBG rules, and (5) adequately monitored the contracts.

RESULTS OF AUDIT

Finding 1: The State's CDBG Disaster Recovery-Funded Services Contracts Did Not Follow Federal and State Requirements

The State did not follow Federal and State requirements and best practices for its infrastructure and revitalization professional and project management services contracts. Specifically, it (1) improperly procured its professional services and project management services contracts, (2) improperly increased the project management services company's contract, (3) included ineligible contract provisions, (4) failed to ensure the contract payment type was consistent, (5) failed to prevent questionable charges, (6) did not ensure its budgets clearly assigned costs according to HUD CDBG cost categories, and (7) did not ensure its project management services contract contained specific and quantifiable performance measures. The State failed to follow requirements and best practices because it disregarded them. As a result, it paid \$9.06 million in questioned costs.

The General Land Office avoided the improper spending of an additional \$75.01 million in Disaster Recovery funds by terminating the project management services contract during our audit.

The State Improperly Procured Its Professional Services Contracts

The State improperly procured its Disaster Recovery-funded professional services contracts. It did not follow Federal and State requirements and its best practices to ensure that it procured its two professional services contracts at fair and reasonable prices. The Texas Contract Management Guide required that the State adequately plan its procurements and show how it determined a fair and reasonable price before performing the actual procurement.¹ However, the State was unable to provide sufficient information showing how it planned its two professional services procurements, and it could not show that it had performed analyses to ensure that the prices that it would pay were fair and reasonable. The State indicated that documentation was not available due to staff turnover.

The State also did not follow the Federal requirements of Office of Management and Budget (OMB) Circular A-87, Cost Principles for State, Local, and Indian Tribal Governments. HUD's grant required that the State follow this circular, which required that contracts with for-profit businesses follow the Federal Acquisition Regulation. The State's two professional services contracts did not require the contractor to follow the Federal Acquisition Regulation.

¹ State of Texas Contract Management Guide, chapter 2, Planning and chapter 4, Professional Services

The State Improperly Increased the Second Contract

The State improperly increased its project management services contract's scope of services and cost when it entered into its fourth contract amendment. The amendment increased the maximum contract amount from about \$68.99 million to \$144 million, significantly increased the services to be provided, and increased the contract's budget from six cost categories to eight. The State did not follow its own guidance when it executed this contract change. The Texas Contract Management Guide stated

“As a general rule, whether a change is material or substantial is a fact question. What is fundamental is the principle that materially changing solicitation specifications after receipt of responses denies an opportunity for others to participate in the solicitation. Therefore, any contract amendments are required to be within the scope of the original contract and the competitive process underlying the original contract.”²

As the changes enacted were both material and substantial, the State could not provide assurance that it properly performed the \$75.01 million contract amendment.³ However, the General Land Office terminated the contract during our audit before it expended funds for amendment 4, which resulted in it avoiding the improper expenditure of the \$75.01 million.

The State's Contracts Included Ineligible Provisions

The State's contracts and contract amendments contained ineligible cost plus a percentage of cost provisions. The two contracts' budgets included a 10 percent markup on direct expenses and subcontractors' costs. HUD's CDBG rules prohibit a cost plus a percentage of cost payment type.⁴ The State included the ineligible cost provisions because its request for proposals stated that markups for materials and expenses would be negotiated and its request for qualifications stated that hourly rates, costs, and related services would be negotiated. Thus, the State's contracts allowed the contractor to budget and invoice using a cost plus a percentage of cost payment type. As shown in table 1, the State's contracts included almost \$4.45 million in ineligible markups, of which the State paid \$919,570. The General Land Office avoided paying more than \$3.29 million of these ineligible costs by terminating the contract.

² State of Texas Contract Management Guide, chapter 7, Contract Administration

³ \$144 million - \$68.99 million = \$75.01 million

⁴ 24 CFR (Code of Federal Regulations) 570.489(g)

Table 1 – Total amount of ineligible markup

Contract	Markup amount in the budget	Markup amount paid	Markup amount remaining
Professional services	\$700,783	\$467,574	*
Project management services	\$3,746,084	\$451,996	\$3,294,088
Totals	\$4,446,867	\$919,570	\$3,294,088

* The remaining \$233,209 markup amount will not be paid as the contract has been completed.

The State Did Not Ensure the Contract Payment Type Was Consistent

The State did not ensure the contract payment type in the project management services contract matched the solicitation payment type. The solicitation stated that “respondent(s) will be compensated based on a negotiated fee for services completed, with payments to be made on a negotiated schedule and as services are delivered.” According to the State’s policy, a fee for service contract payment type was one in which a fee could be established for a unit of service and payments were made for each unit of service completed. The State provided an example of giving flu shots to patients and stated a unit of service was one flu shot.⁵ The State’s contract stated that the contractor would be compensated in accordance with negotiated hourly billing rates set forth in an attachment that listed all of the tasks the contractor would perform. Thus, the contract’s negotiated hourly billing rate by tasks was not a fee for service contract. Instead, the State’s contract contained 11 pages of tasks and the hours allocated for those tasks and direct expenses that the State also would reimburse. Further, the State cannot determine what contract tasks were completed before it paid the contractor.

The State Allowed the Contractor to Bill by Category

The State did not require the contractor to bill by detailed tasks. The project management services contract included an attachment, which contained a list of tasks by cost categories. Each task included positions and hours by positions to complete the task. However, the State did not require the contractor to bill by the detailed task. Instead, it allowed the contractor to bill by category and hourly rates, which resembled a time and material payment type. Since the State allowed the contractor to bill in this fashion, it could not determine what tasks the contractor had completed or whether it had overpaid the contractor for any task.

⁵ Texas Contract Management Guide, chapter 3, Preparing the Solicitation

The State Allowed the Contractor to Bill Using Inflated Amounts

The State accepted the contractor's invoices for both contracts that contained only time and material billing information. By allowing the contractor to bill in this manner, the State paid the contractor on a time and material basis. Reviewing the contractor's underlying costs showed that the State allowed the contractor to bill using inflated cost amounts. Instead of using its actual labor costs and its approved Federal Acquisition Regulation indirect cost rate of 147 percent, the contractor computed its hourly billing rate by using an average hourly wage rate multiplied by 320 percent. Detailed testing of three invoices showed that the contractor's invoiced costs exceeded its Federal Acquisition Regulation allowable costs by \$542,477, or approximately 23 percent of \$2.35 million in labor costs invoiced.⁶ As of July 2011, the State had paid the contractor \$35.23 million on both contracts. Since the contractor used the same billing method for all of its invoices, we estimated that \$8.14 million, or 23 percent of the \$35.23 million, represented inflated labor costs. Thus, the State paid \$542,477 in unreasonable or unnecessary inflated labor costs for the three invoices reviewed, and more than \$7.59 million in inflated labor costs from the other 73 invoices was unsupported.

The State allowed these costs because it instructed the contractor to develop hourly rates that included all costs and expenses. However, it did not specifically require the contractor to follow the Federal Acquisition Regulation because the State's staff was unaware of the requirements. The contractor understood the requirements and admitted it was aware of them. However, it chose not to use them in developing its costs because the State did not require it in the solicitation.

Since the Texas General Land Office terminated the contract, it will avoid paying an estimated \$10.07 million in remaining inflated labor costs.

The State Did Not Ensure the Contractor Properly Categorized Costs

The State's professional management services contract contained multiple cost categories that did not clearly tie to or match HUD's CDBG cost categories. The CDBG program requirements contain three cost categories: administration, planning, and project delivery.⁷ The State's original contract contained six cost categories that it amended to eight, as shown in table 2.

⁶ See the Scope and Methodology Section for an explanation of the testing methodology.

⁷ 24 CFR 570.489(a)(1)

Table 2 – Cost categories by contract

Original contract cost categories	Contract amendment 4 cost categories
1. Environmental	1. Application administration
2. Engineering	2. Project delivery facilitators
3. Construction management	3. Environmental
4. Project controls	4. Engineering
5. Community outreach	5. Construction observation
6. Programmatic support	6. Technology
	7. Outreach support
	8. Programmatic support

Neither the contract language nor the contract budgets specified how the categories in table 2 would be allocated to the three HUD CDBG cost categories. The State’s omissions allowed the contractor to bill its costs to any HUD cost category. For example, the contractor billed and allocated “Engineering” costs to all three HUD categories, but it did not explain why one category was charged versus another. As a result, the State had no assurance the contractor consistently and properly categorized costs charged to this grant.

The State’s Contract Lacked Specific and Quantifiable Performance Measures

The State’s project management services contract did not contain specific or clearly defined performance measures. The original contract, executed in August 2009, did not contain specific time requirements, goals, or milestones to show when the contractor achieved certain levels of progress. Also, it did not contain any penalties or remedies for failing to complete tasks. The State included some time requirements in amendment 4, which it executed 20 months later. In addition, the amendment required the contractor to submit performance reports, and it included a retainage value if the contractor’s performance fell below 90 percent.

The Texas Contract Management Guide required the State’s performance specifications be reasonable and clearly outlined how results would be measured. In addition, the Guide required the contract’s statement of work to provide a clear description of the goods or services to be provided.⁸

The State argued that its contracts contained performance measures. However, both HUD’s monitoring and the State’s contracted internal auditor criticized the State for not having adequate performance measures. Since the State also lacked billing information showing the detailed tasks completed, it could not adequately measure the effectiveness of its Disaster Recovery program. However a review of

⁸ Texas Contract Management Guide, chapter 3, Performance Based Specifications vs. Design Specifications & Elements of a Deliverable

its expenditures showed that as of June 30, 2011, the State had spent more than 83 percent of the available infrastructure and revitalization administrative funds but had only spent 15 percent of the project funds.

The General Land Office Assumed and Canceled the Contract

The General Land Office assumed oversight of the project management services contract on July 1, 2011, 9 days after our audit started. During the audit, regular meetings occurred between the auditors and General Land Office staff to discuss the issues and findings. Before September 1, 2011, discussions included (1) ineligible markups, (2) excessive rates being paid to the contractor, (3) the lack of a contract cost analysis, (4) the lack of supporting documentation for invoices, (5) the fact that cost categories did not match HUD CDBG categories, (6) the lack of monitoring, and (7) the applicable regulations for contracts awarded under HUD's Disaster Recovery grant program. Further, auditors recommended that the contract needed to be redone. On September 1, 2011, the General Land Office cancelled the contract. As a result, the State took action to prevent future payments for ineligible, unnecessary, unreasonable, or unsupported costs totaling more than \$75.01 million.

Conclusion

The State improperly procured and entered into faulty contracts and contract amendments. As shown in table 3, the State's contracts and amendments included ineligible provisions and inflated costs, and the contract's budgets did not match the CDBG cost categories. In addition, for the project management services contract, the contract payment type was not consistent with the solicitation, the contractor did not bill by detailed tasks, and the contract lacked specific and quantifiable performance measures.

The General Land Office terminated the contract during our audit, which will prevent more than \$75.01 million in funds from being improperly spent.

Table 3 – Total amount of questioned costs and funds to be put to better use

Cost category	Ineligible	Unsupported	Unreasonable or unnecessary	Funds to be put to better use
Deobligation of improper contract amendment				\$75,009,910*
Ineligible markups	\$919,570			
Inflated costs		\$7,599,747	\$542,477	
Totals	\$919,570	\$7,599,747	\$542,477	\$75,009,910

* This amount includes the deobligation of ineligible markups totaling \$3,294,088 and inflated costs totaling \$10,065,836

Recommendations

We recommend that HUD’s Deputy Assistant Secretary for Grant Programs require the State to

- 1A. Adopt and follow sound agency business procedures for its Disaster Recovery-funded procurements and payments to ensure they comply with Federal and State policies.
- 1B. Reimburse its Disaster Recovery program from non-Federal funds \$919,570, which was improperly paid to the contractor for amounts billed using the ineligible cost plus a percentage of cost payment method.
- 1C. Reimburse from non-Federal funds or provide support for the estimated \$7,599,747 in unsupported inflated labor costs.
- 1D. Reimburse from non-Federal funds or provide support for the \$542,477 paid for unnecessary and unreasonable inflated labor costs.
- 1E. Document its termination of the professional services contract and its deobligation of the funds, which will result in \$75,009,910 being put to better use.

Finding 2: The State Failed To Adequately Monitor Its Professional and Project Management Services Contracts

The State failed to adequately monitor its professional and project management services contracts. It did not follow Federal or State monitoring requirements and best practices due to staffing cutbacks and management disagreements. Since the State allowed its contractor to assume almost total control of its Disaster Recovery-funded infrastructure and revitalization program, it should have had a strong monitoring function. However, as the few remaining State quality assurance staff focused on the timely payment of invoices, it did not perform any monitoring. As a result, the State did not monitor the contractor to ensure compliance with the contracts and the applicable Federal and State requirements.

The State Did Not Perform Monitoring

From the time it received the Disaster Recovery grant funds until it lost oversight responsibility,⁹ the State performed no monitoring of its professional services or project management services contracts. HUD's CDBG Disaster Recovery rules required the State to have monitoring standards and procedures to ensure program requirements were met. The State had monitoring policies and procedures, but it did not implement them. It did not test or review invoices submitted to determine whether costs were properly allocated or eligible. Also, it did not conduct any site visits to oversee the contractor's project management services. In addition, it failed to review the contractor's financial accounting records to ensure that costs billed to the State were supported.

Management Disagreements Negatively Affected the Program

The State's executive director and its Disaster Recovery program manager disagreed on key program issues. The State originally planned to staff the \$661 million Disaster Recovery infrastructure and revitalization program with 41 employees, including 6 monitoring positions. After receiving the many initial applications, the program manager requested additional staff. He eventually received approval for and hired 56 employees but stated he still did not have enough staff to conduct oversight. The executive director stated that he felt the Disaster Recovery staff were not productive and were trying to prolong their temporary positions. Since the State had reduced the available amount of administrative and planning funds, and because the executive director felt he had

⁹ The Texas Department of Rural Affairs' period of oversight ran from March 4, 2009, through June 30, 2011.

lost control of the staff, he decided to assign their tasks to the contractor and released most of the staff between November 2010 and February 2011.

The State Granted the Contractor Program Control

Since the executive director distrusted the Disaster Recovery employees, he took steps, including contract modifications, that allowed the contractor to assume almost total control of the program, as contractor staff replaced most of the State's Disaster Recovery employees. The contractor became responsible for oversight of the grant and the grant projects, ensuring project completion, the processing of payment invoices, and grantee and subcontractor monitoring.

The State also granted the contractor system access to the State's contract management system, which contained budget, funding, and project management information, and, with HUD's approval, to HUD's Disaster Recovery Grant Reporting (DRGR) system, which contained budget, funding, and reporting information. While HUD's controls prevented the contractor from making or approving its own payment voucher request in the DRGR system, it allowed the contractor to set-up and amend individual project descriptions, including budgets. A State staffer warned the State's executive director that the contractor should not be granted such access, because it allowed the contractor to make changes to the State's and its own budgets, and the system would not maintain a history of such changes. The executive director disregarded this warning.

The executive director's decision to allow the contractor access to both of these systems gave the contractor the ability to adjust budgets and funding without State oversight. State employees admitted that they could not determine whether the contractor had exceeded the Federal funding caps for HUD's administration and planning cost categories.

The Remaining State Quality Assurance Staff Focused on Financial Operations

Only four quality assurance positions remained after the executive director reorganized. Instead of monitoring, the staff focused on financial functions. Staff members stated their jobs consisted of ensuring the contractor's invoices totaled accurately and paying the invoices in a timely manner. They did not monitor the contract for compliance with HUD requirements and did not ensure costs were supported, eligible, and allocated appropriately.

Reviews Reported on the State's Monitoring Issues

The State hired an outside firm to perform independent audits of its operations. The audit firm found in March 2011 that the State's staff did not compare invoiced costs to the services performed to determine reasonableness. In addition, it noted that both the State and the contractor lacked supporting documentation for adjustments to services and amounts paid on invoices. It also found in June 2011 that the State's staff failed to monitor the project management services contract. In its responses to the independent audit firm, the State admitted the issues existed and that it was taking actions to address them.

In October 2010, HUD began performing reviews of the State. In its May 2011 report, it noted that both the State's senior staff and the State's independent auditor had concerns regarding contract oversight. It also expressed concerns with the State's reliance on its contractor for program administration and said the contractor could not track the progress of administrative expenditures relative to project completion. Further, it informed the State that some responsibilities should not be ceded to the contractor.

Conclusion

The State did not adequately monitor its contractor. It did not follow Federal or State monitoring requirements and best practices due to staffing cutbacks and management disagreements. It granted the contractor significant program and system control, but it did not monitor or review the contractor's performance or the contractor's accounting for, allocation of, or support documenting the eligibility of its costs. Without proper monitoring and quality assurance, the State lacked assurance that the \$661 million in Disaster Recovery funds allocated for its infrastructure and revitalization programs would meet the programs' intended purpose.

In a discussion of the finding with the General Land Office, it agreed that monitoring had not occurred and stated it had removed the contractor's access to the various systems. The State told HUD it was aware of the issues and was working to address them.

Recommendations

We recommend that HUD's Deputy Assistant Secretary for Grant Programs require the State to

- 2A. Implement monitoring plans and procedures, which include reviewing the contractor's performance and invoiced costs to ensure they are eligible, necessary, allocable to the program, and adequately supported.
- 2B. Verify that it has limited or restricted the contractor's access to the various systems.

SCOPE AND METHODOLOGY

We conducted our audit at the State's and the General Land Office's offices in Austin, TX, and at the HUD OIG offices in San Antonio and Fort Worth, TX. We performed our audit between June 2011 and December 2011. The audit generally covered the period from October 2008 through June 2011. However, we expanded the scope of our audit as necessary. To accomplish our objectives, we

- Reviewed the Consolidated Security, Disaster Assistance, and Continuing Appropriations Act, 2009.¹⁰
- Reviewed HUD's CDBG and other applicable Federal regulations and requirements.
- Reviewed the Disaster Recovery grant agreement executed by HUD and the State.
- Reviewed the State's policy and guides for disaster relief programs.
- Reviewed the State's statutes, contracting requirements, and other applicable requirements and policies.
- Reviewed the State's professional services solicitations for the infrastructure and revitalization program and the two contracts awarded to identify whether the State complied with Federal and State procurement requirements.
- Analyzed the State's project management services contract amendments to ensure they met the State's standards.
- Obtained a download of the State's general ledger information for the infrastructure and revitalization program that contained data from October 8, 2008, to July 1, 2011. We also obtained a download of the contractor's employee financial data from August 21, 2009, to July 22, 2011.
- Obtained from the State electronic data for three invoices, dated March 5, 2010, September 29, 2010, and May 6, 2011.
- Performed testing on the computer-processed data obtained from the State and the contractor. We determined that the data were sufficiently reliable to meet our objective.
- Obtained quarterly reports from HUD's Disaster Recovery Grant Reporting system. We compared the information to an electronic download of the State's general ledger for reports issued from April 1 to December 31, 2009. Testing was performed to confirm that the information in HUD's system matched the State's general ledger. We were able to confirm and verify project delivery costs and planning costs. However, the State reported \$1.1 million more in administrative expenses to HUD than it posted to its general ledger, a 17.65 percent difference. State staff said the difference was due to timing issues in the allocation of State salary costs. As State salary costs were outside the scope of our audit, we limited our testing to confirming that the amounts invoiced by the contractor reconciled to the amounts paid and reported in the State's accounting system.

¹⁰ Public Law 110-329

- Obtained and reviewed all 24 professional services contract invoices and all 52 project management services contract invoices paid by the State as of August 5, 2011, to determine whether the contractor included ineligible cost plus a percentage of cost markups in the invoices.
- Reviewed and matched both the 24 professional services invoices and the 52 project management services invoices to the State's financial vouchers and its general ledger database to verify that the State accurately posted the information to its general ledger. We also reviewed all of the invoices to ensure that the State accurately recorded the reported cost categories of administrative, planning, and project delivery in its general ledger.
- Reviewed the 52 project management services contract invoices and compared them to cost and task information in the contracts and amendments to determine whether the State ensured the contractor was billing appropriately.
- Selected and reviewed 3 of the 52 invoices from the project management services contract, which totaled \$2.35 million of the \$29.16 million submitted for payment by the contractor. We selected the three invoices without bias, and they represented different time periods during the contractor's oversight of the State's program. As the State received only summary invoices, we requested supporting documentation from the contractor, and it provided labor and direct expenses by invoice in an electronic format for the three invoices. We compared the contractor's actual labor costs to the invoiced labor. We computed estimated indirect costs, using the contractor's approved Federal Acquisition Regulation indirect cost rate of 147 percent, multiplied by the actual labor costs for that invoice. For each invoice, we then added the computed actual labor costs and the estimated indirect costs and compared them to the contractor's invoiced amount to determine the amount of excessive labor costs. We then divided the total amount of the three invoices' excessive labor costs (\$542,477) by the total of the three billed invoices (\$2.35 million), which resulted in the 23 percent estimated amount of inflated costs. The contractor billed all of its invoices from the two contracts, using average hourly rates, and stated that it multiplied the total average hourly rate for each position by 320 percent. As a result, we determined that all of its invoices contained inflated costs. To estimate the total inflated amount, we multiplied \$35.23 million (the total amount of invoiced labor costs for the two contracts) by the 23 percent average inflated invoice amount to arrive at an estimated \$8.14 million total amount of inflated costs. The total amount of inflated costs consisted of the actual \$542,477 calculated inflated costs for the three invoices and the estimated \$7.59 million for all of the remaining 73 invoices billed.¹¹
- Compared the project management services contract's cost categories to HUD's CDBG cost categories in an attempt to reconcile administrative, planning, and project delivery costs.
- Reviewed the independent monitoring firm's internal monitoring reports prepared for the State and HUD's monitoring reports.

¹¹ Includes the 52 management services contract invoices and the 24 professional services invoices, less the 3 invoices reviewed (52 + 24 - 3=73)

- Interviewed HUD's, the State's, the General Land Office's, and the contractor's management and staff.
- Estimated that the State will put more than \$75.01 million to better use by terminating the contract and deobligating the funds. The deobligation of the funds included \$3.29 million in ineligible markups and almost \$10.07 million in inflated costs remaining in the terminated amount.

We conducted the audit 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 audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

INTERNAL CONTROLS

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined that the following internal controls were relevant to our audit objective:

- The control environment¹²
- Controls to ensure compliance with Disaster Recovery program requirements
- Controls to ensure compliance with Federal and State procurement requirements
- Financial controls
- Monitoring controls
- Computer system access controls

We assessed the relevant controls identified above.

A deficiency in internal controls exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

¹² Control environment – the overall attitude, awareness, and actions of directors and management regarding the internal control system and its importance to the entity.

Significant Deficiencies

Based on our review, we believe that the following items are significant deficiencies:

- The State did not have controls to ensure that its professional services contracts were procured in compliance with Federal and State procurement regulations (finding 1).
- The State lacked controls to ensure that its contracts did not contain provisions prohibited by HUD's CDBG Disaster Recovery program rules (finding 1).
- The State lacked financial controls to ensure that its contractor supported and properly allocated its costs (finding 1).
- The State's control environment was lacking as management disagreements prevented the State from monitoring its contracts (finding 2).
- The State's control environment was lacking as management overrode staff concerns and system controls by allowing the contractor access to its and HUD's computer systems (finding 2).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Ineligible <u>1/</u>	Unsupported <u>2/</u>	Unreasonable or unnecessary <u>3/</u>	Funds to be put to better use <u>4/</u>
1B	<u>\$919,570</u>			
1C		<u>\$7,599,747</u>		
1D			<u>\$542,477</u>	
1E				\$75,009,910
Totals	<u>\$919,570</u>	<u>\$7,599,747</u>	<u>\$542,477</u>	<u>\$75,009,910</u>

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.

3/ Unreasonable or unnecessary costs are those costs not generally recognized as ordinary, prudent, relevant, or necessary within established practices. Unreasonable costs exceed the costs that would be incurred by a prudent person in conducting a competitive business.

4/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an OIG recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. In this case, it represents a deobligation of contract funds.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

Comment 1



February 28, 2012

Gerald R. Kirkland
U.S. Department of Housing and Urban Development
Office of Inspector General, Region VI
819 Taylor Street, Suite 13A09
Fort Worth, Texas 76102

Re: The State of Texas Did Not Follow Requirements for Its Infrastructure and Revitalization Contracts Funded With CDBG Disaster Recovery Program Funds

Dear Gerald R. Kirkland:

The Texas General Land Office commends the work performed on the audit of the CDBG Disaster Recovery Program for the period from October 2008 through June 2011. As you know, the Land Office was designated by Governor Perry as the lead agency for the Texas Disaster Recovery Program on July 1, 2011. We take this responsibility seriously and appreciate HUD's recognition of the actions taken by the Land Office to be good stewards of these disaster recovery funds.

Since the Land Office received the program, we have diligently worked to determine pre-existing problems and have addressed those issues by implementing effective resolutions. One example is the contract process, which we have restructured to ensure that contracts with our program management company, as well as contracts with service providers, contain benchmarks and deliverables. Our program continues to make process improvements and identify any hurdles to recovery. It is our goal to more effectively and efficiently administer the program for the benefit of the affected Texas citizens.

We look forward to working with HUD program staff to further address any necessary resolution to these issues.

Sincerely,

Gary Hagood
Deputy Commissioner for Financial Management

Cc: Tracey Hall, Deputy Commissioner, Internal Audit, General Land Office
Jorge Ramirez, Director, Disaster Recovery Program, General Land Office
Luis Arellano, Director, Disaster Recovery Finance, General Land Office

Stephen F. Austin Building • 1700 North Congress Avenue • Austin, Texas 78701-1495
Post Office Box 12873 • Austin, Texas 78711-2873
512-463-5001 • 800-998-4GLO
www.glo.state.tx.us

OIG Evaluation of Auditee Comments

Comment 1 We acknowledge the General Land Office's response and appreciate its efforts to address the issues identified in this report.

Appendix C

HUD COMMENTS



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-7000

OFFICE OF COMMUNITY PLANNING
AND DEVELOPMENT

MEMORADUM FOR: Gerald R. Kirkland, Acting Regional Inspector General for Audit,
6AGA

FROM: Yolanda Chávez, Deputy Assistant Secretary for Grant Programs, DG *Yolanda Chávez*
MAR 06 2012

SUBJECT: **Draft Audit Report: The State of Texas Did Not Follow Requirements for its Infrastructure and Revitalization Contracts Funded With CDBG Disaster Recovery Program Funds.**

The Office of Community Planning and Development (CPD) is pleased that the Office of Inspector General (OIG) has affirmed the observations and concerns noted by CPD disaster recovery staff during its monitoring of the State's Community Development Block Grant disaster recovery (CDBG-DR) funds.

CPD has been actively monitoring the State of Texas' CDBG-DR program for recovery from Hurricanes Ike and Dolly in 2008. Monitoring of the State (and its project management consultant, HNTB Inc.) has occurred since the State submitted its first disaster recovery Action Plan in February 2009. The first action taken against the State occurred in November 2009, when HUD rejected the State's Action Plan Amendment (APA) #1 because the APA lacked local methods of distribution and the State's allocation methodology did not concentrate CDBG-DR funds in the hardest-hit regions of the state. During that same period, Texas signed a conciliation agreement with local housing advocates concerning the State's alleged failure to comply with fair housing laws—specifically, its use of an outdated Analysis of Impediments to Fair Housing Choice. The State subsequently re-submitted APA #1, re-allocating more than \$200 million in CDBG-DR funding from inland counties to those hardest hit along the coast. CPD approved APA #1 in June 2010.

CPD became aware of issues surrounding the contract between the now defunct Texas Department of Rural Affairs (TDRA) and HNTB in October 2010. It then began to raise concerns about TDRA's oversight of the firm as well as its dependence on HNTB to carry out grant management functions normally assigned to state employees. As a result, CPD convened an All-Texas coordination meeting among CPD Directors in Fort Worth, Houston, San Antonio, and Headquarters to assess the State's overall grant performance across all CPD grant programs. Beginning in October 2010, CPD increased the frequency of its CDBG-DR monitoring visits from twice annually to a quarterly basis.

www.hud.gov

espanol.hud.gov

From January 2011 through August 2011, HUD conducted three management reviews which resulted in eight findings of noncompliance and 15 concerns. Most of the findings involved grant administration at the subrecipient level. However, HUD also cited TDRA's failure to provide oversight of HNTB's contract, failure to review HNTB's administrative expenditures, and lack of performance benchmarks for the HNTB contract. In June 2011, CPD met with OIG staff and cited the HNTB contract, including TDRA's oversight of HNTB, as its number one concern. In addition to providing numerous technical assistance visits to Austin, Houston, Beaumont, Galveston, and the Lower Rio Grande Valley to assist the State with resolving findings and building local capacity, CPD has also coordinated cross-cutting training for the State of Texas, covering compliance with Section 3 and the Fair Housing Act.

CPD will work directly with the State of Texas and OIG staff to adequately address the findings noted in the draft report. Again, thank you for your attention to this significant investment in the State of Texas for the long-term recovery of its citizens and communities.