



The Texas Department of Housing and Community Affairs, Austin, TX

Did Not Always Comply with Neighborhood Stabilization Program Requirements



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TO: Shirley J. Henley
Director, Office of Community Planning and Development, 6AD
//signed//

FROM: Gerald R. Kirkland
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SUBJECT: The Texas Department of Housing and Community Affairs, Austin, TX, Did Not Always Comply with Neighborhood Stabilization Program Requirements

Enclosed is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General (OIG), final results of our review of the Texas Department of Housing and Community Affairs' Neighborhood Stabilization Program.

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

The Inspector General Act, Title 5 United States Code, section 8L, requires that OIG post its publicly available reports on the OIG Web site. Accordingly, this report will be posted at <http://www.hudoig.gov>.

If you have any questions or comments about this report, please do not hesitate to call me at 817-978-9309.



August 22, 2012

The Texas Department of Housing and Community Affairs, Austin, TX, Did Not Always Comply with Neighborhood Stabilization Program Requirements

Highlights

Audit Report 2012-FW-0013

What We Audited and Why

We audited the U. S. Department of Housing and Urban Development (HUD) Neighborhood Stabilization Program (NSP1) administered by the Texas Department of Housing and Community Affairs. We selected the Department based upon the large amount of NSP1 funding that it received, more than \$101 million. Our objective was to determine whether the Department complied with NSP1 requirements for obligations, expenditures, program income, monitoring, and reporting.

What We Recommend

We recommend that the Fort Worth Director of HUD's Office of Community Planning and Development recapture \$42,182 that the Department obligated improperly, and require the Department to provide support for more than \$25 million in unsupported obligations and costs.

What We Found

The Department improperly obligated \$42,182. In addition, it could not support more than \$25 million in obligations made by the deadline and \$8,767 in expenditures. Further, it did not report on its progress as required and did not appear to be on schedule to spend funds within required timeframes. As a result, the Department could not assure HUD that it properly managed its more than \$101 million program.

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BACKGROUND AND OBJECTIVE

Under the Housing and Economic Recovery Act of 2008, the U. S. Department of Housing and Urban Development (HUD) distributed, through a prescribed formula, \$3.92 billion in Neighborhood Stabilization Program (NSP1) funds to States and local governments. While NSP1 had similarities to existing HUD programs, it was a newly created program that required recipients to create or modify procedures and systems to manage and comply with requirements. On March 3, 2009, HUD awarded more than \$101 million in NSP1 funds to the State of Texas. The State was to use its NSP1 funds to assist in the rehabilitation of abandoned and foreclosed-upon homes and residential properties.

The governor of Texas selected the Department of Housing and Community Affairs as the lead agency for its \$101 million program. The Department provides for the public service and housing needs of low- to moderate-income families in Texas. The Department established a multilevel approach for the distribution of the NSP1 funds to communities with the greatest need. For the first level, it directly allocated \$76.9 million to local governments and nonprofit agencies in counties identified as having the greatest need. For the second level, the Department competitively awarded \$19.9 million to entities in counties with significant needs, referred to as the “select pool” counties.¹ It entered into a memorandum of understanding with the Texas Department of Rural Affairs, authorizing it to oversee the “select pool” activities.² However, as lead agency, the Department maintained overall responsibility for the entire program.

NSP1 required the Department to obligate its funds within 18 months after HUD signed the grant agreement on March 3, 2009.³ The requirements defined obligations as when the Department placed orders, awarded contracts, received services, and conducted similar transactions.⁴ The Department could not obligate funds simply by awarding NSP1 grants to its subrecipients. As table 1 shows, the NSP1 also required the Department to spend its funds within 4 years. As of May 29, 2012, the Department had drawn down only \$52 million, which was about 52 percent of its grant, although its grant period for expending the funds was 81 percent completed.

Table 1: Statutory deadlines for the Department’s NSP1 grant

Grant number	Date funds available	Obligation deadline set by HUD	Expenditure deadline
B-08-DN-48-0001	March 3, 2009	September 3, 2010	March 2, 2013

Our objective was to determine whether the Department complied with NSP1 requirements for obligations, expenditures, program income, monitoring, and reporting.

¹ The remaining \$5.1 million was for administrative costs.

² This memorandum of understanding was for the period September 25, 2009, through August 31, 2011.

³ Federal Register Docket Number FR-5255-N-01, section II.B

⁴ Federal Register Docket Number FR-5255-N-01, section II.A

RESULTS OF AUDIT

Finding: The Department Did Not Always Comply with Neighborhood Stabilization Program Requirements

The Department did not adequately manage its NSP1 obligations by not maintaining sufficient records to support obligations reported to HUD. Federal regulations required the Department to establish and maintain sufficient records to support that it complied with requirements.⁵ Based on a review of a statistical sample of obligations, the Department did not have valid contracts or other obligating documentation for \$631,402 in reported obligations. Also, it entered into agreements with subrecipients that did not complete their activities, resulting in \$8,767 of unsupported costs. Further, more than \$24.7 million of its reported obligations did not match the subrecipient agreements. In addition, the Department did not report its progress to HUD in a timely manner as required and did not appear to be on track to spend funds by the statutory deadline. These conditions occurred because the Department did not allocate enough resources or establish the effective controls to operate its program. Therefore, the Department did not effectively and efficiently implement its planned program and incurred questioned obligations and costs totaling more than \$25 million.

The Department Could Not Support the Obligation Amounts That It Reported to HUD

The Department did not create and maintain adequate records to support its meeting of the September 3, 2010, statutory obligation deadline. This deficiency occurred because the Department did not allocate the staff and resources necessary to establish the control environment to track and monitor its NSP1 obligations as required by its grant agreement.⁶ Further, it could not effectively support its current obligations, which impaired its ability to manage its program.

In accepting its NSP1 grant, dated March 3, 2009, the Department certified to HUD that it would obligate its NSP1 funds within 18 months, or by the September 3, 2010, deadline. HUD emphasized the importance to all NSP1 recipients of meeting this deadline so they would not need to return funds. On September 4, 2010, the Department reported in HUD's Disaster Recovery Grant

⁵ 24 CFR (Code of Federal Regulations) 570.506

⁶ Ibid.

Reporting (DRGR) system⁷ that it had obligated 100 percent of its grant, thus meeting the obligation deadline.

However, the Department did not establish systems and controls for the obligation of NSP1 funds, which significantly hindered its ability to support its reported obligations. In response to several requests for support of its September 4, 2010, reported obligations, the Department provided a spreadsheet, dated October 17, 2011. It prepared the spreadsheet specifically for this audit using spreadsheets maintained by its program services division.⁸ Department staff explained that the data in the program services' spreadsheets included information through February 2011, 5 months after the deadline. However, the Department could not substantiate the obligations it reported to HUD as meeting the September 3, 2010, deadline. Specifically, the Department could not provide a contemporaneously prepared or verifiable list of obligation amounts by specific NSP1 activities that equaled its obligations reported in the DRGR system.

In attempting to draw an obligation sample, we compared the Department's spreadsheet to the obligations it reported to HUD.⁹ For 28 of 38 (74 percent) Department contracts, the amounts did not reconcile. As table 2 shows, the aggregate discrepancy between the Department's records totaled more than \$9.4 million.

Table 2: Aggregate discrepancy between obligations the Department reported to HUD and its October 17, 2011, spreadsheet supporting the reported amounts

Contract comparison	Reported in the DRGR system on 09/04/2010	Department's spreadsheet 10/17/2011	Aggregate discrepancy
17 overstated contracts	\$30,098,073	\$ 34,385,120	\$ 4,287,047
11 understated contracts	(16,898,251)	(11,759,273)	5,138,978
Total of 28 incorrectly reported contracts	\$13,199,822	\$ 22,625,847	\$ 9,426,025

The Department was responsible for maintaining the information supporting what it reported to HUD through the DRGR system. The Department must reconcile its records and resolve the more than \$9.4 million in aggregate discrepancies that its records showed. As further evidence that its records were inaccurate, table 3 demonstrates the fluctuations in amounts the Department reported to HUD and

⁷ HUD's Office of Community Planning and Development designed the DRGR system for its Disaster Recovery program and other special appropriations. Grantees use the system to report their NSP1 obligations and expenditures. HUD uses data from the system to review activities and required reports.

⁸ The Department provided the program services division's source spreadsheets on January 19, 2012, 4 months after our initial request.

⁹ This comparison did not include the Texas Department of Rural Affairs' agreements.

the amounts it reported on its Web site for its June 30, 2010, quarterly performance report, which it didn't report until June 22, 2011, almost 1 year late.

Table 3: Fluctuations between amounts the Department reported in the DRGR system and on its Web site for its June 30, 2010, quarterly performance report

Description	DRGR system as of 10/31/2011	DRGR system as of 11/16/2011	Department's Web site on 11/21/2011
Total NSP1 funds budgeted	\$100,873,093	\$84,569,796	\$97,974,744
Program funds obligated	25,864,303	24,986,774	25,864,303
National objective NSP1 only – 25 percent set aside¹⁰	\$65,369,757	\$51,851,920	\$62,524,020

None of the Department's budgeted amounts equaled the grant amount of more than \$101 million as they should have. In discussions, Department staff attributed the discrepancies to the DRGR system. However, the DRGR system served as a repository for information that the Department submitted, and HUD used to monitor the Department's program.¹¹ Therefore, the Department was responsible for allocating the resources to accurately record information into the system.

The Department Did Not Obligate NSP1 Grant Funds by the Obligation Deadline

The Department could not support that it obligated all NSP1 grant funds within 18 months of the grant award as required.¹² For 20 of 56 (36 percent) grant activities reviewed, the Department incorrectly reported in the DRGR system that it met its obligation deadline for the grant funds awarded.¹³ For 3 of the 20 activities, it reported that it obligated \$42,182, although there were no executed agreements obligating the funds. For the remaining 17 activities, the Department's system did not contain documentation to support \$589,220 in obligations.¹⁴ This condition occurred because the Department did not effectively manage its NSP1 obligations. It did not allocate sufficient staff to implement policies and procedures for processing obligations. As a result, it did not ensure that its subrecipients entered into agreements that clearly obligated the funds by September 3, 2010.

¹⁰ Federal Register Docket Number FR-5255-N-01, section II.E, required that the Department spend 25 percent of the funds for the purchase and redevelopment of abandoned or foreclosed-upon residential properties to be used to house individuals or families whose incomes did not exceed 50 percent of area median income.

¹¹ HUD reviewed the DRGR system to analyze risk and find anomalies or performance problems that suggested fraud, waste, or abuse of funds. HUD reconciled budgets, obligations, fund draws, and expenditures to the DRGR system.

¹² Federal Register Docket Number FR-5255-N-01, section II.B

¹³ The Department certified that it would obligate the \$101 million NSP1 grant amount by September 3, 2010.

¹⁴ For example, some subrecipients did not date the signatures on the documents supporting the obligations.

Further, the Department did not establish and maintain a system for recording NSPI obligations as required.¹⁵ As a result, it could not provide a reliable list of obligations. The 56 sample grant activities were selected from records that the Department and the Texas Department of Rural Affairs provided.¹⁶ The Texas Department of Rural Affairs provided several spreadsheets showing obligations for “select pool” subrecipients, which it prepared about September 3, 2010, when it entered obligations into the DRGR system. For the remaining obligations, the Department used various sources and took more than a year after the obligation deadline to create a spreadsheet that listed the obligations. The Department did not maintain an accurate obligation record, as more than half of the 56 samples did not match the obligations reported in its housing contract system. In total, its system underreported the sample amount for 34 activities (61 percent) by more than \$4.8 million.¹⁷ The sample listing contained 25 activities that exceeded its system’s obligations and 9 activities for which the listed obligations were less than those reported in its system.¹⁸ This condition occurred because the Department did not have effective systems for reconciling its obligating documents to its system and correcting discrepancies. As a result, it could not support that it obligated its funds by September 3, 2010.

The Department Deobligated More Than \$21 Million for Activities That It Could Not Complete

Of 44 subrecipients, 15 (34 percent) did not complete the planned activities for 24 of 58 (41 percent) grant agreements. This condition occurred because the Department lacked systems and controls for selecting and helping subrecipients complete grant activities within guidelines.¹⁹ As a result, the Department deobligated more than \$21 million for activities that it could not complete.²⁰ The deobligations appear to show that the Department was more interested in meeting the obligation deadline than obligating funds for activities that it could complete. The deobligations may deter its ability to spend funds by March 2, 2013, as required. Table 4 is a summary of deobligated agreements.

¹⁵ Under 24 CFR 570.506, the Department was required to maintain a historical record of funds obligated to meet the deadline.

¹⁶ The Department managed 43, and the Texas Department of Rural Affairs oversaw the remaining 13.

¹⁷ The sample amount showed total obligations of \$35.3 million, while the Department’s system reported a total of \$30.4 million. The Department had taken one sample item in the amount of \$106,315 out of its housing contract system. As a result, we did not compare that sample amount to the system.

¹⁸ The total absolute variance was more than \$5.3 million.

¹⁹ Common business practice would require the Department to select only those subrecipients that could complete the proposed work while complying with Federal regulations.

²⁰ HUD had not deobligated those funds from the Department’s award.

Table 4: Funds deobligated by the Department from its subrecipients

Reason for deobligations	Number of agreements	Funds drawn down for lapsed contracts	Amount deobligated
Agreement terminated	9	\$ 41,621	\$11,597,964
Agreement expired	11	801,070	6,189,830
Amended agreement reduced the amount	4		3,595,891
Totals	24	\$842,691	\$21,383,685

The Department deobligated more than \$12.3 of the \$101 million that HUD awarded (12 percent) within 27 days following the September 3, 2010, obligation deadline. On September 4, 2010, the Department reported in the DRGR system that it had obligated all the awarded funds. However, its quarterly performance report for the quarter ended September 30, 2010, 26 days later,²¹ showed obligations of only \$89.6 million. The Department explained that there are many fluctuations in real estate transactions and the amounts obligated were only estimates that changed upon closing. It also explained that there was no existing requirement that the Department maintain its obligations after the obligation deadline. However, this did not clearly explain what happened to the reported obligations in such a short time period. The \$12.3 million in deobligated funds are shown in the following table.

Table 5: Funds deobligated in 26 days following the obligation reporting

Type of activity	NSP1 funds deobligated
Renovations-new construction	(\$9,466,215)
Land banks	(2,874,858)
Acquisitions	1,024,762
Administrative fees (about 8%)	(955,464)
Demolitions	(143,839)
Rehabilitation	28,809
Total	(\$12,386,805)

HUD regulations specified the documents the Department must have when it obligated NSP1 funds.²² Those documents had to be signed and dated. For instance, under NSP1 the Department could report an obligation when;

- a subrecipient had a signed purchase offer accepted by the seller for an acquisition of real property,

²¹ The Department did not submit this report until November 15, 2011.

²² NSP Policy Alert dated April 23, 2010

- a subrecipient had either a construction contract or other action that was legally binding for rehabilitation of property owned by the subrecipient,
- a subrecipient awarded a construction contract for new housing construction on vacant or demolished property, or
- a subrecipient awarded a demolition contract for a specific property.

All of the required documents mentioned above were legally binding to a subrecipient. Thus, it was unclear why the amounts obligated for these transactions would change so much and often during the short time period without the activities being completed or written amendments to the documents.

Before the Department deobligated NSP1 funds from the remaining balances of two subrecipient agreements, it paid the subrecipients for questionable costs. As a result, the Department spent \$8,767 on unsupported payroll and administrative costs for those agreements that it cancelled.

- **Unsupported Payroll Costs**

Timesheets did not reflect total activity required in fulfillment of the employees' responsibilities to the subrecipients, and there was nothing to indicate that the employees only worked on NSP1 activities. As a result, employees did not report their total activities as required.²³

- **Unsupported Administrative Costs**

Two subrecipients charged indirect costs to NSP1 based on a calculated percentage. When using the direct allocation method for allocating indirect costs under 2 CFR 230, subrecipients were required to prorate costs individually as direct costs to each activity using a base most appropriate to the particular cost being prorated. The base used must accurately measure the benefits provided to each activity and must be supported by current data. However, the Department's housing contract system did not have documentation to support that its subrecipients complied with the regulations. Further, in one instance, a subrecipient did not have a hotel receipt supporting more than \$300.

The Department's Subrecipient Agreements Did Not Support the Obligations

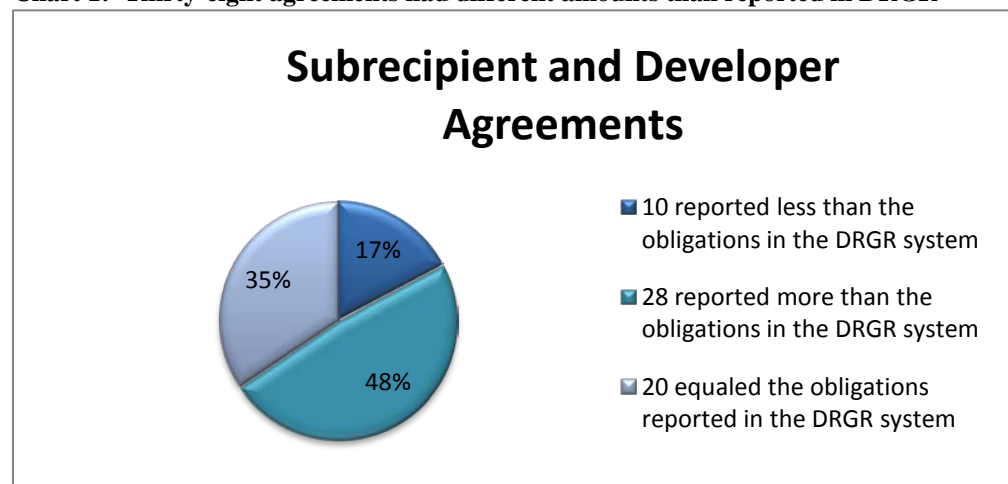
As previously noted, the Department did not maintain adequate records to support its September 3, 2010, obligations. In an attempt to determine which, if any, funds were not properly obligated by September 3, 2010, we compared the

²³ Under 2 CFR 230, each time report account for the total activity for which employees were compensated. The time report must show the total time required in fulfillment of their obligations to the organization.

obligations reported in the DRGR system to the individual subrecipient and developer agreements that were effective on that day. The agreements would help the Department ensure that it spent funds in accordance with program requirements.²⁴ However, the agreements did not support the obligations reported in the DRGR system and the Department could not reconcile the differences.

For instance, of the 58 obligations reported, 38 did not agree with the amounts in the subrecipient grant agreements. Ten agreements, 17 percent, were for less, and 28 agreements, 48 percent, were for more than the reported obligations. In addition, the Department entered into a developer agreement that it did not report. The aggregate amount of the obligation differences totaled more than \$24.7 million, which was unsupported.

Chart 1: Thirty-eight agreements had different amounts than reported in DRGR



To worsen the situation, 22 of the 58 agreements showed that planned grant activities did not match the obligated activities. These differences gave the appearance that the Department did not know what activities it was going to pursue.

The variances occurred because the Department did not allocate the staff and resources necessary to create systems and controls for processing, tracking, and reconciling obligations. As a result, it did not ensure that its grant agreements matched the obligation information it reported. Since the agreements differed from the information submitted to HUD, the Department could not effectively monitor its performance under the submitted plans²⁵ or support that it met the obligation deadline.

²⁴ 24 CFR 570.501(b)

²⁵ Before the Department gave funds to its subrecipients, 24 CFR 570.503 required that the Department enter into subrecipient agreements with its subrecipients. The agreements were required to include a detailed description of the planned work, a schedule for completing the work, and a budget. The subrecipients were also required to provide adequate information for the Department to monitor performance under the agreements.

HUD cautioned grantees that adequate subrecipient agreements, which are “required,” are “essential management tools” for measuring the subrecipients’ performance and “verifying regulatory compliance.” HUD explained that the Department should amend its written agreement when there was an unwritten agreement to change the scope of work. “Neglecting to amend” an agreement places the Department “at risk” because the “agreement is no longer an effective tool for monitoring and enforcing performance standards.” For agreements that have more activities than obligated, the agreement “may continue to legally bind” the subrecipient to the activities that both parties agreed were no longer a responsibility of the subrecipient. According to the guidance, “[c]larifying or correcting these misunderstandings after the fact can be both disruptive and costly.”²⁶ Since the Department did not amend its 38 agreements, it could not support \$24.7 million obligated.

The Department Did Not Report on Its Progress as Required

The Department did not report its progress toward meeting its NSP1 goals as required. HUD required the Department to submit quarterly performance reports using its DRGR system within 30 days following the end of each quarter. It also required the Department to post prominently the quarterly performance report on the State’s official Web site at the time of submission.²⁷ As table 6 shows, only 2 of the Department’s 12 quarterly performance reports met the reporting requirement.

Table 6: Status of required quarterly performance report submissions as of July 12, 2012

Status	Quarterly performance report	Due date	Date submitted to HUD	Number of days late	Report submitted on time?
Submitted timely (2 reports)	06/30/2009	07/30/2009	07/28/2009	0	Yes
	03/31/2012	04/30/2012	04/26/2012	0	Yes
Submitted late (10 reports)	09/30/2009	10/30/2009	11/12/2009	13	No
	12/31/2009	01/30/2010	02/02/2010	3	No
	03/31/2010	04/30/2010	06/11/2010	42	No
	06/30/2010	07/30/2010	06/22/2011	327	No
	09/30/2010	10/30/2010	11/15/2011	381	No
	12/31/2010	01/30/2011	11/22/2011	296	No
	03/31/2011	04/30/2011	01/17/2012	262	No
	06/30/2011	07/30/2011	03/19/2012	233	No
	09/30/2011	10/30/2011	03/28/2012	150	No
	12/31/2011	01/30/2012	04/03/2012	64	No

²⁶ Managing CDBG: A Guidebook for Grantees on Subrecipient Oversight

²⁷ Federal Register Docket Number FR-5255-N-01, section II.O

The Department submitted acceptable June and September 2010, quarterly performance reports nearly 1 year late. However, it did not maintain records or implement a system for summarizing its progress. This condition occurred because the Department did not effectively plan to manage its NSP1 by implementing systems to properly record obligations thereby allowing it to accurately report its performance to HUD in a timely manner. It did not assign enough staff members to run the program and it did not adequately prioritize the requirement for accurate and timely reporting of results. As a result, the NSP1 manager submitted the quarterly performance reports whenever time allowed. The September 2010 quarterly performance report would have informed the public of the Department's obligation status.

The Department did not report its obligations to HUD monthly as it should have. HUD required grantees that were not 100 percent obligated by June 30, 2010, to report monthly on their progress.²⁸ Specifically, HUD required the Department to submit monthly reports until HUD accepted a report demonstrating 100 percent obligation. The Department's September 2010 quarterly performance report established obligations as of the obligation deadline. However, the Department did not submit the September 2010 quarterly performance report until November 15, 2011. Therefore, the Department should have submitted monthly reports on its obligations from June 30, 2010, through October 30, 2011.

In addition, the Department could not support that it met its performance goals that it reported in the DRGR system. The Department's housing contract system showed detailed information on each grant activity. However, it did not summarize the information for easy reporting. Additionally, the Department did not have a system for reconciling its data with the DRGR system; thus, it did not reconcile its actual activities shown in its housing contract system to the activities that it reported in the DRGR system. As a result, it did not have readily available records to support that it met its performance goals, including the requirement to spend at least 25 percent of its funds to benefit individuals and families whose incomes did not exceed 50 percent of the area median income. The Department also did not have records to show that its subrecipients met their milestones and thresholds as required by their grant agreements.

In August 2011, the Department implemented policies and procedures for monitoring subrecipient progress toward meeting program goals, and it had created a database to track subrecipient performance as of January 31, 2012.²⁹ However, it had not implemented policies and procedures for summarizing its total progress. HUD required the Department to meet grant performance goals for several years after expending grant funds. If the Department does not keep

²⁸ Federal Register Docket Number FR-5255-N-01, section II.O.1(b)(i). HUD awarded the funds on March 3, 2009. The end of the 15th month following that date was June 30, 2010.

²⁹ Since the Department had just begun using the database, we did not review the system's effectiveness for tracking performance measures.

records supporting its accomplishments, HUD has no assurance that the Department will comply with these requirements.

In addition, the Department's program division did not have written procedures for tracking and reporting program income. According to the NSP1 manager, the Department had unwritten procedures. When the financial administration division received program income, it notified program staff by email. After receiving notification, one loan specialist entered the information into the DRGR system; another entered the information into the Department's system. According to management, staff continually reconciled the entries. Without formalized program income policies and procedures, the Department could not support that it tracked program income as required.

The Department Had Incomplete Guidelines To Verify Eligibility

The Department's policies and procedures for verifying tenant and homeowner eligibility before approving draw requests for homeowner loans were incomplete. Also, the procedures did not have a timeline for the quality assurance staff to complete their reviews. According to management, properties were set up in the Department's system to comply with the area median income requirements. The subrecipients set up activities in the system, and the specialists reviewed and approved the activity setups. As a result, specialists needed to confirm that each property met its eligibility requirements and quality assurance staff did a second review before requesting NSP1 funds for homebuyer loans. Without clear written procedures for processing setups and draws, the Department may not be able to ensure that its staff understand the requirements and that its subrecipients have the resources necessary to complete their grant activities in a timely manner.

The Department Was Not on Track To Spend Funds in a Timely Manner

Based on the expended funds and progress as of May 29, 2012, the Department did not appear to be spending its NSP1 funds in a timely manner. Federal regulations³⁰ required that the Department spend the total funds awarded within 4 years, or by March 2, 2013.³¹ HUD would recapture all funds not expended by that date. Although it was 3.2 years (81 percent) through the grant, the Department had spent only \$52 million (52 percent) of its grant funds. The Department put itself at risk of not spending the grant funds on time when it selected subrecipients that did not have the capacity to administer the program activities. At least 34 percent of the subrecipients either did not have the capacity

³⁰ Federal Register Docket Number FR-5255-N-01, section II.M.2

³¹ The 4-year expenditure period began on March 3, 2009, when HUD signed the State's NSP1 grant agreement.

or were not willing to complete their NSP1 activities. This problem caused the Department to deobligate at least \$21 million. As table 7 shows, the Department had obligated only \$84 of the \$101 million grant (approximately 83 percent) as of May 29, 2012.

Table 7: The Department’s total drawdowns for NSP1 activities as of May 29, 2012

Activity	Obligated	Funds drawn down	Activity percentage completed
Acquisition – multifamily properties	\$21,154,879	\$20,288,081	96%
Land banks	8,362,291	6,531,276	78%
Demolition	2,433,838	1,666,694	68%
Acquisition – single-family properties	14,640,381	10,348,427	71%
Financing	995,566	413,482	42%
Administrative fees	8,220,142	4,898,421	60%
Rehabilitation or reconstruction – multifamily properties	8,636,639	3,368,867	39%
New construction or rehabilitation – single-family properties	20,158,340	5,357,223	27%
Totals	\$84,602,076	\$52,872,471	

Although the Department seemed to be completing the purchase of properties for multifamily residences and land banks in a timely manner, it was not progressing as well on the other activities. For example, the Department was slow to complete its acquisition, new construction, and rehabilitation goals for single family homes. It had spent only \$15 of \$34 million (approximately 45 percent) obligated for those activities. In another example, the City of Huntsville did not appear to be able to complete its activities. As of May 24, 2012, Huntsville had drawn down only \$155,490 (10 percent) of its \$1.5 million in obligated funds. Funds were not drawn down in a timely manner because there seemed to be delays in receiving guidance to carry out the programs, entering information into the system, getting timely approvals to carry out program activities, and obtaining funds for expenses. The Department’s inability to use its funds could make funds unavailable for capable entities that could complete viable NSP1 activities.

Conclusion

The Department did not always follow requirements when obligating and reporting on its NSP1 funds. It did not keep reliable records to support that it met the statutory obligation deadline. The Department obligated \$42,182 without valid agreements and \$589,220 without complete obligating documents. In

addition, the Department entered into grant agreements with subrecipients that could not complete their NSP1 activities, resulting in \$8,767 in unsupported expenditures. Also, it entered into subrecipient grant agreements that were not the same as the obligations reported in the DRGR system. The aggregate amount of the obligation differences totaled more than \$24.7 million. Further, the Department needs to strengthen its written policies and procedures for program specialists and quality assurance staff during the homebuyer loan process. Also, the Department did not appear to be spending its NSP1 funds in a timely manner. As a result, it did not carry out its activities as planned and could not adequately monitor the activities that it reported to HUD. In addition, the Department did not report on its progress as required. This condition occurred because the Department did not allocate sufficient staff and resources to implement adequate policies and procedures for its NSP1 obligations, thereby putting the program at risk of misappropriated funds.

Recommendations

We recommend that the Fort Worth Director of the Office of Community Planning and Development

- 1A. Recapture and reallocate \$42,182 in ineligible obligations and require the Department to reimburse HUD from non-Federal funds for any NSP1 proceeds spent on these obligations.³²
- 1B. Require the Department to support that \$589,220 in obligations existed as of September 3, 2010, or repay HUD for funds drawn down. The Director should take additional corrective action as appropriate.³³ These were obligations that we reviewed for which the Department's system did not have the required obligating documents.
- 1C. Require the Department to provide documentation to support \$8,767 in unsupported costs or repay any unsupported amounts to HUD.
- 1D. Require the Department to support that \$24.7 million in obligations existed as of September 3, 2010, or repay HUD for funds drawn down. Further, the Director should take additional corrective action as appropriate.³⁴ These were developer and subrecipient agreements that did not agree with the amounts and activities the Department obligated in the DRGR system.

³² According to Federal Register Volume 75, Number 201, section I.B.2, HUD is required to recapture and reallocate up to \$19.6 million in improper obligations. HUD may take other corrective action for funds in excess of \$19.6 million.

³³ Ibid.

³⁴ Ibid.

- 1E. Require the Department to implement adequate procedures and controls
- For processing, documenting, tracking, and reconciling its obligations to its subrecipient grant agreements and information reported to HUD and tracking and reporting its program income.
 - For selecting subrecipients that have the capacity to complete grant programs.
 - For tracking its progress toward meeting its NSP1 performance goals and completing and submitting quarterly performance reports to the DRGR system so that HUD knows the program's status.
- 1F. Require the Department to revise its standard operating procedures for its performance specialists and quality assurance staff to ensure loans and drawdowns are processed in a timely manner and to clearly explain the procedures for approving homebuyer activities for loans and drawdowns. The procedures should include the types of supporting documentation that must be reviewed, incorporating the NSP Homebuyer Workbook,³⁵ and clarifying what checklist(s) will be used and when to determine eligibility. The procedures for quality assurance staff should include a timeline for completing the review.
- 1G. Monitor the Department's progress toward meeting its March 2, 2013, expenditure deadline and follow up on any delays.

³⁵ According to the Department, subrecipients submit this workbook, along with source documentation, when sending household information to the Department for review and approval.

SCOPE AND METHODOLOGY

We performed our fieldwork at the Department's office located in Austin, TX, and our office in Oklahoma City, OK, from July 2011 through May 2012. Our audit scope was January 2009 through July 2011. We expanded our scope to July 12, 2012, for DRGR system reporting progress and May 29, 2012, for expenditure progress.

To accomplish our objectives, we performed the following related to the Department's NSP1 grant funds:

- Reviewed relevant laws, regulations, and HUD guidance;
- Reviewed the Department's policies and procedures;
- Reviewed and analyzed the Department's NSP1 grant agreement and the State's substantial amendment to its annual action plan for Federal fiscal year 2008;
- Reviewed internal audit reports and the February 15, 2011, NSP1 needs assessment report prepared by Training and Development Associates, an independent contractor for HUD;
- Reviewed the Department's monitoring reports of its subrecipients and the Texas Department of Rural Affairs;
- Reviewed the expenditures of 10 subrecipient grant agreements that either expired or were terminated;
- Reviewed 35 percent of the Department's NSP1 obligations as of September 3, 2010, to ensure that the Authority met its obligation requirements;
- Reviewed 13 NSP1 expenditures to determine whether the Department met expenditure requirements;
- Reviewed the status of the Department's NSP1 quarterly performance reports as of November 1, 2011, and the April 2011 annual Section 3 reports³⁶ for timely reporting;
- Interviewed HUD, Department, and Texas Department of Rural Affairs staff and NSP1 subrecipients; and
- Conducted 26 site visits to properties (5 multifamily properties and 21 single family homes) financed with NSP1 funds.

For the obligation sample review of approximately \$75 million in obligations directly overseen by the Department, we used a spreadsheet prepared by the Department more than 1 year following the obligations. The spreadsheet apparently showed the obligations, listed by subrecipient grant activity, which existed as of September 3, 2010, the obligation deadline. For the approximate \$19 million in obligations initially administered by the Texas Department of Rural Affairs, we used spreadsheets prepared by its staff when it entered the September 3, 2010, obligations into the DRGR system. Using the spreadsheets, we identified and reviewed a statistical sample of 56 activities. The sample amount was more than \$35.3 million. The sample universe included 1,430 activities that totaled more than \$93.7 million. These activities

³⁶ The Department certified that it would submit Section 3 reports to HUD showing that, to the greatest extent feasible, it provided job training, employment, and contracting opportunities for low- or very-low income residents in connection with projects and activities in their neighborhoods.

consisted of 1,203 activities administered by the Department and 227 activities initially administered by the Texas Department of Rural Affairs. Twenty-one activities, involving 4 subrecipient grant agreements, were not included in the universe because the information provided by the Department designated them as “cancelled.” The spreadsheet that the Department prepared was not reliable. There were many discrepancies between the contract amounts and activities shown on the spreadsheet and those shown in the DRGR system. As a result, we did not project the results of the review.

We selected a nonstatistical, representative sample of 52 of the Department’s 1,136 NSP1 administrative draws and expenditures. The 52 samples, valued at almost \$1 million, represented almost 3 percent of the more than \$37 million in administrative draws and expenditures. For the survey, we tested 13 of the 52 expenditures with no exceptions. As a result, we did not review the remaining 39. We used a nonstatistical sample because we were evaluating whether the Department kept documentation that supported its expenditures and we were not projecting the results.

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:

- Policies and procedures that the Department's management had implemented to ensure that its program met its objectives.
- Policies and procedures that the Department's management had implemented to ensure that its subrecipients and developers complied with laws and regulations.
- Policies and procedures that the Department's management had implemented to ensure that its resource use was consistent with laws and regulations and that its resources were safeguarded against waste, loss, and misuse.

We assessed the relevant controls identified above.

A deficiency in internal control 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.

Significant Deficiencies

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

- The Department did not establish systems and controls for processing, documenting, tracking, and reconciling its obligations to its subrecipient grant agreements and information reported to HUD (finding).
- The Department did not establish systems and controls for tracking and reporting its program income (finding).
- The Department did not establish systems and controls for selecting subrecipients that had the capacity to complete its NSP1 activities (finding).
- The Department did not have a system in place to ensure that it had adequate staff to oversee its NSP1 activities and its subrecipients (finding).
- The Department did not implement policies and procedures for its program specialists to verify tenant or homeowner eligibility before approving NSP1 draws (finding).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Ineligible <u>1/</u>	Unsupported <u>2/</u>
1A	\$42,182	
1B		\$ 589,220
1C		8,767
1D		24,706,604
Totals	<u>\$42,182</u>	<u>\$25,304,591</u> ³⁷

- 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.


³⁷ According to Federal Register Volume 75, Number 201, HUD is required to recapture and reallocate up to \$19.6 million in improper obligations. HUD may take additional corrective actions related to any amount of unused funds greater than \$19.6 million.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments


TEXAS DEPARTMENT OF HOUSING AND COMMUNITY AFFAIRS
www.tdhca.state.tx.us

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GOVERNOR

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Juan S. Muñoz, PhD
J. Mark McWatters

July 18, 2012

Writer's direct phone # 512-475-3296
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Mr. Gerald R. Kirkland
Regional Inspector General for Audit
U.S. Department of Housing and Urban Development
Office of Inspector General, Region 6
819 Taylor Street, Suite 13A09
Fort Worth, TX 76102

RE: MANAGEMENT RESPONSE TO THE DRAFT AUDIT REPORT FOR THE TEXAS NEIGHBORHOOD STABILIZATION PROGRAM (NSP)


Dear Mr. Kirkland:

Thank you for providing the Texas Department of Housing and Community Affairs (TDHCA) with an opportunity to review the findings and recommendations of your draft audit report issued June 27, 2012, regarding the Texas NSP. We appreciate the time and effort that your audit team put into reviewing our program.

Before we respond to more specific aspects of the report, I would like to first acknowledge that TDHCA has struggled with the Texas NSP and concurs with your assessment that we did not have ideal systems in place as the program was initiated. However, our ability to administer the program was severely impacted by limited initial federal program guidance, subsequent federal changes in guidance mid-way through the program and challenges utilizing the DRGR system.

Mr. William Nixon, HUD Assistant Regional Inspector General for Audit, indicated in our exit conference that our main issue was "paperwork and documentation." We concur that our processes for record-keeping in the initial phases of our program left room for improvement; while we do not agree that our funds were improperly obligated (other than those obligations with which we have been corresponding with HUD over the past nine months), we do agree that they were not well organized. However, in spite of our challenges and lack of ideal systems, we believe that we have source documentation to substantiate TDHCA's commitments, obligations, and decisions. We also are deeply concerned and disappointed with the emotionally charged and pointed language in portions of your report which appear to suggest that TDHCA intentionally mismanaged its administration of the Texas NSP. In fact, TDHCA has acted in good faith and has always attempted to administer this program in a manner that complies with all applicable federal requirements and guidance.

221 East 11th Street P.O. Box 13941 Austin, Texas 78711-3941 (800) 525-0657 (512) 475-3800



Comment 1

In regards to concern for TDHCA's ability to utilize the remaining program funds, I would note that based on current rates of expenditures and activity, TDHCA forecasts that it will have expended *all* funds by the deadline.

We will continue to work through the detailed issues with HUD.

Finding One: Improper Obligation

Regarding the draft audit report findings identified in Finding One, TDHCA would like to emphasize the following:

Comment 2

- Comments throughout the draft audit report indicate that obligation amounts should not have fluctuated or that they should have equaled the individual contract amounts. However, it is not only reasonable, but fully expected, that in the vast majority of real estate transactions there will be fluctuations. The amount originally obligated to a subrecipient for numerous transactions will not be identical to the cumulative amount actually contracted or expended. It would be unrealistic to expect an exact amount in this case. Even in the most "cookie cutter" real estate transactions, everything is couched in terms of estimates up until the drawing of documents for closing.
- In cases where the documented contract amount exceeded the amount obligated, TDHCA did not exceed the obligation amount in the subrecipient agreement; as required by HUD guidance, if the obligation total was less than the agreement, only the obligation amount was permitted to be entered into DRGR, therefore creating data that would be susceptible to being viewed as a discrepancy.
- TDHCA staff has actively managed the NSP contracts by continuously re-evaluating, adjusting, and updating contract amounts to ensure that they reflect the most current facts of each real estate transaction and tracked ongoing activity that, when reported and documented, will of necessity create variations in amounts.

**Comment 3
Comment 2**

- Regarding many of the statements and comments in the draft audit report, TDHCA emphasizes that there is no existing HUD or NSP requirement that 100% of obligations be maintained after September 2010 or that obligations be required to match contracts after that deadline. In a webinar on August 18, 2011, Mr. John Laswick of HUD, stated: "But the fact that it's not exactly the same projects that you had listed as obligated last September, is not something that we're concerned about."

**Comment 4
Comment 2**

- The draft audit report indicates that some of TDHCA's obligations were unsubstantiated and that it "could not effectively support its current obligations." We believe that we have adequate support for each of our current obligations as well as the obligations made by the September 2010 obligation deadline.
- The draft audit report implies that variances in DRGR are the responsibility of TDHCA. While it is true that the Department is responsible for entry into DRGR, TDHCA is not able to make changes in DRGR after the QPR for the period in which the entries were made is reviewed. However, historical reports generated reflecting back to that quarter, or other periods of time, do not reflect what TDHCA entered on those dates. The QPR system has

idiosyncrasies outside of TDHCA's control that prevent its use as a reliable snapshot report of record for this purpose.

Comment5
Comment 2

- While TDHCA acknowledges that the state is responsible for all of the NSP funds it was awarded, it should be emphasized that as soon as TDHCA assumed direct responsibility for the Texas Department of Rural Affairs' contracts (upon its dissolution by action of the Texas legislature), a thorough review was performed, TDHCA identified contracts of concern, reported them to HUD and requested guidance on how to proceed.

Comment2

- TDHCA is now fully current on its Quarterly Performance Reports.

Addendum One provides a more extensive response to the concerns noted in the draft audit report for Issue One, including back up documentation and explanation of attachments.

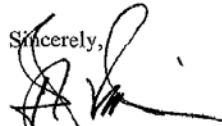
Comment 6

Finding Two: Townhomes of Bay Forest Mortgage

Regarding this multifamily transaction, TDHCA firmly believes that the use of these funds and structure of this partnership were not only eligible expenses but that TDHCA exercised tremendous prudence in making sure that the structure we utilized was within regulatory requirements, both for the NSP funding source and for the leveraged housing tax credits. Because the expenditures were indeed eligibly spent, the full amount of funds, including the balance of \$659,443, should not be recaptured by HUD or reimbursed to HUD. Addendum Two provides a more thorough and in-depth response to the Issue Two concerns noted in the draft audit report.

Thank you for your consideration in reviewing our comments as your finalize your audit report.

Sincerely,



Timothy K. Irvine
Executive Director

TKI/bb

cc: Shirley J. Henley, HUD
Steve Eberlein, HUD
William Bedford, HUD

Addendum One
Texas NSP Management Response to Audit – Detail Regarding Finding One
July 18, 2012

Finding 1: The Department Improperly Obligated and Misspent NSP1 Funds

The Department Could Not Support its Obligations - 1A & 1B

Comment 7

The first two sections of the report text appear to refer to the same findings 1A & 1B. HUD guidance is clear that a subrecipient agreement alone does not constitute valid obligation for NSP1. Obligation is described as, “The amounts of orders placed, contracts awarded, goods and services received, and similar transactions during a given period that will require payment by the grantee (or subrecipient) during the same or a future period.”¹ The Department reviewed each document provided by subrecipients and entered the corresponding aggregate obligation amounts by eligible use in DRGR within the obligation deadline requirements. Unfortunately, that work did not include creation or maintenance of a separate summary record, as found in the audit report. Lack of a separate summary does not invalidate the obligations, nor does that lack create a discrepancy between the documents themselves and the obligations as entered.

Comment 8

Additionally, the spreadsheet provided by OIG as support for the audit report amounts indicates that only Exhibit B (Budget to the subrecipient contracts) was used as a basis for calculation. Included in the absolute value of differences between the obligation amount and the subrecipient agreement are differences between the budget amount for an eligible use as it appears in Exhibit B of the contract, and the set-aside obligation amount entered in DRGR. Requirements for set-aside amounts are included as part of the Exhibit A - Performance Statement of each contract.² The set-aside requirements are described both in terms of dollar amounts to be expended, and unit counts in each contract, as such, the set-aside obligations entered in DRGR are appropriate and reflect the Department’s requirement that subrecipients meet set-aside targets.

Comment 9

In many instances, the obligation amounts taken from documentation provided by subrecipients did not exactly total to the subrecipient agreements. It is nearly impossible to reach an exact amount with multiple individual real estate transactions that had been unknown when the subrecipient agreement was executed a year prior to the obligation deadline. In some cases, the total of subrecipient obligation documentation was more than the contract amount. In these instances the amount of obligation entered by the Department was limited to the agreement amount. If the obligation total was less than the agreement, only that amount was entered in DRGR, as required by the definition of obligation. For the 28 agreements that were more than the reported obligations, the Department believes it acted properly in reporting the true obligation amount. Entry of the full contract amount without supporting obligation documentation would have been a violation of NSP1 requirements.

Comment 10

For the agreements that were less than the obligation amount, the difference was part of an original subrecipient agreement that was amended shortly before the obligation deadline to move rental activities to a Developer Agreement. The reduction to the acquisition obligation and corresponding

¹ See attached NSP Policy Alert, Obligations, April 23, 2010

² See attached Texas NSP Contract, Exhibit A – Performance Statement includes requirements for expenditure of a percentage of non-administrative funds along with a corresponding number of units to benefit households at or below 50% AMI.

administrative funds was missed in the course of obligation entry. The funds have subsequently been obligated to another activity.

The remaining nine contracts that had obligations more than the contract amount were administered by TDRA. TDRA staff entered the obligation amounts for their contracts, as required by the Memorandum of Understanding. When TDRA was dissolved and the NSP1 contracts and files were transferred, the Department conducted an in-depth review of the records along with monitoring visits to all assigned contracts. In the course of review, a number of discrepancies in the TDRA obligations were identified and those concerns communicated to HUD. HUD has completed a review of 100% of the TDRA obligations, and continues to work with the Department to resolve the findings.

Comment 11

Presentation of amounts from the June 30, 2010, Quarterly Performance Reports by the auditors appear to be pulled on different dates from DRGR and their use as an example of the Departments records we believe is misleading. The report posted to the Department's website is the one reviewed and approved by HUD. Once a report is approved, grantees are not longer able to edit it, so that differing budget, obligation or set-aside amounts are the result of programming issues within DRGR.³

The Department Did Not Obligate NSP1 Grant Funds by the Obligation Deadline - Findings 1C and 1D

Comment 12

While NSP1 funds were required to be obligated to individual activities with appropriate supporting documentation, the obligations were reported in DRGR as a total amount per eligible use under each contract. Examining obligations at the per-activity level, rather than all the activities attributable to an eligible use within a contract, would not necessarily result in the same conclusions. It appears that for all of the NSP1 subrecipient contracts, multiple individual activity obligations were combined to total the amounts entered in DRGR. An examination of all of the activities that were used to obligate funds for a contract may have yielded different results.

Further, comparison of obligation amounts to entries in the Department's Housing Contract System is not a valid measure of accuracy. As subrecipients have moved from initial obligation to loan closing and completion of activities, amounts required for rehabilitation to meet property standards frequently change. Variances may be the result of Department staff review of additional documentation, changes in the scope of work, or changes in the cost of goods and services.

The Department Spent \$8,767 of Unsupported Costs of Terminated Subrecipient Agreements

Comment 13

Unsupported Payroll Costs

The Department requires that documentation meeting OMB requirements is provided in order for salary costs to be reimbursed.⁴ Documentation provided to support the draw request in question includes timesheets for a bi-monthly pay period, that reflect an after-the-fact determination of the hours worked on specific NSP1 tasks, they are signed by the employee and the supervisor, thereby meeting the requirements for salary documentation as described in OMB A-122, Appendix B, Item 8m.

³ See attached Add/Edit QPR Screen - When a Quarterly Performance Report is submitted and approved, the "edit" button is automatically removed.

⁴ See attached - NSP Administrative Draw Checklist: Only actual hours worked directly on the NSP Program are eligible for reimbursement and must be documented. Support documentation must include one of the following: payroll journal, cancelled payroll checks, or check stubs, along with the Time Sheet - Form 15.01.

Reimbursement is made on the hours reported as worked on the NSP Program; there is no requirement that subrecipient employees work full-time on NSP.

Comment 14

Unsupported Administrative Costs

Most NSP1 subrecipients use OMB A-122A D.4., Direct Allocation Method as the basis for allocation of administrative costs. An indirect cost rate is not required by OMB, it is one of several methods available to account for expenses.

Comment 15

For the specific draw mentioned that did not include a hotel receipt, the draw as originally submitted was for \$6,425.44, the draw was reduced to \$5,000.00 as approved.⁵ The hotel charge is part of the charges that were not paid by TDHCA.

The Department Did Not Report on Its Progress as Required

Comment 16

In September 2011 an Information Specialist was added to the NSP staff, whose primary assignment is maintenance of accurate DRGR reporting. Working closely with HUD staff, seven (7) Quarterly Reports were submitted and approved between November 15, 2011, and April 26, 2012. The Department is now current for all such HUD reporting.³

Comment 17

Formal submission of QPRs during months 15-18 was not required, in fact the DRGR system was not set up to allow monthly submission. HUD's Policy Alert, New Monthly Reporting Requirements for NSP1 Grantees⁶ includes the following instruction:

Open the QPR for the next quarter (July-Sept), and begin reporting on expenditures right away. You should also note receipt of program income and show its disbursement. Remember that every time you enter new information you should save the QPR, and then your CPD Rep will be able to open the document at the end of the month

Comment 18

Performance reporting is required as units are occupied. All information required to report performance is captured in the NSP Homebuyer Workbook⁷, and the Housing Contract System⁸. During the review period that resulted in this report, there was very little performance reporting activity, as most NSP1 subrecipients were working on acquisition and rehabilitation or construction prior to homebuyer sales. The Department now has sufficient procedures in place to accurately and timely report on performance goals.

Comment 19

Measurement of the 25% setaside requirement will occur at the expenditure deadline, at which time the expenditure per unit occupied by a household at or below 50% AMI will be reported. In addition, it should be noted that the budgets for the NSP multi-family projects, almost all of which are 100% restricted for households at or below 50% AMI, total \$29,791,517.68. This amount alone exceeds the 25% requirement by \$4,292,305.68 prior to addition of set-aside ownership units.

⁵ See attached - 77090000172 Administrative Draw, as approved

³ See attached - Add/Edit QPR Screen

⁶ See Attached Policy Alert - New Monthly Reporting Requirements for NSP1 Grantees

⁷ See attached - NSP Homebuyer Workbook. This workbook is used by subrecipients to submit households to the Department for review and approval.

⁸ See attached - NSP Household Detail Screen

Comment 20

The Department Had Incomplete Guidelines to Verify Eligibility

It is the nature of NSP that most subrecipients are engaged in speculative purchase and rehabilitation, or new construction, of properties before a homebuyer is identified. The Department provides funding for those activities through interim acquisition and construction loans, which include income eligibility of the homebuyer or tenant as a condition of release of financing.⁹ Because funds are provided before the occupant household is identified, verification of income eligibility at draw is not possible.

Household Income Eligibility is verified for all transactions prior to homebuyer loan closing. NSP Program Specialists verify eligibility determinations in accordance with Standard Operating Procedures (SOP)¹⁰ using the NSP Homebuyer Internal Review tool,¹¹ to include review of source documentation provided as an attachment with the NSP Homebuyer Workbook.¹² Quality Assurance staff in the Program Services division complete a secondary review of income eligibility for all homebuyer transactions.¹³ Management reviews a sample of activities quarterly in accordance with the Management Oversight SOP.¹⁴ The Program Specialists are required to complete their review and approve or disapprove the transaction within 10 business days of submission, as described in the current SOP. The same 10 business day requirement for review and approval or disapproval of draws is imposed by the current SOP for that task.¹⁵

The Department was Not on Track to Spend Funds in a Timely Manner

Comment 21

While HUD has not provided final guidance regarding the expenditure deadline and subsequent grant close-out, they have recently provided important information regarding the difference between expenditure and drawdown of NSP1 funds.¹⁶ Based on this clarified guidance, the Department will begin to report subrecipient expenditure differently in future quarters.

The report equates draw down to expenditure. The draw down amount reflects funds drawn through DRGR from the NSP1 Grant or program income to reimburse expenses. The expenditure amount reflects the expenses reported by the Department as accrued by NSP1 subrecipients and developers. The deadline requires that grantees expend 100% of the NSP1 grant amount, regardless of the amount drawn so we believe the two are not the same.

⁹ See attached – NSP Interim Deed of Trust: 7.24 Low and Moderate Income Requirement. It is the intent of Beneficiary and Grantor that 100% of the funds made available under NSP are to be used to meet the low and moderate income requirement established in the Housing and Economic Recovery Act Section 2301 (f)(3)(A)(i) and (ii). The low and moderate income requirement includes individuals and families whose incomes do not exceed 120% of area median income as defined therein.

¹⁰ See attached – NSP Setups Standard Operating Procedure

¹¹ See attached – NSP Homebuyer Internal Review Checklist

¹² See attached – NSP Homebuyer Workbook

¹³ See attached – Quality Assurance NSP Homebuyer Review Checklist

¹⁴ See attached – NSP Management Oversight Standard Operating Procedure

¹⁵ See attached – NSP Drawdown Standard Operating Procedure

¹⁶ See Attached – HUD “Life After Deadlines” presentation slides

Addendum Two
Texas NSP Management Response to Audit – Finding Two Detail
July 18, 2012

Comment 6

Finding 2: The Department Improperly Spent NSP1 Funds on a Refinanced Mortgage

Finding two indicates that the Department improperly spent \$5.5M on the acquisition and rehabilitation of a 128 unit multifamily development known as the Townhomes of Bayforest because, according to the report, the acquisition of the property did not take place. The audit report correctly identifies the subgrantee, Covenant Community Capital Corporation (“Covenant”), as the developer and new owner of the property. The audit report also correctly recognizes that that Department properly obligated funding for Covenant on August 26, 2010. The audit report reflects that on December 31, 2010, the Department closed on a loan and provided funds to Covenant in order to acquire general partnership interest in the property and acknowledges that the property ownership named Townhomes of Bayforest LP, was reorganized at that time though it was not renamed as originally anticipated. The audit report does not recognize that an acquisition of the property did take place in accordance with NSP 1 requirements. On the date of the closing Covenant acquired control and equitable title to the property, rights to the partnership name, and ability to maintain other existing partnership relationships and advantages when they acquired sole controlling general partnership interest to the partnership¹⁷. Acquisition for NSP 1 is ultimately governed by CDBG regulations¹⁸ which provide under 24 CFR 507.201 (a):

“Acquisition in whole or in part by the recipient, or other public or private nonprofit entity, by purchase, long-term lease, donation, or otherwise, of real property (including air rights, water rights, rights-of-way, easements, and other interests therein) for any public purpose, subject to the limitations of § 570.207.” (Underline added)

A change in the name of the ownership entity is not required, nor is acquisition of 100% of the interest in the property required to be an eligible acquisition. Control of the property through the partial acquisition in the form of the acquisition of the general partner interest does meet the requirements of an acquisition, in part, by a private nonprofit entity, by purchase, long-term lease, donation, or otherwise. Moreover, Covenant obtained equitable title to the property when the ownership structure was reorganized and they were added as the new general partner in the partnership¹⁹.

The property in question was originally developed utilizing the tax credit program and, therefore, the original ownership was structured as a limited partnership with a controlling general partner and a limited partner who provided the equity in exchange for full use of the 10 year stream of annual tax credits. At the time of the default, initiation of foreclosure proceedings and subsequent acquisition by Covenant using the NSP funding, there were still several years of tax credits to be utilized and the original limited partner sought to participate in the foreclosure workout process. The limited partner insisted on preserving, for their benefit, the value of the remaining stream of tax credits and thus was

¹⁷ See executed settlement statement and amended partnership agreement.

¹⁸ Federal Register Volume 73, Number: 194 dated October 6, 2008 page 58330, bottom of column 1 “Title III of Division B of the Housing and Economic Recovery Act, 2008 (HERA) (Pub. L. 110-289, approved July 30, 2008) appropriates \$3.92 billion for emergency assistance for redevelopment of abandoned and foreclosed homes and residential properties, and provides under a rule of construction that, unless HERA states otherwise, the grants are to be considered Community Development Block Grant (CDBG) funds.”

¹⁹ The Texas Supreme Court recent ruling in AHF Arbors at Huntsville I, LLC vs. Walker County Appraisal District further substantiates the well established concept of equitable title in Texas where a nonprofit corporation controlling the general partnership interest in a property and having the power to compel transfer of legal title has equitable title to the property and for tax purposes the general partner and partnership are treated as the same.

from the outset of the intervention by Covenant, anticipated to be a limited partner in the ownership structure. Without the inclusion of the existing limited partner, the change of ownership through the acquisition by Covenant could not have been accomplished. While the reorganization of the partnership was extensive²⁰, maintaining the existing partnership name after the acquisition allowed many of the existing relationships with vendors and operations of the property to be continued at the discretion of Covenant without interruption and the costly need to be reestablished.

On the other hand, all of the liability associated with the ownership of the property shifted from the prior general partner to Covenant. The extent of the limited partner's liability is the investment into the partnership and the general partner indemnifies the limited partner in the partnership from any potential loss beyond their preexisting investment. Thus Covenant is fully responsible for their ownership decisions made by them as the general partner.

In addition, the acquisition through the controlling interest of the general partner in this case is analogous to the purchase through a long-term lease since the only other interest in the partnership is the limited partner and they have an agreement to convey their limited interest at the end of the initial compliance period²¹. Just like the lessor in a long term lease, the general partner has full use of the property through its controlling interest but the vesting of title remains in the name of another entity, the partnership. In this case the limited partner retains usage rights over a portion of the bundle of rights under the partnership (the low income housing tax credits) but ultimately agrees to relinquish all rights to the partnership once the value of the credits is extinguished. This is analogous to a long term lease which provides for full ownership and this too would clearly meet the definition of acquisition under 24 CFR 507.210 (a).

Finally the audit report claims that "The Department Improperly Spent NSP1 Funds on a Refinanced Mortgage" and includes in its conclusion the statement that the "funds were used to pay down the delinquent mortgage on the property" implying that this ultimate use of the funds loaned to the new owner ultimately paying the prior owners loan is improper. That conclusion does not recognize that most, if not all, NSP transactions could be construed to be doing the same thing because they are focused on identifying defaulted or foreclosed upon properties (owned by lenders as a result of a loan to another party) and providing funds to a new owner to alleviate the defaulted situation or remedy the foreclosure by paying off the lender. In fact, financing the acquisition of an existing property is almost always going to include the pay down or pay off of the financing that existed prior to the acquisition. Moreover, another element of evidence that a true change of ownership occurred at the subject property is that, like in a more conventional property acquisition, the prior mortgage was entirely eliminated and replaced by a new loan to a new entity.

In the end the reorganized partnership with the same name, controlled by a new general partner, Covenant, provided the Department with a new deed of trust in first lien position to secure the repayment of the new note made by Covenant and payable to the Department. Far from being an improper expenditure, this securitization (not, strictly speaking a securitization but the issuance of a secured promissory note by the partnership with the liability of the new GP) of the purchase of the property was properly completed and the entire \$5.4M in obligation was and continues to be eligible. The \$41,853 in legal fees paid for in the transaction were eligible costs which were documented and identified on the settlement statement in two line items as Attorney's Fees of \$18,953.21 and \$23,000 to

²⁰ The second amended and restated agreement of limited partnership is an extensive document that is 79 pages long

²¹ See right of first refusal and option to purchase agreement

Coats, Rose, Yale, Ryman & Lee, P.C. Thus since the acquisition is eligible the attorney's fees to complete the transaction are also eligible. The \$659,443 of funds remaining are eligible soft costs that have been targeted to reimburse a modest amount of rehabilitation which has now been completed. The draw request has been received by the Department. Thus the entire \$5.4 million activity is or shortly will be spent on eligible NSP1 activities.

**Texas NSP Management Response to Audit – Attachments
July 18, 2012**

1. NSP Policy Alert, April 23, 2010
2. Exhibit A, Texas NSP Contract
3. Quarterly Performance Report
4. NSP Administrative Draw Checklist
5. Administrative Draw 77090000172
6. Policy Alert
7. NSP Homebuyer Workbook
8. NSP Household Detail Screen
9. NSP Interim Deed of Trust
10. NSP Setups Standard Operating Procedures
11. NSP Homebuyer Internal Review Checklist
12. NSP Homebuyer Workbook
13. Quality Assurance NSP Homebuyer Review Checklist
14. NSP Management Oversight Standard Operating Procedure
15. NSP Drawdown Standard Operating Procedure
16. HUD “Life After Deadlines” presentation slides
17. Settlement Statement and Amended Partnership Agreement
18. Federal Register Volume 73, Number 194
19. The Texas Supreme Court ruling in AHF Arbors at Huntsville I, LLC vs. Walker County
20. Second Amended and Restated Agreement of Limited Partnership
21. Right of First Refusal and Option to Purchase Agreement

OIG Evaluation of Auditee Comments

- Comment 1** The Department questioned some of the language in the draft report as being emotionally charged and pointed; but, it did not provide any specific examples. We made several revisions to the report language to attempt to address the Department's concern.
- Comment 2** The Department provided an expanded response in its Addendum One. We address these comments there.
- Comment 3** The comment that HUD does not require grantees to keep the same obligations throughout the NSP1 grant period is valid. However, this was not an issue raised in the draft report. HUD required the Department to have valid obligations for its more than \$101 million award by September 3, 2010. The report concluded that the Department did not have adequate support for its September 3, 2010, obligations. It also concluded that the September 3, 2010, obligations entered into the DRGR system did not match obligations that existed on that date. We provided clarification in the finding.
- Comment 4** As discussed in the report, the Department did not maintain records or implement a system for summarizing its progress and reconciling its obligations to the DRGR system. HUD required the Department to establish and maintain sufficient records to enable HUD to determine whether it complied with applicable requirements.
- Comment 5** The Department acknowledged that it was responsible for all of the NSP1 funds awarded. In October 2011, more than a year after the obligation deadline, the Department notified HUD that it had improperly obligated funds at September 3, 2010. If it had implemented a system for tracking and reconciling the obligations reported in the DRGR system, it would have identified 'contracts of concern' earlier in the process before it entered them as valid obligations in the DRGR system.
- Comment 6** We appreciate the Department providing additional information and clarification. After reevaluation of the evidence, we removed the draft finding from the report.
- Comment 7** We did not dispute the definition of an "obligation." The Department was responsible for supporting the obligations it reported to HUD at the September 3, 2010, obligation deadline. However, as detailed throughout the finding, the Department's records were inaccurate and it could not support or reconcile the obligations it reported to HUD on September 4, 2010. To date, the Department has still been unable to support those obligations in summary form or otherwise. We maintain our position.

Comment 8 We prepared the spreadsheet from information provided by the Department. Based on the Department's comments, we clarified and made changes as appropriate to the finding.

Comment 9 The Department acknowledged that it entered into 38 written agreements with its subrecipients that did not total the amounts in the subrecipient grant agreements, 28 of which exceeded the obligations. The Department entered actual obligations into the DRGR system as of September 3, 2010. However, its grant agreements and contracts with its subrecipients and developers for the same period were not for the same activities and amounts as those reported in the DRGR system. Even though the Department entered into 14 of the 38 agreements between 6 months and 1 year before the September 3, 2010, obligation deadline, it entered into 11 agreements within 5 months before the deadline and the remaining 13 agreements within 1 to 2 months before the deadline. The Department did not amend any of the agreements to match the actual obligations entered into the DRGR system.

This caused fluctuations between the agreements and information in the DRGR system. The Department did not keep records to show where the fluctuations existed. If it had been properly managing its NSP1, its records would have shown what changed in the obligations and how the changes reconciled to the DRGR system.

Under the written agreements, the Department was bound to spend NSP1 funds for the activities and amounts included in the agreements. As a result, it obligated funds that were not available when it entered into subrecipient agreements that exceeded the obligated funds reported in the DRGR system. We did not revise the finding based on the Department's comment.

Comment 10 The Department agreed that it made errors when it entered obligation information into the DRGR system. If it had a system in place that reconciled the obligations in the subrecipient agreements to the obligations reported in its housing contract system and the DRGR system it could have identified the discrepancies earlier in the process.

The regulations³⁸ required that the Department enter into a written agreement with each subrecipient before disbursing HUD funds. The agreement must remain in effect during the time that the subrecipient has control over the funds. The written agreement must include a description of the work to be performed, a schedule for completing the work, and a budget. The information should be in sufficient detail to provide a sound basis for the Department to effectively monitor performance under the agreement. NSP1 regulations required additional documents to obligate funds, such as purchase offers and construction contracts. In response to the Department's comments, we made no changes to the report.

³⁸ 24 CFR 570.503

Comment 11 The Department was responsible for maintaining the information it reported to HUD through the DRGR system. HUD required the Department to submit its June 30, 2010, quarterly performance report on July 30, 2010. As table 3 of the report showed, over a 22-day period³⁹ between October 31, 2011, and November 21, 2011, the amounts the Department reported to HUD fluctuated significantly. These significant fluctuations over such a short timeframe, along with the Department submitting the reports more than a year after they were due, further support the conclusion that the Department did not have adequate controls over its obligations.

Comment 12 Obligated NSP1 funds should have appropriate supporting documentation for both total obligations and individual activities. As required in the grant agreement, funds would be obligated no later than September 3, 2010. Further, the Department agreed that funds were obligated for an activity when orders were placed, contracts were awarded, services were received, and similar transactions had occurred that required payment by the Department or subrecipient during the same or a future period. The Department could not obligate funds into the DRGR system for an activity when it entered into subawards (e.g., grants to subrecipients or to units of local government). Therefore, as stated in the report, we tested sample activities the Department recorded as obligated by the deadline and concluded that the Department's system of record did not contain supporting documentation for its obligations.

HUD required the Department to establish and maintain sufficient records to enable HUD to determine whether it complied with applicable requirements.⁴⁰ The Department should record accurate obligation amounts in its system of record, which should also reconcile with the DRGR system. Therefore, it is necessary for the Department to track and record changes as needed in a timely manner in its housing contract system to ensure that a valid obligation exists. Further, the tracking of obligations and subsequent expenditures assists the Department in monitoring subrecipients' progress and should improve its ability to administer the grant.

Comment 13 We clarified the criteria in the finding.

Comment 14 We added clarification in the finding.

Comment 15 The Department did not provide support for the \$6,425 in costs.

Comment 16 We updated the finding to include information provided by the Department in its comments and verified in the DRGR system. We also updated table 6 to reflect the Department's submission of its late quarterly performance reports. However, we did not test the accuracy of the information reported in these submissions.

³⁹ This was more than 15 months after the quarterly performance report due date.

⁴⁰ 24 CFR 570.506

- Comment 17** Monthly reporting submissions were not required for grantees for which HUD had accepted a quarterly performance report that reflected that it had met the 100 percent obligation requirement. The Department’s reporting was late and when the monthly reporting requirement began, it did not have a HUD-approved quarterly performance report showing that it had obligated 100 percent of its grant funds. We made clarifying changes, as needed, to the finding.
- Comment 18** We disagree that there was little performance activity during the audit. All NSPI activities were essential to completing the program as planned. Thus, the acquisition, land banking, demolition, renovation, and construction activities were all necessary. HUD required the Department to establish and maintain sufficient records to enable HUD to determine whether it complied with applicable requirements.⁴¹ The Department should capture the entire population in a single system or report to identify the information needed by HUD to monitor the program. We did not change the finding based on the comments.
- Comment 19** The Department needs to show that it spent funds as budgeted and obligated. It should implement a system for tracking its overall progress towards meeting the 25 percent setaside requirement as budgeted. We did not change the finding based on the Department’s comments.
- Comment 20** We made changes, as appropriate, to the finding. After the Department provided the NSP Homebuyer Workbook, we recommended that it incorporate the workbook into its standard operating procedures.
- Comment 21** While we based the audit analysis on the reported drawdowns shown in the DRGR system, the Department did not submit documentation with its response to show that it had spent more than the \$52 million discussed in the report. We did not change the finding based on the Department’s response.

⁴¹ 24 CFR 570.506