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TO: Theresa M. Porter, Director, Office of Community Planning and Development,
Kansas City, KS, 7AD

FROM: //signed//
Ronald J. Hosking, Regional Inspector General for Audit, Kansas City Region,
7AGA

SUBJECT: The State of Kansas Did Not Properly Obligate Its Neighborhood Stabilization
Program Funds

HIGHLIGHTS

What We Audited and Why

We audited the State of Kansas' (State) Neighborhood Stabilization Program I (NSP I). We selected the State for review based on our risk assessment of the U.S. Department of Housing and Urban Development's (HUD) community planning and development programs and the amount of NSP I funding received by the State.

Our audit objectives were to determine whether the State properly obligated its NSP I funds and the State's contracts contained all of the required provisions.

What We Found

The State improperly obligated more than \$12 million of its NSP I funds by reporting its funds as obligated in HUD's Disaster Recovery Grant Reporting system without those funds being linked to a specific address and/or household. Also, the State entered into NSP I contracts without all of the required provisions.

What We Recommend

We recommend that the Director of the Kansas City, KS, Office of Community Planning and Development require the State to (1) implement a system to track and support its obligations as defined by HUD rules and regulations and (2) deobligate any portion of the more than \$12 million in NSP I funds that has not been expended and was improperly obligated. In addition, we recommend that the State amend its NSP I contracts with its subrecipients to include the missing provisions and the additional NSP I funding awarded. Finally, we recommend that the State's NSP staff receive training regarding the required provisions of NSP I contracts.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided the draft report to the State on August 10, 2010 and requested a response by August 17, 2010. It provided written comments on August 16, 2010.

The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVES

The Neighborhood Stabilization Program (NSP) was authorized under Title III of the Housing and Economy Recovery Act of 2008 (Housing Act) and provides grants to every State and certain local communities to purchase foreclosed-upon or abandoned homes and rehabilitate, resell, or redevelop them to stabilize neighborhoods and stem the declining value of neighboring homes. The Housing Act calls for allocating funds to “states and units of local governments with the greatest need,” and in the first phase of the program (NSP I), the U.S. Department of Housing and Urban Development (HUD) allocated \$3.92 billion in program funds to assist in the redevelopment of abandoned and foreclosed-upon homes.

On March 18, 2009, HUD executed an agreement with the State of Kansas (State) for more than \$20.9 million in NSP I funds. The State initially approved 17 cities/counties to receive NSP I funds. The State’s program budget included the following:

- Nearly \$4.6 million to establish financing mechanisms for the purchase and redevelopment of foreclosed-upon homes and residential properties;
- Nearly \$12.93 million for the purchase and rehabilitation of abandoned or foreclosed-upon homes or residential properties to sell, rent, or redevelop the homes or properties;
- Nearly \$856,000 for establishing land banks for foreclosed-upon homes or residential properties;
- Nearly \$484,000 for the demolition of blighted structures; and
- Nearly \$2 million for planning and administration costs.

In addition to its NSP I funding, in fiscal year 2010, HUD provided the State with more than \$18.2 million in Community Development Block Grant (Block Grant) funds, more than \$8.5 million in HOME Investment Partnerships Program (HOME) funds, more than \$897,000 in Emergency Shelter Grant funds, and more than \$384,600 in Housing Opportunities for Persons with AIDS funds. In addition, the State received more than \$4.6 million in Block Grant funds under the American Recovery and Reinvestment Act of 2009.

The Disaster Recovery Grant Reporting system (DRGR) was developed by HUD for the Disaster Recovery Block Grant program and other special appropriations. HUD used DRGR to track NSP I funding because no other application and reporting system was sufficiently flexible to deal with the alternative requirements. The Line of Credit Control System (LOCCS) is HUD’s primary system for processing and making grant, loan, and subsidy payments. LOCCS provides disbursement controls for over 100 HUD grant programs and disburses over \$20 billion to thousands of HUD’s business partners.

Our audit objectives were to determine whether the State properly obligated its NSP I funds and the State’s contracts contained all of the required provisions.

RESULTS OF AUDIT

Finding 1: The State Improperly Obligated More Than \$12 Million of Its NSP I Funds

The State improperly obligated more than \$12 million of its NSP I funds. This condition occurred because the State did not develop a system to track its obligations. As a result, HUD will recapture any portion of the State's NSP I funds not obligated by September 18, 2010.

The State Improperly Obligated Its NSP I Funds

The State improperly obligated more than \$12 million of its NSP I funds. It obligated the funds in DRGR when it entered into written agreements with its subrecipients or units of local government. However, Federal Register, Volume 73, No. 194, October 6, 2008, section II (A), states that funds are not obligated for an activity when grants to subrecipients or to units of local government are made. NSP Policy Alert, Volume 3, April 2010, page 1, further states that HUD does not consider NSP funds obligated for a specific activity unless the obligation can be linked to a specific address and/or household.

As of June 30, 2010, the State had reported its entire NSP I funds of nearly \$21 million as obligated in DRGR based on its subrecipient agreements. However, the only way the State could track its obligations, as defined by HUD rules, was based on its total expenditures to date. As of June 30, 2010, the State's total expenditures were less than \$8.9 million, a difference of more than \$12 million.

The State Did Not Have a System To Track Its NSP Funds

The State did not develop a system to track its obligations. Because the State based its obligations on the subrecipient agreements, it did not believe it was necessary to develop a system to track obligations as defined by HUD's rules. As a result of our review, the State was developing a system to properly track its obligations.

HUD Will Recapture Funds Not Properly Obligated

HUD will recapture any portion of the State's NSP I funds not properly obligated by September 18, 2010. If the State does not deobligate the more than \$12 million in unsupported obligations and reobligate the funding with acceptable support, HUD will recapture those funds. The Housing Act requires HUD to recapture any portion of the NSP I funds not properly obligated within 18 months of when HUD and the State signed the grant agreement. By reobligating the funds and relating the funds to specific addresses and/or households, the State will comply with HUD requirements and put the NSP I funds to better use.

As of June 30, 2010, the State had expended nearly \$8.9 million of its NSP I funding. The State's monthly NSP I expenditures from July 2009 through June 2010 averaged \$741,434. Assuming the State continues to spend at the current monthly average, we estimate that its total projected NSP I expenditures will be more than \$10.8 million as of September 18, 2010. Therefore, unless the State implements a system to track its obligations and reobligates its NSP I funds with acceptable support, we estimate that its total balance of unobligated NSP I funds as of September 18, 2010, will be more than \$10.1 million.

Recommendations

We recommend that the Director of the Kansas City, KS, Office of Community Planning and Development require the State to

- 1A Implement a system to track and support its obligations as defined by HUD rules and regulations.
- 1B Deobligate any portion of the more than \$12 million in NSP I funds that has not been expended and was improperly obligated so that the estimated \$10,145,313 in NSP I funds can be put to better use on projects that have obligations that can be linked to a specific address and/or household before the September 18, 2010, deadline.

Finding 2: The State Entered Into Contracts Without the Required Provisions

The State entered into NSP I contracts without all of the required provisions. This condition occurred because the State did not adequately train its staff regarding HUD contract requirements. As a result, it lacked assurance that its subrecipients would comply with all program requirements.

Required Provisions Were Not Included in NSP I Contracts

The State entered into 17 NSP I contracts that did not include provisions required by Federal regulations. According to 24 CFR (Code of Federal Regulations) 570.503(b), the agreement between the grantee and the subrecipient must include certain provisions. These provisions include statement of work, records and reports, program income, suspension and termination, compliance with Federal laws, environmental concerns, and reversion of assets.

All 17 contracts between the State and its subrecipients were limited and did not include the required provisions. The contracts did not address reversion of assets and did not fully address compliance with Federal laws and environmental concerns. Also, the State did not amend its contracts or update its action plans when it awarded its subrecipients additional NSP I funding.

As a result of our review, the State was preparing contract amendments to address the missing provisions and include the additional NSP I funding awarded.

The State Did Not Adequately Train Its Staff

The State did not adequately train its staff regarding HUD contract requirements. The State's NSP I staff members told us that they had not been trained regarding the required provisions of NSP I contracts and were not familiar with "Managing CDBG [Community Development Block Grant], A Guidebook for CDBG Grantees on Subrecipient Oversight," chapter 3, which addresses the required provisions of subrecipient agreements for NSP I.

There Was No Assurance of Program Compliance

The State lacked assurance that its subrecipients would comply with all program requirements. In addition, the State could not ensure that HUD's and its own interests were protected.

Recommendations

We recommend that the Director of the Kansas City, KS, Office of Community Planning and Development require the State to

- 2A Amend its NSP I contracts with its subrecipients to include the missing provisions and the additional NSP I funding awarded.
- 2B Adequately train its staff regarding the required provisions of NSP I contracts.

SCOPE AND METHODOLOGY

We performed our audit from April through June 2010 at the State's office at 1000 SW Jackson, Topeka, KS. Our audit period was December 1, 2008, through April 30, 2010, and was expanded as necessary.

To achieve our objectives, we reviewed HUD's and the State's rules, regulations, policies, and procedures. In addition, we interviewed HUD and State NSP I staff. We also reviewed the State's NSP I project files and related documentation. Also, we reviewed a 2009 HUD monitoring review of the State's Block Grant and HOME programs.

Additionally, we reviewed the State's Office of Management and Budget Circular A-133 audits for the years ending June 30, 2009 and 2008, and its audited financial statements for the years ending June 30, 2009 and 2008. Finally, we reviewed the State's payroll records, timesheets, and other related documentation.

We used the LOCCS grant detail to determine that the State had obligated more than \$20.9 million and expended nearly \$8.9 million as of June 30, 2010. To help estimate the funds to be put to better use, we averaged the State's monthly NSP I expenditures from July 2009 through June 2010, and this amount averaged \$741,434. If the State continues to spend at the current rate, we estimate that the total NSP I expenditures will be more than \$10.8 million as of September 18, 2010. If we subtract this amount from the total NSP I obligations, we estimate that the State's total balance of unobligated NSP I funds as of September 18, 2010, and funds to be put to better use will be more than \$10.1 million.

We reviewed the funding approval and NSP agreement between HUD and the State and one contract between the State and the Kansas Housing Resource Corporation. Also, we reviewed the 17 contracts between the State and its subrecipients.

We reviewed a sample of 14 of the 232 activities with NSP I expenditures during our audit period. These 14 projects totaled more than \$1.67 million. We based our sample on the two counties that expended the highest amount of dollars and the activities with the highest total expenditures. We reviewed 12 NSP I purchase activities, 1 NSP rehabilitation activity, and 1 administrative fee activity.

For the purchase and rehabilitation activities, we reviewed each project file to determine whether it had the correct documentation such as the appraisal, sales contract, and HUD-1 settlement statement. In addition, we reviewed the files to determine whether the properties were previously foreclosed upon or abandoned, the purchase discount amount, and whether an environmental review was conducted. Also, we traveled to each property site to determine whether the property existed. Finally, we reviewed all files to determine whether the project's expenses were eligible, were adequately documented, and complied with NSP I expenditure requirements.

We relied on computer-processed data contained in DRGR and LOCCS. We performed sufficient tests of the data, and based on the assessment and testing, we concluded that the data were sufficiently reliable to be used in meeting our objectives.

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

INTERNAL CONTROLS

Internal control is a process adapted 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 objectives:

- Controls over obligating NSP I funds.
- Controls over developing NSP I contracts.

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 State did not have adequate controls over obligating its NSP I funds (see finding 1).
- The State did not have controls to ensure that its contracts contained all of the required provisions (see finding 2).

APPENDIXES

Appendix A

SCHEDULE OF FUNDS TO BE PUT TO BETTER USE

Recommendation number	Funds to be put to better use 1/
1B	\$10,145,313

Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (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.

Implementation of our recommendations require the State to deobligate any portion of an estimated \$10.1 million in NSP I funds which were improperly obligated so that those funds can be put to better use on projects that have obligations that can be linked to a specific address and/or household.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments



*Mark Parkinson, Governor
William R. Thornton, Secretary*

KansasCommerce.com

August 12, 2010

Ronald J. Hosking
Regional Inspector General for Audit
U.S. Department of Housing and Urban Development
Region VII Office of Audit
400 State Avenue
Gateway Tower II – 5th Floor
Kansas City, Kansas 66101

Dear Inspector General Hosking:

The Office of Inspector General conducted an audit of the State of Kansas' Neighborhood Stabilization Program from May 11 to June 21. On behalf of the Kansas Department of Commerce and the Kansas Housing Resources' Corporation, co-administrators of this grant, I would like to convey my thanks to OIG for the professional nature of the audit and for the information provided that helped us improve our administration of the program and interactions with the subgrantees.

As I am sure you know, development of the NSP program occurred with tight deadlines and a minimum of guidance from HUD, which also was developing a new program under time pressure. Our CDBG program does not usually deal with this sort of housing program, so we had to work closely with another state agency as well as the subgrantees to speedily begin the activities. Other states, as well, have worked hard to develop programs to use these dollars to benefit housing in their areas worst hit by foreclosures. Other states also labored to develop programs before detailed guidance was available because of tight timelines.

OIG has reported two findings from the course of the Kansas audit.

Finding one stated the State of Kansas "improperly obligated monies in the DRGR reporting system and did not have an adequate system to track obligations."

The State of Kansas properly obligated monies and had an adequate system for tracking under the guidance we had received as we developed the program between October and December of 2008. HUD did not issue official guidance concerning obligations until April of 2010. Before that, the State believed we were obligating our funds properly. All of our grantees submitted an Action Plan that stated how they intended to expend their NSP funds. We entered an address with each draw request into the DRGR system; however, our obligation showed that all dollars were obligated.

Comment 1

Ref to OIG Evaluation

Auditee Comments

Comment 2

Ronald J. Hosking
Regional Inspector General for Audit
August 12, 2010
Page 2

Since receiving the new guidance and currently, we require each of our grantees to report to us all obligations (properties by address that have contracts, with an estimated amount for carrying costs). The State fully expects to have 100 percent of our NSP allocation obligated by the September deadline, and to have properly utilized these federal dollars to benefit Kansas residents who are able to purchase rehabilitated homes. We have implemented a system to better track our obligations under the NSP program.

Finding two was that the Kansas NSP contracts did not include two specific requirements, the Reversion of Assets clause and an Environmental clause. This has since been corrected by sending out amendments to the contracts of all Kansas NSP grantees. This was helpful information that will be utilized by our CDBG program. Our program had undergone several regular HUD reviews in the past in which we were not informed of the requirements for those two clauses.

Thank you for the opportunity to respond to the audit findings. We will discuss our responses to other recommendations of the audit in our meeting planned for Aug. 16.

Sincerely,



Carole Jordan, Director
Rural Development Division

PC: [REDACTED]

OIG Evaluation of Auditee Comments

Comment 1 The new system developed by the State of Kansas to track their NSP obligations should adequately resolve the concerns reported in Finding 1.

Comment 2 The State of Kansas took quick action to amend their NSP contracts and insert all appropriate provisions into their contracts. This should resolve the concerns reported in Finding 2.