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Audit Report Number 2008-DE-1003
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TO: Sharon Jewell, Acting Director, Office of Community Planning and Development, 8AD

FROM: //signed//  
Ronald J. Hosking, Regional Inspector General for Audit, 8AGA

SUBJECT: The State of Colorado Did Not Comply with Community Development Block Grant Program Requirements

## **HIGHLIGHTS**

### **What We Audited and Why**

We audited the State of Colorado (State), Division of Housing's (Division) Community Development Block Grant (CDBG) program. We selected the State's CDBG program because it received almost \$22 million in CDBG funds in 2006 and 2007 and we had not previously performed an audit of its program.

Our objective was to determine whether the Division (1) awarded CDBG funds to ineligible projects and (2) properly identified and reported program income data.

### **What We Found**

The Division used CDBG funds for ineligible and questionable projects. This condition occurred because management's main focus was on selecting projects that were for the greater good of the state, even if some projects did not fully comply with the U.S. Department of Housing and Urban Development's (HUD) requirements. As a result, the Division awarded more than \$4.6 million in grants that did not effectively meet the needs of the intended nonentitlement low- and moderate-income beneficiaries.

The Division also did not effectively identify, report, or classify program income generated by its subrecipients. This condition occurred because the Division did not have adequate controls. As a result, neither the Division nor HUD could be assured that subrecipients used program income for its intended purpose. In addition, the Division did not realize the full benefits of the allowable amounts for planning and administrative costs and for public service activities.

### **What We Recommend**

We recommend that HUD require the Division to repay from nonfederal funds the \$1.7 million in ineligible grants. HUD should require the Division to develop and implement effective controls over establishing and administering projects and identifying and recording program income. We also recommend that HUD determine the eligibility of the questioned costs and require the Division to repay from nonfederal funds the amounts determined to be unsupported or unnecessary.

For each recommendation in the body of the report 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 Division officials on August 26, 2008, and received their written response on September 9, 2008. The Division officials concurred with the recommendations.

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**

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Title I of the Housing and Community Development Act of 1974 (Public Law 93-383) established the Community Development Block Grant (CDBG) program. The U. S. Department of Housing and Urban Development (HUD) distributes CDBG funds to metropolitan cities or counties as entitlements for use in urban areas. It also distributes funding to states to provide to local governments in nonentitlement areas. The State of Colorado (State) and HUD signed a funding approval/agreement each year that established the funding and terms for the CDBG program.

Grant year	Grant amount
2006	11,120,921
2007	10,768,763
Total	21,889,684

All CDBG activities must meet one of the following national objectives:

- (1) Benefit low- and moderate-income persons,
- (2) Aid in the prevention or elimination of slums and blight, or
- (3) Meet certain community development needs having a particular urgency.

The State equally divided its CDBG funds among three State offices: the Division of Housing, the Division of Local Government, and the Governor's Office of Economic Development and International Trade. The Office of Local Affairs governs the CDBG functions of these offices. The Division of Housing (Division) was the focus of our audit.

Our objective was to determine whether the Division (1) awarded CDBG funds to ineligible projects and (2) properly identified and reported program income data.

## RESULTS OF AUDIT

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### Finding 1: The Division Improperly Awarded Grants from CDBG Funds

The Division used CDBG funds for ineligible and questionable projects. This condition occurred because management's main focus was on selecting projects that were for the greater good of the state, even if some projects did not fully comply with HUD's requirements. As a result, the Division awarded more than \$4.6 million in grants that did not effectively meet the needs of the intended nonentitlement low- and moderate-income beneficiaries.

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#### **Ineligible Grants Were Awarded to Entitlement Entities**

The Division inappropriately awarded grants to entitlement entities. An entitlement entity is an urban city or county that receives annual CDBG allocations from HUD. As explained in 24 CFR [*Code of Federal Regulations*] 570.480, states that elect to receive CDBG funds are to use the funds for units of general local government in the state's nonentitlement areas. The Division inappropriately awarded eight grants to three entitlements in the state. The eight ineligible CDBG grants totaled more than \$1.7 million.

#### **Unsupported Grants Might Not Have Met National Objectives**

The Division awarded grants to activities without proof that they met the required national objective to benefit low- and moderate-income persons in nonentitlement areas. Regulations at 24 CFR 570.483 require the state to ensure that at least 51 percent of the persons receiving benefits from an activity under the low- and moderate-income national objective meet the income requirements.

The Division awarded 21 CDBG grants, totaling more than \$2.8 million, for which the grant project files did not document the attainment of the low- and moderate-income national objective. Eleven of the grants were for entities to perform local needs assessments. The contracts for these 11 grants stated that the projects met the national objective in 24 CFR 570.483(b)(5). This requirement states that the project is allowable if the state can document that at least 51 percent of the persons who would benefit from the implementation of the plan are

low- and moderate-income persons. The project files did not contain documentation supporting that 51 percent requirement.

The Division did not ensure that the other 10 grants fully complied with HUD and State CDBG requirements. State revolving loan fund guidelines for the rehabilitation and the downpayment assistance programs and CDBG contracts required that all loans from revolving loan funds be to eligible low- and moderate-income persons. HUD required that the State use CDBG funds in nonentitlement areas. In addition to not fully documenting the national objective requirements, these grants had other deficiencies:

- Grantees administering four revolving loan funds awarded loans to homeowners living in entitlement areas.
- HUD required that the State properly underwrite the grants. Four of the projects showed evidence of inadequate underwriting.
- Two projects' files contained evidence of questionable project or administrative costs.

### **Management's Focus Did Not Ensure Compliance**

Division management officials stated that their main focus was to select projects that were for the greater good of the state, even if some projects did not fully comply with HUD's requirements. The Division did not have procedures to ensure that grants were not awarded to entitlement entities. It did not require proper documentation of HUD's requirement that at least 51 percent of beneficiaries be low or moderate income. Division management officials stated that they considered all CDBG housing projects to be 100 percent compliant with the low- and moderate-income national objective. Therefore, they were not concerned about documenting evidence of compliance.

### **Grants Were Ineligible and Questionable**

Because of the inadequate procedures, the Division awarded more than \$4.6 million in grants that did not effectively meet the needs of the intended nonentitlement low- and moderate-income beneficiaries.

## Recommendations

We recommend that the Director of HUD's Denver Office of Community Planning and Development

- 1A. Require the Division to repay from nonfederal funds the \$1,748,041 in ineligible CDBG funds awarded to entitlements.
- 1B. Determine the eligibility of the more than \$2.8 million associated with the 21 questionable projects.
- 1C. Require the Division to repay from nonfederal funds any portion of the more than \$2.8 million determined to be unsupported or unnecessary.
- 1D. Require the Division to establish and implement effective policies and procedures to ensure that CDBG funds are not awarded to entitlements.
- 1E. Require the Division to establish and implement effective policies and procedures to ensure that it obtains adequate documentation to support compliance with the CDBG national objective requirements.

## Finding 2: The Division Did Not Effectively Identify, Report, or Classify Program Income

The Division did not effectively identify, report, or classify program income generated by its subrecipients. This condition occurred because the Division did not have adequate controls. As a result, neither the Division nor HUD could be assured that subrecipients used program income for its intended purpose. In addition, the Division did not realize the full benefits of the allowable amounts for planning and administrative costs and for public service activities.

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### **The Division Did Not Effectively Identify Program Income**

The Division did not effectively identify program income data related to the grants it awarded for revolving loan funds for home rehabilitation or for downpayment assistance loans. The principal and interest payments generated from these loans were program income as defined in 24 CFR 570.489(e).

The Division required subrecipients with revolving loan funds to maintain detailed records for each loan, including detailed borrower and program income information. However, it did not collect this detailed program income data. It required the subrecipients to submit quarterly and annual reports that included program income totals, not the detailed information.

As a result, the Division did not have adequate program income data to ensure that all subrecipients with revolving loan funds accurately reported program income. For example, one subrecipient notified its local government entity in October 2005 that it used about \$155,700 in program income for general operating expenses. The local government did not provide this information to the Division until March 2007. The quarterly and annual reports received by the Division did not contain sufficient detail to show the misuse of funds.

### **The Division Did Not Properly Report Program Income**

The Division did not report program income in HUD's Integrated Disbursement and Information System (IDIS). HUD's "Guidance for Reporting CDBG Accomplishments in IDIS" states, "HUD requires reliable, comprehensive



information regarding program performance in order to comply with the Government Performance and Results Act of 1993.”

During a 2007 monitoring review, HUD required the Division to obtain and enter into IDIS the program income for 2006 and 2007. To address this requirement, the Division requested that subrecipients with revolving loan funds submit special two-year reports that included total program income earned and spent. However, it did not obtain the reports for all projects. The Division provided us 32 reports, but we identified 12 other revolving loan fund projects for which the Division did not provide special reports.

The special reports did not provide detailed program income information. We identified other deficiencies in the report data. For example, one report was not mathematically accurate. The report showed a 2006 ending balance of \$47,417, but the listed numbers totaled \$73,774. The 2007 ending balance was \$47,520, but the numbers totaled \$275,669. Using the \$73,774 as the beginning balance, the 2007 ending balance would be \$302,026. However, the quarterly report as of December 31, 2007, showed an ending balance of \$32,526.

### **The Division Inappropriately Classified Program Income**

The Division inappropriately converted program income to miscellaneous income. As stated in 24 CFR 570.489(e)(2)(ii), the amounts generated by eligible activities carried out by an eligible nonprofit, as defined in section 105(a)(15) of Title 1 of the Housing and Community Development Act of 1974, are not considered program income. HUD has determined that income generated by an eligible nonprofit subrecipient is miscellaneous income and is not federal funds. Therefore, the Division did not need to report these amounts to HUD. The Division issued a letter to all revolving loan fund subrecipients strongly encouraging them to request a conversion to miscellaneous income. It did not have adequate records to support the determinations and inappropriately approved some program income conversions to miscellaneous income. For example, it approved a town government entity to convert amounts generated by its revolving loan fund to miscellaneous income.

### **The Division Did Not Have Adequate Controls**

The Division did not have adequate controls over program income in place to ensure that the information from the subrecipients was accurate and complete. It did not have procedures in place to enter the program income into HUD’s system. The Division needed procedures to ensure that it obtained complete and detailed

information to support the full amounts of program income generated and to enter this information into HUD's system.

### **The Division Was Missing Benefits**

The Division and HUD could not be assured that subrecipients used program income for its intended purpose. Additionally, HUD requirements state that program income can be added to the CDBG funding allocation to calculate the funding limits for the planning and administrative costs and the public service activities. The Division missed the benefit of the increased limits by not reporting program income in HUD's system.

### **Recommendations**

We recommend that the Director of HUD's Denver Office of Community Planning and Development

- 2A. Require the Division to establish and implement policies and procedures to ensure that all program income is identified and entered into HUD's system.
- 2B. Require the Division to establish and implement policies and procedures to ensure that conversions to miscellaneous income are properly completed.
- 2C. Provide technical assistance as needed to assist the Division in identifying and recording program income and properly determining miscellaneous income.

## SCOPE AND METHODOLOGY

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Our review period was from January 1, 2006, to December 31, 2007. We expanded our scope as necessary. We reviewed HUD and State criteria and contracts, met with HUD and State staff, and looked at HUD and State records.

We reviewed the State CDBG activities of the three State offices responsible for the administration of the program. Our review of the Division of Local Government did not identify problems with its controls. We identified a minor deficiency with the Governor's Office of Economic Development and International Trade that we addressed in a separate letter. We determined that the Division of Housing had indications of significant deficiencies, so we performed a detailed audit of that office and are reporting the results in this audit report.

We requested a list of all CDBG projects active during our review period. Division staff provided three lists that were significantly different. We combined the lists and determined that they contained 86 projects. Division staff told us that 18 of the projects either closed before our audit period or were not yet under contract. We completed a 100 percent review of the 68 remaining available project files. We reviewed these files to obtain an understanding of the project documentation and to determine whether the Division properly established and completed CDBG projects. We used computer-generated lists while determining the active CDBG projects during our audit period but did not place reliance on the computer data.

We reviewed all program income documentation provided by the Division to determine whether the records were complete and whether the Division adequately accounted for the program income earned on CDBG projects. We also reviewed the available information relating to the conversions of program income to miscellaneous income to determine whether the Division had properly approved the conversions.

We performed our on-site audit work from February to June 2008 at the State's offices at 1313 Sherman Street, Denver, Colorado.

We conducted this performance 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

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Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

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

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

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## Relevant Internal Controls

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

- Controls over ensuring that CDBG projects were established in accordance with HUD regulations.
- Controls over identifying, reporting, and classifying CDBG program income earned in HUD's Integrated Disbursement and Information System.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

## Significant Weaknesses

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

- The Division did not have adequate controls to ensure that CDBG grants complied with HUD requirements (finding 1).
- The Division did not have adequate controls over identifying, reporting, and classifying program income generated by its subrecipients (finding 2).

# APPENDIXES

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## Appendix A

### SCHEDULE OF QUESTIONED COSTS

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Recommendation Number	Ineligible 1/	Unsupported 2/
1A	\$1,748,041	
1B		\$2,887,423

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. In this instance, the Division awarded grants to entitlement entities, which violated HUD's requirements.

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 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. In this instance, the Division awarded grants for which there was no or insufficient support to show compliance with HUD requirements.

## Appendix B

### AUDITEE COMMENTS AND OIG'S EVALUATION

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#### Ref to OIG Evaluation

#### Auditee Comments

#### Comment 1

Finding 1: The Division Improperly Awarded Grants from CDBG Funds

1A. Require the Division to repay from nonfederal funds the \$1,748,041 in ineligible CDBG funds awarded to entitlements.

The Division concurs that CDBG funds were awarded to entitlements and that we will work with HUD to set up a repayment schedule.

The Division funded several projects with the intent of serving low-income homeless persons from "non-entitlement" areas who were residing in "entitlement" areas. Many homeless persons migrate to entitlement areas because they need homeless services.

The Division also contracted with an entitlement area to fund the Statewide Foreclosure Hotline that received many calls from residents of non-entitlement areas needing assistance.

1B. Determine the eligibility of the more than \$2.8 million associated with the 21 questionable projects.

The Division concurs that back up documentation that the auditor considered sufficient to determine if the projects met CDBG eligibility requirements was not in the project files.

The Division will work with HUD to determine if these projects are eligible under the CDBG program and will provide the needed documents to demonstrate the eligibility of the \$2.8 million.

1C. Require the Division to repay from nonfederal funds any portion of the more than \$2.8 million determined to be unsupported or unnecessary.

The Division concurs that if we cannot produce the supporting documentation of eligibility, we will work out a repayment agreement with HUD.

1D. Require the Division to establish and implement effective policies and procedures to ensure that CDBG funds are not awarded to entitlements.

The Division concurs that we need to implement additional policies and procedures to ensure that CDBG funds are not awarded to entitlements and we will work with HUD on good practices.

**The Division is currently updating its application, award letter, monitoring documents and contracts to ensure that they capture the correct information. The Division will have these documents approved by HUD.**

1E. Require the Division to establish and implement effective policies and procedures to ensure that it obtains adequate documentation to support compliance with the CDBG national objective requirements.

**The Division concurs that we need to add additional policies and procedures and implement them to ensure that it obtains adequate documentation to support compliance with the CDBG national objective requirements. The Division will work with HUD on sound practices.**

## **Finding 2: The Division Did Not Effectively Identify, Report, or Classify Program Income Data**

2A. Require the Division to establish and implement policies and procedures to ensure that all program income is identified and entered into HUD's system.

**The Division concurs that we need to establish and implement additional policies and procedures to ensure that all program income is identified and entered into HUD's system.**

2B. Require the Division to establish and implement policies and procedures to ensure that conversions to miscellaneous income are properly completed.

**The Division concurs that we need to establish and implement policies and procedures that are "approved" by HUD to ensure that conversions to miscellaneous income are properly completed.**

2C. Provide technical assistance as needed to assist the Division in identifying and recording program income and properly determining miscellaneous income.

**The Division concurs that we need additional technical assistance as needed in identifying and recording program income and properly determining miscellaneous income.**

### **OIG Evaluation of Auditee Comments**

**Comment 1** The Division concurs with all the recommendations and plans to work with HUD on the corrective actions needed to resolve the recommendations.