



OFFICE OF THE STATE AUDITOR

TWO COMMODORE PLAZA
206 EAST NINTH STREET, SUITE 1900
AUSTIN, TEXAS 78701

LAWRENCE F. ALWIN, CPA
State Auditor

April 20, 1998

Re: An Audit of Management Controls at the
Texas Department of Housing and Community
Affairs

Members of the Legislative Audit Committee:

The Texas Department of Housing and Community Affairs (Department) should improve controls over the process used to award and administer federal funds for housing programs to its related nonprofit corporation, the Texas State Affordable Housing Corporation (Corporation), to ensure that delays in committing and expending funds are minimized. Delays in the commitment and expenditure of awarded funds may put the Department's federal funds at risk of not being expended within the five-year statutory time frame. The Department awarded \$17.6 million in federal *Home Investment Partnership Program* (HOME) funds to the Corporation for the fiscal years 1995 and 1996. As of June 1997, the Corporation had awarded \$6.7 million, or 39.3 percent of its total awards, to specific eligible housing projects. The U.S. Department of Housing and Urban Development awarded the Department approximately \$59 million of HOME funds for this two-year period.

The Department also needs to ensure that policies and procedures affecting the award process are implemented and enforced so that changes in award criteria for the Housing Trust Fund program are thoroughly analyzed and the Department's Board has complete information in making its decisions.

The Department is to be commended for its efforts in addressing the recommendations from prior audit reports relating to improvements needed in general management controls and contract administration. In following up four prior audit reports issued by the State Auditor, the Department has implemented all recommendations except one. The recommendation not implemented was superseded by revisions to the Texas Manufacturing Housing Standards Act effective September 1, 1997.

The audit objectives were to assess whether the Department has established controls necessary to fulfill its mission and to identify opportunities for improvement in its management controls. The scope of this audit included consideration of the Department's management controls for policy management, information management, and performance management. The Department's largest federal programs, including the Community Development Block Grant, HOME, Low-Income Home Energy Assistance, Community Services Block Grant, as well as revenue bond accounts and resource management controls, have been included in other audits performed by the State Auditor's

SAO Report No. 98-037

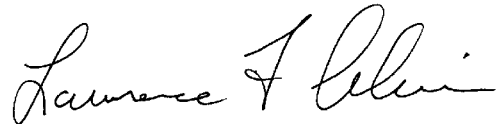
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Office, other independent auditors, and the Department's internal auditors. Due to risk factors identified during fieldwork, audit resources were focused on the policy management control area. As a result, limited work was performed in the areas of information and performance management controls.

The Texas Department of Housing and Community Affairs management has indicated its general agreement with the recommendations. The full text of management's response to each finding raised in this letter is attached. We have included an auditor's follow-up comment addressing the Department's response to the second issue.

If you have any questions relating to this audit, please contact Frank Vito, Audit Manager, at 479-4700.

Sincerely,

A handwritten signature in black ink that reads "Lawrence F. Alwin". The signature is written in a cursive style with a large initial "L".

Lawrence F. Alwin, CPA
State Auditor

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Attachments (3)

- Report of audit findings
- Management's responses
- State Auditor's follow-up comment

cc: Mr. Larry Paul Manley, Executive Director, Texas Department of Housing and Community Affairs

Summary of Issues

Management of Department Funds Awarded Can Be Improved by Addressing Organizational and Operational Issues Involving the Texas State Affordable Housing Corporation

Improvements are needed in the process used by the Department to award and administer federal funds to the Corporation to ensure that delays in committing and expending funds are minimized. The Corporation was established in 1994 as a nonprofit organization, in accordance with Government Code Section 2306.555, to undertake activities that benefit the State and its inhabitants by promoting and fulfilling any purposes and programs operated by the Department. However, the Corporation does not have a system in place to manage awards received from the Department. Once awards are made to the Corporation, it must then work to identify qualified projects to receive the funds through a subsequent award process. No plans have been developed detailing how awards of these funds would be made to eligible recipients. The Corporation has not designated staff to manage the award process or to administer the awards to eligible recipients. Staff members from the Department perform these functions under an administrative agreement with the Corporation. These activities are in addition to the staff members' primary duties within the Department.

The Department considers the Corporation a subrecipient of federal awards. However, the Department does not require the Corporation to meet all the program rules or the federal requirements that apply to other subrecipients. The Corporation does not go through the competitive award process as most other recipients. While the Corporation has applied for federal *Home Investment Partnership Program* (HOME) funds for the 1995 fiscal year, a complete application package was not prepared. Applicants are required to submit specific information as part of the application package including a needs assessment, program design, capability of the applicant, and financial design. Even applicants considered through the direct award process must submit an application complying with all HOME requirements.

Additionally, the award agreements with the Department do not include specific information to monitor the Corporation's performance. The specific tasks and a schedule to complete the tasks are not part of the agreement. The budget includes only the amount of the program and administrative funds awarded. The federal HOME regulations require the recipient agreement to describe the tasks to be performed, a schedule for completing the tasks, and a budget. This information must be in sufficient detail to provide a sound basis for the Department to monitor performance. Without the information, the Department cannot effectively monitor performance under the agreement.

Use of the Corporation to administer federal awards in this manner could put federal funds at risk of not being expended within the five-year statutory time frame. Since the development of a project and completion of housing construction can take several years, delays in awarding funds can make it harder for the State to meet the compliance requirement. Federal funds that are not spent must be returned to the Federal Government and are not available to meet housing needs.

The organization of the Corporation and the operating relationship between it and the Department are in compliance with the original legislation that established the Corporation as a separate legal entity. Under this statute, the Corporation was dependent on the Department for its management guidance and operational resources. The legislation creating the Corporation provided that the Department's Board would also serve as the Corporation's Board. The statute provided that the Corporation could contract with the Department for services. This overlap of management and operations has contributed to the Department not holding the Corporation to the same controls and standard as other subrecipients during the award process.

Revised legislation, effective September 1, 1997, addresses some of these concerns and should help the Department and the Corporation establish an improved control structure that would better represent the interests of both entities. House Bill 2577, 75th Legislature, amended the Department's enabling statute, Government Code Section 2306. The legislation provided more direction concerning activities between the Department and the Corporation. It restricted the Department from transferring funds to support the administration of the Corporation or subsidizing its operations in any way. The Department is to be fully compensated by the Corporation for any property or employees shared by the Corporation. Department employees are not to be shared beyond the time such sharing is absolutely necessary. Once implemented, these steps should help to ensure that activity between the Department and the Corporation is conducted in an independent manner.

While the legislation addresses some specific organizational issues, the Department needs to go beyond these new rules to address all the concerns relating to the management of the awarded funds. Areas not specifically addressed by this legislation include the need for the Corporation to submit a complete application package for HOME awards made by the Department and the need for detailed plans explaining how the funds will be used to meet the goals and mission of the Corporation and the Department. Additionally, policies and procedures are needed to address the methods the Corporation will use to advertise, award, and monitor the recipients of the Department's funds. By implementing these improvements, the risk of commitment and expenditure delays are reduced and the possibility of returning federal funds will be diminished.

The Department Needs to Ensure Policies and Procedures Affecting the Award Processes Are Implemented and Enforced

The Department has not formally adopted policies and procedures for the operation of the Housing Trust Fund (HTF) program. The staff has drafted Standard Operating Procedures for the HTF; however, these procedures do not include a clearly defined methodology used for the awards process. The HTF staff collects and analyzes data to prepare the criteria for the Notice of Funding Availability (NOFA), but the Department does not document this process. The draft procedures call for the development of the NOFA by the HTF staff with review and approval by the Department's Counsel and then the Executive Director.

The lack of procedures partially contributed to an unsuccessful NOFA for the fiscal year 1997. This is the only NOFA that failed to make awards since the initial HTF program

NOFA issued in 1992. This NOFA appears to have been detrimentally impacted by late changes in the key award criteria and a less than a six-week application period provided to the applicants. The key award criteria included the type of activity funded, income levels that they must serve and the time frame for the funding cycle. These late changes were not subject to the same internal analysis as the original criteria and the Department implemented the criteria changes without public comment on the new program design. These changes limited the pool of potential applicants to the extent that only seven applicants applied for the NOFA, no applications met the criteria, and the Department made no awards from the NOFA.

Failure to distribute the \$4.3 million in funds from the HTF may affect the ability of the Department to meet program goals. The stated goals of the HTF are to provide housing for low and very-low income persons and families. Besides not meeting HTF goals, another effect of the unsuccessful NOFA was that General Appropriations from prior periods are at risk to lapse. This means that the Department may have to return appropriated funds totaling \$784,634 in the HTF to the State's General Revenue Fund and the funds cannot be used to meet housing needs. The Department is working with the Comptroller of Public Accounts to resolve this issue.

Additionally, another \$679,800 of the \$4.3 million included in the NOFA were General Revenue Funds that would have lapsed if not committed by the close of the fiscal year ended August 31, 1997. The Department awarded these funds as a grant to the Corporation. The Board acknowledged that this award was done outside the normal application procedures and requirements of the HTF. This was done so the Department would not lose the opportunity to use the funds. This is an additional example of the Department awarding funds to the Corporation without plans addressing how awards of these funds would be made to eligible recipients as discussed previously in this report.

Also, policies and procedures to ensure that the Board makes award decisions based upon complete information provided by the Department were not enforced. Procedures should be followed to ensure that the Board receives complete information from the Department so that fully informed decisions are made. Complete information has not always been provided to the Board concerning the total funding sources for each proposed project. Additionally, Board minutes do not reflect that Board members are notified when waivers of program rules must occur to approve awards to certain projects.

The Department Is Addressing Prior Audit Recommendations

The Department has implemented the recommendations from four prior audit reports issued by the State Auditor's Office with one exception. The recommendation not implemented was from a report on the Manufactured Housing Division when it was with another agency. The recommendation related to the need to establish procedures to ensure installation inspections of manufactured housing are done on a timely basis and to establish a time frame for completing the back log. The Department was not able to address this finding with existing resources. The Legislature revised the Texas Manufactured Housing Standards Act, effective September 1, 1997, which directs the Department to establish an inspection program with coverage based on a sample of at

least 25 percent of the homes installed. The Department can now develop a process for inspecting homes using this sample approach.

Related Report

Subsequent to the conclusion of the fieldwork performed on this audit, the U.S. Department of Housing and Urban Development (HUD) issued a comprehensive monitoring report on the *Home Investment Partnership Program (HOME)* January 30, 1998. The review covers three areas: overall program management, file reviews, and on-site inspections. The report includes six findings and five concerns. The findings and concerns address the relationship between the Department and the Corporation, the commitment and expenditures of HOME funds, incomplete or inaccurate information provided to HUD, and other specific compliance issues.

The Department strongly disagrees with the finding and concerns relating to the Texas State Affordable Housing Corporation. Department management has provided a written response to HUD to support its position on each finding and concern. HUD and the Department are in the process of working to resolve all the issues raised in the report.



TEXAS DEPARTMENT OF HOUSING AND COMMUNITY AFFAIRS

George W. Bush
GOVERNOR

Larry Paul Manley
EXECUTIVE DIRECTOR

April 16, 1998

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Lawrence F. Alwin, CPA
Office of the State Auditor
206 East Ninth Street Suite 1900
Austin, Texas 78701

**Re: Management Control Audit of the Texas Department of Housing and
Community Affairs**

Dear Mr. Alwin:

The Texas Department of Housing and Community Affairs (Department) is in general agreement with the most recent recommendations of the State Auditor's Office concerning management controls of the Department. My staff and I appreciate the opportunity to revise our responses previously submitted to you to align with the most recent version of your report. We also appreciate the opportunities that you and your staff have afforded us to explain the operations of the Department and, in doing so, to resolve many of the preliminary audit issues and concerns.

We regret to discover that certain issues continue to be of concern to your staff. Specifically, your staff has misinterpreted the cause of the unsuccessful 1997 Notice of Funds Availability (NOFA). Your staff concluded that the NOFA was unsuccessful due to a lack of procedures, changes in the key award criteria, an inadequate application period and the Department's failure to solicit public comment on the appropriate criterion for the NOFA. The Department firmly believes that a lack of qualified applicants was the primary reason that no funds were allocated. Additionally, the Department attempted to address the needs of tenants below 30% of area median income, which proved to be exceedingly difficult, yet is important given our legislative mandate. We continue to work on addressing this issue. The lack of qualified applicants was a substantive issue - not one resulting from process or Department management.

Nor does the Department agree with the implication that the Texas State Affordable Housing Corporation (TSAHC) will not expend its federal funds within the five-year statutory time frame required under Federal mandate. In fact, TSAHC is committing and expending its

funds at a rate consistent with the overall rates of all other subrecipients and has never suffered a deobligation of funds, which is not uncommon with other grantees. TSAHC will be treated consistently with all other subrecipients with regard to funding deobligations.

The Department has carefully considered each "finding" identified in the report and responds to each "recommendation" below.

Summary of Management's Responses:

The Department is making necessary improvements in its process to award and administer federal funds to TSAHC. Additionally, TSAHC is in the process of implementing systems to better manage awards received from the Department. Recent legislation passed by the 75th Legislature has provided a reasonable basis for establishing a separate and distinct control structure for TSAHC and for taking these actions.

The State Legislature of Texas clarified organizational and operational issues concerning the TSAHC. With the seating of the new Board of Directors in January 1998, TSAHC is now in position to finalize implementation of the new legislation. Full implementation of the legislation, fully staffing TSAHC and finalizing its policies and procedures will effectively result in implementing your recommendations. The target date for this implementation is year end 1998.

The unsuccessful 1997 Housing Trust Fund Notice of Funds Availability (NOFA) was not the result of a lack of adequate procedures, changes in the key award criteria, an inadequate application period or a lack of public comment but, rather, was a result of the lack of qualified applicants responding to an admittedly difficult NOFA.

The Department believes that its policies and procedures are designed to promote a fair and equitable award process. The Department recognizes the need to formally adopt standard operating procedures used by the Housing Trust Fund and will do so during the current year. The Department will enhance its standard operating procedures to describe in greater detail a clearly defined methodology used for the awards process and the procedure for developing a NOFA, which will include documentation standards. The procedures will attempt to standardize the time allotted for, and the provision of, notice, as well as the periods for response to NOFAs, once issued.

The Department believes that its current processes for soliciting public comment throughout the year and for developing the annual State Low Income Housing Plan and Annual Report (the "Plan"), as well as the Annual Consolidated Plan - One Year Action Plan,

provides the public more than ample opportunity to comment on the plans of the Department. We have an entire division whose work is devoted to this effort. Public input is always considered in the development of individual NOFAs. Additionally, soliciting, receiving, accumulating, and analyzing input for each NOFA that the Department prepares is not considered the best use of limited staff resources.

The Department needs the flexibility to target particular NOFAs to specific needs and geographic areas. In attempting to reach harder to serve populations, we will continue to encounter difficulties achieving 100% success for each NOFA, but if we resort to structuring NOFAs for only those applicants we are positive can be successful, we will not be attempting to stretch our resources to address greater need. On balance, we believe that to try and not be successful is much better than not trying at all. In any event, our goal and internal directive is to effectively utilize all resources available to us.

The Department's current practice in regard to providing its Board with information relating to proposed projects' funding sources is to identify and describe all funding sources and the funding history for proposed projects. This information is included in the Credit Underwriting Summary that is presented to the Board with the project proposals. Additionally, information relating to proposals whereby the Board's approval will require a waiver of an existing program rule will be included in future Board books.

The Department's willingness and success in implementing the prior recommendations from four prior State Auditor's Office audit reports, as well as prior recommendations from the Department's external auditors, demonstrates management's overall positive attitude and the importance to management of controls. Management notes that prior audit findings and recommendations have been addressed and implemented based upon assessments by the State Auditor's Office and the Department's external auditors.

Section 1- Management of Department Funds Awarded Can Be Improved by Addressing Organizational and Operations Issues Involving the Texas State Affordable Housing Corporation.

Management's Response:

The Department has made the necessary improvements in its processes to award and administer federal funds to TSAHC. Additionally, TSAHC is in the process of implementing systems to better manage awards received from the Department. Recent legislation passed by the 75th Legislature has provided a reasonable basis for establishing a separate and distinct control structure for TSAHC and for taking these actions.

The State Legislature of Texas clarified organizational and operational issues concerning the TSAHC effective September 1, 1997. The Board membership was revised and the legislature clarified that TSAHC is to stand on its own. Acts 1997, 75th Leg., ch. 980, eff. Sept. 1, 1997; amending Texas Govt. Code Ann. Sec. 2306.553.¹ Implementation of the new legislation, to some extent, was delayed by the need to await the seating of this new board of directors in January 1998. From an accounting and audit perspective, TSAHC has been a "development stage" company to date. With the new legislative authority, we are rapidly transitioning it into a fully operational entity that will stand on its own.

Most of the audit recommendations will be fully implemented as a result of compliance with the new legislation. Management from both the Department and TSAHC are in the process of developing plans that address all provisions of the legislation. Staff from each entity have been assigned responsibility to implement their respective plans. Our internal target date for completion is fiscal year-end 1998, although certain component parts may take longer. Nevertheless, we believe we can achieve substantial compliance this fiscal year.

A separate and distinct control structure is now in effect for TSAHC since it now has a separate governing board and is in the process of fully staffing its operations. With the exception of the office of president, no officers and employees of TSAHC share employment with the Department. Until staffing is complete, the Department will continue to provide administrative services to TSAHC, as necessary, under an administrative services agreement. TSAHC will compensate the Department for the services it provides based upon a best estimate of the costs of the services provided. Management of TSAHC overlaps with the management of the Department only at the President level, as mandated by the new legislation.

TSAHC has been, and is, considered and treated as any other subrecipient of the Department. The following recommendations have either been implemented or will be implemented during the 1998 fiscal year:

- TSAHC will submit complete application packages for HOME awards made by the Department.

¹The composition of TSAHC's board of directors was changed to consist of two members of the Department's board of directors and four other members (including the presiding officer) unaffiliated with the Department and appointed by the Governor. The operations of TSAHC were affected in that "the department may not transfer any funds to the corporation to support the administration of the corporation or to subsidize its operations in any way," [Sec. 2306.555(g)] and that "[t]ransfer of property from the department to the corporation shall be fully compensated." Sec. 2306.555 (h).

- Award agreements between the Department and TSAHC will provide sufficient information so the Department can monitor the awards. This information will include details on how the award of funds will be used, tasks to be performed, a schedule for completing the task and a budget consistent with the Department's requirements of any other grantee/subrecipient.

Additionally, TSAHC's award processes are being enhanced, where appropriate and not inconsistent with requirements imposed upon any other grantee/subrecipient, to include:

- plans of how it will award funds to eligible recipients to meet the goals and mission of TSAHC and the award criteria,
- designated staff to manage the award process and the administration of awards to eligible recipients, and
- policies and procedures to address the methods TSAHC will use to advertise, award, and monitor the recipients of Department funds.

Section 2 - The Department Needs to Ensure Policies and Procedures Affecting the Award Processes are Implemented and Enforced

Management's Response

The Housing Trust Fund operates under standard operating procedures, which have been implemented by management though they have not been formally adopted. The standard operating procedures will be formally adopted during the current fiscal year. The Department will enhance its standard operating procedures to describe in greater detail a clearly defined methodology used for the awards process and the procedures for developing a Notice of Funds Availability (NOFA), which will include documentation standards. The procedures will attempt to standardize the time allotted for, and the provision of, notice, as well as the periods for response to NOFAs, once issued.

The Department believes that its current processes for soliciting public comment throughout the year and for developing the annual State Low Income Housing Plan and Annual Report (the "Plan"), as well as the Annual Consolidated Plan - One Year Action Plan, provides the public more than ample opportunity to comment on the plans of the Department. The formal citizen participation process for the current Plan included a 31-day public comment period beginning January 26, 1998. During this period, the public was afforded a formal opportunity to provide comment and input into the Department's planning process by means of facsimile

transmission, mail and e-mail. This comment period was published in the Texas Register and included the other efforts listed below.

- Seven public hearings were scheduled at different locations throughout the state. The Department's Governing Board held an additional eighth public hearing.
- Over 1,100 public and private organizations, both nonprofit and for profit, were notified by fax, e-mail, and mail about the public hearing schedule and the 31-day public comment period.
- Copies of the public hearing schedule were posted in every library in the participating cities.
- A copy of the public hearing schedule was posted on the Department's internet web site.
- A draft copy of the Plan was made available on the Department's web site.
- Draft copies of the Plan were made available at 55 state depository libraries.

After public input is reviewed, the Plan is finalized and submitted to the Governor, Lieutenant Governor, Speaker of the House of Representatives and members of the Legislature.

We have an entire division whose work is devoted to this effort. Public input is always considered in the development of individual NOFAs. The Department believes that soliciting informal input throughout the year and making a concentrated effort, on an annual basis, to solicit formal comment provides the public ample opportunity to provide input into the planning process. This approach also allows the Department flexibility it needs to target particular NOFAs to specific needs and geographic areas. Additionally, soliciting, receiving, accumulating, and analyzing input for each NOFA that the Department prepares is not considered the best use of limited staff resources.

The Department believes that its policies and procedures are designed to promote a fair and equitable award process. The unsuccessful 1997 NOFA was not the result of a lack of procedures, changes in the key award criteria, an inadequate application period or a lack of public comment but, rather, was the result of the lack of qualified applicants. The 1997 NOFA, though admittedly a difficult one, was subjected to the same procedures as other successful NOFAs that the Department publishes.

The Department needs the flexibility to target particular NOFAs to specific needs and geographic areas. In attempting to reach harder to serve populations, we will continue to encounter difficulties achieving 100% success for each NOFA, but if we resort to structuring NOFAs for only those applicants we are positive can be successful, we will not be attempting to

stretch our resources to address greater need. On balance, we believe that to try and not be successful is much better than not trying at all. In any event, our goal and internal directive is to effectively utilize all resources available to us.

The Department's current practice in regard to providing its Board with complete information relating to proposed projects' funding sources is to identify and describe all funding sources and the funding history for proposed projects. This information is included in the Credit Underwriting Summary that is presented to the Board with the project proposals. Additionally, information relating to proposals whereby the Board's approval will require a waiver of an existing program rule will be included in future Board books. This practice will be formalized in the Department's Standard Operating Procedures during the current fiscal year.

Section 3 - The Department is Addressing Prior Audit Recommendations

Management's Response:

Management recognizes the value of recommendations resulting from external assessments of the Department's operations. Acting on those recommendations demonstrates management's overall attitude and awareness concerning the importance of controls. The Department has addressed all audit recommendations from four prior State Auditor's Office audit reports with the exception of one recommendation. This one recommendation, which is no longer relevant, was directed to another agency that was previously responsible for regulating manufactured housing. The Department's external auditors' conclusion, for the most recent annual audit, that all of their prior audit recommendations have been successfully implemented further demonstrates management's commitment to the implementation of effective management controls.

The recommendation to perform installation inspections of manufactured housing on a timely basis and establish a time frame for completing a backlog, which accumulated during the time another agency was regulating manufactured housing, is no longer relevant. The Legislature revised the Texas Manufactured Housing Standards Act, effective September 1, 1997, by allowing the Department to use a sampling approach that will cover at least 25% of the homes installed. The Department is currently in compliance with these provisions of the Act relating to installation inspections.

Lawrence F. Alwin
April 16, 1998
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Conclusion

Again, the Department appreciates the opportunity to adjust our responses previously submitted to you to align with the most recent version of your report draft. We look forward to receiving the final published report, at which time the Department intends to fully implement the current recommendations where it is practical to do so.

Sincerely,

Larry Paul Manley,
Executive Director

cc: Frank Vito, Audit Manager

State Auditor's Follow-Up Comment to The Texas Department of Housing and Community Affairs

Issue 2

The State Auditor wishes to clarify that the audit report states the causes of the unsuccessful NOFA in 1997 to be the late changes made to the key award criteria and the less than six-week application period. These changes were the reason why there was a lack of qualified applicants. The audit finding reported states that these late changes did not go through the same procedural analysis and review process that is set out in the Department's draft procedures. If a follow-up review had been performed on these changes, the restrictive criteria may have been identified thereby enabling adjustments to be made to increase the pool of qualified candidates.

The report recommends that policies and procedures drafted for this process be implemented and that they be revised to include a clearly defined methodology to be used for the Housing Trust Fund award process. The methodology should address areas like the review of last minute revisions and the policy and procedures should set out a process to document the justification for revisions so the Department will have the historical data and knowledge to improve decision making in the future.