Housing and Community Development Department

Housing Finance Audit

Report on Internal Controls and Activities for Housing Finance

November 22, 2006

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Introduction

The County of Santa Barbara Housing and Community Development Department (hereafter "HCD") administers several programs that provide affordable housing options to eligible residents of Santa Barbara County. The Finance Division of HCD works to secure, administer, and monitor funding for these several types of housing programs.

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Per the County's 2006-07 Proposed Budget, the Finance Division of HCD is the largest division of HCD. The Finance Division includes 6.8 staff out of a department total of 13, and is comprised of a manager, four housing program specialists, a departmental analyst, and an office assistant. The actual accounting is performed by a Cost Analyst from HCD's "Management, Assessment and Planning" division.

"Housing Finance assesses the County's affordable housing needs annually. Financial and technical assistance is provided to profit-motivated and non-profit developers of affordable housing projects. Staff provides assistance in project development to planners and administrators in other public agencies and cities, and provides leadership for the consortium formed with cities eligible to receive Federal affordable housing funds through the HOME Program and Community Development Block Grant (CDBG) funding through the State of California's Small Cities Program." – *2006-07 Proposed Budget Service Description*

The Finance Division (also referred to as "Housing Finance" in this report) itself is primarily an administrative conduit that receives program funding, and then awards or distributes it in accordance with funding guidelines and restrictions to achieve program objectives. As noted above, recipients of the funding can include individuals, other governmental agencies, and community-based organizations providing housing programs. In this audit report, we present and group our findings and recommendations by each funding source, i.e. program. Overarching findings with respect to the Division as a whole are included as "General Program" findings.

Purpose and Scope

Our audit of the Finance Division of HCD was limited in scope. For ease of reference, the Finance Division's functions can be broken down into three primary areas:
1) securing and awarding of available funds,
2) accounting for funds and compliance with specific funding guidelines, and
3) monitoring program distributions and ultimate program success with identified plans.

…we did not audit the award process or confirm the success of the program with funding allocations

Due to time and other resource limitations, we did not audit the award process or confirm the success of the program with funding allocations (areas 1 and 3 above). Our audit focused on area 2 – accounting for funds and compliance with specific funding guidelines. With this limited scope in perspective, the purpose of our audit was to identify the types of funding and their respective sources administered by the Finance Division of HCD, and determine whether an adequate and effective system of controls has been developed over the accounting function related to these funds.

Our audit examined transactions recorded in the County's financial system and amounts or balances available for housing programs for the fiscal years ended 6/30/05 and 6/30/06. For this 2-year period, our audit examined over $13 million. Additionally, although we touched on the shared equity component of the Inclusionary Housing program during our audit of Housing Finance, an in-depth examination of this program was conducted independent of this audit and the results have been addressed in a separate report.

We feel our examination included sufficient inquiries, observations, and tests of transactions to provide a basis for our conclusions and to enable us, where appropriate, to recommend changes to procedures to assist management in achieving its objectives. In some cases, we relied on audit work performed by Federal and/or State auditors who performed tests of compliance in relation to their own specific funding source.

A. Management Oversight

Background:

This finding is a broad one in that it encompasses the tone and direction exemplified by management through its actions or inactions with respect to Housing Finance activities. It comes about as an overall, cumulative impression supported by the number and type of findings we found when conducting the audit. It is not made lightly or to merely point out flaws. Our intent is to highlight the significance of management's leadership in carrying out the program's objectives and the issues that can arise if management does not perform its role responsibly.

Finding:

We found that the management of the Housing Finance division does not have a comprehensive, clearly articulated view of the finance and accounting activities of the division.

We found that the management of the Housing Finance division does not have a comprehensive, clearly articulated view of the finance and accounting activities of the division. In fact, there was a clear hands-off attitude for the responsibility of understanding the financial reports, the financial processes, and the overall monitoring of the results of any financial activities. This disregard for the need and purpose of the fiscal operations of the division has resulted in several control weaknesses which can cause material errors, environments susceptible to fraud, and lost revenue. Among these weaknesses, we found the following:

- Lack of segregation of duties
- Lack of necessary accounting procedures, such as reconciliations
- Lack of adequate and complete file documentation
- Lack of adequate monitoring of program requirements
- Lack of compliance with grant requirements, such as matching County funds
- Lack of management oversight of work performed by staff
- Lack of knowledge of how other divisions of HCD impact Housing Finance

The tone from the top appeared to be one of maximizing administration allowances, whether earned or not.

We also found that, although Management claimed ignorance of most aspects of the financial issues, they were very aware of the matching and administration allowances for specific grants. However, they did not take the necessary steps to ensure compliance with these provisions. The tone from the top appeared to be one of maximizing administration allowances, whether earned or not. Thus, per management, timesheets were coded inaccurately to increase administration costs for certain grants.

Recommendation:

Management must make understanding the accounting and financial issues of all housing programs a priority and implement review processes and policies for key functions in the division. Management must also make compliance with grant provisions a part of each funding source and initiate tangible procedures to ensure such compliance.

Management Response:

We agree. A modification of the existing HCD organization will follow a careful review and re-articulation of departmental goals and objectives. The financial complexity of the various HCD programs appears to warrant reclassification of staff positions to permit the hiring of a high level professional accountant to oversee all HCD financial and accounting activities. Corrective action will be commenced upon the arrival of the new HCD department director.

B. Accumulated Funds

Background:

Although our audit period spanned 2 fiscal years (2004-05 and 2005-06), in many cases we had to extend our research to many years prior in order to gain a full understanding of the specific funding or accounting issue. Additionally, as noted in the "Purpose and Scope" section of this report, we did not audit to confirm that program disbursements conformed to identified organizational objectives. However, based on the expanded periods we reviewed, we noted that balances are accumulating in the funds and accounts used to manage and support the various housing programs.

There does not appear to be a concerted, documented effort by management to spend the financial resources available for affordable housing programs.

Finding:

There does not appear to be a concerted, documented effort by management to spend the financial resources available for affordable housing programs. Our audit showed that account balances have grown significantly over the past several years without any planned or actual disbursement activity. Specifically, we found issues with the Isla Vista Redevelopment Agency, the Socio-Economic Mitigation Program (SEMP) fees, and with a Portfolio Recapitalization Loan, which we detail in the "Program Specific" findings section of this report. The unspent balances at 6/30/06 for these 3 programs alone is over $5 million. Additionally, in the current fiscal year, $500,000 in awarded Community Development Block Grant funds for a home homeownership purchase program was lost due to inadequate planning for the use of the funds. The lack of distribution of funds gives the perception of: 1) program ineffectiveness, 2) lack of management oversight, and 3) lack of program purpose.

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Recommendation:

Management should be more proactive in the planned and actual use of accumulated funds in order to fulfill their goal of providing affordable housing.

Management Response:

We agree. An integral element of the HCD reorganization process will be a review of each existing HCD Business Process currently in place and the alignment of each process with one or more of the department's goals/objectives. Process controls will be implemented in each instance to assure the timely and effective expenditure of funds for the intended purposes.

1. Trust Funds (In-Lieu Fees)

Background:

Housing Finance receives fees ("in-lieu fees"), which are assessed on developers and project owners to support the production and maintenance of affordable housing. In-Lieu fees are generated when developers of certain residential projects in the County's unincorporated areas elect to pay fees rather than construct affordable housing units as required by the County's Housing Element.

However, the process, when we tested it, was far from simple or transparent and wrought with exceptions.

The process as described to us for fee calculation and collection appeared straight-forward at first. Essentially, in-lieu fees are calculated using the formula in the Housing Element Implementation Guideline (HEIG) in effect at the time the project's application is complete, and before a project is officially "mapped," any in-lieu fee is paid as a Condition of Approval. However, the process, when we tested it, was far from simple or transparent and wrought with exceptions.

Finding:

We found that historical organizational changes of where in-lieu fees are calculated and collected, and a failure to guide the transition with formal procedures and documented exception policies, has caused lost revenue to the County, inconsistent application of rules, and inaccurate calculation of fees. We found in our testing of nine (9) projects that the in-lieu fee process is so disjointed, that:

a) In-lieu fees of over $350,000 appear to not only be uncollected, but management was completely unaware that the amount was even owed to the County. For these particular projects, it appeared that a process breakdown occurred when the applicant/developer changed mid-project. There was not a formal mechanism to ensure that the in-lieu fees were paid for this type of event.

b) Additional in-lieu fees could have been lost to the County due to inconsistent and incorrect application of the guiding formula for the fee calculation, due to missing or outdated source documents, and due to lack of a clear definition of a project's scope change that would necessitate an increased fee. For example, a fee calculated as $200,000 in an earlier HEIG may be $1 million in a later HEIG as a result of updated fees/rates. The guiding HEIG for a project can change if a project's original plan is modified significantly enough to cause a new project application. When this happens, the new "project application complete date" determines whether the original HEIG is applicable or whether a newer HEIG overrides the original. We could not assure the appropriate calculation of the fees because we could not rely on the source documents provided to us.

c) In-lieu fees are calculated by another division of HCD (Housing Development), but the Housing Finance Division was unaware of this fact until our auditors brought it to their attention.

d) In-lieu fees were incorrectly calculated by HCD (Housing Development Division) resulting in overcharging a project developer by almost $18,000.

e) In-lieu fees are owed for four (4) current development projects, but since 1) there is no definitive master inventory identifying projects in progress that owe the fee, 2) the guiding criteria for the fee calculation is inconsistent, and 3) there is no formal communication process in place to ensure the fees are paid, it seems highly likely that the fees will be calculated incorrectly and remain uncollected.

Recommendation:

Management of both Planning & Development and HCD should better define the rules, collection process, and exceptions surrounding in-lieu fees. The documented, agreed upon solution should include clear communication of the fees owed and by whom, how the fees have been calculated, when/if fees should be modified, when the fees are due, who the fees will be collected by, and how fees paid will be confirmed.

Management Response:

We agree. Sound processes for calculating, collecting, and monitoring in-lieu fees will be developed and documented in coordination with the Planning and Development department. Initial steps in this effort will include preparation of a complete master inventory of projects owing the fee and the installation of controls to ensure that all fees are collected on a timely basis. We are actively working with the Planning and Development Department to research the status of the fees receivable.

2. Isla Vista Redevelopment Agency (IVRDA)

Background:

In 1990, along with other economic vitality goals, the IVRDA was formed to improve the supply of affordable housing in Isla Vista. The IVRDA affordable housing program is funded by a “20% housing set-aside tax” assessed on the properties located in Isla Vista. In fiscal year 2004-2005 and fiscal year 2005-2006, IVRDA housing set-aside revenues totaled $652,734 and $737,123, respectively. As with in-lieu fees and other housing revenue, Housing Finance is responsible for administering these funds to support housing programs within required parameters.

The current method used to award these housing set-aside dollars to projects in Isla Vista is through the annual Notice of Funds Available (NOFA) process conducted by Housing

Finance. It is through this process that most housing funds are awarded. We did not specifically audit the award process as stated earlier in this report. However, our findings that follow are based on the fact that these available housing set-aside funds continue to grow with minimal or no actual disbursement of funds occurring for housing programs.

Finding:

We found that Isla Vista program objectives for affordable housing are not being met due to a lack of proactive management within Housing Finance, and due to the annual NOFA process, which the IVRDA is subject to in order to receive project funding. Specifically,

The NOFA process is unnecessary for IVRDA housing projects.

a) The NOFA process has not produced the desired results to be applicable to the current IVRDA situation. The bureaucratic nature and resultant duration of time until availability of funding through the lengthy NOFA process coupled with the needs and timely nature of the IVRDA in considering and undertaking affordable housing projects are in direct conflict.

b) The NOFA process is unnecessary for IVRDA housing projects. The IVRDA's 20% housing set-aside revenue is available and sufficient to fund affordable housing projects for currently proposed projects.

c) Since its inception (1990) to 6/30/2006, the IVRDA has received $4.6 million in housing set-aside revenue and earned $469,000 from interest and other sources, but has only spent $2 million on housing activities. The IVRDA is currently out of compliance with California RDA law and needs to spend the housing set-aside revenue they're receiving on low to moderate-income housing, otherwise they will be subject to sanctions. The Housing Fund had reserves of $3 million as of 6/30/2006, which exceeds its legal reserve limit by over $600,000. The Housing Fund will earn an additional amount of approximately $750,000 in FY 2006-07, further exceeding its legal limit.

Recommendation

The IVRDA should be removed from under the umbrella of HCD. The IVRDA can operate efficiently independently from HCD. Isla Vista is a community unique from most other urban areas in Santa Barbara County, and as such needs to be approached differently with regards to affordable housing. HCD provides an unnecessary layer over the IVRDA which assesses administration fees, further degrading the funds available for affordable housing projects. The IVRDA should be put under the direction of the Santa Barbara County Redevelopment Agency in order to more efficiently carry out the housing projects in the community and to provide more focus to the needs of the project area.

Management Response:

We agree with the above findings and with the Auditor's recommendation that the IVRDA Housing Set-Aside funds be removed from under the umbrella of HCD and that the IVRDA

Housing Set-Aside funds be placed under the direction of the Santa Barbara County Redevelopment Agency in order to more efficiently carry out the housing projects in the community and to provide more focus to the needs of the project area. HCD management has prepared a request for Board action regarding this item. However, HCD Housing Specialists will continue to provide support to joint housing efforts to the IVRDA as needed.

3. Portfolio Recapitalization Loan

Background:

In late 2004, HCD acquired a $1,100,000 loan designed to fund the Hillside House project. The funding was secured; however, the project never came to fruition. HCD decided to move forward with the loan with the hopes that a project requiring this funding would present itself in the near future.

As of October 2006, HCD has lost roughly $64,000 on this loan...

Finding:

As of November 2006, HCD has yet to use any of these funds or locate projects that can use the funding. As of early October 2006, HCD has lost roughly $64,000 on this loan due to the difference between the loan rate (5.625%) and the average rate of return during this time period (3.22%) for the County pool. If HCD opts to retain the loan, they will lose roughly $200,000 over the life of the loan.

Recommendation

In order to avoid losing more money on this inactive funding source, we recommend that HCD retire this debt.

Management Response:

We agree with the finding and with the Auditor’s recommendation that HCD retire this loan to avoid $135,000 in additional potential losses. An action to retire this loan was taken to the Board of Supervisors on January 23, 2007.

4. Inclusionary Housing – Shared Equity

Background:

The Shared Equity Appreciation (SEA) component of the Inclusionary Housing program allows purchasers of certain affordable housing units to share in the appreciation of the property. In this program, eligible individuals purchase homes at below-market rates, and then after designated periods (5, 10, or 30 years) are allowed to sell the home at the market rate and keep 100% of the profit. If the home is sold prior to the end of the designated period, the purchaser and the County split the home's equity appreciation based on pre-established formulas. For fiscal years 2004-05 and 2005-06, the revenue from this shared equity totaled $521,069 and $363,333, respectively.

Equity proceeds received by the County "shall be used for the rehabilitation of affordable housing in the County of Santa Barbara including monitoring, covenant enforcement, and repurchase of for-sale affordable units, and preparing repurchased for-sale affordable housing units for occupancy."

Formula errors and the inclusion of inappropriate fee deductions resulted in a loss of $13,680.

Finding:

We found that HCD calculated the equity share incorrectly, costing the County $13,680 on the 4 homes sold during the audit period. These calculation errors are due to an incorrect formula and the inclusion of inappropriate fees as deductions.

Recommendation

Management needs to institute a review process, update their computation spreadsheet, review the accuracy of those calculations, and verify that all of the variables are properly accounted for in the calculation.

Management Response:

We agree. HCD has corrected the formula on its computation spreadsheet and documented the process for calculating equity shares accurately. This process, along with various other HCD business processes and calculations will continue to be subject to management review to assure accuracy of process outcomes.

5. Housing Assistance Program (HAP)

Background:

The Housing Assistance Program (HAP) is designed to assist low income households finance the purchase of a home by providing a down-payment on a market value home. The down payment is considered a loan from the County to the home purchaser to be repaid if/when the home is sold. The program is limited to first time homebuyers as defined by program guidelines. The funding for this program comes from the State Community Development Block Grant. When a HAP loan home is sold, the return of the original loan plus any shared equity is retained by Housing Finance to fund further housing programs. In fiscal year 2005-2006, the grant allocation amount totaled $500,000. This program currently has 63 outstanding loans.

Finding

Our review revealed weaknesses within all the HAP program components.

The HAP program has what we consider four main components: initial eligibility, ongoing monitoring and compliance, loan tracking, and the County's shared equity calculation which is performed if and when the property is sold. Each of these four components had findings that are noted here:

a) We found that no new HAP loans were given out between 2004 and 2006 due to HAP loan guidelines and loan limits that were not responsive to the current housing market. Early efforts to update the guidelines were unsuccessful and by the time HCD received approval on updated guidelines, the grant's spending deadlines could not be met and resulted in the loss of the $500,000 grant allocation.

b) We found instances where the participant's household income was calculated using net pay as opposed to gross pay. This practice can lead to incorrectly qualifying households that should not be able qualify for the program. We also found two instances where files lacked the necessary information to verify that the initial income eligibility test had been performed.

c) During our audit, we were notified of 6 loans for which the County had subordinated to. Our review of these files found that for 5 out of the 6 loans, HCD had improperly allowed the HAP participants to withdraw funds based on the increased equity of the homes. HCD allowed the subordination of these loans in anticipation of the Board of Supervisors approving changes to the HAP guidelines, which would have allowed the County to subordinate on the HAP loans. In the end, the Board of Supervisors rejected the proposal to modify the HAP guidelines.

d) We noted 3 instances in which the annual occupancy verification was not completed. We noted one instance in which the monitoring database (used to store the applicant's mailing address) did not contain the correct address. The review of the Accurint system revealed that for at least one of the applicants, the HAP loan residence did not appear to be the primary residence as required per the HAP loan agreement.

e) We noted a lack of document retention and a lack of supervisory review with regards to the equity calculations. Two of the equity calculations were improperly calculated; this resulted in the County under collecting by $4,500. Due to missing documentation, specifically the settlement agreement, we were unable to re-perform the equity calculation for 5 of the files selected for review. Selected HAP loan files were missing the variable sheets required to verify that the County received its fair share from the sale of specific HAP residences.

<u>Recommendation</u>

Management should evaluate all aspects of this program since each program component showed significant control weaknesses. Emphasis should be placed on the importance of organization and accurate and thorough documentation practices during initial staff training as well as at the initiation of each new affordable housing development. The HAP guidelines need to be updated to reflect verbal policies and procedures, and policies should address the proper documentation of verbal communications.

Accurate and complete program files are essential to management's ability to properly administer and monitor the program. In order to ensure that only eligible families are qualified for this program, management needs to ensure the consistency of the household income calculation. Management needs to create a better tracking system to not only ensure all annual occupancy verifications are performed but to also ensure that they are being done timely.

It is unclear if management truly endorses this program based on our findings and the ultimate loss of the $500,000 grant.

The bottom line is that the goals of this program must be better articulated and the policies and procedures under which the program operates must reflect those goals. It is unclear if management truly endorses this program based on our findings and the ultimate loss of the $500,000 grant.

Management Response:

We agree with the reported findings and with the Auditor's recommendation that HCD management should review all aspects of this program since each program component showed significant control weaknesses. It is the intent of HCD management to clearly articulate the goals of this program as well as all HCD programs, to emphasize the importance of organization and completeness of program files and documentation, to carefully provide 'on the job' training to staff, and to adequately review work performed for completeness and accuracy.

6. Housing Rehabilitation Loan Program (HRLP)

Background:

The HRLP is designed to provide low interest housing rehabilitation loans to low and very low income households. The original source of funds came from CDBG funds, however, the program is structured to use recycled loan funds (referred to as program income) to self-fund the program. However, this program has been dormant for the last four years. HCD is currently working to secure additional CDBG funding as well as re-evaluate the existing Housing Rehabilitation Program Guidelines in order to resurrect this program. Since the typical housing rehabilitation loan period was set at 20 years, HCD is still receiving program income from outstanding loans. Across fiscal years 2004-2005 and 2005-2006, program income from 38 active HRLP loans totaled almost $200,000.

(Housing Finance earned program income of $530,730 and $552,254, from all amortized HAP, HRLP, and other loans for fiscal years 2004-05 and 2005-06, respectively.)

Much like the HAP program, the HRLP allows for the deferred payment of the loan (only under very specific circumstances). However, unlike the HAP program, the HRLP can function more like a traditional loan program in which monthly payments are required from the loan recipients. The HRLP loan rates are mostly based on the household's income level.

Finding:

We found the following issues related to the HRLP:

Over this four-year period, if we include the program income earned from HAP and other loans, $2 million could have been recycled for further housing programs.

a) Our first finding is the fact that program income of $100,000 is being received annually and yet the program's objective to make additional rehabilitation loans has been dormant for the last four years due to outdated guidelines. *Over this four-year period, if we include the program income earned from HAP and other loans, $2 million could have been recycled for further housing programs.* We did not audit how these proceeds are being used – we did confirm that they are not being recycled as new loans.

b) We found there is no formal process stated in the HRLP guidelines for collecting delinquent payments of HRLP loan balances. After two collection letters are sent out, and a phone call is made the by the HCD accountant, the loan is reclassified from amortized to deferred status (loan balance is not owed until sale of property). Once the loan is classified as deferred, no additional collection work is attempted.

c) We found that 2 out of the 10 HRLP files selected for review contained loan rates inconsistent with the HRLP guidelines. One HRLP participant was given a lower rate than allowed for and one HRLP participant was given a higher rate than allowed for under the HRLP guidelines.

d) We found that loan payments received had not been recorded in the loan tracking system since June 2006 (i.e., loan payments received from July 2006 thru October 2006 had still not been recorded as of our audit date of November 2006).

e) A substantial number of the files reviewed failed to contain adequate support for the calculated household income.

Recommendation

HCD should update the program guidelines and develop a strategy for the use of program income. Additionally, we recommend management develop and implement a clear and concise program manual to address all administrative and program issues. The manual should identify proper policies and procedures for every component of the program and provide program boundaries to be followed by all employees. Additionally, the inherent risk that exists in an affordable housing program requires constant oversight and guidance by HCD management. Management policy and decision-making should not be left to the discretion of staff personnel. The manual should be periodically reviewed and updated to ensure all issues are addressed in a timely manner.

We further recommend that written procedures be developed to assist in the implementation and enforcement of management determined policies. Written procedures are a hallmark of an efficient and effective internal control framework. In the absence of written practices, personal judgment and inconsistent handling of processes may occur.

Management Response:

We agree with the above findings. As part of our plan to review each HCD program we will update, as recommended, HRLP guidelines, and will prepare a program manual addressing administrative and operational issues for each program component. It is our intent that consistent management oversight of this program and all other HCD programs will become the departmental norm.

7. Supportive Housing Program Grants (AKA Continuum of Care)

Background:

The primary objective of this program is to provide funding for the development of supportive housing and supportive services designed to assist homeless persons transition from homelessness as well as provide them with the skills that will allow them to live as independently as possible. These Supportive Housing Program (SHP) grants are multi-year and project specific grants. In fiscal year 2004-2005 and fiscal year 2005-2006, the total grant allocation for Santa Barbara County totaled $280,449 and $281,249 respectively. Our audit of this program relied somewhat on a monitoring report from the U.S. Department of Housing and Urban Development. The funding for this program was earmarked for the three projects identified below. We selected one of the three (the Homeless Management Information System) for our audit.

- *Casa Esperanza Day Center*: $160,586 annual grant designed to fund a day center that provides support services and case management to enable and transition homeless persons into permanent housing.

- *Good Samaritan Shelter Transitional Facility*: $17,850 annual grant designed to help support the operational costs of an eight unit permanent housing program for the Clean and Sober Living program for women in Santa Maria.

- *Homeless Management Information System*: $102,813 annual grant designed to provide funding for the development of a Homeless Information System. Partnering with Ventura County, the Homeless Information System is designed to collect various pieces of information (such as age and gender) about the individuals receiving services thru HCD's community partners. HCD monitors the activity, reviews the data collected, and performs site reviews.

Finding:

We found that HCD was unaware of the grant's 20% match requirement, and therefore, failed to meet the grant match requirement by roughly $17,000.

Here are our findings related to the Homeless Management Information System:

a) We found that HCD was unaware of the grant's 20% match requirement, and therefore, failed to meet the grant match requirement by roughly $17,000.

b) We found that the HCD program administrator failed to accurately code his time to the program, thus, we were unable to verify the actual administration costs incurred on this grant. As such, HCD could be required, by the granting agency, to pay back the $3,279 in administration reimbursements.

c) Housing has yet to develop written procedures related to the on-going maintenance, monitoring, and implementation of the Homeless Management Information System. In addition, HCD is relying on their counterparts in Ventura County to cover whenever the program manager is out due to vacation or illness. Although having Ventura County assist with the program is helpful, the fact that the backup for program operations is not located in the same office can 1) create scheduling issues, 2) cause management to not have necessary information readily available, and 3) perpetuate the lack of intimate knowledge with internally developed procedures and service providers.

Recommendation

Instruction manuals, procedure manuals, checklists, contact listings, and reference guides need to be developed to adequately manage this grant. In addition, Housing needs to cross train another employee within the department on this grant in order to avoid potential hardships due to prolonged absences such as employee vacations or illness, and to maintain program continuity. Management must also implement procedures that will ensure compliance with program requirements.

Management Response:

We agree with the findings. As part of our HCD action plan, we will thoroughly review grant requirements and document via the development of program manuals, checklists, contact listings etc. each of the business processes necessary to assure the effective administration of this program.

8. Community Development Block Grant (CDBG)

Background:

The primary objectives of this program are to provide decent housing and increasing economic opportunities to persons of low and moderate income levels. These Community Development Block Grants (CDBG) are multi-year and project specific grants. During fiscal year 2004-2005 and fiscal year 2005-2006, HCD had $2,420,000 (in total) grant funds available for the following projects:

- *Mercy Housing*: $500,000 grant that will be used for the construction of a 170-unit rental apartment project.

- *La Morada Special Needs Foster Children Facility*: $750,000 grant that will be used for facility rehabilitation and special needs rental assistance.

...we found several instances in which total grant revenues were not being reconciled against total grant expenditures.

- *Ventucopa Water Systems Study*: $35,000 grant that will be used to review the existing Ventucopa water system to determine what can be upgraded and /or improved.

- *Women's Economic Venture Microenterprise Loan Fund*: $800,000 grant that will be used to fund loans designed to provide assistance to businesses and real estate projects to create and / or retain jobs.

- *Agricultural Workers Housing Needs Study*: $35,000 grant designed to fund a site feasibility study and site selection study for a farm worker housing project in the Carpinteria Valley.

- *Yardi Community Development Block Grant*: $300,000 grant will provide assistance for the Yardy Systems, Inc. infrastructure improvements.

<u>Finding</u>

During our review of the various projects, we found several instances in which total grant revenues were not being reconciled against total grant expenditures. This resulted in situations where 1) HCD failed to pay a contractor's invoice even though HCD had been reimbursed for that particular expenditure by the granting agency, 2) HCD failed to request reimbursement for qualifying grant expenditures, and 3) HCD failed to meet the grant matching requirements. More specific findings by project follow:

a) Yardi Project:
   - This $300,000 grant had a $60,000 matching requirement. Based on the actual grant drawn down amount of $236,425, the corresponding matching requirement would have been $46,885. The County / City of Goleta only had a cash match of $19,964.

   - HCD over billed administration fees by $6,914 due to having incurred insufficient administrative expenditures to justify the actual grant reimbursement amount.

b) Women's Economic Venture 2003-2005 grant:
   - o HCD paid a vendor $14,256 but never requested reimbursement from the granting agency.

   - o HCD under billed administration fees by $8,031 due to HCD not monitoring the balance left to collect on the grant.

c) Women's Economic Venture 2004-2006 grant:
   - o HCD over billed administration fees by $1,779 due to a math error.

Recommendation

Although HCD appeared to perform periodic reconciliations during the preparation of the reimbursement requests, these reconciliations only focused on direct expenditures incurred during a specific period. We recommend that the following procedures be implemented by HCD to ensure that these errors do not repeat themselves:

- HCD perform grant reconciliations that focus on not only verifying that enough costs were incurred to validate the direct expenditure reimbursement requests, but also include the administration reimbursement requests and grant matching requirements to fully capture a grant's financial picture.

- HCD adopt an Indirect Cost Rate Proposal (ICRP) in order to efficiently calculate and support the indirect costs associated with running the various programs.

- HCD institute management review procedures of the grant reconciliations by someone other than the preparer.

Management Response:

We agree with the finding. Grant reconciliations will be performed on a periodic basis (at least quarterly) and will include administrative reimbursement requests and grant matching requirements, in addition to direct grant expenditures. Reconciliations will be reviewed by someone other than the original preparer of the reconciliation.

9. HOME Grant Program

Background

Santa Barbara County is the lead agency for a consortium formed with the cities of Buellton, Carpinteria, Goleta, Lompoc, Santa Maria, and Solvang. The consortium selects the housing projects to complete while HCD administers the allocation of funding to those projects. These projects encompass homeowner assistance, rental housing rehabilitation, and the new construction of housing for low and very low income families. In fiscal year 2004-2005 and fiscal year 2005-2006, the total grant allocation for the Santa Barbara County HOME Consortium totaled $2,027,449 and $1,817,235, respectively, representing the largest funding source of Housing Finance. These funds are actually an entitlement to the County, which means that funding will not be lost to the County if the original housing-related projects applied for change. In the case of a true grant, which is a promise to pay, amounts will not be received unless the grant-specific purpose occurs.

…we found that Housing Finance followed HUD procedures for draw-downs and properly recorded them in the County's financial system without exception.

Finding

The process and systems mandated by the Federal Housing and Urban Development Department (HUD) provides good controls surrounding the disbursement (i.e., draw-down) of funds to the County. Except for the lack of segregation of duties, we found that Housing Finance followed HUD procedures for draw-downs and properly recorded them in the County's financial system without exception.

We found that HCD's HOME program files were not always complete and that the components of those files were not being tracked or reviewed for completeness. In certain situations, the actions taken appeared to be contrary to the adopted guidelines. Additionally, the rational and support for the apparent guideline deviations were not documented or mentioned in the respective files.

Although we did not test the overall Notice of Funds Available (NOFA) process, which is how HOME funds are allocated, we have been informed that some members of the Loan Committee who approve the awards to fund could also be a key member of one of the recipient organizations. Thus, it would appear that a conflict of interest may exist with this process.

Recommendation

Management needs to ensure that there are proper segregation of duties and that employees are adequately trained on file documentation, and files should be regularly reviewed for internal guidelines compliance.

Management Response:

We agree with the finding. As part of our effort to re-engineer each of the existing HCD business processes, we will strive (within the confines of available staffing) to achieve adequate segregation of incompatible duties. Adequate documentation and maintenance of files will be emphasized in future staff training.

10. Orcutt Community Facilities District

Background

On October 8, 2002 the Orcutt Community Facilities District (OCFD) was formed. A special tax is levied on the structures located within the OCFD in order to finance infrastructure construction as well as to pay for certain public operations and maintenance services. In fiscal years 2004-2005 and 2005-2006, the special tax assessment totaled $29,017 and $70,577, respectively.

The accounting for the OCFD is performed by HCD and ideally includes the disbursement of tax revenue to the departments providing County services to the district based on a "threshold" amount or other guiding policy. The disbursement threshold amount or policy is currently being evaluated via an update to the "Public Infrastructure Financing Program" report to be completed by an outside contractor.

Finding

We found that the tax proceeds being collected have yet to be disbursed to the service departments because Housing has not yet established a "threshold" dollar amount or policy for initiating the transfer of monies to the various service departments.

We also found that the majority of the policy decisions related to the OCFD are being made by the County Executive Office (CEO). HCD is content to let the CEO develop the policy for the use and application of this fund. Aside from paying the claims related to the "Public Infrastructure Financing Program" report, HCD has taken a less than pro-active stance with regards to the use and application of these monies.

Recommendation

…it is our recommendation that the fund be moved from under the umbrella of HCD and placed under the CEO's umbrella.

Regardless of the outcome of the "Public Infrastructure Financing Program" report, it is apparent that HCD must develop a policy and procedure for disbursing monies from the fund in order to reimburse the servicing departments. If the fund does not contain sufficient monies to cover the actual costs already incurred by the service departments, HCD needs to create a plan that is equitable to all of the entities involved.

If HCD cannot make these policy decisions and considering that HCD's primary area of expertise deals with affordable housing issues, it is our recommendation that the fund be moved from under the umbrella of HCD and placed under the CEO's umbrella.

Management Response:

We agree with the finding. Due to extremely limited HCD accounting resources, we will seek direction from the CEO concerning removal of the responsibility for OCFD accounting oversight from under the HCD 'umbrella'.

Audit Report Conclusion

Management lacks effective and focused oversight of the finance activities within Housing and Community Development. A nonexistent overall strategy to achieve delineated housing objectives is causing millions of dollars that have been earned or otherwise gained for the purpose of funding affordable housing programs to needlessly accumulate. Financial transactions and assets that the Housing Finance Division is responsible for managing are minimally protected due to weak and ineffective internal controls.

Several programs and grant compliance requirements, such as County matches, were found only through the audit process. Additionally, at least $350,000 of in-lieu fees owed to Housing Finance were found through the audit's discovery of inadequate control processes surrounding in-lieu fees. An attempt at creative financing through a "Portfolio Recapitalization Loan" produced a funding vehicle that cost the County money without being utilized for any project.

We found programs that are dormant and revenue sources that have been lost due to management not performing their role effectively. We found programs that are disproportionately incurring administration fees due to management not performing their role responsibly. We found that documentation of important decisions that were made against policy, and lack of documentation in general, were common themes and resulted due to management not taking their role critically.

Suffering the lowest priority by Housing Finance management, who nurtured a hands-off approach to understanding the County's financial accounting and monitoring tools, was the technical accounting function. This coupled with management's inability to simplify the program jargon to the lay person causes unnecessary confusion when trying to better understand program requirements. All of these elements appear to have created an environment lacking key controls necessary to mitigate the risk of error and fraud, such as segregation of duties, account reconciliation, and management review.

We do not wish to be unduly harsh with our audit findings. We do recognize the efforts made by management to secure varied funding sources for housing programs. However, we hope that the future will bring higher scrutiny to the internal controls and the accounting supporting the programs. Doing so will help to meet overall program objectives. We sincerely appreciate the efforts by HCD staff and management in assisting in our examination.

Respectfully submitted,

Robert W. Geis, CPA
Auditor-Controller