

# Memorandum



CITY OF DALLAS  
(Report No. A16-008)

**DATE:** March 18, 2016  
**TO:** Honorable Mayor and Members of the City Council  
**SUBJECT:** Audit of the Department of Housing/Community Services' Contract Monitoring<sup>1</sup>

The Department of Housing/Community Services (HOU) does not have formal (written, approved, and dated) policies and procedures for the: (1) solicitation, evaluation, selection of developers, and underwriting of new single-family and multi-family affordable housing development projects (Projects); and, (2) monitoring of the loan agreements (financial assistance contracts). As a result, HOU cannot ensure effective internal controls are in place and that HOU personnel are performing their duties consistently.

### Background

The Development Division of the Department of Housing/Community Services (HOU) provides financial assistance (sometimes referred to as gap financing) to developers of new single-family and multi-family affordable housing development projects (Projects).

During Fiscal Years (FY) 2012 through FY 2014, HOU provided developers with \$29.9 million in funding to complete a total of 54 Projects that produced 482 affordable single-family and multi-family units.

**Source:** HOU

In addition, documentation of HOU's monitoring practices for 54 Projects from Fiscal Year (FY) 2012 through FY 2014, totaling \$29.9 million, is either absent, limited, inconsistent, or incomplete. Although HOU relies on experienced personnel to monitor these contracts, without proper monitoring documentation, the City cannot ensure: (1) Projects were appropriately and consistently monitored; (2) developers complied with

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<sup>1</sup> This audit was conducted under the authority of the City Charter, Chapter IX, Section 3 and in accordance with the Fiscal Year 2014 Audit Plan approved by the City Council. The audit objective was to evaluate whether the monitoring processes used for selected contracted programs are adequate to ensure compliance with contract terms and conditions. This objective was further defined to include the controls over the developer selection process. The audit scope included HOU's monitoring processes for financial assistance contracts with developers of new single-family and multi-family affordable housing development projects completed between October 1, 2012 and September 30, 2014. This audit was conducted 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 upon our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusion based on our audit objective. To achieve the audit objective, we interviewed HOU personnel; reviewed policies and procedures; the Code of Federal Regulations Title 24, *Housing and Urban Development*; Administrative Directive 4-09, *Internal Control (AD 4-09)*; researched best practices for writing policies and procedures and common industry best practices for housing development contract monitoring; tested a judgmental sample of development projects; and, performed various analyses.

all contract requirements; (3) construction expenses were reasonable and appropriate; and, (4) Projects were completed on time.

These issues and the associated recommendations are discussed in more detail on the following pages. In addition, please see Attachment I for Background information related to the audit, Attachment II for Common Industry Best Practices for Affordable Housing Development, and Attachment III for Management's Response to the report recommendations.

## The HOU Does Not Have Formal (Written, Approved, and Dated) Policies and Procedures

The HOU does not have formal (written, approved, and dated) policies and procedures for the: (1) solicitation, evaluation, selection of developers, and underwriting of Projects; and, (2) monitoring of the financial assistance contracts. Specifically, the HOU does not have policies and procedures for the following processes:

- Preparation and posting of the Notice of Funding Availability (NOFA) which is the solicitation to prospective developers for new Projects
- Evaluation (scoring) of the developers' responses to the NOFA
- Selection of qualified developers who propose the most beneficial Projects
- Underwriting the selected Projects
- Monitoring the financial assistance contracts

<b>Policies and Procedures</b>
A formal policy:
<ul style="list-style-type: none"><li>• Sets standards and expectations for policy objectives</li><li>• Is broad, current, comprehensive, inviolate, and specifies responsibility for action</li><li>• Establishes a framework for both management and staff decision-making</li><li>• Provides guidance for handling organizational and programmatic issues</li></ul>
Formal procedures provide:
<ul style="list-style-type: none"><li>• Concise directives and guidelines for carrying out department policies</li><li>• Detailed steps to complete a given activity</li><li>• Definitions for supervisory and review roles</li><li>• Definitions for tasks, roles, and responsible parties</li><li>• Points of contact for questions and assistance</li><li>• Options, cautions, warnings and decision points</li></ul>
<b>Sources:</b> <i>Writing Policies and Procedures</i> , Copedia; <i>Policy and Procedures Writing Guide</i> , Boise State University; <i>Guide to Writing University Policy</i> , Columbia University; <i>The Policy and Procedure Manual Bureau of Business Practice: Managing "By the Book"</i> , Vermont Department of Human Resources.

Without formal policies and procedures, HOU cannot ensure effective internal controls are in place and that HOU personnel are performing their duties consistently to ensure that:

- Developers' responses to the NOFA undergo the same comparative review, scoring, or evaluation against adopted criteria
- The most beneficial Projects for the City of Dallas (City) are selected in a fair and transparent manner
- All underwriting decisions follow the same methodology
- The best return on the City's investment is achieved

According to Administrative Directive 4-09 (AD 4-09), *Internal Control*, each department is required to establish and document a system of internal control procedures specific to its operations, mission, goals, and objectives. The AD 4-09 requires each department to establish internal controls in accordance with *The Standards for Internal Control in the Federal Government* by the Comptroller General of the United States (Green Book). The Green Book identifies established policies and procedures as a control activity needed to manage risk. Specifically, management:

- Documents in policies for each unit the responsibility for an operational process' objectives and related risks; and, control activity design, implementation, and operating effectiveness
- Defines policies through day-to-day procedures, depending on the rate of change in the operating environment and complexity of the operational process
- Communicates to personnel the policies and procedures so that personnel can implement the control activities for their assigned responsibilities
- Reviews policies, procedures, and related control activities periodically for continued relevance and effectiveness in achieving the entity's objectives or addressing related risks

## Documentation of HOU Project Monitoring Practices is Absent, Limited, Inconsistent, or Incomplete

Documentation of HOU's monitoring practices (see textbox) for 54 Projects totaling \$29.9 million for FY 2012 through FY 2014 is either absent, limited, inconsistent, or incomplete. As a result, the City cannot ensure:

- Projects were appropriately and consistently monitored
- Developers complied with all contract requirements
- Construction expenses were reasonable and appropriate
- Projects were completed on time

### The HOU Project Monitoring Practices

The HOU Project Coordinators (Coordinators) meet with developers to communicate requirements and receive progress updates. Project Coordinators prepare weekly reports for the Division Manager's review.

The HOU Project Inspectors (Inspectors) visit construction sites on a weekly basis and prepare ad-hoc updates of construction progress. Inspectors verify the quality of construction and construction materials, but are not required to consistently document their methodology or the results of the verification.

Coordinators and Inspectors approve developers' requests for reimbursement of construction expenses prior to the Division Manager's approval for payment.

Coordinators are required to verify the construction line items on the draw request to check which items should be paid.

Inspectors are required to verify the percentage of completion of construction line items on the draw request.

**Source:** Interviews with HOU management and staff

Interviews with HOU management and staff and a judgmental sample of 30<sup>2</sup> of 54, or 56 percent, of the Projects completed during FY 2012 through FY 2014 showed HOU:

- Did not retain any documentation related to the solicitation, evaluation, selection, and underwriting for these Projects

According to HOU, the selection of Projects prior to FY 2015 was performed solely by the former HOU Director who did not document the reasoning for choosing particular Projects. The HOU staff did collect and retain documentation related to the chosen developers' financial and compliance history.

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<sup>2</sup> A judgmental sample of 30 of the 54, or 56 percent of the Projects completed between FY 2012 and FY 2014 was selected. After examining the first ten Projects provided by HOU, auditors did not find the necessary documentation to continue testing. Auditors confirmed the unavailability of documentation for the remaining 20 projects with HOU staff and ended testing.

- Retained incomplete and inconsistent documentation of contract monitoring, such as:
  - Documentation to confirm agreement between the City and the developer regarding Federal and City requirements that must be included in the development contract and communicated to developers. Eight of ten Projects sampled, or 80 percent, did not include this documentation.
  - Records of site visits by HOU inspectors, including detailed documentation of the inspector's evaluation of the percentage completed compared to specified criteria.

Three of ten Projects sampled, or 30 percent, did not include logs of inspector visits to construction sites showing the percent of project completion at each visit. The seven Projects that did include logs of inspector visits to construction sites sometimes included additional documentation, such as: (1) copies of building permits and inspections; and, (2) the final inspection of a completed project.

#### **Documents Commonly Used in Contract Monitoring**

- Minutes of pre-construction and other meetings with the developers
- Site visit reports by project monitors
- Checklists of contract terms and City and department standards against which the developers' performance was evaluated
- Documentation to show if the developer complied with all contract requirements and City and department standards
- Documentation of non-compliance and assistance provided by the monitoring department to achieve compliance
- Documentation of the methodology used by the monitoring department to verify whether developers' requests for reimbursement of construction expenses are accurate, reasonable, and supported by relevant and sufficient documentation, such as contractor/supplier invoices.
- Approvals and denials of developers' requests for reimbursement

**Source:** *Texas Statewide Contract Management Guide*, Texas Comptroller of Public Accounts; *2015 Nebraska Affordable Housing Program*, Nebraska Department of Economic Development – Housing and Community Development Division; *Best Practices in Government: Components of an Effective Contract Monitoring System*, Georgia State Auditor, July 2003, *Texas Housing Impact Fund Policy and Guidelines*, Texas State Affordable Housing Corporation.

In addition, none of the HOU approvals of developer requests for reimbursement included any documentation to show the methodology HOU used to verify the accuracy and reasonableness of the expenses claimed by the developers. Currently, HOU relies on the percentage of a Project completion document that is prepared by the developers' architects to support requests for reimbursement without contractor/supplier invoices and/or periodic verification of the developers' actual expenses as allowed by the financial assistance contracts.

City Code Section 39C-11 (2) Duties and Responsibilities of Department Directors requires that directors *“adequately document the transaction of government business and the policies, services, programs, functions, activities, and duties for which the department director and department staff are responsible.”*

According to the Green Book, documentation is required for the effective design, implementation, and operating effectiveness of an entity's internal control system. The Green Book includes minimum documentation requirements as follows:

- Management develops and maintains documentation of its internal control system
- Management documents in policies the internal control responsibilities of the organization
- Management evaluates and documents the results of ongoing monitoring and separate evaluations to identify internal control issues
- Management evaluates and documents internal control issues and determines appropriate corrective actions for internal control deficiencies on a timely basis
- Management completes and documents corrective actions to remediate internal control deficiencies on a timely basis

We recommend the Director of HOU:

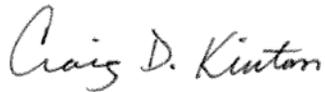
- I. Develop and implement formal (written, approved, and dated) policies and procedures for the following processes:
  - Preparation and posting of the NOFA which is the solicitation to prospective developers for new Projects
  - Evaluation of the developers' responses to the NOFA
  - Selection of qualified developers who propose the most beneficial Projects
  - Underwriting the selected Projects
  - Monitoring the Projects
- II. Develop, implement, and retain complete and consistent documentation for the following processes:
  - Preparation and posting of the NOFA which is the solicitation to prospective developers for Projects
  - Evaluation of the developers' responses to the NOFA
  - Selection of qualified developers who propose the most beneficial Projects

- Underwriting the selected Projects
- Monitoring the Projects

Please see Attachment III for management's response to the recommendations made in this report.

We would like to acknowledge management's cooperation during this audit. If you have any questions or need additional information, please contact me at 214-670-3222 or Carol Smith, First Assistant City Auditor, at 214-670-4517.

Sincerely,



Craig D. Kinton  
City Auditor

#### Attachments

C: A. C. Gonzalez, City Manager  
Alan E. Sims, Chief of Neighborhood Plus  
Bernadette Mitchell, Director – HOU  
Cynthia Rogers-Ellickson, Interim Assistant Director – HOU

**ATTACHMENT I**

**Background**

**Gap Financing**  
 Funds that are used to fill the financing gap between the projected total development cost of the project and other available funding sources.  
 Source: HOU

The Development Division of the Department of Housing/Community Services (HOU) provides financial assistance (sometimes referred to as gap financing) to developers of new single-family and multi-family affordable housing development projects (Projects). The HOU is responsible for the: (1) preparation and posting of the Notice of Funding Availability (NOFA) which is the solicitation to prospective developers; (2) evaluation (scoring) of the developers' responses to the NOFA; (3) selection of qualified developers who propose the most beneficial Projects for the City of Dallas (City); (4) underwriting the selected Projects; and, (5) monitoring the Projects.

During Fiscal Years (FY) 2012 through FY 2014, developers received \$29.9 million in HOU financial assistance to complete a total of 54 Projects that produced 482 affordable single-family and multi-family units (see Table I below). The \$29.9 million was provided from the following funding sources: (1) General Obligation bonds; (2) Community Development Block Grant (CDBG); (3) HOME Investment Partnerships Program (HOME); and, (4) the Neighborhood Stabilization Program (NSP).

**Table I**

**The HOU Loan Agreements (Financial Assistance Contracts) by Fiscal Year and the Associated Projects Completed and Units Produced**

<b>Fiscal Year</b>	<b>HOU Financial Assistance Contracts</b>	<b>Projects Completed</b>	<b>Single/Multi-Family Units Produced</b>
2012	\$ 4,245,730	15	153
2013	13,733,752	25	145
2014	11,899,963	14	184
<b>Totals</b>	<b>\$ 29,879,445</b>	<b>54</b>	<b>482</b>

Source: HOU

Statutory and City Bond Covenant Requirements for Affordable Housing

The Code of Federal Regulations Title 24, *Housing and Urban Development*, prescribes eligibility and compliance requirements for affordable housing developments funded by the United States Department of Housing and Urban Development (HUD). The City's General Obligation bond covenants prescribe the eligibility requirements for City funded Projects.

**The HOU Contract Monitoring Practices**

The HOU applies the same monitoring practices to both federally-funded and City funded Projects.

After the developer is selected and HOU has received the City Council's approval to fund the Projects, HOU is responsible for monitoring the developers' compliance with contract requirements. These monitoring responsibilities are divided between HOU Project Coordinators and Inspectors. The HOU Project Coordinators are required to:

- Prepare contract documents
- Provide guidance and work with the developer to resolve issues arising during the contract period
- Prepare weekly status reports for assigned Projects

Depending upon their area of expertise, HOU Inspectors are required to monitor the developers' compliance with:

- Contract specifications and construction progress
- Environmental requirements
- Wage requirements under the Federal Davis-Bacon and Related Acts

The HOU Contract Coordinators and Inspectors also approve developer requests for reimbursement of construction expenses prior to the final approval by the Division Manager.

**Office of Financial Services' Monitoring Responsibilities**

The Grants Compliance Group (GCG) of the Office of Financial Services (OFS) is primarily responsible for monitoring HOU contracts supported by HUD. The GCG monitors five sources of funding pertaining to HOU contracts: (1) CDBG; (2) HOME; (3) Emergency Solutions Grant (ESG); (4) Housing Opportunities for Persons with AIDS (HOPWA); and, (5) Section 108 Loan Guarantees. Based on a risk assessment, the GCG monitors to ensure that the contracts are administered efficiently, effectively, and in compliance with applicable laws. The GCG documents its results in monitoring reports with recommendations to the City Departments responsible for administering the contracts. This audit focused on HOU's monitoring responsibilities rather than GCG's monitoring responsibilities.

## ATTACHMENT II

### Common Industry Best Practices For Affordable Housing Development

The following Best Practices for Affordable Housing Development were obtained from the following sources: (1) *Texas Statewide Contract Management Guide*, Texas Comptroller of Public Accounts; (2) *2015 Nebraska Affordable Housing Program*, Nebraska Department of Economic Development – Housing and Community Development Division; (3) *Best Practices in Government: Components of an Effective Contract Monitoring System*, Georgia State Auditor, July 2003; (4) *Texas Housing Impact Fund Policy and Guidelines*, Texas State Affordable Housing Corporation (TSAHC); (5) *2015 Multifamily Tax-Exempt Bond Programs Policies and Request for Proposal*, (TSAHC); (6) *2016 Multifamily Direct Loan Notice of Funding Availability*, Texas Department of Housing and Community Affairs (TDHCA); (7) *Developing an Economic Development Incentive Policy*, October 2008, Government Finance Officers Association; (8) *Underwriting and Loan Policy*, TDHCA; and, (9) *2012 Fraud Examiners Manual – Contract and Procurement Fraud*, Association of Certified Fraud Examiners.

#### **Solicitation, Evaluation (Scoring), and Selection of Development Proposals**

To ensure fairness and transparency in the solicitation, evaluation (scoring), and selection of development proposals, related policies and procedures should include the following practices:

- Development of specifications and a formal, repeatable methodology for consistent solicitations that include definitions of:
  - Award criteria
  - Eligible and ineligible activities, applicants, and proposals
  - Minimum requirements, for example:
    - Minimum development and construction experience requirement
    - Minimum percent of proposed affordable units requirement
    - Legislative compliance requirements
    - Environmental requirements
    - Requirement that developments may not cause displacement of current residents

- Aggregate exposure limit; for example, \$1 million to a single borrower or a group of related entities
- Maximum subsidy per unit
- Minimum square footage per unit
- Minimum quality of amenities, construction materials, and appliances
- Award priorities, preferences, and target needs, such as:
  - Geographic locations
  - Transportation hubs
  - Developments with highest community support
  - Public Benefit
- Promotional interest rates for meeting target needs
- Application process, timeline, and deadlines
- Development of criteria, scoring matrix, and methodology for proposal evaluation and scoring
- Development of criteria and qualifications for a review committee formation
- Documented process for conducting applicant background checks
- Definition of tie breakers
- Public hearings and meetings

### **Underwriting of Affordable Housing Development Proposals**

To ensure fairness and the best return on the City's investment, underwriting policies and procedures should include evaluation of proposals against the following financial feasibility standards:

- Loan to Value Ratio maximum
- Sales and Income projections minimums
- Debt Coverage Ratio minimum

- Vacancy rate minimum
- Expense ratio limit
- Repayment sources availability
- Reserve requirements for rental developments:
  - Escrows for taxes and insurance
  - Replacement reserves for new construction
  - Operating Reserves

**Contract Monitoring**

To ensure developers' compliance with contract terms and with City and department standards, contract monitoring should include the following practices:

- Development and enforcement of timeliness, cost, and quality standards for a completed project and for each stage of the project
- Contract definition and clear communication to developers of performance measures, standards, expectations, and deadlines for the completion of tasks and submittal of deliverables
- Enforcement of compliance with legislative requirements, timeliness, cost, and quality standards as a condition for the reimbursement of construction costs incurred by the developers
- Development and use of consistent monitoring activities to compare actual performance against the adopted standards, such as:
  - Post-award meetings should be held to reiterate the developers' understanding of what is required and essential
  - Off-site "desk" reviews of performance reports submitted by developers' should be performed to determine compliance with contract requirements
  - Site visits should assess the developers' performance versus scheduled or reported performance and should result in site monitoring reports detailing the findings
  - Inspection checklists should be based on specific inspection methodology and should be used to compare actual results against contract requirements

- Monitoring reports should include the following information:
  - Areas reviewed, files and areas inspected, and who conducted the inspection
  - Explanations for disputes and delays in delivery
  - Results (status) and the conclusion reached by the reviewer
  - Performance discrepancies noted and follow-up
  - Incentives and consequences used to obtain optimal performance
- Development and use of consistent methodology for the verification of the accuracy and reasonableness of developers' requests for reimbursement of construction expenses:
  - Actual expenditures should be compared to the approved budget
  - Expenditure reimbursement rates and completed work should match what is allowed by the contract
  - Relevant documents should adequately support each request for payment
  - Invoices should be reviewed to ensure that developers' billing coincides with contract progress
  - Payment should be withheld pending satisfaction with the project progress

Management's Response

Memorandum

RECEIVED

MAR 18 2016

City Auditor's  
Office



CITY OF DALLAS

DATE: March 18, 2016  
TO: Craig D. Kinton, City Auditor  
SUBJECT: Response to Audit Report:  
Audit of the Department of Housing/Community Services' Contract Monitoring

Our responses to the audit report recommendations are as follows:

Recommendation I

We recommend the Director of HOU develop and implement formal (written, approved, and dated) policies and procedures for the following processes:

- Preparation and posting of the NOFA which is the solicitation to prospective developers for new Projects
- Evaluation of the developers' responses to the NOFA
- Selection of qualified developers who propose the most beneficial Projects
- Underwriting the selected Projects
- Monitoring the Projects

Management Response / Corrective Action Plan

Agree  Disagree

The Director of Housing agrees with Recommendation I: to develop and implement formal (written, approved, and dated) policies and procedures.

The Department has already started researching various written and implemented policies and procedures from authoritative sources, i.e. HUD, Texas contract management manual. The Department will collect sample formats for the structure of the policy and procedure documents and select a format. Target completion date by September 30, 2016. During the 2<sup>nd</sup> Quarter of FY 2016-17, the Department will have a written 1<sup>st</sup> draft of the policies and procedures. Target completion date by April 31, 2017. During the 4<sup>th</sup> Quarter of FY 2016-17, the Department will implement and begin testing the new policies and procedures and make revisions as necessary. Once the adjustments are finished, monitoring will begin. Testing and monitoring will continue through implementation date.

"Dallas, the City that Works: Diverse, Vibrant and Progressive."

**Implementation Date**  
June 30, 2018

**Responsible Manager**  
Development Manager III

**Recommendation II**

We recommend the Director of HOU develop, implement, and retain complete and consistent documentation for the following processes:

- Preparation and posting of the NOFA which is the solicitation to prospective developers for Projects
- Evaluation of the developers' responses to the NOFA
- Selection of qualified developers who propose the most beneficial Projects
- Underwriting the selected Projects
- Monitoring the Projects

**Management Response / Corrective Action Plan**

Agree  Disagree

The Director of Housing agrees with Recommendation II: to develop and implement formal (written, approved, and dated) policies and procedures.

Following are the Intermediate target dates:

The Department has already started researching various written and implemented policies and procedures from authoritative sources, i.e. HUD, Texas contract management manual. The Department will collect sample formats for the structure of the policy and procedure documents and select a format. Included in the policies and procedures will be details on the development, implementation, and retainage of consistent documentation for the files. Target completion date by September 30, 2016. During the 2<sup>nd</sup> Quarter of FY 2016-17, the Department will have a written 1<sup>st</sup> draft of the policies and procedures. Target completion date by April 31, 2017. During the 4<sup>th</sup> Quarter of FY 2016-17, the Department will implement and begin testing the new policies and procedures and make revisions as necessary. Once the adjustments are finished, monitoring will begin. Testing and monitoring will continue through implementation date.

**Implementation Date**  
June 30, 2018

**Responsible Manager**  
Development Manager III

Sincerely,

*for Patrick S. Syabu*  
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Bernadette Mitchell, Director  
Department of Housing/Community Services

*Alan E. Sims*  
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Alan E. Sims  
Chief of Neighborhood Plus