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California Housing and Community Development Should Improve Its Fraud Risk Management Practices for Its ESG CARES Act Program

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Subject: The California Department of Housing and Community Development Should Improve Its Fraud Risk Management Practices for Its ESG CARES Act Program

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our audit of fraud risk management practices at the California Department of Housing and Community Development's Emergency Solutions Grants (ESG) Coronavirus Aid, Relief, and Economic Security (CARES) Act program.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, as amended, requires that OIG post its reports on the OIG website. Accordingly, this report will be posted at https://www.hudoig.gov.

If you have any questions or comments about this report, please do not hesitate to call Tanya Schulze, Audit Director, Grants Management Audit Division, at (213) 534-2471.

Highlights

The California Department of Housing and Community Development Should Improve Its Fraud Risk Management Practices for Its ESG CARES Act Program | 2024-LA-1001

What We Audited and Why

We audited the California Department of Housing and Community Development (HCD) with the objective of evaluating HCD's fraud risk management practices for its Emergency Solutions Grants Coronavirus Aid, Relief, and Economic Security Act (ESG CARES Act) program and assessing the maturity of its efforts to prevent, detect, and respond to fraud. Fraudulent activity in the ESG CARES Act program can lead to significant financial losses, reputational damage to the grantee and the U.S. Department of Housing and Urban Development (HUD), breach of fiduciary duty, and most importantly, loss of funding assistance to intended beneficiaries. A robust antifraud program will help ensure that pandemic grant funds are put toward their intended uses, funds are spent effectively, and assets are safeguarded.

Congress provided $4 billion for the ESG CARES Act program, which represented a 1,379 percent increase to the regular 2020 annual ESG appropriation. Given the influx of funding, we initiated a series of audits examining ESG CARES Act grantees' fraud risk management practices and evaluating whether selected ESG CARES Act grantees are adequately prepared to prevent, detect, and respond to fraud. HCD was selected because it was authorized more than $319.5 million in ESG CARES Act program funds, a 2,505 percent funding increase from its formula ESG allocation for fiscal year 2020.

What We Found

HCD was not adequately prepared to prevent, detect, and respond to fraud due to the lack of focus it placed on fraud risks and establishing a robust fraud risk management framework. Although HCD established a departmentwide enterprise risk management (ERM) framework, it was not robust enough to proactively identify fraud risks, and it was not developed with leading industry standards and best practices.[1] This deficiency resulted in the lowest desired maturity goal state – ad hoc – for the organization's antifraud initiatives. HCD noted that it had limited resources to implement additional fraud risk measures. Further, HCD believed that it was not necessary to create a separate fraud risk management framework or build upon its existing ERM framework to incorporate fraud risk management practices.

HCD's management is responsible for managing fraud risk, including assessing the potential of fraud, and designing and implementing strategies to mitigate fraud risks. Because it placed little emphasis on identifying fraud risks under its ERM framework and did not improve its antifraud practices to rise to a higher fraud risk management maturity level, it put more than $319.5 million in ESG CARES Act funds at an increased risk of fraud. Although a well-designed fraud risk management framework is not infallible

[1] Chief Financial Officers Council's Antifraud Playbook; the U.S. Government Accountability Office's (GAO) Standards for Internal Control in the Federal Government, also known as the Green Book; and GAO's A Framework for Managing Fraud Risks in Federal Programs

regarding fraud and risks of fraud, it is a powerful tool that can enhance management decision making, strengthen HCD's reputation, and reinforce its commitment to safeguard HUD funding with regulators and the public.

What We Recommend

We recommend that HUD instruct HCD to (1) establish a separate fraud risk management framework or evaluate and build upon its ERM framework by incorporating fraud risk management practices and (2) obtain training or technical assistance on the implementation of fraud risk management practices.

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Background and Objective

On March 11, 2020, the World Health Organization characterized the outbreak of the coronavirus disease 2019 (COVID-19) as a pandemic. In response, Congress provided $4 billion in the Coronavirus Aid, Relief, and Economic Security (CARES) Act for the Emergency Solutions Grants (ESG) program to use to "prevent, prepare for, and respond to coronavirus, among individuals and families who are homeless or receiving homeless assistance and to support additional homeless assistance and homelessness prevention activities to mitigate the impacts created by coronavirus" in two rounds of funding, as follows:

- Round 1: $1 billion allocated under the ESG formula to grant recipients.
- Round 2: $2.96 billion allocated under a formula targeted toward communities with a high incidence of sheltered and unsheltered homeless and those at most risk for homelessness.

HUD moved quickly to make COVID-19 relief funding available to communities across the Nation. Between 2020 and 2022, HUD awarded the California Department of Housing and Community Development (HCD) more than $319.5 million in ESG CARES Act funds in three separate allocations, as shown in table 1. This award represents a 2,505 percent funding increase from its annual formula ESG grant allocation.

Table 1: ESG CARES Act funding allocated to HCD between 2020 and 2022 (as of December 11, 2023)

ESG CARES Act Allocations	Grant agreement award date	Allocation amount	Total disbursed	Balance	Expenditure deadline
ESG-CARES Act 1	June 25, 2020	$43,990,603	$43,990,603	-	September 30, 2023
ESG-CARES Act2	November 25, 2020	271,730,986	259,182,437	$12,548,549	September 30, 2023
Reallocation	September 22, 2022	3,818,845	-	3,818,845	June 30, 2024
Total		**319,540,434**	**303,173,040**	**16,367,394**	

California Department of Housing and Community Development

HCD is a department within the California Business, Consumer Services, and Housing Agency (BCSH) of the State of California. HCD awards loans and grants to public and private housing developers, nonprofit agencies, cities, counties, and State and Federal partners.[2] The Division of Financial Assistance (DFA), an operational division within HCD, is responsible for administering approximately 15 programs, both State and Federal. In February 2021, DFA split into two distinct divisions (State and Federal financial assistance divisions) due to HCD's continued increase in funding to address housing and homelessness. The Division

[2] In addition to ESG CARES Act, HUD provided pandemic funds to HCD, including $150.6 million in CDBG CARES Act funds and $155 million in HOME Investment Partnerships program American Rescue Plan funds.

of Federal Financial Assistance (DFFA) administers funding primarily from the U.S. Department of the Treasury and HUD,[3] including the ESG CARES Act grant program.

Fraud Risk Management

Fraud involves obtaining something of value through willful misrepresentation, while fraud risk is the vulnerability within an entity's processes and controls that could be exploited to obtain something of value through willful misrepresentation.

The COVID-19 pandemic significantly changed the operating landscape of Federal, State, and local governments. The substantial increase in funding associated with the pandemic relief funds also increased opportunities for fraud, as the overall ESG CARES Act funding was 14 times the regular 2020 ESG annual allocation. As a result, entities must react proactively through improving or revamping their processes, internal controls, and overall governance structure to keep pace. Building, designing, and implementing a robust fraud risk management framework will aid in mitigating risks and decreasing the likelihood of fraud. Effectively managing fraud risk helps to ensure that grant funds are put toward their intended uses, funds are spent effectively, and assets are safeguarded.

In October 2018, the U.S. Chief Financial Officers Council and the U.S. Department of the Treasury, Bureau of the Financial Officers Council, developed Program Integrity: The Antifraud Playbook (Antifraud Playbook) for use by the entire financial management community, including Federal, State, and local agencies. It helps to clarify and operationalize the concepts put forward in other guidance, including the U.S. Government Accountability Office's (GAO) Standards for Internal Control in the Federal Government (Green Book), GAO's A Framework for Managing Fraud Risks in Federal Programs[4] (Framework), and other guidance, such as the Office of Management and Budget (OMB) circulars. The Antifraud Playbook contains a maturity model designed to help agencies assess and identify the current state and goal state of their antifraud program and related efforts. The maturity model includes four progressive levels of fraud risk maturity, which are defined below from the lowest to highest desired goal state.

- Ad hoc – Fraud risk management processes are disorganized, even chaotic, and antifraud efforts are undocumented and in a state of dynamic change, tending to be driven in an ad hoc, uncontrolled, and reactive manner.
- Initial – The agency is aware of the need for a more formal fraud risk management approach, and repeatable processes have been developed. Risks are still managed largely in a reactive way.
- Operational – Fraud risk management activities across the organization are aligned with controls, and information on fraud risks is aggregated and analyzed and is easily available to the necessary individuals.
- Leadership – The agency's focus is on continually improving fraud risk management through both incremental and innovative changes and improvements. Risks are managed largely in a proactive way.

[3] 2021 Leadership Accountability Report, December 21, 2021
[4] GAO-15-593SP, A Framework for Managing Fraud Risks in Federal Programs, issued July 2015

Further, the Antifraud Playbook organizes fraud risk management into the following four phases: (1) create a culture, (2) identify and assess, (3) prevent and detect, and (4) insight into action.

On September 10, 2014, GAO updated the Green Book, which sets internal control standards for Federal entities and may be adopted by State, local, and quasi-governmental entities.[5] It provides managers with criteria for designing, implementing, and operating an effective internal control system by defining the standards through each of the 5 components and 17 principles. While all principles are important for creating an internal control environment that is conducive to preventing and detecting fraud, principle 8 provides specific guidance related to assessing fraud risks.

According to GAO's Green Book and the Committee of Sponsoring Organizations' (COSO) Internal Control-Integrated Framework,[6] assessing the risk of fraud is one of many principles for establishing an effective internal control system. In addition, due to the importance of this principle, both organizations have published their own fraud risk management guides with the intention to support organizations in meeting this principle. GAO and COSO make it clear that for a system of internal control to be effective, each of the principles, including "assessing the risk of fraud," must be present, functioning, and operating together in an integrated manner.

GAO's framework states, "…[f]raud poses a significant risk to the integrity of federal programs and erodes public trust in government." The primary audience of the Framework is managers in the U.S. Federal Government, but the leading practices and concepts described in the Framework may also be applicable to State, local, and foreign government agencies, as well as nonprofit entities that are responsible for fraud risk management. The Framework identifies leading practices; encompasses control activities to prevent, detect, and respond to fraud; and identifies four components – (1) commit, (2) assess, (3) design and implement, and (4) evaluate and adapt – for effectively managing fraud risks.

HUD Fraud Risk Management

HUD is responsible for designing its programs such that there are sufficient controls to support robust fraud risk management practices. The Payment Integrity Information Act of 2019, and implementing guidance from OMB[7], require HUD to establish financial and administrative controls to identify and assess fraud risks. OMB circular A-123 specifically requires that Departments like HUD incorporate leading practices from GAO's Green Book as well as the Fraud Risk Framework. In turn, HUD policy implementing OMB A-123 guidance says that HUD managers have the responsibility to design, implement, and operate processes with embedded internal controls that mitigate the risk of fraud, waste, and abuse in HUD

[5] According to 2 CFR (Code of Federal Regulations) 200.303, the non-Federal entity must establish and maintain effective internal control over the Federal award, which provides reasonable assurance that the non-Federal entity is managing the Federal award in compliance with Federal statutes, regulations, and terms and conditions of the Federal award. These internal controls should comply with guidance in Standards for Internal Control in the Federal Government, issued by the Comptroller General of the United States, or the Internal Control Integrated Framework, issued by COSO.

[6] The State of California adopted the Green Book as its framework. COSO developed an Internal Control Integrated Framework and a Fraud Risk Management Guide; however, since the State did not adopt COSO, it does not specifically apply to our review.

[7] Departmental Fraud Risk Management Policy (2022.1), effective date March 31, 2022

programs. It also says that "to determine the effectiveness of fraud risk management activities, HUD program and support managers will routinely evaluate existing fraud risk controls."

HUD OIG's October 2021 audit, "Fraud Risk Inventory for the CDBG and ESG CARES Act Funds", noted several opportunities for HUD to improve its fraud risk management practices in its ESG CARES Act program. The audit report noted that the Office of Community Planning and Development (CPD) did have existing controls that could detect fraud, such as monitoring reviews, but that they could be improved through the implementation of a fraud risk checklist or other instrument during CPD's monitoring activities. Importantly, as stated in the audit report, HUD expects its grantees to be proactive in the identification and remediation of fraud, and that the responsibility for the assessment and mitigation of fraud risks rested primarily with the grantees.

HCD's Enterprise Risk Management Framework

HCD established an enterprise risk management (ERM) framework in 2019 to manage its organizational risks and further its strategic goals and objectives. The ERM framework has five interrelated components: (1) governance and culture; (2) strategy and objective setting; (3) performance; (4) review and revision; and (5) information, communication, and reporting, which generally correspond to the components of the Green Book, the Framework, and the Antifraud Playbook.

HCD's ERM framework was designed using a bottom-up approach, in which the various divisions under HCD's oversight are responsible for creating and maintaining internal controls over their respective processes. The divisions are also responsible for identifying risks and relaying them to the ERM office. Through the upward chain of command, risks are vertically elevated to HCD's Executive Risk Oversight Committee (EROC) to assist with decisions on how to respond to significant risks. The entire process is outlined in the ERM Plan, which details the five stages to properly manage HCD's risks, including

- Identify: The divisions identify all risks that must be managed, record them on the divisional risk registers, and report significant risks to the ERM office. Working in tandem with the divisions, the ERM office will include risks resulting from internal audits performed by HCD's Audit and Evaluations branch and risks from any external audits to the divisional risk registers and the Enterprise Risk Report (ERR).
- Assess: The ERM office will conduct a risk assessment and will collaborate with the divisions to evaluate the risks and determine risk probability and impact. Risks are scored and prioritized.
- Respond: After evaluating the risks' probability and potential impact, a plan is developed to address the risks. The ERM office will also collaborate with the divisions to determine the response to the risks.
- Monitor: The ERM office, with the assistance of the division, will review the risk registers, monitor the risks, and elevate the more significant risks and responses to the ERR.
- Report: The ERM office will provide quarterly ERRs to the EROC to aid in responding to significant risks. In addition, every 2 years, the ERM office will complete the State Leadership Accountability Act report on the adequacy of the department's systems of internal control and monitoring practices. The report will identify all inadequacies or weaknesses in the department's systems of internal control, which will also be added to the ERR and evaluated in the same manner as the other risks.

Our objective was to assess HCD's fraud risk management practices for preventing, detecting, and responding to fraud when administering the ESG CARES Act program.

Results of Audit

HCD's Fraud Risk Management Practices Should Be Improved for Its ESG CARES Act Program

While HCD had put an ERM framework into place,[8] it was not adequately prepared to prevent, detect, and respond to fraud risks within its ESG CARES Act program. Specifically, HCD (1) had not established a dedicated antifraud component to design and oversee fraud risk management activities, (2) had not performed a fraud risk assessment or developed a process to regularly conduct such assessments, (3) had not developed a response plan to identify fraud risks or address potential fraud swiftly, (4) did not have a process to evaluate the effectiveness of fraud risk management activities, and (5) did not have plans for engineering a separate fraud risk management framework or enhancing its ERM. This deficiency was largely due to the lack of focus it placed on fraud risks and the little emphasis it placed on establishing a robust fraud risk management framework, resulting in the lowest maturity level, ad hoc, for each of the four phases of the framework. According to HCD's management, making a change such as this was unwarranted because HUD does not require implementation of a fraud risk management framework and no event precipitated the need to build upon its ERM to incorporate fraud risk management practices.[9] However, the goal of establishing a robust fraud risk management framework and antifraud activities is to prevent fraud and potential fraud from occurring. HCD could be better positioned to manage fraud risk in the ESG CARES Act program, as well as in other HUD and Federal Government funding it receives, and to safeguard more than $319.5 million in HUD ESG CARES Act funds.

HCD's Fraud Risk Management Practices Were Inadequate, and Antifraud Efforts Should Be Improved

We assessed HCD's fraud risk management practices, using the Antifraud Playbook, the Green Book, and the Framework, and determined that its practices were inadequate and should be improved. Based on our assessment, HCD's overall fraud risk management practices were at the lowest desired state of maturity, and opportunities existed to improve antifraud efforts to better identify and protect against fraud. Our assessment of HCD's maturity level is organized in terms of the Antifraud Playbook's four phases, which integrate with the Green Book's five components of internal controls and the Framework's four components of managing fraud risks. (See the Background and Objective section.)

Phase 1 – create a culture maturity level: HCD did not adequately build a governance structure and develop an antifraud-aware culture or establish an antifraud tone at the top.

HCD's overall tone at the top sets the standard regarding its tolerance of fraud.

- The Antifraud Playbook encourages agencies to build a structure and develop a fraud-aware culture.
- The Green Book discusses the creation of an oversight body with the responsibility to oversee the department's internal control system. Further, management uses established standards of

[8] We did not evaluate the overall effectiveness of HCD's ERM framework. Our review was limited to assessing fraud risk management practices within the framework.

[9] According to HUD, its monitoring was not designed to evaluate the grantees' fraud risk management framework; therefore, HUD would not have been able to cite them for a violation of their fraud risk management framework. HUD monitored fraud risk based on reviewing policies and procedures.

conduct as the basis for evaluating adherence to integrity and ethical values across all levels of the department.

- The Framework provides that management should create a structure with a dedicated entity to lead fraud risk activities. The antifraud entity serves as the repository of knowledge on fraud risks and controls, manages fraud risk-assessment processes, leads or assists with training and other fraud-awareness activities, and coordinates antifraud initiatives across the program.

Our assessment of HCD's maturity within this phase was at the "ad hoc" maturity level because it had not established a sufficient antifraud governance structure or culture.

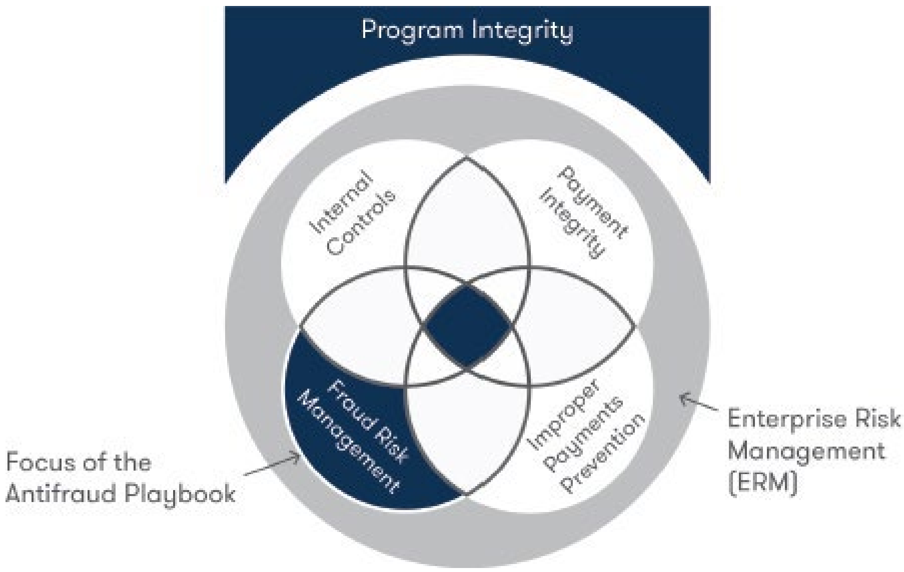
HCD had not established an antifraud tone at the top that aligned with the Antifraud Playbook, the Green Book, and the Framework. Specifically, it had not engineered a separate fraud risk management framework, had no immediate plans to build upon its ERM framework[10] to strengthen its fraud risk management practices, and had not designated a component or individual to design and oversee its fraud risk management activities. The only oversight body HCD had was its newly created EROC, but it was not a dedicated antifraud committee dealing with fraud matters.

According to the Antifraud Playbook, fraud risk management is a part of an ERM framework (see Visual 1.). However, the objectives of each are distinct and separate:

- ERM aims to integrate the culture, capabilities, and practices of an organization with strategy-setting, with a purpose of managing risk in creating, preserving, and realizing value.[11]
- Fraud risk management ensures program integrity by continuously and strategically mitigating the likelihood and impact of fraud. [12]

Despite these discrete differences, both share some commonalities that facilitate a streamlined integration of the two frameworks.

Visual 1:



[10] See the Background and Objective section for a description of HCD's ERM.
[11] COSO, Enterprise Risk Management, Integrating with Strategy and Performance, June 2017
[12] GAO-15-593SP, A Framework for Managing Fraud Risks in Federal Programs, issued July 2015

HCD stated that no event precipitated the need to develop a separate fraud risk management framework or to build upon its current ERM framework to incorporate assessing fraud-specific risks. HCD further stated that HUD, as its partner in administering the ESG CARES Act program and regulatory agency, did not notify it of a violation and did not require that it establish a fraud risk management framework.[13] HCD and DFFA, the division within HCD that administers the ESG CARES Act program, cited additional factors for not implementing a fraud risk management framework, including (1) the lack of resources and capacity, (2) the unexpected occurrence of the pandemic and the rapid deployment of funds,[14] (3) the fact that DFFA is a relatively new division, and (4) the speed at which it developed and implemented its ERM framework.

Although HCD had a functioning ERM framework in place, it fell short in identifying, assessing, responding to, and mitigating fraud risks in the ESG CARES Act program. The focus of HCD's ERM framework is not on managing fraud risk, but rather, on managing a broad spectrum of risks that are cross-divisional in nature and impacts the entire department. For example:

- Financial: The risk of monetary loss to HCD.
- Operational: The risk of loss resulting from inadequate or failed procedures, systems, or policies. An event that disrupts business processes.
- Reputational: The risk of loss resulting from damages to an organization's reputation, consequent to an adverse event, even if HCD is not responsible.
- Compliance: The risk of failing to act in accordance with state or federal laws and regulations, internal policies, or prescribed best practices.
- Security: The potential for loss of an asset because of a threat exploiting a security vulnerability. A breach of an organization's physical or data security.
- Political: The risk of loss resulting from a certain political climate, consequent to an adverse event to stakeholders, even if HCD is not responsible.

Therefore, HCD's ERM framework is not suitable to be solely relied on to mitigate the likelihood and impact of fraud.

Phase 2 – identify and assess maturity level: HCD did not sufficiently identify fraud risks or consider fraud risk factors, perform a fraud risk assessment, or develop a process to regularly conduct fraud assessments.

HCD is required to assess fraud risks as part of its internal control activities.

- The Antifraud Playbook encourages agencies to identify fraud risks and develop a path forward for executing, repeating, and expanding a fraud risk assessment that is unique and customizable for the agency.
- The Green Book states that management identifies risks throughout the entity and that risk assessment is the identification and analysis of risks. Further, management uses the fraud risk factors to identify fraud risks. As part of analyzing fraud risk, management also assesses the risk

[13] According to the CPD field office representative that covers HCD, HUD's monitoring was not designed to evaluate the grantees' fraud risk management framework; therefore, HUD would not have been able to cite them for a violation of their fraud risk management framework.

[14] State of California Auditor's Office, Report 2020-611 (ca.gov), concluded that HCD failed to expedite access to Federal funding to address the impact of the COVID-19 pandemic on the homeless population.

of management override of controls. The oversight body oversees management's assessments of fraud risk and the risk of management override of controls so that they are appropriate. The Green Book also states that allegations of fraud or suspected fraud reported by the Office of Inspector General or internal auditors, personnel, or external parties that interact with the entity may be used to identify fraud risks.

- The Framework describes management plan regular fraud risk assessments that are tailored to the program, identify inherent fraud risks, assess the likelihood and impact of inherent fraud risks, determine fraud risk tolerance, and document the program's fraud risk profile.

Our assessment of HCD's maturity within this phase was at the "ad hoc" maturity level because its ERM process did not sufficiently consider fraud risks and lack of reporting on fraud risks as part of State requirements for fraud reporting.

ERM process. Under its ERM framework, HCD had a working process to identify risks and regularly conduct risk assessments. However, such risk assessments were not specific to fraud. Therefore, its process was inadequate in assisting HCD in analyzing and mitigating fraud risks. HCD officials in the ERM office, the Audit and Evaluations branch, and DFFA confirmed that they had not performed fraud-specific risk assessments. Therefore, they had not developed a process to plan and regularly conduct fraud risk assessments, determined HCD's risk tolerance, examined the suitability of existing controls, prioritized residual risks, or assessed risks to determine a fraud risk profile.

According to the ERM Plan, the ERM office will review all audits, internal and external, for ongoing risks to HCD and determine whether any risks identified should be added to the risk registers. The ERM office[15] did not include any ESG CARES Act program-related fraud risks on DFFA's 2020 through 2023 risk registers. However, on October 12, 2021, we issued an audit identifying the following risk factors that contribute to the risk of fraud for the ESG CARES Act funds:

- increase funding and volume of payments,
- pandemic environment,
- CARES Act provisions,
- decentralized processes, and
- self-certification.

The ERM office missed the opportunity to conduct a fraud risk assessment or reduce current and potential risks of fraud within its programs, specifically the ESG CARES Act program. The Audit and Evaluations branch stated that it had not conducted a fraud risk assessment because a fraud review was inherently built into its audits of various programs and it considered fraud risk assessments to be an executive leader function.

Despite lacking the capacity to administer its grant funds[16] and receiving a 2,505 percent funding increase from its formula ESG allocation in a short time, DFFA did not identify or record significant fraud risks on its 2020 through 2023 ERM risk registers to reflect the existence of fraud risks regarding its ESG CARES Act funds. It also did not modify this view after becoming aware of

[15] The enterprise risk officer, who was responsible for reviewing external reports, no longer worked at HCD when we began our audit, and the current enterprise risk officer had not yet reviewed risks from external audits.

[16] State of California Auditor's Office, Report 2020-611, Report 2020-611 (ca.gov). HCD improved capacity by engaging a consultant to provide grant administration support and training.

suspected fraud in its ESG CARES Act program on March 2, 2022.[17] DFFA did not include the risk(s) in its risk registers after being notified because it believed that anything in writing regarding fraud could become a publicity risk[18] and that the risk was mitigated; specifically, (1) the subrecipient was insured for losses, and HCD's risk of loss was low; (2) the funds could be recaptured as part of a subsequent pay request; and (3) DFFA believed that this was a "one-off" situation. However, the occurrence of fraud or suspected fraud indicated that fraud risk existed in the ESG CARES Act program; therefore, this risk should have been included in the risk registers. DFFA had a process through which the risk could have been identified and logged. However, it unilaterally decided that this risk did not rise to a sufficient level to be included in the ERM risk registers. Effectively, by omission, DFFA eliminated the benefit its ERM process could have had on identifying and assessing this risk. DFFA officials explained that the risk assessment process was not the only way for fraud to be identified and that fraud was addressed in the design and implementation of its ESG CARES Act program system.

<u>State requirements for fraud reporting.</u> The State of California requires State agencies, such as HCD, to report fraud, suspected fraud, or errors to heighten awareness of the potential breakdown of the control activities that serve to protect State assets. It also enacted the State Leadership Accountability Act to minimize fraud, errors, and waste of government funds and strengthen internal controls. Biennially, each agency head conducts an internal review and prepares a Leadership Accountability Report to identify all inadequacies and weaknesses in the system of internal control.

The December 21, 2021, Leadership Accountability Report did not report on the adequacy of internal controls to address fraud risks in the ESG CARES Act program. The ERM office reported, "HCD received large augmentations of state and federal funding to administer COVID-19 response and recovery programs" and the "acute risk that the pandemic poses," but the risks were framed in terms of deployment of funding expeditiously, administrative challenges, and hiring and onboarding staff quickly. It did not report on risks related to possible financial and nonfinancial fraud that could impact the integrity of the ESG CARES Act program. The report also stated, "consideration of potential fraud," but the risk registers that were provided did not adequately show that consideration.

Fraud risk management practices encourage establishing a proactive environment to effectively manage fraud risks. However, relying on the design and implementation alone is insufficient to proactively manage fraud risks within HCD's programs. HCD has an opportunity to improve its fraud risk management practices by developing a policy requiring the regular identification and assessment of fraud risks and conducting a formal fraud risk assessment process.

Phase 3 – prevent and detect maturity level: HCD did not design or implement sufficient antifraud controls.

HCD should manage fraud risks by designing and implementing specific control activities to prevent and detect potential fraud.

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[17] On March 2, 2022, a subrecipient notified HCD of an open investigation by local law enforcement due to allegations of fraud and misuse of ESG CARES Act funding.

[18] The division risk liaison (DRL) is responsible for overseeing the division risk register. DFFA's DRLs are the deputy director and assistant deputy director. The risk register is a divisional document, limited to management use, and insulated from exposure to the public. Also, when a risk is elevated to the ERR, only executive team members of HCD and the EROC have access to that report. It is not shared with staff and is labeled as confidential.

- The Antifraud Playbook encourages agencies to develop or strengthen antifraud controls that mitigate the highest risk areas and to start or advance a fraud analytics program. Managers who effectively manage fraud risks in this phase design and implement specific control activities, including policies, procedures, techniques, and mechanisms, to prevent and detect potential fraud.
- The Green Book states that management periodically reviews policies, procedures, and related control activities for continued relevance and effectiveness in achieving the entity's objectives or addressing related risks. Management communicates quality information down, across, up, and around reporting lines to all levels of the entity. Further, the oversight body receives quality information that flows up the reporting lines from management and personnel. Information relating to internal control communicated to the oversight body includes significant matters about adherence to, changes in, or issues arising from the internal control system. This upward communication is necessary for the effective oversight of internal control.
- The Framework provides that as part of its antifraud strategy, managers who effectively manage fraud risks design and implement specific control activities – including data analytics activities, fraud-awareness initiatives, reporting mechanisms, and employee-integrity activities – to prevent and detect potential fraud. Developed in phase 2, managers will use the fraud risk profile to allocate resources to respond to residual fraud risks.

Our assessment of HCD's maturity within this phase was at the "ad hoc" maturity level because HCD (1) did not conduct a fraud risk assessment that would have identified fraud risks of the entity to design and implement antifraud controls, (2) missed an opportunity to enhance or improve internal controls in response to a reported suspected fraud, and (3) did not have an antifraud strategy to combat fraud risks of the agency.

Since HCD did not conduct a fraud risk assessment, it could not develop or implement the other fraud risk management practice steps as provided in the Antifraud Playbook, the Green Book, and the Framework. Specifically, it did not (1) develop a fraud risk profile to respond to residual fraud risks, (2) develop an antifraud strategy based on a fraud risk profile, (3) design and implement specific control activities to prevent and detect fraud, and (4) develop a plan outlining how to respond to identified instances of fraud. HCD also had not incorporated fraud-specific data analytics techniques into its antifraud efforts.

HCD's internal control system was vulnerable with respect to fraud. Since DFFA did not include the identified suspected fraud[19] regarding misuse of ESG CARES Act funding in its risk registers, incomplete information was communicated to executive leaders to determine the impact of the suspected fraud and to make decisions on how to strengthen internal controls to address the issue. The ERM office and the Audit and Evaluation branch[20] were not aware of any fraud or potential fraud with the ESG CARES Act program because it was not reported. Therefore, the suspected fraud was not actively monitored, updated, and addressed by the ERM office, Audit and Evaluation branch, or EROC on an ongoing, systemic basis. BCSH and HCD officials stated that they were aware of the suspected fraud when it occurred, yet they did not see the need to instruct DFFA to adjust its internal controls to mitigate the risk of potential fraud because they believed that their ERM framework was effective and uncovered the suspected fraud. Because they were told to "stand down" by a Federal official who was investigating the matter, they did not evaluate the causes of the suspected fraud. However, HCD was not prevented from (1) assessing its

[19] On March 2, 2022, a subrecipient notified HCD of an open investigation by local law enforcement due to allegations of fraud and misuse of ESG CARES Act funding.
[20] The Audit and Evaluation branch investigates fraud on an as needed basis.

exposure to the suspected fraud in the ESG CARES Act program, (2) repeating its internal control processes to bolster antifraud practices, and (3) developing written policy to convey expectations of senior leaders to manage fraud risks. While the suspected fraud was uncovered, it is an indication that fraud risk exists in the ESG CARES Act program. To take a more proactive stance, HCD should improve certain controls to reduce the risk of similar or suspected fraud going undetected.

HCD and DFFA did not have an antifraud strategy to respond to fraud risks specific to the department. Although DFFA stated that it had attended fraud-based training hosted by third parties, such as the Office of Inspector General or the U.S. Department of Justice, and fraud risk management is the responsibility of every employee,[21] HCD had not offered or organized antifraud trainings, which would increase employees' and subrecipients' awareness of potential fraud schemes that may arise while they administer or implement the ESG CARES Act program. Therefore, HCD should design and implement sufficient antifraud controls to improve its fraud risk management practices to combat suspected fraud or fraud risks.

Phase 4 – insight into action maturity level: HCD did not evaluate the effectiveness of its fraud risk management activities.

HCD can evaluate the effectiveness of its antifraud controls using a risk-based approach and adapt activities to improve fraud risk management.

- The Antifraud Playbook encourages agencies to use available information, either within the agency or from external sources, and turn that insight into actionable tasks. Effective management in this phase would involve managers' monitoring and evaluating the effectiveness of preventive activities, including fraud risk assessments, antifraud training, and analytics activities. Collecting and analyzing data from reporting mechanisms, such as hotlines, and instances of detected fraud, through items such as the fraud risk assessment, analytics activities, and Inspector General investigations, are a part of this monitoring and evaluation process. These data will allow entities to monitor fraud trends and provide another avenue for identifying potential internal control gaps or weaknesses.
- The Green Book states that management monitors the internal control system through ongoing monitoring and separate evaluations and management should remediate identified internal control deficiencies on a timely basis. Depending on the entity's regulatory or compliance requirements, the entity may also be required to report issues externally to appropriate external parties, such as the legislators, regulators, and standard-setting bodies that establish laws, rules, regulations, and standards to which the entity is subject.
- The Framework provides that managers conduct risk-based monitoring and evaluate the effectiveness of preventive activities, monitor and evaluate fraud risk management activities with a focus on measuring outcomes, and adapt fraud risk management activities and communicate the results of monitoring and evaluations.

Our assessment of HCD's maturity within the insight into action phase was at the "ad hoc" maturity level because it did not evaluate existing controls related to its fraud risks and did not report suspected fraud through the State's reporting mechanism as soon as it identified the suspected incident.

According to the Leadership Accountability Report, HCD continually monitors and evaluates ongoing risks

[21] At the time of hire, HCD requires all employees to sign an "Expectations Memo," which defines the department's expectations of ethical values in their professional conduct.

to ensure that internal control systems are working as intended. Each division holds regular meetings to review performance measures, discuss operations and potential control issues, and make recommendations for improvements based on data derived from performance measures. In addition, the Audit and Evaluations branch, as the group charged with assessing internal controls, will assist the department in developing internal controls and monitoring the ongoing status of audit findings to corrective action plan implementation. However, based on our discussions with HCD officials, this evaluation did not include fraud risks. The responsibility of an effective internal control system resides with management. Therefore, HCD did not have a process to specifically evaluate the effectiveness of its fraud risk management activities.

The State of California has a proactive mechanism in place to monitor and evaluate suspected incidents of fraud for its State agencies. HCD did not use this reporting system until after we inquired about it during our audit. DFFA did not notify the Office of State Audits and Evaluations (OSAE) of its suspected incident until August 24, 2023. Because it took nearly a year and a half to report the suspected incident,[22] HCD was not able to provide OSAE with incident updates every 180 days until the incident was resolved.[23] Therefore, HCD did not take advantage of this reporting mechanism, which it could have used to proactively monitor and evaluate the effectiveness of its controls. The incident of suspected fraud indicated an internal control gap or weakness in its fraud risk management practices. As a result of management's inaction in reporting the suspected fraud, management could not and did not consider remediating potential internal control deficiencies within the ESG CARES Act program. HCD should improve its practices to evaluate the effectiveness of its fraud risk management practices in line with leading industry standards and best practices.

HCD Did Not Consider It Necessary To Implement a Fraud Risk Management Framework

HCD's management did not consider it necessary to implement a fraud risk management framework or build upon its existing ERM framework to assess the fraud risks of the organization because no event precipitated the need to do so and resources were limited. Also, HUD did not require it to establish a fraud risk management framework.[24] HCD management stated that the ERM framework was in place when it was notified of the suspected fraud[25] regarding misuse of ESG CARES Act funding. Management believed that the current system and controls it had in place caught the suspected fraud; therefore, no additional improvements with its ERM framework or internal controls were necessary. While in this instance, HCD was fortunate to have been notified, without adequate fraud detection controls, it may not be so fortunate if another instance arises. Fraud risk factors are often present in circumstances in which fraud occurs, and they should be evaluated to determine whether the weakness in the system remains and could be further exploited. As discussed, HCD had developed and implemented controls to facilitate

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[22] On March 2, 2022, a subrecipient notified HCD of an open investigation by local law enforcement due to allegations of fraud and misuse of ESG CARES Act funding.

[23] An incident is considered resolved when an internal investigation is complete and corrective action has been taken or a referral has been made to the proper authority.

[24] According to HUD, its monitoring was not designed to evaluate the grantees' fraud risk management framework; therefore, HUD would not have been able to cite them for a violation of their fraud risk management framework. HUD monitored fraud risk based on reviewing policies and procedures.

[25] On March 2, 2022, a subrecipient notified HCD of an open investigation by local law enforcement due to allegations of fraud and misuse of ESG CARES Act funding.

and support fraud risk management practices, but they can be improved to raise HCD's fraud risk management maturity from an ad hoc to a leadership level. Updating the governance structure and improving processes and controls that align with industry standards and best practices[26] would strengthen and advance HCD's antifraud program.

The State of California has adopted the Green Book as a framework for an internal control system, which includes as one of its principles for management to assess the risk of fraud when responding to risks.[27] According to GAO, assessing the risk of fraud is one of the principles for establishing an effective internal control system. In addition, due to the importance of this principle, GAO and COSO have published their own fraud risk management guides with the intention to support organizations in meeting this principle. GAO and COSO make it clear that for a system of internal control to be effective, each of the principles must be present, functioning, and operating together in an integrated manner. If a principle or component is not effective or the components are not operating together in an integrated manner, an internal control system cannot be effective. Further, State of California Government Code, sections 13400 through 13407, require State agencies to establish and maintain a system of internal control, as fraud and errors are more likely to occur from a lack of effective systems of internal control when active monitoring measures are not maintained to ensure that controls are functioning properly.[28] This responsibility includes documenting the system, communicating system requirements to employees, and ensuring that the system is functioning as prescribed and is modified, as appropriate, for changes in conditions.[29] Therefore, as a State of California agency, HCD is required to establish a system of internal control that abides by the Green Book. The objective of a fraud risk management framework is to ensure program integrity by continuously and strategically mitigating the likelihood and impact of fraud. Having a weak fraud risk management framework increases the risk that HUD's Federal funds granted to the State of California for the ESG CARES Act program, totaling more than $319.5 million, may be more susceptible to fraud, making it more likely that fraud will go undetected. Further, management will not be positioned to understand program-specific risks, design corresponding controls to prevent them, and evaluate their effectiveness to determine whether adaptations or improvements are needed.

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[26] GAO's Standards for Internal Control in the Federal Government, also known as the Green Book; GAO's A Framework for Managing Fraud Risks in Federal Programs; and Chief Financial Officers Council's Antifraud Playbook.

[27] This language can be found in the State Administrative Manual, Internal Control, section 20060.

[28] The State Leadership Accountability Act 13401(a)(2)

[29] The State Leadership Accountability Act 13402

Conclusion

The pandemic exposed HUD, its grantees, and its subrecipients to fraud risk factors that contributed to the risk of fraud in the ESG CARES Act program. As the grantee, HCD is responsible for ensuring that grant funds are used in accordance with program requirements, and it is not relieved of that responsibility when it subawards the ESG CARES Act grant to its subrecipients. Therefore, it is prudent for HCD to incorporate fraud risk management practices that proactively identify and respond to fraud risks and safeguard taxpayer funds. We determined that HCD's antifraud activities and controls were at the lowest desired maturity level and opportunities exist to improve. HCD was unprepared to prevent, detect, and respond to fraud risks largely due to the lack of focus it placed on fraud risks as part of its ERM process and the little emphasis it placed on establishing a robust fraud risk management framework. While no antifraud program is completely foolproof, implementing a comprehensive antifraud program, including conducting regular fraud risk assessments, is a proactive way to make fraud less attractive to commit. Therefore, it is incumbent upon HCD to either engineer a fraud risk management framework or build upon its existing ERM framework, aligning with industry standards and best practices for fraud risk management to protect itself, its stakeholders, and the more than $319.5 million in ESG CARES Act funds it administers from unforeseen risks.

According to the Association of Certified Fraud Examiners: "One reason we can likely expect more fraud to proliferate is the massive changes in underlying fraud risks that have arisen since the onset of the pandemic…business leaders need to treat these changes as more than temporary and incorporate them into their risk assessments and anti-fraud plans."

Even though we are now operating in a post pandemic environment, the risk of fraud will remain high until HCD creates a culture and framework that can regularly detect and prevent fraud, as well as identify, assess, and take corrective action on fraud risks.

Recommendations

We recommend that the Director of HUD's San Francisco Office of Community Planning and Development instruct HCD to

1A. Establish a separate fraud risk management framework or evaluate and build upon its ERM framework by incorporating fraud risk management practices that are consistent with the principles of GAO's Standards for Internal Control in the Federal Government (Green Book), including developing a fraud risk management framework in alignment with best practices identified in GAO's A Framework for Managing Fraud Risks in Federal Programs and the Chief Financial Officers Council's Antifraud Playbook.

1B. Obtain training or technical assistance on the implementation of fraud risk management practices consistent with the principles of GAO's Standards for Internal Control in the Federal Government (Green Book).

Scope and Methodology

We conducted our audit field work from April through October 2023 in Los Angeles, CA. The audit covered the period April 1, 2020, through March 31, 2023. All interviews and discussions were conducted remotely via Microsoft Teams. We reviewed HCD's ERM in terms of assessing its fraud risk management practices. We did not evaluate the overall effectiveness of HCD's ERM framework. Our audit focused on HCD's administration of ESG CARES Act grant funds.

To gain an understanding of the fraud risk management environment at HCD and adequately conduct our assessment, we performed the following:

- Reviewed pertinent criteria and fraud risk guidance, including 2 CFR (Code of Federal Regulations) 200.303; California Government Code Title 2, Division 3, Part 3, Chapter 5 (13400 through 13407); the State Administrative Manual 20060 and 20080; GAO's Standards for Internal Control in the Federal Government (Green Book); GAO's A Framework for Managing Fraud Risks in Federal Programs; and the Chief Financial Officers Council's Antifraud Playbook.

- Interviewed the following officials:

    - The deputy secretary of housing for BCSH, the agency with oversight responsibility for HCD.
    - HCD officials, including the chief deputy director of HCD; the deputy director, assistant deputy director, branch chief, and HCD specialist I of DFFA; the branch chief and staff auditor of the Audit and Evaluation Branch; the risk officer of the ERM unit; and the deputy director of the Organizational Development Division, the division that provides oversight of the ERM unit.
    - The senior manager and lead homeless service specialist of ICF Consulting.

- Reviewed the 2020 to 2023 DFFA risk registers and ERRs, "Expectations Memos," and fraud training slides, as well as other relevant documentation, to confirm testimony obtained from interviewing HCD personnel.

- Reviewed the draft ESG Financial Management Policies and Procedures, a sample of three non-fraud-related risk assessments conducted in 2023, and Risk Management Plans to obtain an understanding of HCD's ERM process in terms of its available fraud risk management practices.

- Used the Antifraud Program Maturity Model from the Antifraud Playbook to determine the maturity level of HCD's fraud risk management practices. We followed GAO's Standards for Internal Control in the Federal Government, GAO's A Framework for Managing Fraud Risks in Federal Programs, and the U.S. Chief Financial Officers Council's Antifraud Playbook guidance to perform our assessment and identify areas for improvement.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective(s). We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Appendixes

Appendix A – Auditee and HUD Comments and OIG's Evaluation

Ref to OIG Evaluation – Auditee Comments

The following comments were provided by the State of California:

STATE OF CALIFORNIA - BUSINESS, CONSUMER SERVICES AND HOUSING AGENCY GAVIN NEWSOM, *Governor*

DEPARTMENT OF HOUSING AND COMMUNITY DEVELOPMENT
OFFICE OF THE DIRECTOR
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MEMORANDUM FOR: Office of Audit/Office of Inspector General/US Department of Housing and Urban Development

FROM: Gustavo Velasquez, Director
Office of the Director

SUBJECT: Office of Inspector General Report 2024-LA 100X June 2024

Dear Kilah S. White, Assistant Inspector General for Audit, Office of Inspector General, GA

Thank you for the opportunity to review and provide comments to the audit titled, "Housing and Community Development Should Improve Its Fraud Risk Management Practices for Its ESG CARES Act Program." HCD generally concurs with the recommendations OIG is making to the HUD San Francisco Office of Community Planning Development and will take appropriate steps, under the direction of HUD, to implement the recommendations provided by the OIG, where feasible.

Comment 1 > HCD is committed to a systematic and comprehensive approach to the management of risks, including fraud risk, as an integral part of its strategy formulation and implementation. HCD remains committed to promoting and following the consistent use of industry standard risk management tools and guidance to comply with risk management principles while accepting accountability for risk at all levels. We have expanded upon the Department's Enterprise Risk Management (ERM) framework to strengthen internal controls and incorporate fraud risk management practices through the development of a comprehensive fraud risk management policy, implementation plan, framework, and roles/responsibilities matrix, which can be broadly applied to all HCD programs. HCD's next steps will be to implement these fraud risk management practices into program specific policies and procedures.

Responses to HCD recommendations are below.

Recommendation 1: Establish a separate fraud risk management framework or evaluate and build upon its ERM framework by incorporating fraud risk management practices.

HCD Response: HCD is currently working on implementing a fraud risk management (FRM) program, as an expansion of our existing ERM program, using the Government Accountability Office's (GAO) Standards for Internal Control in the Federal Government (Green Book), GAO's A Framework for Managing Fraud Risks in Federal Programs (Framework), and the Chief Financial

Ref to OIG Evaluation – Auditee Comments

Officers (CFO) Council's Antifraud Playbook (Playbook) as guidance materials. The FRM program includes an enterprise wide FRM policy, an FRM framework, an FRM implementation plan, roles and responsibility matrix, and a formal FRM training curriculum for all HCD employees, to be facilitated by the ERM unit. The ERM unit will implement ad hoc and requested fraud risk assessments to analyze and verify adequate internal controls. The ERM unit will also embed FRM into its current enterprise risk reporting process by adding the appropriate fraud risk incident categories. This will ensure that all HCD executive team leaders are aware of potential fraud risks, prevention and detection tactics, and mitigation or corrective action plans.

Comment 2 >

Additionally, the establishment of the enterprise FRM program will support and supplement the Division of Federal Financial Assistance's internal control systems outlined within their existing, program specific, policies and procedures.

HCD will work closely with HUD's Community Planning and Development Division (CPD), San Francisco Regional Office to ensure that HCD's FRM and FRM practices align and comply with federal risk management practices and standards. We will launch the full FRM program, throughout the department beginning in August of 2024, as the policy, framework, implementation plan, and accompanying documents are in the final stages of internal review and approval.

Recommendation 2: Obtain training or technical assistance on the implementation of fraud risk management practices consistent with the principles of GAO's Standards for Internal Control in the Federal Government (Green Book).

HCD Response: HCD's Enterprise Risk Management Office will obtain certified fraud examiner accreditation within the next two months. Within three months of achieving fraud examiner accreditation, ERM Officers will provide all appropriate department staff with training and management to ensure successful implementation of FRM practices. This will include integration of fraud risk management practices consistent with the principles of GAO's Green Book.

Comment 3 >

In addition to these efforts, previously HUD OIG had provided a three-day training to HCD on fraud risk management. HCD will also continue to work closely with HUD CPD to obtain guidance on training and technical assistance on the implementation of fraud risk management practices consistent with the principles of GAO's Standards for Internal Control in the Federal Government (Green Book). As HCD has grown significantly, HCD will work with HUD to secure additional fraud risk management training modules to ensure all new staff are onboarded and up to date on appropriate fraud risk and mitigation practices.

Thank you for the opportunity to provide a response to this audit.

Sincerely,

Gustavo Velasquez
Director

Ref to OIG Evaluation – HUD Comments

The following comments were provided by the HUD San Francisco CPD Director:

U.S. Department of Housing and Urban Development
Community Planning and Development – 9AD
One Sansome Street, Suite 1200
San Francisco, CA 94104-4430
www.hud.gov
espanol.hud.gov

July 5, 2024

Kilah S. White
Assistant Inspector General for Audit
Office of Inspector General
451 7th Street SW
Washington, DC 20410

Dear Ms. White:

Subject: Draft Report – State of California ESG CARES Act Fraud Risk Management Framework

The Department of Housing and Urban Development (HUD) received the draft audit report from the HUD Office of Inspector General (OIG) for the California Department of Housing and Community Development (HCD) audit for its fraud risk management framework on June 18, 2024. The draft audit report describes deficiencies in HCD's fraud risk management framework and offers two recommendations for HUD. The OIG recommends that HUD, and specifically the San Francisco Office of Community Planning and Development, instruct HCD to:

1A. Establish a separate fraud risk management framework or evaluate and build upon its ERM framework by incorporating fraud risk management practices that are consistent with the principles of GAO's Standards for Internal Control in the Federal Government (Green Book), including developing a fraud risk management framework in alignment with best practices identified in GAO's A Framework for Managing Fraud Risks in Federal Programs and the Chief Financial Officers Council's Antifraud Playbook.

1B. Obtain training or technical assistance on the implementation of fraud risk management practices consistent with the principles of GAO's Standards for Internal Control in the Federal Government (Green Book).

The Field Office appreciates the insights offered by the draft audit report and understands the value of a robust fraud risk management framework in protecting Federal funds. The Field Office also appreciates OIG's consideration of the feedback the Field Office provided on the draft finding outline in a letter shared by the Field Office on February 23, 2024. In response to OIG's June 18th correspondence and invitation to provide feedback on the draft report, the Field Office is providing the following comments:

1. The Field Office acknowledges the updates made to the language of the recommendation, specifically changing *require* to *instruct*, for consistency with the Field Office's authority to request action from HCD. These updates reflect the Field Office's understanding that it does not have the authority to require HCD to implement a fraud risk management framework that is consistent with the Green Book and the supplemental Anti-Fraud Playbook. The Field Office conveyed the following feedback in its February 23rd response to OIG:
   a. Regarding 2 CFR Section 200.303 Internal Controls, HUD does not have the legal authority to require a grant recipient to implement fraud risk management protocols described in the Green Book. 2 CFR Section 200.303 states that "The non-Federal entity must establish and maintain effective internal control over the Federal award that provides reasonable assurance that the non-Federal entity is managing the Federal award in compliance with Federal statutes, regulations, and the terms and conditions of the

Comment 4>

Federal award. These internal controls should be in compliance with guidance in "Standards for Internal Control in the Federal Government" issued by the Comptroller General of the United States or the "Internal Control Integrated Framework", issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)." The Field Office understands that there is a legally significant difference between "must" and "should" which is described at 2 CFR Section 200.101(b) Applicability. When the word "must" is used it indicates a requirement. Whereas, use of the word "should" or "may" indicates a best practice or recommended approach rather than a requirement and permits discretion.

b. Regarding the State Leadership Accountability Act (SLAA), the SLAA requires state agencies to establish and maintain systems of internal control but does not require state agencies to comply with the Green Book. Section 1340(a) of the SLAA describes the same five components of effective internal control as the Green Book but the SLAA does not contain a specific mandate to conduct assessments of fraud risks. The Field Office also noted that the State Administrative Manual (SAM) used the Green Book as a framework in enacting the SLAA but did not incorporate the Green Book verbatim or by reference.

Comment 5 >

The Field Office maintains its position that any management decision and subsequent corrective actions must be consistent with the Field Office's statutory and regulatory authorities.

2. The Field Office observed that there were instances in the draft report in which a conclusion was inferred based on personal or organizational motivation rather than organizational institutions (i.e., policies and procedures). For example, the first sentence on page 3 of the *What We Found* section states "HCD was not adequately prepared to prevent, detect, and respond to fraud *due to the lack of attention and focus it placed on fraud risks* and establishing a robust fraud risk management framework." Based on the Field Office's review of the draft report, it appears that HCD believed it was operating in a manner consistent with the regulatory requirements for internal controls, and therefore, would not ascribe its lack of a fraud risk management framework as a result of inattentiveness to fraud risk. The Field Office recommends updating this sentence to rely on the institutional observations, like the language used in the draft audit report for the city of Honolulu which resulted in a similar finding stating that "The City did not adequately develop a fraud risk management framework for the ESG-CV program to prevent, detect, and respond to fraud."

Comment 6 >

Thank you for the opportunity to provide feedback on the draft report. If you have any questions, please contact Nicholas Nordahl, Senior Community Planning and Development Representative, at nicholas.d.nordahl@hud.gov or at 415-489-6762.

Sincerely,
ALICE WALKUP
Digitally signed by: ALICE WALKUP DN: CN = ALICE WALKUP C = US O = U.S. Government OU = Department of Housing and Urban Development, Office of Community Planning and Development Date: 2024.07.05 15:56:09 -07'00'
Alice Walkup
Director
Community Planning and Development Division

cc:
Tanya Schulze, Audit Director
Vincent Mussetter, Assistant Audit Director
[redacted]

* name redacted for privacy reasons

OIG Evaluation of Auditee and HUD Comments

Comment 1 We appreciate and value HCD's receptiveness to our recommendations and willingness to take corrective action in a timely manner. We also commend HCD for its initiative in promoting and implementing FRM tools promulgated by industry standards. HCD will have the opportunity to demonstrate its implementation of the planned fraud risk management policies and procedures to HUD CPD through the audit resolution process.

Comment 2 We agree with HCD's efforts of embedding its FRM within its ERM framework and its plans of launching the full FRM program by August of 2024.

Comment 3 We commend HCD's willingness to work with HUD CPD to obtain training and technical assistance to fully implement the recommended FRM framework to ensure that current and new staff are trained to be aware of fraud risk practices.

We agree that HUD OIG offered a three-day fraud training in 2021 and commend HCD's attendance. However, the training was not attended by all employees at HCD or DFFA, and while the training covered fraud and fraud risks, it was not focused on the best practices outlined in the Playbook or the Framework.

Comment 4 We acknowledge the wording of 2 CFR 200.303, and the differences between "must" and "should." However, HUD is also responsible for abiding by a provision of the Payment Integrity Information Act of 2019 (PIIA), codified at 31 U.S.C 3357, which requires OMB to maintain guidelines for agencies to conduct an evaluation of fraud risks and using a risk-based approach to design and implement financial and administrative control activities to mitigate identified fraud risks that incorporate leading practices from GAO's Fraud Risk Framework. Further, OMB A-123 directs Federal agencies to follow the leading practices outlined in the Fraud Risk Framework. Lastly, HUD's own Departmental Policy on the Implementation of OMB Circular A-123, Management's Responsibility for Enterprise Risk Management (ERM) and Internal Control, specifies that HUD management has the responsibility to design, implement, and operate processes with embedded internal controls that mitigate the risk of fraud, waste, and abuse in HUD programs. CPD's grantees are considered part of the "extended enterprise" as defined in OMB A-123, which has impacts on the Agency's overall fraud risk for the program. Therefore, these "extended enterprises" and their impacts on fraud risk to overall program should be managed and mitigated by the program office by applying the principles in GAO's Fraud Risk Framework to its grantees.

As discussed in CPD's response, it previously provided comments to us in this regard, and we adjusted the recommendation for the draft report. Given HUD's objective of eliminating or reducing "fraud events to the lowest extent possible to ensure the most effective and efficient use of funds and resources,"[30] instructing HCD to follow its own requirements would be in line with HUD's objective and authority. Implementing the

[30] Departmental Fraud Risk Management Policy (2022.1), effective date March 31, 2022

recommendations will help reduce the risk of fraud in the program and ensure CPD funding is used for its intended purposes.

Comment 5 We agree that the SLAA[31] requires state agencies to establish and maintain a system of internal control[32] and that the SLAA 13403 (a)(1) to (a)(5) describes the same five components of internal control[33] as the Green Book. We also agree with the Field Office that the Green Book was not enacted verbatim in the State Administrative Manual.

However, we disagree that the SLAA does not require state agencies to comply with principles outlined in the Green Book. On the contrary, the SLAA clearly and succinctly describes the requirements for fraud risk management practices, which coincides with principles of the Green Book and the phases of the Antifraud Playbook.

Although the SLAA does not contain literal language requiring state agencies to comply with the Green Book, it contains concepts that state agencies are mandated to follow, which are operationalized by the Green Book, the Playbook, and the Framework. To assess and strengthen its internal controls,[34] state agencies must effectively design, implement, and operate the five components of internal control in an integrated manner, including conducting an effective fraud risk assessment to identify risks that may be a threat to internal controls.

Finally, HCD has not disputed the applicability of the Green Book's fraud risk requirements and appears to be in agreement with the audit recommendations.

Comment 6 We disagree with CPD's assertions that our conclusions were inferred based on personal or organizational motivation. As listed in the Scope and Methodology section and discussed throughout our audit report, we derived our conclusions based on interviews with HCD personnel and our evaluation of available documentation.

Based on CPD's review of the draft audit report, CPD asserted that HCD believed it was operating in a manner consistent with regulatory requirements for internal controls and the finding was not due to HCD's inattentiveness to fraud risk. We have considered CPD's suggestion and, to avoid confusion, have more clearly stated our conclusion that HCD lacked focus placed on fraud risks during our audit period. We spoke with various divisions within HCD, and each division consistently confirmed the absence of a documented antifraud policy or strategy, a fraud risk profile, a fraud risk assessment, or a fraud risk plan. The lack of such documentation provides evidence that establishing control activities related to fraud risk was not at the forefront of HCD's priorities. Additionally, while reviewing the Division of Federal Financial Assistance's (DFFA) risk registers and Enterprise Risk Reports, we determined that organizational-wide risks were identified, but fraud risks related to the ESG-CV program were not, even after the suspected fraud with a subrecipient arose. Further, as stated in our report, executive management stated there was no event that precipitated the need for a separate fraud risk management framework or the need to enhance its ERM other than good

[31] HCD is subject to the State of California's Government Code section 13400 through 13407, also known as the State Leadership Accountability Act (SLAA)

[32] SLAA 13402

[33] SLAA 13403

[34] SLAA 13401 (b)(3)

management practices. This view did not change despite being aware of the suspected fraud at a subrecipient. We therefore stand by our assertion that there was a lack of attention and focus placed on fraud risks during our audit period.

Based on HCD's response to the draft report and discussion with HCD during the exit conference, HCD's senior management appears agreeable to the audit recommendations and are in the process of enhancing HCD's attention and focus on fraud risk management. HCD's efforts to enhance its fraud risk management in accordance with the audit recommendations can be confirmed by CPD as part of the audit resolution process.

Finally, we disagree with CPD's suggestion that we update the report's wording to correspond to language used in the City and County of Honolulu draft audit report. Updating our report to reflect the statement on the Honolulu report would not be an accurate representation of the circumstances at HCD. We used language in the HCD audit report that identified the cause of the finding, while the quote cited by CPD from the Honolulu draft report does not detail the cause of its respective finding.