Issue Date January 19, 2011
Audit Report Number 2011-SE-1002

TO: Virginia Sardone, Acting Director, Office of Affordable Housing, DGH

//signed//
FROM: Ronald J. Hosking, Regional Inspector General for Audit, Region X, 0AGA

SUBJECT: Washington State Housing Finance Commission, Seattle, WA, Did not Always Disburse Its Tax Credit Assistance Program Funds in Accordance With Program Requirements

HIGHLIGHTS

What We Audited and Why

We audited the Washington State Housing Finance Commission (Commission) because it was the largest recipient of the Tax Credit Assistance Program (TCAP) grant in the U.S. Department of Housing and Urban Development's (HUD) Region 10. The Commission received more than $43 million in TCAP funds from the American Recovery and Reinvestment Act of 2009 (Recovery Act). Our objectives were to determine whether the Commission established eligible grant projects, entered TCAP information into FederalReporting.gov accurately and completely, and paid eligible TCAP expenditures in accordance with the applicable Recovery Act and HUD rules and regulations.

What We Found

The Commission complied with the applicable Recovery Act and HUD rules and regulations in establishing eligible grant projects, and in the entering of TCAP information into FederalReporting.gov. However, it did not always disburse TCAP funds in accordance with program requirements. The Commission reimbursed two project owners for ineligible permanent loan fees, ineligible appraisal fees, and unsupported legal costs. It paid these fees because there were weaknesses in its oversight process.

What We Recommend

We recommend that the Director of HUD's Office of Affordable Housing require the Commission to reimburse $170,036 to its U.S. Treasury line of credit from non-Federal funds for the ineligible expenditures. We also recommend that the Director require the Commission to provide supporting documentation for the $17,068 in unsupported costs or reimburse its U.S. Treasury line of credit from non-Federal funds. Further, we recommend that the Director require the Commission to establish and implement written policies and procedures for the review and approval of budgets and draw requests.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided the discussion draft of the audit report to the Commission on December 23, 2010, and requested its comments by January 6, 2011. The Commission provided its written comments on January 6, 2011. It generally agreed with the facts upon which the finding and recommendations were based, but it disagreed with the characterization that it was a finding.

The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVES

On February 17, 2009, President Obama signed the American Recovery and Reinvestment Act of 2009 (Recovery Act) into law. The purpose of the Recovery Act was to jump-start the Nation's economy, with a primary focus on creating and saving jobs in the near term, and to invest in infrastructure that would provide long-term economic benefits. The Recovery Act appropriated $2.25 billion under the HOME Investment Partnerships Program (HOME) heading for a Tax Credit Assistance Program (TCAP) grant to provide funds for capital investments in low-income housing tax credit projects. The U.S. Department of Housing and Urban Development (HUD) awarded TCAP grants to the 52 State housing credit agencies. On June 24, 2009, HUD awarded the Washington State Housing Finance Commission (Commission) more than $43 million in TCAP funds to be used on qualified low-income buildings that were awarded low-income housing tax credits under section 42 of the Internal Revenue Code (IRC).

Although these funds were appropriated under the HOME heading, TCAP funds are not subject to any HOME requirements other than the environmental review and can only be used in low-income housing tax credit projects, which are administered through the U.S. Department of the Treasury. HUD awarded TCAP grants to facilitate development of projects that received low-income housing tax credit awards between October 1, 2006, and September 30, 2009. Since a major purpose of these funds was to immediately create new jobs or save jobs at risk of being lost due to the current economic crisis, the Recovery Act established deadlines for the commitment and expenditure of grant funds and required State housing credit agencies to give priority to projects that would be completed by February 16, 2012. The grantee was required to distribute the TCAP funds competitively under the requirements of the Recovery Act and pursuant to its existing qualified allocation plan.

The Commission helps communities across Washington State create more affordable housing, build quality facilities for a wide range of uses, and lend assistance to those who earn their living from the land. It finances mortgage loans for affordable single-family homes, apartment development, and facilities for nonprofit organizations. It also issues tax-exempt 501(c)(3) bonds to finance nonprofit housing as well as facilities owned by nonprofit organizations. The Commission finances a spectrum of affordable multifamily housing statewide by means of allocating Federal low-income housing tax credits and issuing of tax-exempt bonds.

As of September 16, 2010, the Commission had awarded all of its TCAP funds to 10 low-income housing tax credit projects, two of which had not yet closed, and had disbursed more than $15 million in TCAP funds. The 10 projects are multifamily projects which will create or rehabilitate 652 low-income housing units in Washington State for large families, the elderly, disabled individuals, and homeless individuals.

According to Recovery.gov, the use of these TCAP funds had resulted in the creation of 82 jobs as of August 31, 2010.

Our objectives were to determine whether the Commission

- Established eligible grant projects in accordance with HUD rules and regulations,
- Entered TCAP information into FederalReporting.gov accurately and completely, and
- Paid eligible TCAP expenditures in accordance with the applicable Recovery Act and HUD rules and regulations.

RESULTS OF AUDIT

Finding 1: The Commission Reimbursed Ineligible and Unsupported Costs

The Commission reimbursed two project owners for ineligible permanent loan fees, ineligible appraisal fees, and unsupported legal fees (see appendix D). This condition occurred because there were weaknesses in the Commission's oversight process. Consequently, it spent more than $170,000 on ineligible costs, and more than $17,000 on unsupported legal fees. These funds could have been made available for other eligible TCAP expenses.

The Commission Used TCAP Funds To Pay for Ineligible Permanent Loan Fees

The permanent loan fees were invoiced as permanent loan origination fees, administrative fees, monitoring fees, and legal fees for permanent loan financing. In one instance, the Commission reimbursed a permanent loan origination fee to Washington Community Reinvestment Association at loan closing that had been incorrectly included in the approved budget as an eligible expenditure for TCAP. Commission staff told us that it and the industry considered permanent loan origination fees ineligible as part of the project basis cost under section 42 of the IRC (see appendix C).

Two other invoices included administrative fees and monitoring fees. The Commission initially assumed that the administrative fees were for loan underwriting costs and the monitoring fees were for construction monitoring. When asked, the Commission confirmed with the vendors that these fees consisted of a number of eligible and ineligible activities. Since the Commission could not further identify the eligibility of these activities and did not want to take any unnecessary risk, it stated that it would reclassify these costs as permanent loan fees and consider them ineligible since the project had sufficient other eligible costs for which to use the TCAP funds.

The Commission also paid for ineligible legal fees that consisted of bond issuance financing and bond approval fees, which it categorized as permanent financing fees. It approved the reimbursement even though permanent financing fees were not a budgeted line item in the original approved budget. The Commission agreed that the industry standard is that permanent loan fees are ineligible costs under section 42 of the IRC (see appendix C).

The Commission Paid for Ineligible Appraisal Fees

The Commission also agreed that the industry standard is that appraisal fees are ineligible basis costs under section 42 of the IRC. When asked, Commission staff provided a standard budget form that included various types of costs. The lines for some of these costs, including appraisals, were blacked out since the industry standard is that these costs are ineligible project basis costs under section 42 (see appendix C). However, the Commission paid for these ineligible appraisal fees at loan closing for one project. The original approved budget included $10,000 in TCAP funding for appraisal fees.

The Commission Paid for Unsupported Legal Fees

Unsupported fees were legal fees for which the Commission could not specifically identify whether they were related to eligible construction loans or for ineligible permanent loan financing. Supporting documentation for invoices included vendor bills showing the number of hours for various activities performed. Most often, the bills included a description of multiple activities and a total number of hours charged for the activities. Consequently, the hours for eligible TCAP activities were unidentifiable.

The TCAP written agreement between the Commission and the project owner requires the project owner to request funds spent only on eligible costs, furnish invoices for which payment is requested, and identify the applicable line item in the development budget. The project owner submitted the invoices as received from the vendors, with the hours commingled for multiple tasks, and invoiced them as legal fees and HUD legal fees. Neither the vendors nor the project owners separated the eligible hours for construction loan tasks from the ineligible hours for permanent loan financing tasks to support eligible TCAP reimbursements.

The Commission Did Not Review the Budget and the Draw Requests in Detail

There were weaknesses in the Commission's oversight process. The Commission did not review the project budgets and the draw requests in detail to confirm that the costs budgeted and invoiced were eligible costs. Before the TCAP grant was awarded, the Commission was changing the format of its budget form. It did not review the information in detail when the budgets were transferred to the new form, and some ineligible costs were included in the budget.

When the Commission reviewed the draw requests, it did not review the supporting documentation in detail and did not compare the draw request line items to the approved budget to determine eligibility of the costs. The Commission believed that it would identify any ineligible costs when it reviewed the projects' certified costs at project completion.

The Commission spent more than $170,000 on ineligible permanent loan fees and appraisal fees and more than $17,000 on unsupported legal fees. These funds could have been made available for other eligible TCAP expenses.

Recommendations

We recommend that the Director of HUD's Office of Affordable Housing

1A. Require that the Commission reimburse its U.S. Treasury line of credit $170,036 from non-Federal funds for the ineligible permanent loan fees and appraisal fees.

1B. Require that the Commission provide supporting documentation for the $17,068 in unsupported costs or reimburse its U.S. Treasury line of credit from non-Federal funds.

1C. Require that the Commission establish and implement written policies and procedures for the review and approval of budget forms and draw requests to specifically incorporate a review of the detail and verification that the costs are eligible for TCAP funding.

SCOPE AND METHODOLOGY

We reviewed the Commission's project selection process, its reported TCAP information, and its TCAP expenditures to ensure that it established eligible grant projects, entered TCAP information into Recovery.gov accurately and completely, and paid eligible TCAP expenditures in accordance with the applicable Recovery Act and HUD rules and regulations. To accomplish our objectives, we reviewed applicable laws, regulations, HUD requirements, Commission requirements, Commission policies and procedures, and IRC section 42 eligible basis costs requirements. We interviewed HUD staff, Commission staff, and Internal Revenue Service staff to obtain further knowledge of program specificity. We also conducted two site visits.

We reviewed a listing of all the projects that were awarded low-income housing tax credits from October 1, 2006, to September 30, 2009, under section 42(h) of IRC of 1986 to ensure that the 10 projects selected for TCAP funding were included on that listing and that those projects were required to be completed by February 16, 2012.

We selected 2 of the 10 projects to review for the full-time equivalency reported. We selected one project with the highest full-time equivalency reported in Recovery.gov for the quarter ending March 31, 2010, and another project with the highest TCAP expenditure rate, at 90 percent, for the quarter ending June 30, 2010. For expenditure reporting, we reviewed all expenditures reported for the quarter ending March 31, 2010.

The Commission was awarded more than $43 million in TCAP funds and as of September 16, 2010, had expended more than $15 million. For our review of expenditures, we reviewed all draw requests from February through August 2010 for 4 of the Commission's 10 TCAP projects to ensure that the expenditures were for TCAP-eligible activities. For this review, we selected

- The two largest projects with the largest dollars spent to date.
    - One project was awarded $11.8 million and had spent $6.3 million.
    - Another project was awarded $11.6 million and had spent $3.3 million.
- The two projects with the highest TCAP expenditure rate with at least 90 percent expended.
    - One project was awarded $1.4 million and had spent $1.26 million (90 percent).
    - Another project was awarded $1.1 million and had spent $1 million (91 percent).

We also reviewed 11 of 24 draws of the 7 projects with expenditures to ensure that funds were expended within 3 days of draw from HUD's account and that no advances were made to the project owners. We selected the first and last draws of projects with more than $1.5 million in expenditures and the first draw for projects with $1.5 million or less in expenditures. However, for the project that was awarded the $351,518 grant, the first draw was only $80,671, so we reviewed the two draws that the project had to reach an assurance level for that project.

We did not rely on automated data for our analysis because the Commission did not have an automated database system for TCAP reimbursements.

The audit generally covered the period February 2009 through August 2010. We expanded our audit period as needed to accomplish our objectives. We performed our audit at the Commission, 128 2nd Avenue, Seattle, WA); at two project sites in Toppenish and Bellingham, WA; and at the HUD OIG (Office of Inspector General) office in Seattle, WA, from September 16, 2010 to November 8, 2010.

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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

INTERNAL CONTROLS

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

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

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Controls to ensure that the Commission followed applicable laws and regulations with respect to the eligibility of TCAP projects.
- Controls to ensure that the Commission followed applicable laws and regulations with respect to the entering of TCAP information into FederalReporting.gov.
- Controls to ensure that the Commission paid only for eligible costs under TCAP.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiency

Based on our review, we believe that the following item is a significant deficiency:

- The Commission did not have adequate controls in place to ensure that reimbursements were only for eligible expenditures for TCAP (finding 1).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Ineligible 1/	Unsupported 2/
1A	$170,036	
1B		17,068

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation	**Auditee Comments**
	January 6, 2011
	Attention: Ronald Hosking, Regional Inspector General for Audit
	Washington State Housing Finance Commission Comments on HUD-OIG Audit of the TCAP program:
Comment 1	While we do not disagree with the facts upon which the HUD-OIG finding was made, we do disagree with the resulting finding; specifically we take issue with the characterization that there exists a "weakness in our process and oversight" of the TCAP program, that we failed to disperse TCAP funds in accordance with program requirements, and that we failed to have appropriate controls in place to ensure TCAP resources paid for only TCAP eligible costs.
Comment 2	We feel strongly that, as TCAP Grantee, we have met and continue to meet the spirit and intent of the TCAP program. The basis for our opinion lays in the fact that much of the guidance we have received predominantly directs us to follow practices stipulated in IRS Section 42. HUD Notice CPD-09-03-REV specifically states, "The TCAP assistance provided to a project must be made in the same manner and subject to the same limitations as required by the state housing credit agency with respect to an award of LIHTC to a project (i.e., as required under Section 42 of the IRC and its implementing regulations).
Comment 3	In developing the Commission's TCAP program and processes, "in the same manner as required under Section 42" has meant that a project would be required to follow the "best practices" that have evolved over more than 25 years of LIHTC program activity. The Housing Credit law requires Allocating Agencies to limit Credit allocations to the amount necessary for financial feasibility and viability as a qualified low-income housing development. As part of their analysis, agencies must evaluate all sources and uses of funds and the reasonableness of development and operating costs. Agencies typically verify expenditures by requiring developers to submit a detailed cost certification. In January 2000, the IRS issued regulations requiring independent verification of sources and uses of funds in the form of a CPA audit report called the *Final Cost Certification,* based on an accountant's audit or examination of financial documents and certifications the development owner provides. The Commission's review and approval of this CPA audit report is the process on which the LIHTC industry relies to verify *eligible basis*. Since TCAP funds can only be spent on items that qualify as *eligible basis*, the Commission built its cost verifying process on the industry standard.
	That said, given our experience with the HUD-OIG review, we stand corrected in our interpretation and resulting approach. We now have greater clarity of our charge as the TCAP Grantee and the expectations of HUD. We have put in place additional controls to more closely govern, on a draw by draw basis, all TCAP project expenses to ensure that only TCAP eligible costs are reimbursed with TCAP resources. We also have received direction on how to engage the process for reimbursing our US Treasury line of credit with non-Federal funds as directed and will proceed immediately.
	We appreciate the opportunity to comment.

OIG Evaluation of Auditee Comments

Comment 1 In our discussion of the finding outline, the Commission stated that the deficiency existed in its process. The Commission also confirmed that it had not planned to review the eligibility of costs for the TCAP program until project completion when the project owners submit the final cost certifications for eligible basis costs that have been audited by a certified public accountant. This resulted in TCAP funds being used to pay for ineligible costs.

Comment 2 Although the HUD notice directed the commission to provide assistance to projects in the same manner as required by the state housing credit agency with respect to other tax credit projects, the notice also stated that TCAP funds must be used only for capital investment in eligible projects. Capital investment means costs included in the eligible basis of the project. Further, the grantee was to, "…repay TCAP funds that were used for ineligible costs…" By not reviewing invoices in detail, but waiting for the project to be completed to review costs for eligibility, the Commission used TCAP funds to pay ineligible costs and must repay those costs.

Comment 3 Although the Commission was following "best practices" and relying on a final cost certification audit report by an independent certified public accountant, this would not necessarily identify all ineligible costs as audits typically do not review all costs, but only a sampling of costs. Therefore, some ineligible costs could potentially be missed and still be paid with TCAP funds. In addition, ineligible expenses identified at project completion would have to be reimbursed from non-federal funds to the Commission's Treasury line of credit. The Commission would then be at risk of forfeiting TCAP funds that could have been applied to eligible expenses during the project.

Appendix C

CRITERIA

HUD allows costs for TCAP that are eligible basis costs under section 42 of the IRC. The Internal Revenue Service does not have specific eligible and ineligible basis costs outlined in the IRC. The industry starts out with section 42(d)(3) of the IRC, which states that eligible basis items are a project's depreciable costs. Specifically, it states that eligible basis is the project's adjustable basis as of the close of the first taxable year of the credit period. The Commission looks to 20-plus years of programmatic knowledge about what items can be included and what must be excluded from eligible basis. It also refers to the best practices provided by the National Council of State Housing Agencies, the Low-Income Housing Tax Credit Handbook published by Novogradac & Company, and specific guidance and letter rulings from the Internal Revenue Service. From these resources, the Commission derived a budget form that identified eligible and ineligible basis costs under section 42 of the IRC for low-income housing tax credit. The Commission's budget worksheet showed that appraisal fees, permanent loan fees, and legal fees with respect to organization, syndication, and financing were ineligible. These costs are recognized by the industry and the Commission as ineligible. Therefore, according to industry practice and the Commission's interpretation, these fees are not eligible basis costs of a project and, thus, are ineligible costs for TCAP.

Appendix D

TABLE OF DEFICIENCIES FOR FINDING 1

Deficiencies	Project A	Project B	Total
Permanent loan fees	$ 83,962	$77,800	$161,762
Appraisal fees	8,274		8,274
Subtotal ineligible fees	**92,236**	**77,800**	**170,036**
Unsupported legal fees	*17,068*		*17,068*
Total ineligible fees and unsupported costs	**$109,304**	**$77,800**	**$187,104**