

PERFORMANCE AUDIT  
OF THE

**Kentucky Housing Corporation**

**Kentucky Appalachian Housing  
Program**

Grant: KY-16444

OIG Report Number: 14-01

GRANT PERIOD: OCTOBER 2009 – DECEMBER 2012

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Mr. Hubert N. Sparks  
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Transmitted herewith is a report of Watkins Meegan LLC, a Performance Audit of the Kentucky Housing Corporation's Kentucky Appalachian Housing Program. The report is in response to Contract No. BPA 11-01-A.

*Watkins Meegan LLC*

Tysons, Virginia  
November 7, 2013

Kentucky Housing Corporation – Kentucky Appalachian Housing Program

KY-16444

**Background**

The Appalachian Regional Commission (ARC) is a regional economic development agency that represents a partnership of federal, state and local governments. Established by an act of Congress in 1965, ARC is composed of the governors of the 13 Appalachian states and a federal co-chair, who is appointed by the President. Local participation is provided through multi-county local development districts (LDDs). Each year ARC provides funding for several hundred projects in the Appalachian Region, in areas such as business development, education and job training, telecommunications, infrastructure, community development, housing and transportation. These projects help create jobs; improve local water and sewer systems; increase school readiness; expand access to health care; assist local communities with strategic planning; and provide technical and managerial assistance to emerging businesses.

Kentucky Housing Corporation (KHC, or the Grantee) is a self-supporting public corporation of the Commonwealth of Kentucky. KHC works with many partners across the state, including lenders, government agencies, nonprofit housing providers, builders, real estate agents, community organizations and developers, to create affordable housing opportunities through an array of programs and services. KHC also administers federal programs, including rental assistance, that make safe, quality, affordable housing available to low-income Kentuckians. Additional programs offered by KHC include rental housing production financing, homeownership education and counseling, and a variety of rental assistance, housing rehabilitation and home repair initiatives.

On September 28, 2009, ARC approved the Kentucky Appalachian Housing Program (KAHP) grant, number KY-16444 (the Grant), in the amount of \$500,000 to KHC for the period October 1, 2009 to September 30, 2011 to provide good quality, affordable housing for low-income people in eastern Kentucky. On January 25, 2011, ARC approved the extension of performance period to September 30, 2012. An additional extension was subsequently granted extending the performance period through December 31, 2012.

The Grant enabled KHC to make funds available to local and regional housing service providers who apply for funds through KHC. KHC was responsible for managing the application process, managing financial transactions, documenting project outcomes and otherwise monitoring project activity to ensure successful implementation. On January 11, 2011, ARC approved the selection of sub-grantees proposed by KHC. The four sub-grantees were:

- Federation of Appalachian Housing Enterprises, Inc. (FAHE) \$403,000
- Daniel Boone Community Action Agency, Inc. \$45,000
- Kentucky River Foothills Affordable New Homeownership Program \$32,000
- Bell Whitley Housing Initiatives Program \$20,000

Once the grants were awarded by KHC to the sub-grantees, housing construction and rehabilitation activities took place in distressed Appalachian counties.

**Objective**

Watkins Meegan LLC was engaged to conduct a performance audit of the Kentucky Housing Corporation, Kentucky Appalachian Housing Program Grant for the period October 1, 2009 to December 31, 2012. The purpose of our performance audit was to determine the following:

**Objective (Continued)**

- Funds expended and claimed for reimbursement from ARC and matching requirements were valid program expenses and in accordance with the ARC Grant requirements;
- Internal controls were in place to ensure compliance with the Grant requirements; and
- Goals and objectives of the Grant had been achieved.

**Executive Summary**

Per the documentation provided by KHC, Grant funds were used to support the construction and rehabilitation of housing and the construction of multi-family rental housing for low-income families in Appalachian counties of Kentucky. The project was designed to serve those families with the lowest incomes in the sub-grantee service areas.

KHC requested reimbursement of \$500,000 from ARC for Grant-related expenses for the period ended December 31, 2012. Matching funds from federal, state and local sources, as reported by the sub-grantees to KHC, were \$7,416,457 for the same period. The total reported expenditures for the performance period were \$7,916,457, approximately \$1.7M greater than the approved budget with the variance derived from additional reported federal, state and local matching funds obtained.

Per the terms of the Grant, KHC's responsibilities included management of the application process, related financial transactions, and documentation of project outcomes and overall monitoring of project activities. A number of findings were noted related to the overall administration of the Grant and measures to ensure compliance with the terms and conditions of the Grant agreement. In general terms, KHC acted as a pass-through organization and did not designate any funds from the Grant for its own use or to cover any Grant-related costs incurred. KHC generally passed down compliance responsibilities to the end recipients of the Grant funds and did not have sufficient procedures in place to monitor compliance with the terms and conditions of the Grant agreement. Resulting findings included the absence of, or limitations to, processes for KHC to: provide progress reports to ARC; validate expenditures and matching funds as reported by sub-grantees; monitor sub-grantee compliance with Davis-Bacon Act standards; and perform inspections of construction work completed.

**Scope**

We performed a program review of the KAHP Grant KY-16444 at the KHC and FAHE offices from June 17-20, 2013, as described under this section and under the audit methodology section. Our review was based on the terms of the Grant agreement and on the application of procedures in the modified ARC Audit Program.

We conducted this performance audit in accordance with Generally Accepted Government Auditing Standards (GAGAS). 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.

### **Audit Methodology**

Our procedures were based on the Audit Program guidelines provided by the ARC Office of the Inspector General and included suggested procedures over KHC's accounting and internal control systems affecting the Grant. KHC passed all funds through to sub-grantees and did not draw any funds from the Grant for its own use or to cover any Grant-related costs. As a result, we included in the performance audit a review of processes and controls at FAHE, the recipient of over 80 percent of the Grant funds. We met with the Director – Housing Program Management Office and the Special Program Specialist at the KHC office and the Vice President of Consulting Programs at the FAHE offices to discuss their respective departments' overall structure and processes around grant administration and monitoring. We also discussed and reviewed other financial and operational elements related to the conduct of the program with a sample of FAHE's participating members.

Our review of background material included ARC's Grant Agreement and related documentation, ARC Grant approvals, the KHC Grant application to ARC, the sub-grantee applications to KHC, information from ARC's Grant management system, other supporting Grant documentation and audited financial statements pertaining to KHC and FAHE for the fiscal year ended July 30, 2012.

We reviewed controls over the application process for funding construction and rehabilitation programs and the controls in place for recording, accumulating and reporting costs under the Grant, and observed and made inquiries regarding whether the goals and objectives of the project funded with ARC monies had been met.

For a sample of the funded construction units, we examined funding applications, supporting documentation, including reporting from the sub-grantees, reimbursement requests and performance data maintained by KHC and FAHE to manage and monitor the KAHP program. We evaluated the process for compliance with applicable Grant requirements and regulations.

### **Results**

#### **Compliance with Grant Provisions**

As reported by KHC, the funds disbursed under these agreements were used to support the construction and rehabilitation of homeownership housing and the construction of multi-family rental housing for low and very low-income families in Appalachian counties of Kentucky. The project was designed to serve those families with the lowest incomes in the sub-grantees' service areas.

KHC requested reimbursement from ARC for \$500,000 of Grant-related expenses for the period ended December 31, 2012. As reported by the sub-grantees to KHC, matching funds, provided from federal, state and local sources were \$7,416,457 for the same period. The total reported expenditures for the performance period, were \$7,916,457, approximately \$1.7M greater than the approved budget with the variance derived from additional reported federal, state and local matching funds reported.

KHC passed all funds through to sub-grantees and did not draw any funds from the Grant for its own use or to cover any Grant-related costs incurred. The Grant funds were distributed among four sub-grantees that are local and regional housing service providers. FAHE received a majority of the funds, \$403,000. FAHE, in-turn, passed the Grant funds through to its Member Groups without drawing any funds for its own use. The participating FAHE Member Groups and other KHC sub-grantees monitored and reported matching funds from federal, state and local sources in addition to managing the housing construction and renovation projects.

**Results (Continued)**

Compliance with Grant Provisions (Continued)

Specific performance objectives for the Grant were not clearly defined in the application, and progress reports and final reports were not provided to us during the course of the audit. As a result, we were unable to conclude on the achievement of specific objectives; however, as described by KHC during the audit, the project activities supported by the Grant funds were consistent with ARC's goals and objectives, resulting in the construction or rehabilitation of 152 housing units in Appalachian Kentucky.

We examined supporting documentation for the transfer of ARC funds from KHC to FAHE and reviewed a sample of the reimbursements requested from the FAHE Member Groups.

Per the terms of the Grant, KHC's responsibilities included management of the application process, related financial transactions and documentation of project outcomes and overall monitoring of project activities. A number of findings were noted related to the overall administration of the Grant and measures to ensure compliance with the terms and conditions of the Grant agreement. In general, KHC acted as a pass-through organization and passed down compliance responsibilities to the sub-grantees and end recipients of the Grant. KHC did not have sufficient procedures in place to monitor compliance with the terms and conditions of the Grant agreement.

At the conclusion of the audit, we noted and discussed the following findings, observations and recommendations with Management:

**Finding – Performance Reporting**

ARC Grant agreements require grantees to submit interim and final reports in prescribed formats as noted in the ARC Grant Administration Manual. The narrative report format includes the following sections: cover page; background; recent/upcoming activities; progress made toward project outcomes; problems encountered; outlook for program continuation and sustainability; and, for the final report only, conclusions and recommendations. These narrative reports allow for the assessment of progress against anticipated outputs and outcomes, enabling the Grantee and ARC to assess whether the project is progressing as expected and if the project has achieved, or will achieve, its stated goals and objectives within the appropriate timeframe. It was noted during our audit, that the funding requests submitted by KHC for draws on the ARC Grant funds were not supported by narrative progress reports and that, to date, no final narrative report has been submitted for this Grant as required within 30 days of the completion of the period of performance.

Recommendation:

KHC should submit a final report in the required format to close out the Grant as soon as possible. For future Grants, written progress reports should be submitted in accordance with the reporting requirements established by ARC, including narrative elements along with reimbursement requests to gauge progress against the outcomes and outputs specified in the Grant applications and to provide details on the financial status of the Grants.

Management Response:

In response to the finding, the Grantee stated that reports had been provided to ARC as required and provided details of the past correspondence with its ARC Program Representatives.

**Finding – Performance Reporting (Continued)**

*Auditor Response: The timing of the reports referenced by the Grantee tie to the Grant funding reimbursement requests that we obtained during our audit; however, the periodic narrative progress reports that are supposed to be provided to ARC, if prepared, were not provided by the Grantee during the audit and were not included in the ARC files and records for the Grant.*

**Finding – Validation of Sub-Grantee Reported Expenses and Matching Funds**

Through discussion with KHC Management, it was noted that there is no formal process in place to validate expenses and the matching funds reported by sub-grantees for the ARC-funded expenditures. Applications from the sub-grantees to KHC for funding include a summary of the ARC funded expenses, non-ARC federal, state and local matching funds in place; signed draw requests are submitted. However, there is no process in place to validate the numbers reported, on a sample basis or otherwise.

**Recommendation:**

KHC should implement a process to ensure that it can independently validate the ARC and matching funds reported by the sub-grantees and/or formalize the requirement for sub-grantees to do the same and implement a process to monitor sub-grantee compliance.

**Management Response:**

In response to the finding, the Grantee stated that KHC's Compliance Department monitors sub-grantees to ensure proper documentation and support for additional federal and state funds awarded by KHC for units where ARC funds are also awarded. The Grantee further stated that 26 percent of the ARC-supported units were awarded less than \$2,000 in ARC funds and were considered to be low risk by KHC.

*Auditor Response: The Grantee did not provide specific details on the nature of the Compliance Department monitoring program or the basis for the risk assessment referenced. The Grant agreement between KHC and ARC does not contemplate any exclusion from the requirements to monitor sub-grantee based on risk. As a result, we reiterate the recommendation that a formal process to validate matching funds reported by sub-grantees be implemented.*

**Finding – Compliance with Davis-Bacon Act**

From discussions with KHC Management, it did not appear that any process exists to formally track or document compliance with the Davis-Bacon Act fair wage standards. The ARC Grant agreement with KHC conveys the obligation to ensure that the distribution of the funds is conducted in compliance with the Davis-Bacon Act. Davis-Bacon Act provisions followed by ARC require the application of the Act requirements for any contract involving rehabilitation of any structure of eight or more units and for any contract involving new construction of five or more single-family units.

**Recommendation:**

KHC should implement a process to ensure that it can validate and enforce sub-grantee compliance with Davis-Bacon requirements if any contractor completes a number of projects in excess of the thresholds noted above. To the extent that KHC determines that certain provisions in the Grant agreement do not apply, the assumptions and interpretation supporting that decision should be validated with ARC in advance to ensure that the approach is agreed upon by both parties.

**Finding – Compliance with Davis-Bacon Act (Continued)**

Management Response:

In response to the finding, the Grantee prepared and provided analysis of the Davis-Bacon Act requirements and its interpretation of the applicability of the Act. The Grantee concluded that the Davis-Bacon requirements did not apply for the ARC grant.

*Auditor Response: The Grantee's assumptions and interpretation should be validated by ARC to ensure consistency.*

**Finding – Limitations of Inspections Process**

The Grant award requires the Grantee to monitor project activity to ensure successful implementation. Through discussion with the KHC inspectors, it was noted that the process to validate that work has been performed at a given location is limited in scope and only performed after the final completion of the work. This process limits the extent to which the inspectors have visibility into what specific work was performed at the site and what materials were used in the process. ARC funds were intended to be spent on site preparation and utility work, neither of which can be effectively validated through inspection after completion of the project. Even though the Grantee delegated its responsibility, it is still responsible for establishing a process to monitor the work performed by the sub-grantees.

Recommendation:

KHC should enhance the inspections process to ensure that the inspectors can effectively validate the work performed. This will likely require additional inspections during the course of the projects, or verification that inspections by sub-contractors were performed at the appropriate time, and/or coordination with other local inspectors already engaged to inspect the construction work.

Management Response:

In response to the finding, the Grantee stated that it requires sub-grantees to inspect units during the construction period and that it relies on the sub-grantees' inspections to ensure that work has been completed. KHC then inspects all units at completion. The Grantee also noted that KHC does not allocate any of the Grant funds to cover the administrative costs of performing inspections and, as a result, cannot inspect every unit multiple times during the construction period.

*Auditor Response: Reliance on sub-grantee inspections may be appropriate if a formal monitoring process is implemented to ensure ongoing compliance with the terms and conditions of the Grant agreement.*

**Finding – ARC Contribution to Project Funding**

The ARC approval for the Grant included a condition that the ARC contributions to any project not exceed 20 percent of the total cost of that project. Based on review of the sub-grantee reporting of matching funds for each project, we noted that although in the aggregate, the ARC contribution was below the 20 percent threshold for the Grant funds as a whole; there were 29 individual projects where the ARC contribution exceeded this threshold.

Recommendation:

We recommend that KHC follow up with its ARC point of contact to resolve this issue and determine the appropriate treatment for the exception items noted.

**Finding – ARC Contribution to Project Funding (Continued)**

Management Response:

In response to the finding, the Grantee represented that the contribution threshold for ARC funds had been increased to 25 percent through discussion with its ARC project coordinator and provided support in the form of email correspondence between KHC and ARC.

*Auditor Response: Through review of the support provided by KHC, we noted that no firm conclusion was reached by ARC and no approval was granted to KHC to modify the threshold. It was further noted that 3 of the 29 exceptions exceeded the revised threshold being applied by KHC.*

**Finding – Support for Grant Amendments**

During our fieldwork, we noted that \$26,000 of expenses reimbursed with Grant funds were incurred after the end of the performance period of the grant. Without written documentation, the Grantee does not have official approval for changes to Grant terms and the changes and associated expenditures could be disallowed.

Recommendation:

Grantee policies and procedures should require that approval for all Grant amendments be obtained in writing prior to Grant expiration and that no incremental costs should be incurred against the Grant until such written approval is obtained. ARC should review the expenditures incurred in the final extension period of the Grant to ensure that they are valid.

Management Response:

In response to the finding, KHC advised us that in September 2012, ARC had verbally approved extension of the Grant period from September 30, 2012 to December 31, 2012. However, formal written approval for this extension was not obtained until September 12, 2013, after KHC requested support from its ARC representative for the approval of the extension of the Grant performance period.

*Auditor Response: Although the retroactive authorization extended the period of performance, the expenditures incurred during the final extension period should be reviewed by ARC to ensure allowability.*