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November 18, 2021

Honorable Jane Hughson  
Mayor  
City of San Marcos  
630 E Hopkins  
San Marcos, TX 78666

Dear Mayor Hughson:

We are pleased to provide the attached 2021 Quarter 3 Internal Audit Report with respect to internal audit services performed for procurement and finance activities related to the Housing and Urban Development (HUD) Community Development Block Grant - Disaster Recovery (CDBG-DR) funding the City of San Marcos, Texas (the City) received as a result of the May 2015 (DR-4223) and October 2015 (DR-4245) floods. This work was performed based on the terms outlined in the engagement letter dated April 10, 2017. The areas covered during the internal audit were jointly identified with the City according to a risk-based internal audit plan and is outlined within this report.

Our services were performed in accordance with the Statement on Standards for Consulting Services issued by the American Institute of Certified Public Accountants (AICPA). However, our services did not constitute an engagement to provide audit, compilation, review, or attestation services as described in the pronouncements on professional standards issued by the AICPA, and, therefore, we will not express an opinion or other form of assurance with respect to our services.

In addition, our services did not constitute an examination or compilation of prospective financial information in accordance with standards established by the AICPA. We did not provide any assurance regarding the outcome of any future audit or regulatory examination or other regulatory action; nor did we provide any legal advice regarding our services; the responsibility for all regulatory and legal issues with respect to these matters resides with the City. It is further understood that the City is responsible for, among other things, identifying and ensuring compliance with laws and regulations applicable to the City's financial statement activities.

This report is intended solely for the information and use of City and is not intended to be, and should not be, used by any other party, with the exception of oversight agencies for the performance of their oversight responsibilities.

We appreciate the cooperation received from management and staff of the City during the performance of this internal audit.

Very truly yours,

Deloitte & Touché LLP

Kathie Schwerdtfeger, Partner

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# Executive Summary

## Background

The City has been awarded approximately \$34 million in Community Development Block Grant Disaster Recovery (CDBG-DR) grants by the U.S. Housing and Urban Development Department (HUD) as a result of the significant flooding events of May and October 2015. This funding is subject to federal compliance requirements found in 2 CFR §200 *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* and 24 CFR §570 *Community Development Block Grants*. Based on the HUD Action Plan developed by the City, the funds were allocated for the development of infrastructure and housing projects. To oversee the spending and oversight of the grant funds received, the City has developed policies and procedures to administer the CDBG-DR program. As needed, contracted professionals are engaged to provide additional technical assistance. Additionally, the City developed CDBG-DR policies and procedures, established internal controls, and implemented systems to govern the use of the HUD funds received.

In accordance with requirements set forth by HUD, The City has engaged Deloitte & Touché LLP to conduct internal audits each year of program funds and activities to evaluate compliance with national objectives, the City's HUD CDBG-DR Action plan and related amendments, federal program regulations, and City policies and procedures related to the CDBG-DR funding. Additionally, the internal audits evaluate the design and operating effectiveness of internal controls over program activities and funds and provides recommendations for enhancement, when needed.

## Our Scope & Objectives

The area of focus for this internal audit included procurement, contracts, and finance activities for CDBG-DR activities occurring in the City's third quarter of Fiscal Year 2021 from April 1, 2021 through June 30, 2021.

Each area was reviewed to evaluate the following:

- The design and operating effectiveness of internal controls of the Finance and Purchasing Departments
- Compliance with Federal program and administrative regulations governing the CDBG-DR program
- Compliance with City policies and procedures governing the CDBG-DR program
- Compliance with the City's HUD Action Plan for Disaster Recovery and related amendments

## Procurement and Contracting:

The assessment procedures included evaluation of the contract front-end life cycle, from request for proposal (RFP) to the establishment of a contract. The procurement process was evaluated for the services listed below and included the procurements for which an RFP was issued under these grants between April 1, 2021 through June 30, 2021. Contracts resulting from the procurement process were also reviewed.

New procurements or contracts occurring during this review period are listed below:

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	No New Procurements or Contracts Reported for Q3
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Change Orders that occurred are listed below:

218-197	K. Friese & Associates ACIS #5
218-253	Halff Associates ACIS #6

**Expenditures:**

The assessment procedures evaluated whether federal regulations and City policies and procedures were followed in the approval and payment of CDBG-DR related expenditures during the period of April 1, 2021 through June 30, 2021. The selected expenditures were also evaluated to determine whether they were reasonable, necessary, allowable, and properly evidenced by supporting documentation. A sample of expenditures was selected from program expenditures for the period and included infrastructure, housing, public facilities, administration, and planning activities.

The testing methodology included an analysis of at least 30% of the transactions executed during the period and consisted of an evaluation of invoices, proof of payment, general ledger, the HUD Quarterly Performance Reports (QPR) and HUD Disaster Recovery Grants Reporting System (DRGR) reporting and compliance with applicable policies, procedures, and federal grant regulations.

Final observations and recommendations included in the report were discussed with the City on November 9, 2021 and the report was released on November 18, 2021.

**Prior Audit Findings:**

The assessment procedures utilize interviews and follow-up meetings with City staff to review the status of resolution or evidence of progress relating to any prior audit findings from prior quarterly internal audits, HUD monitoring visits, or other external audits with findings directly related to the CDBG-DR program. The review concluded that the City has addressed all of the prior findings from previous quarters' internal audits.

The City underwent a HUD monitoring visit in June of 2020. The final report of that visit was issued on October 26, 2020 and the City had until May 26, 2021 to respond. The City has provided formal responses to all findings noted in the October 2021 Monitoring Report. At the time of this Q3 Internal Audit Report, all findings and concerns were completed by the City. A formal response from HUD acknowledging closure of the findings has yet to be issued. It should be noted that two out of the three Concerns noted in the October 2020 HUD Monitoring Report, and three out of the five Findings in that report, align with City's Internal Audit observations reported in previous quarters. These are noted below:

- HUD Concern #1, Re: Expenditure Deadlines
- HUD Concern #2, Re: Staff Capacity
- HUD Finding #2, Re: Recordkeeping
- HUD Finding #3, Re: Contract Cost and Price and Cost Reasonableness
- HUD Finding #4, Re: Documentation for Evaluation and Selection of Professional Services

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## Approach

The internal audit activities performed included the following:

- **Step 1:** Interviewed the following key stakeholders involved in administering the CDBG-DR program to gain an understanding of program activities during the period and obtain their input related to potential risks to the program:
  - Anna Miranda - Finance Assistant Director
  - Carol Griffith - Housing and Community Development Manager
  - Jason Dunn - Grants Compliance Specialist
  - Jacquelyn Thomas - Senior Engineer
  - Jesse Garcia - Finance Grants Manager
  - Lynda Williams - Purchasing Manager
  
- **Step 2:** Performed the following review and testing procedures:
  - **CDBG-DR Contracts**
    - Obtained procurement and contract related documents for procurement and contract activities that occurred during the period.
    - Assessed the City of San Marcos Action Plan for Disaster Recovery and the City's Purchasing Policy to verify consistency and adherence with federal regulations and HUD policy;
    - Evaluated RFP and Contract activity since the last internal audit to determine whether they were consistent with the City's procurement policy;
    - Assessed the RFP and bid review evaluation process;
    - Evaluated contracts established for required Federal clauses;
    - Identified areas for improvement and developed recommendations for consideration.
  
  - **CDBG-DR Expenditures**
    - Obtained expenditure data for program expenditures that occurred during the period.
    - Selected approximately 30% of expenditures for testing from General Ledger with a focus on activities with high spend during the period;
    - Assessed purchase or approval processes related to work performed;
    - Evaluated invoices for contracts established and associated purchase orders
    - Evaluated labor, equipment, and other charges based on rates and amounts and mathematical accuracy and reasonable of invoice and/or allocation methods; and Evaluated invoice review processes.
  
- **Step 3:** Conducted a closing meeting and discussed the observations and recommendations with management.

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# Observations and Recommendations

As noted on page 4 of this report, Observations and Recommendations, including Management Response & Corrective Action Plan are presented and addressed herein.

Observation Category	Observation	Observation	Recommendations/Management Action Plans
	Condition	Criteria, Cause, Effect	Recommendation
Q3 Expenditure Review	<p><b>3E-a.</b> In three (3) instances, the General Ledger amount for construction invoices included the 5% retainage fee. This General Ledger amount was also used to draw down for Federal reimbursement. While the 5% retainage fee is a cost incurred against the contract value itself, it is not an expense paid by the City at the time of invoicing, and therefore not eligible for reimbursement at this time.</p>	<p>Per 2 CFR 200.302(a)(2), Financial Management, requires records the non-Federal entity to provide accurate, current, and complete disclosure of the financial results of each Federal award or program in accordance with the reporting requirements.</p> <p>Under Financial Accounting Standards Board (FASB) ASC 606, retainage that is contingent upon any condition other than the passage of time is not considered a receivable.</p>	<p>The City should reimburse the CDBG-DR account for the funds drawn down in advance of the actual expenditure.</p> <p>Once the expenditure becomes a valid expenditure, the funds may be drawn down and placed into the CDBG-DR account.</p> <p>Because the retainage withheld by the vendor during invoicing will be billed at contract's end, the City need only track the currently invoiced amount to avoid duplication of expenditures within the City's General Ledger.</p> <p>The City should also consider a system that separately tracks costs incurred against the contract versus actual expenditures to monitor compliance with the contract's not to exceed amount and phase estimates.</p>
	<p><b>3E-a. CoSM Response:</b></p> <p>The City has reduced drawdown requests in Q4 by the amounts over reported in Q3 to reimburse the CDBG-DR account. Procedures are now in place to track withheld retainage against incurred expenditures. Draw down requests will only be made for paid costs. Draw down for the withheld construction retainage will be made when this final payment is made to the vendor.</p>		

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	<p><b>3E-b.</b> In one (1) instance, an expense was incorrectly coded to the CDBG-DR program and included in the quarterly drawdown.</p> <p>This issue was identified at the time of expenditure sample selection and is currently in the process of being resolved.</p>	<p>2 CFR 200.303, Internal Controls, requires that recipients 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 Federal award.</p>	<p>The City should reimburse the CDBG-DR account for the non-program related funds that were drawn down.</p> <p>Additionally, the City should continue to adhere to the internal controls that are in place for the execution and approval Federal program activities.</p>
	<p><b>3E-b. CoSM Response:</b></p> <p>The City will correct the coding of the invoice and credit the DR grant in the next drawdown request.</p>		
<b>Q3 Drawdown Review</b>	<p><b>3D-a.</b> In seven (7) instances, both voucher creation and drawdown occurred in Q4 rather than in the quarter when the expenditure was incurred or shortly thereafter.</p> <p>This observation has been noted in previous quarters' Internal Audit Reports.</p> <p>In prior monitoring visits HUD identified the City as a slow spender of HUD CDBG-DR funds. In response, the City committed to avoid delays to spending and drawdowns.</p>	<p>Per 2 CFR 200.302(b)(2), Financial Management, recipients of funding are responsible for accurate, current, and complete disclosure of the financial results of each Federal award or program.</p>	<p>*Recommendation from previous quarters remains the same and resolution is considered in progress.</p> <p>The City is attempting to resolve previous and current findings related to timely drawdowns.</p> <p>The City's current procedure is to draw down funds once a month, or at least once per quarter.</p> <p>The City should consider amending this procedure to require City staff to draw down funds monthly or biweekly to better tie federal drawdowns to federal program expenditures occurring in the period. In not doing so, the City is covering federal program costs with City general revenue for a longer period of time than strong financial management would advise.</p>

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Observation Category	Observation	Observation	Recommendations/Management Action Plans
	Condition	Criteria, Cause, Effect	Recommendation
	<p><b>3D-a. CoSM Response:</b></p> <p>The City is committed to improving processes to request more timely drawdowns. Staffing shortages have affected timeliness of data gathering and reporting. Target timeframe to fill vacancies is by first quarter of calendar year 2022.</p>		

