



City of San Marcos CDBG-DR Internal Audit Report



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June 3, 2019

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

Dear Ms. Hughson:

We are pleased to provide the attached 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 & Touche LLP

By: _____
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 & Touche 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.

As of the last Quarterly Report to HUD dated March 31, 2019, the City has expended \$4,083,238.30 or approximately 12% of the anticipated \$34 million in HUD CDBG-DR funding for the various projects set forth in the City's HUD approved CDBG-DR Action Plan and related amendments. They have completed 6 homes under the City's Housing Repair/Rehabilitation Home Program and have begun design of each of the 5 approved infrastructure projects.

Our Scope & Objectives

The area of focus for this internal audit included procurement, contracts, and finance activities for CDBG-DR activities. Each area was reviewed to determine the following:

- Design and operating effectiveness of internal controls
- 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 September 25, 2018 through April 23, 2019. Any contracts resulting from the procurement process were also reviewed.

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- 218-230 On-Call Stormwater Consulting (Professional Services)
- 218-312 Rental of Storage Units for House Reconstruction (Informal)
- 218-345 CDBG-DR Housing Study and Needs Assessment
- 219-111 On-Call Survey Services (Professional Services)
- 219-129 On-Call Water Wastewater Engineering (Professional Services)

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 September 26, 2018-April 23, 2019. These 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 all 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.

Fieldwork was conducted from April 22 through May 22, 2019 and initial observations and recommendations with the HUD-CDBG-DR Program Manager on May 24, 2019. The report was finalized and released to the City on June 3 2019.

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:
 - Stacy Brown – Housing and Community Development Manager
 - Heather Hurlburt – Director of Finance
 - Lynda Williams – Purchasing Manager
 - Andrea Veach – Grants Manager
 - Elsa Dominguez – Grants and Compliance Specialist
 - Jackie Thomas – Senior Engineer
- **Step 2:** Performed the following review and testing procedures:
 - **CDBG-DR Contracts**
 - Obtained procurement and contract related documents for all 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 all 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.

Observations and Recommendations

Observation Category	Observation	Observation	Recommendations/Management Action Plans
	Condition	Criteria, Cause, Effect	Recommendation
<p>1</p> <p>Updates to Policies & Procedures</p>	<p>The City's current policies do not always reflect the process being followed.</p> <ul style="list-style-type: none"> The City's travel policy related to HUD CDBG-DR travel expenses does not reflect the current process being followed. Purchasing and finance policies do not differentiate between Check Requests and Contract payments which have different processes. 	<p>Per 2 CFR §200.318, grant recipients must have their own written policies and procedures that are as or more stringent than federal requirements. By utilizing processes outside of the documented City policies and procedures, the City is at risk for performing crucial grant activities outside of the federal requirements, which can result in a variety of findings and/or questioned costs.</p>	<p>The City should update its policies to reflect current grant program specific processes. Additionally, the City should outline the various payment processes that are utilized and under what circumstances each is to be utilized. During the internal audit, the finance department identified this discrepancy and acknowledged the need to amend the policies to reflect the current processes performed.</p>
<p>2</p> <p>Updates to Policies & Procedures</p>	<p>Authorization of Change In Services Form and Request for City Manager Signature form require signatures by both Finance and the City Manager. In many cases, the Purchasing Manager signed for both finance and as the City Manager delegee.</p>	<p>Per 2 CFR §200.318, grant recipients must have their own written policies and procedures that are as or more stringent than federal requirements. The City has a procedure in place to ensure 3 levels of approval are required prior to approving a purchase - however, utilizing the same signature multiple times negates the level of approval required by the policy. This results in a potential issue with segregation of duties, and the reduction in level of approvals could result in less oversight than the City intended.</p>	<p>The City should institute and document a mitigating control in instances where multiple approval roles are the same person. We suggest utilizing an additional manager to approve for Finance in cases where the Purchasing Manager will approve on behalf of the City Manager.</p>
<p>3</p> <p>Procurement</p>	<p>Cost Reasonableness analyses required by federal regulation were not reviewed by or filed with the Purchasing and Contracting Division for any procurements this period. Cost Analyses are required for every transaction and should be included in procurement files and decisions. The Housing and Community Development Manager performed the cost analyses and had them on file.</p>	<p>Per 2 CFR §200.323, a cost or price analysis must be performed in connection with every procurement action in excess of the simplified acquisition threshold. Although the Cost Reasonableness Analyses were performed by the grants department, the purchasing department being unable to validate or provide these in the event of an audit could result in high questioned costs due to non-compliance with federal procurement regulations. Additionally, lack of Cost Analysis review by purchasing can result in vendors being selected that do not provide the best value.</p>	<p>The City should create and integrate a Cost Reasonableness Analysis process into its purchasing activities. Purchasing should oversee this process and validate that costs were determined reasonable prior to approving contracts. They should maintain documentation of the analyses performed in the procurement files.</p>

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Observation Category	Observation	Observation	Recommendations/Management Action Plans
	Condition	Criteria, Cause, Effect	Recommendation
<p>4</p> <p>Procurement</p>	<p>Discrepancies were found between the paper and electronic procurement files maintained.</p> <p>While a procurement checklist is utilized by the purchasing department throughout the process, no "audit" or additional level of review is being performed on the files to confirm compliance with and supporting documentation for each of the requirements outside of an expectation that team members perform "self-audit".</p>	<p>Per 2 CFR §200.333 and 2 CFR §200.336(a), the City could be requested to provide complete supporting documentation for any procurement and financial transaction pertinent to the Federal award in order to respond to audits, examinations, excerpts, and transcripts from multiple parties. It is crucial that the City is able to submit complete procurement and financial files in the event of an audit or other Federal request.</p> <p>Undocumented or incomplete procedures increases the risk of the procurement being questioned and the resulting contract and services being deemed non-compliant resulting in questioned costs and potential deobligations of funding.</p>	<p>The purchasing department should reconcile electronic files and paper files to determine that consistent and complete procurement files are being maintained. Going forward, the City should consider adopting a single source electronic file system as the official file copy of procurement records. This will promote greater efficiency, reduce the risk of incomplete records, and allow the department to respond timely and accurately to audit and program review requests.</p> <p>A second level review of purchasing procedures applied to individual procurement packages should be implemented to provide greater level assurance that appropriate requirements are met and documented.</p>
<p>5</p> <p>Expenditure Review</p>	<p>Inaccurate allocation methods for labor to activities were identified. Prior accountant performed labor allocations based off a percentage of hours of the total hours going to CDBG-DR rather than by person and specific rate as required making costs allocated inaccurate. This resulted in some labor costs being overstated, while others were understated.</p>	<p>Per 2 CFR §200.430, federal regulation requires that charges to Federal awards for salaries and wages be based on records that accurately reflect the work performed. These records must be supported by a system of internal control which provides reasonable assurance that the charges are accurate, allowable, and properly allocated. The improper allocation method identified during this review does not accurately reflect the amount of work per person allocated to each activity and could result in questioned costs and risk of funding for allocated labor costs.</p>	<p>The finance department should review all prior allocations to determine proper allocation of labor to applicable activities and adjust the charges to the CDBG-DR program as necessary to align with federal requirements. During the internal audit, the finance department identified this improvement opportunity and has acknowledged the need to review and correct prior transactions.</p>
<p>6</p> <p>Expenditure Review</p>	<p>An invoice was paid that did not include supporting documentation for subcontractor expenses. Without backup for expenses, the City could not have adequately validated that the expenses were allowable and reasonable.</p>	<p>Per 2 CFR §200.403, reimbursable costs must be reasonable, allocable and allowable. Without expense documentation, the City could not have verified these expenses complied with the federal cost principles. A determination that these costs were not adequately supported could result in the questioning of these costs and potential deobligation.</p>	<p>The City should request the contractor provide the expense documentation to confirm these expenses were allowable. Going forward, the City should implement in both its contracts and payment policies that expense documentation must be provided and evaluated for compliance with federal requirements even when approved by a department or prime vendor.</p>

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Overall Recommendation for Program Specific Training

Based on the issues identified above and interviews with multiple departments, grant specific training was not always available. Given recent staff turnover and new positions in multiple departments, as well as multiple areas in which grant requirement knowledge could be expanded, we highly recommend the City provide program-specific training to those staff members involved in CDBG-DR grants management activities. This training should be mandated for all new personnel and annual updates provided to those working with the program. This will aid in better understanding of program requirements, how City policies and procedures work within the program and help increase the City's abilities to continue monitoring their CDBG-DR grant funding in an effective and compliant manner.

Management Response and Corrective Action Plan



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Management Response & Corrective Action
Deloitte & Touche Internal Audit Report – May 2019

Deloitte General Observation: *“Given the recent staff turnover and new positions in multiple department, as well as multiple areas in which grant requirement knowledge could be expanded, we recommend providing program-specific training to those staff members involved in CDBG-DR grant management activities. This training should be mandated for all new personnel and annual updates provided to those working with the program.”*

CoSM: The Finance Department is working on a three-prong approach to build capacity of staff members involved with grant management:

- 1. Creation of grants specific positions:** Previously, the Finance Department had a Grant Accountant position that reported to the Accounting Manager. This accountant focused on reconciliations and documentation management for grant related expenditures, as well as calculations for time allocations and all other accounting tasks related to CDBG-DR. In March of 2019, a position was filled for a Grants Manager, who in coordination with Purchasing and Accounting Managers, will evaluate existing processes and build capacity within the Department to ensure strong internal controls over expenditures and grant management processes. A second position was created for a Grants and Compliance Specialist. This person will initially focus exclusively on CDBG-DR processes, policies, and resource creation. They will liaise between the Finance Department and the program implementation teams. A stronger focus on grant compliance and processes will strengthen the city’s ability to reduce any existing or perceived risks in grant management.
- 2. Grant management capacity building:** The Grants Division is already conducting one-on-one meetings with Accounts Payable and Contract Management staff in the Accounting Division to identify areas of improvement. Additionally, issues that came up during the preparation of expense documents for this audit have been used as examples for learning key elements that Finance Department staff needs to review prior to processing a payment request in order to remain compliant with our grant agreements and federal regulations.
Outside of the Finance Department, the Grants Manager has already conducted a training on accurate timekeeping with the program implementation team when new timesheet formats were rolled out to minimize risk in the time allocation process at the user and approver levels.
- 3. Grant Program specific capacity building:** Both the Finance Department and the Planning & Development Services Departments have invested in training staff members on crosscutting regulations that apply to CDBG-DR grants as well as on HUD sponsored workshops specifically related to the implementation of CDBG-DR programs and compliance with national objectives and regulations. Additionally, any new hires in the Grants Division staff will be required to complete an online webinar series on HUD Exchange¹ for new grantee as part of their onboarding process. This webinar was recommended by the HUD representative assigned to our grant (<https://www.hudexchange.info/news/2016-cdbg-dr-webinar-series/>).

¹The HUD Exchange is an online platform that provides program information, guidance, resources, and assistance to HUD partners including trainings on program and financial management.



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At this time, the Grant Division is also updating the City's internal CDBG-DR Financial Management Manual to include more detailed process information related to reconciliations, internal voucher creation, DRGR drawdown voucher creation, preparation of data for Quarterly Performance Reports, among others. Resources such as an updated chart of accounts, program project strings, key regulations, and a staffing matrix will also be part of the onboarding package for new staff working on CDBG-DR grant management.

Deloitte Observation 1 – Updates to policies & procedures: *"The City's current policies do not always reflect the process being followed.*

- *The City's travel policy related to HUD CDBG-DR travel expenses does not reflect the current process being followed.*
- *Purchasing and finance policies do not differentiate between Check Requests and Contract payments which have different processes."*

CoSM: This observation identifies two separate policies which will be addressed individually below:

a) Travel

In order to minimize risk of performing activities outside of federal requirements, the Finance Department has engaged in a review of processes related to federally funded travel expenditures.

A workgroup comprised of the Finance Director, Purchasing Manager, Accounting Manager, and Grants Manager has identified the need to review travel processes to remain in compliance with General Rules in 41 CFR 301, as well as integrate key elements of 2 CFR 200, and 24 CFR 570.206 to the CDBG-DR travel authorization process.

The current process being followed referenced in the observation is an electronic approvals process through TylerMunis (the City's accounting system) once verbal approval for travel has been received and employees use purchase cards to make arrangement. All P-Card transactions go through an internal approval process that includes supervisors. The approval of a P-Card transaction for travel is very comprehensive and ensures that program teams, as well as finance and compliance personnel review the correct allocation of each expense. The workgroup will identify what part of the current policy and current process can be merged to produce a standard travel operating procedure.

The workgroup will also consult with experts on interpretation of these regulations as well as GSA established reimbursement rates. If deemed necessary, the City will update its policies to reflect any changes in procedures.

b) Request for Checks (RFC) & Contract Liquidations

The CDBG-DR Financial Management manual is being updated and will address the payment processes available for payment to vendors and contractors so that policies pertaining to check requests and contract liquidations are clear. This information will include when to use each method of payment, how to initiate each method in the financial system, and what information is required for the submission to be approved by the Finance Department.

The Finance Department has already conducted training sessions on basic procurement and vendor payment processes for any city employee interested in attending. It was mandatory for new employees in the Grants Division to attend.



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Deloitte Observation 2 – Updates to policies & procedures: *“Authorization of Change In Services Form and Request for City Manager Signature form require signatures by both Finance and the City Manager. In many cases, the Purchasing Manager signed for both finance and as the City Manager delegee.”*

CoSM: In order to remain in compliance with 2 CFR §200.318, the Finance Department will review any processes related to Section D.3.c.1-3 (p. 10-11) of its Purchasing Policy as it relates to establishing a mitigating control in instances where multiple approval roles (in different levels) have been assigned to the same individual. The current policy requires three levels of approval prior to purchases being completed. While this is a strong policy, the City understands how utilizing the same signature on multiple levels could be seen as negating the internal controls.

It should be noted that the “Request for City Manager’s Signature Form” is merely a coversheet/internal transmittal document which the department uses to provide City Managers with information in regards to what they are being asked to sign. City Managers read this coversheet, but are not required to sign it. For this reason, and the frequency with which documents are submitted to the CM’s office for signature, it would be impractical for the Finance Director to sign off on each of these transmittal forms. The City will review wording on the coversheet since it appears the word “approval” in the signatures line can cause undue confusion. It should be clear that signatures in the transmittal form do not imply approval of any of the attachments.

Once the review of approval roles and designees is complete, the Finance Department will communicate changes to leadership and department heads to ensure compliance with internal controls.

Deloitte Observation 3 – Procurement: *“Cost Reasonableness analyses required by federal regulation were not reviewed by or filed with the Purchasing and Contracting Division for any procurements this period. Cost Analyses are required for every transaction and should be included in procurement files and decisions. The Housing and Community Development Manager performed the cost analyses and had them on file.”*

CoSM: The Finance Department will create a sustainable plan for integrating cost reasonableness analysis procedures to its purchasing activities and determine how they will be carried out. While the Finance Department builds capability and capacities, it will oversee the process while the program implementation team continues to determine the reasonableness of contracts based on their expertise in the field.

As the department in charge of financial records, the Purchasing & Contracting Division will be responsible for managing and maintaining all documentation related to the analyses performed in the official procurement files. Any files kept by other staff members involved in CDBG-DR program management and administration will be working copies and not part of the official procurement records.

Deloitte Observation 4 - Procurement: *“Discrepancies were found between the paper and electronic procurement files maintained.*

While a procurement checklist is utilized by the purchasing department throughout the process, no ‘audit’ or additional level of review is being performed on the files to confirm compliance with and supporting documentation for each of the requirements outside of an expectation that team members perform ‘self-audit’.”

CoSM: The Purchasing Manager and Grant Manager will establish a schedule to conduct self-audits on procurement samples to ensure that no discrepancies exist between files being maintained. This additional level of review will provide assurances that appropriate requirements are being met and documented. Existing procurement checklist will also be reviewed to ensure procurement staff is showing their work when conducting file reviews. Additionally, the Finance Department will re-evaluate its internal workflow and determine if the Grant



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Manager or Grant and Compliance Specialist should be involved in assisting with grant related procurement processes in other ways.

A conversation around single-source filing and digitization of files has begun in the department with the understanding that it will guarantee greater consistency, efficiency and accuracy. The goal is to move to an electronic system with standardized folders for each procurement process. At this time, efforts are being made to reach that goal starting with grant specific files.

Deloitte Observation 5 - Expenditure Review: *"Inaccurate allocation methods for labor to activities were identified. Prior accountant performed labor allocations based off a percentage of hours of the total hours going to CDBG-DR rather than by person and specific rate as required making costs allocated inaccurate. This resulted in some labor costs being overstated, while others were understated."*

CoSM: As noted in the Recommendation/Management Action Plans section of the report, the Finance Department identified this issue during the preparation of audit materials. The Grants Division will begin to review and correct internal documentation for prior transactions, which includes review of staff paper timesheets and allocation of benefits for FY18 and FY19. Once internal documentation and calculations are reviewed and correct costs identifies, funds drawn down will be reconciled and accounts will be balanced out in subsequent requests for reimbursement.

In order to mitigate the risk of incorrect allocations, the Grants Team has already developed an updated timesheet and is analyzing 3rd party timekeeping alternatives that will increase efficiency and reduce the risk of human error in allocation calculations. As of May 2019, all CDBG, CDBG-DR and grant-funded Finance Department staff members are using the new timesheet format. This format will be rolled out to HUD-funded Planning Department staff in June of 2019.

Deloitte Observation 6 - Expenditure Review: *"An invoice was paid that did not include backup for subcontractor expenses. Without backup for expenses, the City could not have adequately validated that the expenses were allowable and reasonable."*

CoSM: The City acknowledges that additional backup documentation should have been requested for the invoice referenced in this transaction and will make every reasonable effort to remedy the situation by requesting backup documentation from the contractor for the expenses that have already been paid. This was communicated to AP and the Accounting Manager in a Memo submitted to Deloitte as part of their sample and is attached here for reference.

Accounts Payable processed this invoice based on the information submitted by the PM's after invoices were reviewed and work was certified as complete. Staff members submitting and approving invoice submission are responsible for revising all backup documentation as part of their assigned workflow responsibilities. The Grant Division will create refresher training for all grant expense top-level approvers to understand what a processable payment request should and include and how to obtain said information.

Payment approval workflow has also been modified to include the Grants Manager for specific General Ledger accounts assigned to federal and non-federal grants for an extra level of review of backup documentation, contract compliance, and appropriate GL account assignments.

[Accompanying chart of general roles and responsibilities follows in next page.]



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