

TEXAS DEPARTMENT OF HOUSING AND COMMUNITY AFFAIRS

**A Follow up Internal Audit of the Physical Inspection section of the Compliance Monitoring division
Audit Report # 22-004**

Executive Summary

The Office of Internal Audit (OIA) performed a follow up audit of the Physical Inspection section of the Compliance Monitoring division at TDHCA, its processes and procedures, vender management, as well internal controls and rules and regulations under which it operates. Based on our review and analysis, the Physical Inspection section at TDHCA seems to be operating effectively in monitoring properties and developments that are funded through TDHCA for compliance with all applicable rules and standards.

Observations and Recommendations

- OIA recommends that the Physical Inspections section revise and update all current SOPs to reflect current information to create consistency and efficiency for all parties involved.
- OIA recommends that the Physical Inspections section create a formal contract with On-Site Insight (OSI) that would:
 - Outline the roles and responsibilities of each party in avoiding any apparent or possible conflict of interest between OSI inspectors and TDHCA properties that they're assigned to inspect.
 - Ensure consistency in the performance of the inspections, as well as compliance with all applicable standards.
- OIA recommends that the Physical Inspections section management establish and document a training program and modules focused on requirements of each funding program in order to create consistency and reliability in the inspections that are being performed by the staff.

Management Response

Management agreed to our recommendations. Detailed responses are included in the body of the report.

Objective, Scope and Methodology

Our scope included a review of applicable portions of the Texas Administrative Code (TAC), HUD's standards, and TDHCA Board resolutions, as well as the Standard Operating Procedures (SOPs) related specifically to Physical Inspection section and its processes. We also accompanied the Inspection manager on two of his inspection visits to observe his processes.

Mark Scott

6/7/2022

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Date Signed



TEXAS DEPARTMENT OF HOUSING AND COMMUNITY AFFAIRS

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Board Members of the Texas Department of Housing and Community Affairs ("TDHCA")

RE: FOLLOW UP INTERNAL AUDIT OF THE PHYSICAL INSPECTION SECTION AT TDHCA

Dear Board Members:

This report presents the results of the Office of Internal Audit ("OIA") "Follow up Internal Audit of the Physical Inspections Section of the Compliance Monitoring Division at TDHCA." This audit was conducted in accordance with applicable audit standards. It included the objectives to evaluate and explain the Physical Inspections Section of the Compliance division, and to review the administrative and internal control procedures related to the operation of the division.

Follow up Internal Audit of the Physical Inspections section rated high on the annual risk assessment and was included in the approved Fiscal Year 2020 audit work plan because the Physical Inspection section had not been selected for audit previously at TDHCA. This audit was initially conducted in FY 2020, and a report was issued on August 14, 2020. However, due to scope limitations imposed by COVID19 pandemic, and interest expressed by Committee members, OIA planned to review this unit more comprehensively once the pandemic related restrictions were lifted. The division also had two changes of management in less than three years.

This report is divided into the following sections:

- A. Overall Results
- B. Background
- C. Scope and Methodology
- D. Parties involved in the Physical Inspections processes
- E. Funding Sources subject to Physical Inspections
- F. Inspection visits

G. Other audit work

A) Overall Results

Based on our review and analysis, the Physical Inspection section of Compliance Monitoring Division at TDHCA seems to be operating effectively in monitoring properties and developments that are funded through TDHCA for compliance with all applicable rules and standards.

B) Background

The Physical Inspection section performs and administers inspections for developments monitored by the Department throughout the affordability period¹. The minimum affordability period for Tax Credit developments is 30 years, during which the property is subject to routine Compliance monitoring reviews. The federal compliance period is the first 15 years of the affordability period, during which the tax credits that have been given to the developers can be taken away or recaptured by the Internal Revenue Service if the property fails to comply with applicable rules and regulation. Once the federal compliance period ends, the Department relies on State enforcement mechanisms to ensure compliance through the end of the affordability period.

The Physical Inspection section ensures that developments are habitable, well maintained, are ready for occupancy, follow appropriate accessibility standards, and comply with applicable program rules and regulations. Developments funded through the Department's Multifamily Direct Loan Programs are subject to a mid-construction inspection to track construction progress. All multifamily developments must undergo a final construction inspection to ensure compliance with applicable accessibility standards. These inspections are required prior to the issuance of funding or critical documents, depending on the program. At least every three years thereafter a Uniform Physical Condition Standards (UPCS) inspection is also performed. Some UPCS inspections are conducted by Department staff, while others are outsourced. The Physical Inspection section oversees the contract with the UPCS vendor and ensures that owners correct all identified deficiencies.

Additionally, the section inspects single family homes rebuilt, rehabilitated, and receiving down payment assistance or HOME funded rental assistance; homes and apartments receiving weatherization funds; structures funded under the Amy Young Barrier Removal Program; conducts Housing Quality Standards evaluations; and reviews Emergency Shelters. Inspectors may conduct site inspections, construction inspections, and Uniform Physical Condition

¹ The minimum affordability period for a Tax Credit development is 30 years, and refers to the minimum time period that the property will remain under established rent limit.

Standards inspections on new construction and acquisition and/or rehabilitation multifamily developments and for rebuilt or rehabilitated single family homes.

The Physical Inspection (PI) section also conducts physical inspections for the Housing Tax Credit Program (HTC), the Multifamily Tax-Exempt Bond Program (Bond), HOME Investment Partnerships Program (HOME), Housing Trust Fund (HTF), Tax Credit Assistance Program (TCAP), Tax Credit Exchange Program (Exchange) and the Neighborhood Stabilization Program (NSP) and Single Family housing programs at the participating properties based on the frequency stipulated under each program rules.

C) Scope and Methodology

The Texas Internal Auditing Act, Tex. Gov't Code §2102.005 requires auditing of a state agency's major programs and systems. Our scope included a review of applicable portions of the Texas Administrative Code (TAC), HUD's standards, and TDHCA Board resolutions, as well as the Standard Operating Procedures (SOPs) related specifically to Physical Inspection section and its processes. Based upon our preliminary understanding of the Physical Inspections Section we identified critical points and risk, to develop our audit objectives and an audit program including methodology.

During the restrictions imposed by COVID-19 pandemic, the physical inspections of properties under TDHCA purview were limited to mid construction inspections for new constructions of multifamily properties with Direct Loan financing. Per HUD guidelines, these inspections were required to be completed as before. All other inspections were placed on hold for safety reasons. In addition, planned changes to key processes by management and major regulatory updates that were expected in early 2021, limited the scope of our initial audit in FY 2020.

A management change within the Physical Inspection section took place in February 2020, and was followed by another change in management in late FY 2021. The new Physical Inspection management has been focused on bringing all pending inspections up to date as fast as possible, while hiring and training new inspectors. Due to the volume of inspections that is required on annual basis, as well as the deadlines associated with some of the programs that funds those properties, the division contracts with an outside vendor, Onsite Insight (OSI), to perform some of the inspections. More details related to OSI are provided in a later section of this report.

Standard Policies and Procedures (SOP)

An SOP is a procedure specific to the operation of a division that describes the activities necessary to complete tasks in accordance with applicable rules and regulation. It defines expected practices in a process where quality standards exist. SOPs play an important role in any organization and division as policies, procedures and standards needed to operate in a

successful way. They can create efficiencies, consistency and reliability, fewer errors, and value added to the division.

Since our last review of this section in 2020, the Physical Inspection Section management has worked on standardizing processes and documenting them into SOPs. During our follow up review we've verified that the division has created a new set of SOPs that outline the process of Physical inspection for different funding sources from initial steps of scheduling an inspection to post-inspection and follow up on findings and areas of non-compliance as applicable. However, we also have noted that some of the information, as well as processes, in the current SOPs are already outdated and need to be revised and updated to include the current processes and information.

Observation Number	Status Pertaining to the Recommendations and Action to be Taken	Target Completion Date	Responsible Party
22-004.01	OIA recommends that the Physical Inspections section revise and update all the current SOPs to reflect current information and to create consistency and efficiency for all parties involved.	September 30, 2022	Director of Compliance

Management Response

Physical Inspection had a change in management in September of 2021 and some processes have been changed and/or been updated. Management is aware Standard Operating Procedures (SOPs) require updating and the process to identify outdated SOPs has begun. Additionally, Management has selected two senior inspectors to assist with this process. All SOPs will be updated immediately and this process is expected to be fully completed by September 30, 2022

D) Parties involved in the Physical Inspections process

• **TDHCA Staff**

At the conclusion of this audit the Physical Inspections Section consisted of 15 staff, including the Manager and ten Inspections Specialists, operating under the Director of Multifamily Compliance. This team completes all the physical inspections of multifamily properties operating under one or more of the many TDHCA managed Programs. In addition, the inspectors responsible for mid and final multifamily property construction inspections as well as various single-family Program inspections. Some inspectors are also responsible for reviewing construction plans based on Program requirements.

The UPCS inspections have to meet the standards of IRS §42², Low Income Housing Credit Program. TDHCA's inspectors use UPCS4 software in calculating the property score and issuing a report after each inspection. The software is set up to calculate and produce a score based on the information and citations entered and according to IRS §42 standards. Properties that score 60 or below are placed on accelerated inspection schedule and are scheduled annually until their score improves and reaches 75 or more.

The inspection report, along with any identified deficiencies, will be sent to the property management no later than 45 days after the inspection date. The property management is required to submit an action plan to the Department within 90 days, unless they ask for extension which can postpone the deadline for another 90 days. Due to COVID-19 Pandemic, the IRS has extended this deadline for all properties until December 31, 2022³.

- **Property Owners / Managers**

Property Owners are organizations that create and manage affordable housing via various federally funded Programs. Physical Inspection staff coordinate with Property Managers to schedule, complete and communicate results of physical inspections. Property Owners, via their Property Managers, are responsible for complying with scheduled inspections and closing out any deficiencies found during the inspection process within the specified time period.

The Department offers training sessions in the Uniform Physical Conditions Standards (UPCS) for property owners and their representatives to ensure compliance with all program requirements. UPCS training is co-sponsored by the Department's Inspection staff and either the Rural Rental Housing Association of Texas (RRHA) or the Texas Apartment Association (TAA). Focus is on the basics of the inspection protocol, common deficiencies, and corrections with an emphasis on helping property managers and staff prepare for inspections.

- **Internal Revenue Service / Department of Housing and Urban Development**

The IRS and HUD are federal agencies that require both TDHCA and Property Owner's compliance with established rules and regulations related to state and federally funded housing programs. TDHCA ensures compliance with the applicable rules and regulations through the Physical Inspections and periodic compliance monitoring reviews.

- **On-Site Insight inspectors**

UPCS, or Uniform Physical Condition Standards, are inspections that are performed every three years to ensure that the property's physical condition remains in compliance with the applicable standards. Due to the number of properties that are subject to periodic inspections, and the division's limited resources, TDHCA assigns some of its multifamily development physical inspections to its contractor On-Site Insight (OSI). The assignments are typically made after the Physical Inspections staff have

² IRS §42 program provides tax incentives for investors to make equity investment. In exchange for equity, investors receive tax credits and other tax benefits associated with ownership of the project to offset federal income taxes for a ten year period.

³ IRS Notice 2022-05

reached their maximum number of inspections for the year, and for UPCS inspections in areas that would be more cost effective to have the inspections performed by OSI inspectors. The division administers inspections performed by the OSI inspectors. The OSI inspectors submit their report, along with any possible findings, to the physical inspection division which is then responsible for issuing the report to the property owners and following up on citations and action plans as needed.

OSI uses a software to score the properties inspected by them before submitting their report to PI section. The software used by OSI is not the same as the one used by TDHCA, UPCS4, and was selected and purchased by OSI directly. The division does not have any assurance of its compatibility to UPCS4, or its compliance with IRS §42 standards. The current contract with OSI does not outline any guidelines for selecting the software used in the inspection process. This issue can create inconsistency in the inspection of properties under TDHCA purview.

The contract between TDHCA and OSI is renewed annually through a “Request For Proposal” (RFP) that is posted for public proposals by the procurement division. The contract with OSI has been renewed for the last several years after receiving their new RFP each year. The term of the current contract is due to expire on September 30, 2022. According to their RFP, OSI seems to outsource 100% of the inspections that are assigned to them by TDHCA.

In reviewing RFP documentation and the renewal process, we’ve noted that the current contract with OSI does not contain a clause related to the responsibility of monitoring and avoiding any possible conflict of interest between OSI inspectors and the TDHCA properties that they inspect. OSI appears to have a conflict of interest clause in their contract with their inspectors / sub-contractors related to OSI itself, but they do not have any policies in place for TDHCA properties. We also noted that the Compliance division has a policy in place that would prohibit the PI inspectors and Compliance monitors from inspecting any property that they’ve worked for in the last five years to avoid any appearance of conflict of interest.

Observation Number	Status Pertaining to the Recommendations and Action to be Taken	Target Completion Date	Responsible Party
22-004.02	<p>OIA recommends that the Physical Inspections section create a formal contract with OSI that would:</p> <ul style="list-style-type: none"> a) Outline the roles and responsibilities of each party in avoiding any apparent or possible conflict of interest between OSI inspectors and TDHCA properties that they’re assigned to inspect. b) Ensure consistency in the performance of the inspections, as well as compliance with all applicable standards. 	October 1, 2022	Director of Compliance

Management Response

Management has identified areas of improvement concerning the contractual relationship with On Sight Insight (OSI). Management will update its contract with (OSI), to outline roles, and responsibilities, timelines for inspections scheduling of inspections, payments and will address any conflict of interest between OSI inspectors and TDHCA properties. Management will ensure that OSI inspectors are trained within UPCS inspection protocols and complies with all standards and policies. Management will work with Financial Services and Legal Divisions, as needed, to ensure the contract is updated in the renewal contract by October 1, 2022

E) Funding sources subject to Physical Inspections

Each year TDHCA is allocated funds under various federal programs for the purpose of incentivizing private organizations to create additional affordable housing inventory. For the purpose of maintaining compliance with each Program's rules and federal requirements, the Physical Inspections section completes inspections for the following programs:

- IRS Low Income Housing Tax Credit (LIHTC) – LIHTC program allocates a certain amount of housing federal tax credits annually for financing development of affordable multifamily housing. The allocations are awarded to private developers through an annual competitive bidding process.
- Multifamily Tax-Exempt Bond – This program provides for an annual amount of Private Activity Bonds that may be issued for the purpose of financing development of affordable multifamily housing.
- HOME Investment Partnerships Program (HOME) - The HOME Investment Partnership Program is funded by HUD with the purpose of expanding the supply of decent, safe, affordable housing and strengthening public-private housing partnership. TDHCA administers the HOME Program on behalf of state of Texas primarily in rural parts of the state.
- Section 811 Project Rental Assistance (PRA) program– The Section 811 PRA program is a federally funded program with the purpose of providing project-based rental assistance for extremely low-income persons with disabilities linked with long term services.
- Housing Trust Fund (HTF) – The State Housing Trust Fund provides loans and grants to finance, acquire, rehabilitate, and develop decent and safe affordable housing. The State HTF currently administers the following single family programs; Texas Bootstrap Program and Amy Young Barrier Removal Program.
- Tax Credit Assistance Program (TCAP) – Multifamily direct loans
- Tax Credit Exchange Program (Exchange) - Program administered by TDHCA allows for the limited exchange of HTC credits for cash grants, appears to be phased out at this time

- Neighborhood Stabilization Program (NSP) - The NSP is a HUD funded program authorized by the Housing and Economic Recovery Act of 2008, as a supplemental allocation to the Community Development Block Grant (CDBG) Program.
- Single Family housing programs – This program includes various programs related to single family home development for low income individuals in Texas

Each property could be funded by one or multiple sources of funding, therefore it could be subject to multiple standards. All of the programs above, except for Single Family Housing Program, require an inspection of the property every three years throughout the affordability period. Single Family Housing Program are subject to inspection by TDHCA’s sub-recipients for initial and final inspections. Properties that have multiple sources of funding are subject to the most restrictive standards and requirements. The developers are required to submit an inspection report that shows compliance with all the applicable rules and regulations for their funding sources during the Construction Cost Certification process. An outstanding deficiency on the physical inspection report can delay this process and prevent the developer from completing their funding process.

Due to the pandemic and Governor’s issuance of disaster declaration on March 13, 2020, the Governing Board of TDHCA authorized the Executive Director to waive or extend certain construction inspection requirements as of May 21, 2020. This waiver has not be revoked as of the completion of this audit, however the Physical Inspections staff have resumed all regular inspections and are in the process of performing all inspections that have been pending since the waiver was issued in 2020. The division has hired two more inspectors recently to keep up with the volume of the inspections needed. The new inspectors need to be trained on different program requirements, including ADA (American with Disability Act) and HUD standards.

Observation Number	Status Pertaining to the Recommendations and Action to be Taken	Target Completion Date	Responsible Party
22-004.03	OIA recommends that the Physical Inspections section management establish and document a training program and training modules focused on requirements of each funding program in order to create consistency and reliability in the inspections that are being performed by the staff.	August 24, 2022	Director of Compliance

Management Response

Management strives to adhere to the various program rules and regulations and to ensure consistency of work among the inspectors by implementing mandatory trainings and meetings. Management will create training materials for inspectors that focus on the requirements of each funding program Management has also scheduled a mandatory ADA, and Fair Housing training for all staff on August 22 -24, 2022

H) Inspection visits

To gain a better understanding of the Physical Inspection process, internal auditors accompanied the Physical Inspection manager on two of his scheduled inspections and shadowed him throughout his inspection process. The first inspection was a UPCS inspection for the phase two of a development in Austin area which consisted of four buildings. The inspection included review and inspection of the ADA accessibilities, fire sprinkler heads in each unit, fire extinguishers in the hallways and the leasing office, smoke detectors in each unit, as well as other items in common areas and the common amenities. The second inspection was the Final inspection for a Tax Credit development. This property was a single building with 65 total units, from which 55 units are under Low Income rent restrictions and ten units are rented at market rates. The property was fully occupied at the time of the inspection.

Prior to each of the visits the Physical inspection manager selected 10% of the units at each property to be inspected. He selected the units based on the occupancy report on CMTS. All of the units were occupied at the time of our visit and were under the programs administered by TDHCA. We noted that the sampling methodology was appropriate, and the selection process was done properly, which resulted in variety of units to be inspected representing different types of tenants. Although under the same program, the inside condition of some the units differed greatly from one to another based on each tenant. The manager inspected all of the units according to the same rules and standards.

A general observation related to the second inspection visit; this development was a newly completed property and the building structure was still in a very good shape. However, the conditions inside of each unit varied greatly. Some units were very organized and clean, while some were in need of cleaning.

In both visits the inspection process seemed to follow all of the applicable rules and requirements, and the inspector seemed very thorough in his review and evaluation of safety measures. The property representatives were responsive to all of the identified deficiencies that were brought up to their attention and seemed committed to correcting them as soon as possible.

I) Other audit work

As stated in the introduction section of this report, the initial audit of the Physical Inspection section was performed in 2020 and a report was issued in August of that year. This review was focused primarily on the areas that were not reviewed during the initial audit due to restrictions imposed by COVID19 pandemic, as well as follow up to our observations and recommendations during the previous audit.

OIA extends our sincere appreciation to the Directors of Compliance and the manager of Physical Inspections and their respective teams for their cooperation and assistance during the course of this review.

Sincerely,

Mark Scott

Mark Scott, CPA, CIA, CISA, CFE, MBA
Internal Audit Director

NS / MS