



MAR 21 2007

The Honorable Kenneth M. Donohue
Inspector General
United States Department of Housing and Urban Development
451 7th Street, S.W.
Washington, DC 20410-4500

Dear Mr. Donohue:

Enclosed is our report on the external peer review of the Department of Housing and Urban Development (HUD), Office of Inspector General (OIG), audit function. We conducted this review in accordance with the President's Council on Integrity and Efficiency guidelines and discussed the review with members of your staff during the exit conference on February 21, 2007.

You provided comments to the draft report's finding and recommendation and described actions taken or planned that satisfy the intent of the report recommendation. We considered the comments when preparing the final report and no further comments are required. Your response to the draft report is included as Appendix C with excerpts, the proposed completion date for implementation, and our position incorporated into the relevant sections of the report. We did not find anything in the response to the Reported Monetary Benefits issue, which was beyond the scope of the peer review, that caused us to change our conclusion on this matter.

We appreciate the professionalism and cooperation extended by your staff to our auditors during the external peer review process. If you have any questions or comments, please contact me or Elliot P. Lewis at 202-693-5170.

Sincerely,

A handwritten signature in cursive script that reads "Gordon S. Heddell".

Gordon S. Heddell
Inspector General

Enclosure

Unmodified Opinion Report
U.S. Department of Housing and Urban Development
Office of Inspector General, Office of Audit

We have reviewed the system of quality control for the audit function of the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General (OIG), Office of Audit (OA) in effect for the period August 11, 2004, through March 31, 2006. A system of quality control encompasses HUD OIG's organizational structure, and the policies adopted and procedures established provide it with reasonable assurance of conforming with generally accepted government auditing standards (GAGAS). The elements of quality control are described in GAGAS and promulgated by the Comptroller General of the United States. The design of the system and compliance with it in all material respects, are the responsibility of HUD OIG. Our objective was to determine whether the internal quality control system was adequate as designed and complied with to provide reasonable assurance that applicable auditing standards, policies, and procedures were met. Our responsibility was to express an opinion on the design of the system and HUD OIG's compliance with the system based on our review.

Our review was conducted in accordance with the guidelines established by the President's Council on Integrity and Efficiency and the Executive Council on Integrity and Efficiency. In performing our review, we obtained an understanding of the system of quality control for HUD OIG. In addition, we tested compliance with HUD OIG's quality control policies and procedures to the extent we considered appropriate. These tests included the application of HUD OIG's policies and procedures on selected audits. Because our review was based on selective tests, it would not necessarily disclose all weaknesses in the system of quality control or all instances of lack of compliance with it. Nevertheless, we believe that the procedures we performed provide a reasonable basis for our opinion.

Because there are inherent limitations in the effectiveness of any system of quality control, departures from the system may occur and not be detected. Also, projection of any evaluation of a system of quality control to future periods is subject to risk that the system of quality control may become inadequate because of changes in conditions, or because the degree of compliance with the policies and procedures may deteriorate. Our objective, scope, and methodology are provided in Appendix A. In addition, we have provided general comments in Appendix B.

In our opinion, the system of quality control for the audit function of the HUD OIG in effect for the period August 11, 2004, through March 31, 2006, has been designed to meet the requirements of the quality control standards established by the Comptroller General of the United States for a Federal Government audit organization and was complied with during the year ended to provide HUD OIG with reasonable assurance of conforming with applicable auditing standards, policies, and procedures.

We noted, however, conditions that warrant your attention though they did not impact our opinion. These matters are described in the Finding and Recommendation that follow. Further, we addressed in Appendix B another matter that, although beyond the scope of the peer review, we wanted to bring to your attention.

Finding and Recommendation

The HUD OIG did not always follow its own policies and procedures as described below. By ensuring a greater level of compliance, the HUD OIG could increase the level of assurance that its audits comply with applicable standards. We believe the findings and recommendations addressed in this section represent opportunities for improvement in the system of quality control. During our review, we provided your office additional information about these findings and recommendations, including a listing of the applicable audits.

Audit Documentation

GAGAS requires that audit documentation be appropriately detailed to provide a clear understanding of its purpose and source and the conclusions reached. GAGAS further requires that auditors: be free from impairments to their independence; consider risks due to fraud; and assess the reliability of computer-processed data. HUD OIG's policies and procedures address the importance of audit documentation and provide guidance for preparation, which are important to ensure compliance with GAGAS. However, in all eight audits reviewed, we found one or more areas where documentation could be improved, including documentation related to, auditor independence, reliability of computer-processed data, assessment of fraud risks, and audit report cross-referencing.

- **Documentation of Auditor Independence (GAGAS 3.03; AOM 3-02)**

GAGAS 3.03 states, "In all matters related to the audit work, the audit organization and the individual auditor, whether government or private, should be free both in fact and appearance from personal, external and organizational impairments to independence." AOM 3-02 provides that all members of the audit team who charge time directly to the assignment, must complete an independence certification indicating that they are free from personal and external impairments to independence.

Five audits reviewed did not include independence certifications for seven independent verifiers. Further, two audits reviewed did not include independence certifications for two auditors, one audit reviewed did not include independent certifications for two HUD OIG managers, and four audits reviewed identified four HUD OIG managers who approved their own independence certifications. HUD OIG management did not document their independence in accordance with OIG policies and procedures.

In the two internal Management Assistance Reviews (MAR) we reviewed, the MAR reviewers did not identify the lack of independence certifications for a manager and two independent reviewers for two of the audits they reviewed.

- **Documentation - Reliability Assessments of Computer-Processed Data (GAGAS 7.59, 7.68 and 7.66)**

GAGAS 7.59 requires auditors to assess the reliability of computer-processed data when such data is significant to the audit findings. GAGAS 7.68 states, “Audit documentation should be appropriately detailed to provide a clear understanding of its purpose and source and the conclusions the auditors reached. . . .” In addition, GAGAS 7.66 provides that an experienced auditor should be able to ascertain from the audit documentation the evidence that supports the auditors’ significant judgments and conclusions.

One audit reviewed did not contain adequate details or references to support the reliability assessment of computer-processed data. The data were significant to the audit findings.

- **Documentation - Assessment of Fraud Risks (GAGAS 7.22)**

GAGAS 7.22 states, “Auditors should also be aware that assessing the risk of fraud is an ongoing process throughout the audit and relates not only to planning the audit but also to evaluating evidence obtained during the audit.”

One audit reviewed did not contain documentation supporting the assessment of fraud risks. The audit staff indicated that steps to assess fraud risks were planned, discussed, and implemented, but they failed to document them. Fraud risk audit documentation was not prepared in accordance with GAGAS.

- **Documentation – Audit Report Cross-Referencing (GAGAS 3.51, 7.66 and 7.68; AOM 3-28)**

GAGAS 3.51 states “each audit organization should prepare appropriate documentation for its system of quality control to demonstrate compliance with its policies and procedures.” GAGAS 7.66 provides that an experienced auditor should be able to ascertain from the audit documentation the evidence that supports the auditors’ significant judgments and conclusions. In addition, GAGAS 7.68 states, “Audit documentation should be appropriately detailed to provide a clear understanding of its purpose and source and the conclusions the auditors reached, and it should be appropriately organized to provide a clear link to the findings, conclusions, and recommendations contained in the audit report.” AOM 3-28 requires independent verification of all statement/facts/figures to supporting audit documentation.

One audit reviewed did not have several sections (predominantly the background) of the audit report cross-referenced to supporting audit documentation. Management is aware of this issue and indicated that all future reports will be cross-referenced in their entirety and independently verified.

Recommendation

HUD OIG should reemphasize and monitor (through supervisors and MAR reviewers) compliance with its policies on documenting audit report cross-referencing, independence certifications, reliability assessments of computer-processed data, and assessment of fraud risks.

Views of HUD OIG

Management concurred and plans to reemphasize and monitor the compliance of their policies and procedures in the areas of documenting audit report cross-referencing, independence certifications, reliability assessments of computer-processed data, and assessment of fraud risks. Clarification of their Audit Operations Manual will be completed by March 31, 2007 and follow-up reviews by September 30, 2007.

DOL OIG Evaluation of HUD OIG's Views

Management actions planned are responsive to the recommendation.

Gordon S. Heddell
Inspector General

Objective, Scope, and Methodology

Objective

We conducted an external peer review of the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General (OIG), Office of Audit (OA). The objective was to determine whether the HUD OIG's internal quality control system was adequate and complied with to provide reasonable assurance that applicable standards, policies, and procedures were met.

Scope

The external peer review originally was to cover audit reports issued during the period April 1, 2005, through March 31, 2006, but was expanded to include a report issued August 11, 2004, a date within the 3-year period subsequent to the prior peer review. The audit period was expanded due to a notation of "Additional costs that were added this period to reports that were issued in prior reporting periods" in supporting documentation for the Semiannual Report for the period ending September 30, 2005. Fieldwork was conducted from October 10, 2006, through December 1, 2006. We performed on-site fieldwork at the HUD OIG Headquarters and five selected HUD offices in Philadelphia, PA; Chicago, IL; Boston, MA; Fort Worth, TX; and Kansas City, KS.

Methodology

We conducted our review in conformity with standards and guidelines established by the PCIE. We tested compliance with the HUD OIG's system of quality control to the extent we considered appropriate. We used the Guide for Conducting External Peer Reviews of the Audit Operations of the Inspector General (Guide), April 2005. The Guide provided guidance for conducting external peer reviews of the audit operations of Offices of Inspector General. The Guide was developed to ensure the adequacy and consistency of the reviews in accordance with the 2005 policy statement issued by the PCIE audit committee. As part of our review, we sent Appendix A of the Guide to the HUD OIG for completion. Appendix A is designed to obtain general information about the HUD OIG's policies and procedures. We used the HUD OIG's responses to Appendix A, along with the HUD OIG policies and procedures, to determine whether the HUD OIG's policies and procedures provide reasonable assurance that GAGAS would be met.

We also provided audit staff at the Philadelphia, PA; Chicago, IL; Boston, MA; Fort Worth, TX; and Kansas City, KS HUD OIG offices with the opportunity to complete an anonymous questionnaire. These questionnaires were used to determine the extent to which the HUD OIG's quality control policies and procedures had been effectively communicated to audit staff, and to obtain the audit staff's views about a number of factors relating to their offices' adherence to those policies and procedures. We used the results of the questionnaires to help assess whether the HUD OIG's internal quality control system was in place and operating effectively. We received responses from 72 percent of the audit staff (49 responses out of 68 questionnaires sent), which, in our judgment, is a fair representation of the HUD audit staff at these five offices.

We tested compliance with HUD OIG's system of quality control by reviewing seven performance audit reports and one financial audit report. Of audit reports issued by HUD OIG during the period of April 1, 2005, through March 31, 2006, we selected the following audits:

1. "Additional Details to Supplement Report on the Fiscal Year 2004-2005 Financial Statements," Report Number 2006-FO-003, November 15, 2005. (Financial audit)
2. "National City Mortgage Company, Non-supervised Lender; Miamisburg, Ohio; Improper Submission of Late Requests for Endorsement Increased the Risk to Insurance Fund," Report Number 2005-CH-1015, August 23, 2005.
3. "The U.S. Department of Housing and Urban Development Did Not Properly Award Fiscal Year 2004 Healthy Homes and Lead Hazard Control Grants," Report Number 2006-PH-001, December 7, 2005.
4. "The City's Housing Program and the Role of the Housing and Economic Development Finance Agency," Report Number 2004-KC-1005, August 11, 2004.
5. "Vulnerability Assessment of HUD's Computer Network," Report Number 2006-DP-0003, January 31, 2006.
6. "Audit of Milford, Connecticut, Housing Authority's Capital Fund Program, Development Grants for Scattered Sites, Section 8 Voucher Program, and Specific Administrative Policies and Procedures," Report Number 2005-BO-1003, April 25, 2005.
7. "The Sanctuary Multifamily Equity Skimming, Geneva, Ohio, The General Partner Improperly Used More Than \$43,000 in Project Funds," Report Number 2006-CH-1002, November 17, 2005.
8. "Housing Authority of the City of Houston Section 8 Housing," Report Number 2005-FW-1012, July 20, 2005.

In addition, we reviewed the internal quality control process by selecting two audits that were included in the HUD OIG's two most recent MARs.

1. "Corinthian Mortgage Corporation, Mission, KS, Did Not Always Comply with Federal Housing Administration Requirements," Report Number 2005-KC-1006, May 13, 2005.
2. "City of Cleveland Empowerment Zone Program, Cleveland, Ohio," Report Number 2003-CH-1016, April 25, 2003.

Where appropriate, we reviewed the audit documentation, training records, and personnel files, and conducted interviews with audit staff to determine whether established policies, procedures, and applicable professional standards were followed. We documented the results of our reviews by completing the appendices contained in the President's Council on Integrity and Efficiency

(PCIE) external peer review guide. After completing the external peer review guide, we developed any necessary findings and formulated our conclusions.

We used the following criteria in performing our external peer review:

Generally Accepted Government Auditing Standards Government Auditing Standards, 2003 Revision, issued by the Comptroller General of the United States ensure integrity, objectivity, and independence is maintained in planning and conducting audits and reporting on the results of audits.

HUD Audit Operations Manual The HUD AOM sets forth guidelines for the conduct of audits by the HUD OIG. The Audit Operations Manual establishes the policies and procedures to be followed by the HUD OIG, including supervisory review of audit working papers and reports and the independent referencing of all audit reports prior to issuance.

HUD AutoAudit Manual The AutoAudit software, developed by Paisley Consulting and based on Lotus Development Corporation's Lotus Notes groupware technology, automates the entire process of planning, creating and maintaining the documentation for the audits. HUD Auditors are required to prepare audit documentation in accordance with GAGAS, the guidelines of the HUD AOM, and the AutoAudit Manual. The AutoAudit Manual documents the protocols for use of AutoAudit. We found that the AutoAudit Manual, if properly followed, promotes consistency in audit documentation preparation and efficiency in the audit process.

General Comments

One of the most noteworthy accomplishments of the organization is the Audit Operations Manual. The manual provides comprehensive guidance on Government Auditing Standards published by the Comptroller General of the United States, and elaborates on general statements with specific policies and procedures.

Also, HUD OIG should be commended for its MAR program, which is designed to identify deficiencies and departures from the Audit Operations Manual.

During our peer review of your office's system of quality control for the audit function, we noted a matter that was beyond the scope of the peer review, but which we want to bring to your attention. This matter is described below.

Reported Monetary Benefits

In one audit included as a part of the peer review, we noted that questioned costs totaling \$1.5 million were reported. However, we also noted OIG subsequently reported in its Semiannual Report to Congress (SAR) an additional \$72.9 million of monetary impact associated with the audit. Based on documentation provided to us, we believe this is in conflict with HUD OIG policy.

The Inspector General Act defines the term "recommendation that funds be put to better use" as recommendations that funds could be used more efficiently through, among other actions, reductions in outlays, deobligation, costs avoidance, and other savings which are specifically identified. HUD OIG's Audit Operations Manual (AOM) states that, "...funds to be put to better use should be reasonably precise about the dollar amount involved. If the auditors are uncertain about the monetary impact, they should leave the amount open rather than overstate the case by claiming the whole contract, project, or line item." Further, the AOM states that, "Care and sound judgment must be exercised to ensure that only reasonable and defensible estimates and factual data are used."

HUD OIG's SAR for the period ending March 31, 2006, reported additional monetary benefits, funds to be put to better use, of \$72.9 million for the audit report entitled, "The City's Housing Program and the Role of the Housing and Economic Development Finance Agency" (HEDFC) (Report No. 2004-KC-1005, dated August 11, 2004). The 2004 audit report broadly discussed numerous performance issues and deficiencies related to HEDFC's operations, and recommended in part that the City not enter into future contracts with HEDFC unless performance deficiencies were addressed and the contract was awarded competitively. Following the HUD OIG audit report, the City did not re-award a contract to HEDFC.

In response to our statement of facts, HUD OIG stated that the \$72.9 million in funds put to better use represented savings that occurred as a result of the city not continuing to use HEDFC as its primary sub-recipient. Specifically, the amount represented the net assets (principally a \$57.2 million loan portfolio) held by HEDFC as of May 31, 2005. Our concern with claiming

this monetary benefit is twofold: 1) the audit report, while noting many operational and performance issues with HEDFC, did not call into question all of the Federal funds administered by this entity, and 2) the amount claimed was provided to HUD OIG as an interim accounting and it was made clear to HUD OIG that this amount was expected to be significantly reduced.

HUD OIG indicated that the \$72.9 million was the best estimate at the time the HUD program office wanted to close this audit. However, we believe this is contrary to HUD OIG's AOM, which required that no monetary benefit be claimed if there was any uncertainty as to the dollar amount involved. Neither Government Auditing Standards, the Inspector General Act, nor HUD OIG policy requires quantification of a monetary impact.

For the foregoing reasons, we recommend that you review this matter to ensure that the reported \$72.9 million monetary impact is in accordance with the Inspector General Act and existing policy.

Views of HUD OIG

Management disagrees that it was improper for them to report the \$72.9 million monetary benefits when the HUD program office requested to close the audit. They also believe their actions were consistent with the Inspector General Act and the policy set forth in their Audit Operations Manual for developing funds to be put to better use. Management's complete response can be found in Appendix C of this report.

DOL OIG Evaluation of HUD OIG's Views

We considered management's response and did not find anything to change our conclusions on this matter. HUD OIG maintains that all of the federal funds managed by HEDFC were impacted because the City ceased doing business with HEDFC and they were ordered to return all HEDFC assets to the City. We did not question the \$4.2 million (\$1.8 grants and \$2.4 program income) in funds put to better use claimed in the September 30, 2005, SAR, which represented the FY 2005 administrative grant funding that would no longer be awarded to HEDFC. Our observation related to the value of assets held by HEDFC. While the City's actions may have impacted all federal funds with HEDFC there is no evidence of how HEDFC assets (principally a loan portfolio) were put to better use; rather, they continued to be used in the same manner by another entity or tied up in litigation resulting in a much lesser amount.



U.S. Department of Housing and Urban Development

Office of Inspector General

451 7th Street SW
Washington, DC 20410

MAR - 9 2007

The Honorable Gordon S. Heddell
Inspector General
United States Department of Labor
200 Constitution Ave., NW
Washington, DC 20210

Dear Mr. Heddell:

Thank you for the opportunity to respond to your February 26, 2007 draft report of the external peer review of the Department of Housing and Urban Development (HUD), Office of Inspector General (OIG) audit function. We are pleased that your review confirmed that our system of quality control has been designed to meet the requirements of the quality control standards established by the Comptroller General of the United States and that our adherence to this system provides reasonable assurance of compliance with auditing standards, policies and procedures. The draft report discusses two issues – a finding and recommendation relating to audit documentation and a matter relating to reported monetary benefits that was beyond the scope of the peer review. Our response to these two issues follows.

Finding and Recommendation

We concur with your recommendation to reemphasize and monitor the compliance of our policies and procedures in the areas of documenting audit report cross-referencing, independence certifications, reliability assessments of computer-processed data, and assessment of fraud risks. In order to accomplish this we will clarify our Audit Operations Manual where needed and send a memorandum to all audit staff by March 31, 2007 reminding them of our policies and procedures in these areas. I have also directed the Office of Management and Policy (the division responsible for our Management Assessment Reviews) to conduct follow-up reviews of subsequent assignments completed by the individual audit offices in question to ensure they are following our documented policies and procedures relating to the areas noted in your report. These reviews will be completed by September 30, 2007.

Reported Monetary Benefits

Appendix B of the draft report discusses a matter that was beyond the scope of the peer review relating to a decision to report monetary benefits under Report No. 2004-KC-1005, "The City's Housing Program and Role of the Housing and Economic Development Financial

Corporation.” As discussed below, we believe that the decision to report the amount in question was reasonable under the circumstances and was consistent with the Inspector General Act and the policy set forth in our Audit Operations Manual.

The Inspector General Act defines the term “recommendation that funds be put to better use” to mean a recommendation by the office that funds could be used more efficiently if the management of an establishment took actions to implement and complete the recommendation. In this instance, the City (the auditee) took actions to more efficiently use federal funds by ceasing doing business with the Housing and Economic Development Financial Corporation (HEDFC), competitively awarding management of HEDFC’s loan portfolio (its largest asset) to another contractor, and getting the federal courts to place HEDFC under receivership. The federal court instructed the receiver to account for and return all assets to the City’s control. These actions were the direct result of the HUD OIG report reviewed during the peer review.

The draft peer review report made two primary assertions: (1) the audit report, while noting many operational and performance issues with HEDFC, did not call in to question all of the federal funds administered by this entity, and (2) the amount claimed was provided to HUD OIG as an interim accounting and it was made clear to HUD OIG that the amount was expected to be significantly reduced.

Assertion (1):

One of the recommendations in the HUD OIG report was for the City’s housing program to competitively award all services that City staff would not perform. The audit also recommended that the City Manager clearly define packages of housing services the City planned to contract for and develop a competitive process to award all housing contracts. Once the process was in place, HUD OIG recommended that the City not enter into contracts with HEDFC unless HEDFC demonstrated an ability to perform the work and was selected through a competitive process.

By reporting the numerous operational and performance issues with HEDFC and making recommendations that the City cease doing business with HEDFC unless it could compete for the City’s housing services, HUD OIG questioned the underlying controls associated with all of the federal funds administered by HEDFC. According to the HUD action official, the City used a consultant to assist the City in improving its contracting process for fiscal year 2005 housing awards. In fiscal year 2005, the City did not award any additional contracts to HEDFC, nor did it renew HEDFC’s existing contracts. This effectively put HEDFC out of business.

In his management decision, the HUD action official thoroughly explained the actions the City and HUD took to address the recommendations in the OIG audit report. This included the fact that HEDFC was placed under receivership and that the receiver was directed by the court to return HEDFC’s assets to the City at the earliest opportunity. Thus, all of the federal funds managed by HEDFC were impacted by our recommendation.

Assertion (2):

We disagree with draft report's conclusion that it was improper for the HUD OIG to report the \$72.9 million monetary benefits when the HUD program office requested to close the audit. Instead the Department of Labor (DOL) peer review team believes no monetary benefit should be claimed.

HUD OIG did not receive a clear value from HUD (via the receiver) of HEDFC's assets until the recommendations were closed. When the report was initially issued, HUD OIG did not claim the value of the assets in the report because there was no certainty at that time that HUD and the City would be able to complete implementation of the recommendations.¹

HUD OIG did not report the value of the assets at the time of the management decision because we were aware that the receiver would be providing HUD an estimate of the value of the assets. To be conservative, we did not report any monetary amounts until we received that information. It is important to note that the monetary benefit of this action is best quantified by the amount of assets HEDFC was administering for the City at the time the City decided not to renew HEDFC's contract. This is the amount of assets put to better use, not the value of the assets as they exist at some future point in time. Due to the very nature of the liquidation process, the value of the assets will likely decrease over time. Waiting longer to value the assets does not produce a more accurate value of the assets at the time the contract was expired; it only produces a lower value of those assets. By choosing to take a more conservative approach and not report the monetary value at the time we issued the report, we exercised care and sound judgment to ensure that only reasonable and defensible estimates and factual data were used in establishing the monetary value of the City taking actions recommended by HUD OIG.

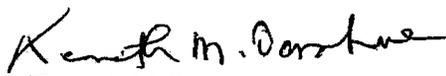
Further, the HUD action official provided us with this estimate and accepted the \$72.9 million provided by the receiver as the best valuation of assets at the time that the HUD action official requested that the recommendations be closed. Accepting the monetary amount was within the discretion of the HUD action official and HUD OIG had no reason to disagree with the amount. Therefore, we accepted the valuation and reported the amount as funds to be put to better use.

We would like to thank the DOL peer review team for their thorough review of our operations and the comments and suggestions that are contained in the draft report. If you have any questions or comments relating to our response to the draft report, please contact me at

¹ The draft peer review report asserts that the decision to claim the \$72.9 million as funds to be put to better use was contrary to a provision in the Audit Operations Manual that cautions auditors not record amounts at report issuance, but wait until the precise amount is known, usually as part of the management decision process. This is exactly what occurred for this audit. When the report was issued, \$0 was reported. Subsequently, upon receipt of the receiver's report and the request from the HUD action official to close the recommendation, the amount was recorded as an increase to cost in the audit resolution tracking system. This was in accordance with the Audit Operations Manual provision cited in the draft report.

202-708-0430 or have your staff contact James Heist, Assistant Inspector General for Audit at 202-402-8112.

Sincerely,


Kenneth M. Donohue
Inspector General