

Internal Audit Department
NeighborWorks® America

Audit Review of Capital Conversions and Grant Adjustments

Project Number: NW.FLDC.CAPU.2016

Audit Review of Capital Conversions and Grant Adjustments

Table of Contents

Function Responsibility and Internal Control Assessment.....	3
Executive Summary of Observations, Recommendations and Management Responses	4
RISK Rating Legend	8
Background	9
Objective	9
Scope	9
Methodology.....	9
Observations and Recommendations	10
Conclusion	11
<i>Appendix A: Description of Terminology Used</i>	<i>12</i>

August 18, 2016

To: NeighborWorks America Audit Committee

Subject: Capital Conversions & Grant Adjustments

Please find enclosed our draft audit report for the Capital Conversions & Grant Adjustments review. Please contact me with any questions you might have. Thank you.

Frederick Udochi
Chief Audit Executive

Attachment

cc: P. Weech
T. Chabolla
K. Watts

**Function Responsibility and Internal Control Assessment
Audit Review of Capital Conversions & Grant Adjustments**

Business Function Responsibility	Report Date	Period Covered
Field Operations	August 18, 2016	October 1, 2015 Through April 30, 2016
Assessment of Internal Control Structure		
Effectiveness and Efficiency of Operations		Generally Effective¹
Reliability of Financial Reporting		Not Applicable
Compliance with Applicable Laws and Regulations		Not Applicable

This report was conducted in accordance with the *International Standards for the Professional Practice of Internal Auditing*.

¹ **Legend for Assessment of Internal Control Structure:** **1. Generally Effective:** The level and quality of the process is satisfactory. Some areas still need improvement. **2. Inadequate:** Level and quality of the process is insufficient for the processes or functions examined, and require improvement in several areas. **3. Significant Weakness:** Level and quality of internal controls for the processes and functions reviewed are very low. Significant internal control improvements need to be made.

Executive Summary of Observations, Recommendations and Management Responses

Summarized Observation Risk Rating	Management Agreement with Observation (Yes/ No)	Internal Audit Recommendation Summary	Accept IA Recommendation (Yes/ No)	Management's Response to IA Recommendation	Estimated Date of Implementation (Month/Year)	Internal Audit Comments on Management Response
<p>Observation No. 1 –</p> <p>Out-dated procedures within the capital fund balance adjustment policy</p> <p>Internal Audit noted that there were sections of the policy that were not reflective of the actual practice of execution. Section C in the policy referenced a specific category of capital conversions – from ‘permanently restricted capital’ to ‘unrestricted capital’ in order to support a cash loan loss reserve. However, in practice this category requires that funds be classified as a ‘temporarily restricted’ asset on the organization’s balance sheet for such a cash loan loss reserve which</p>	Yes	<p>Recommendation No. 1 –</p> <p>Update the Capital Fund Balance Adjustment Policy</p> <p>Internal Audit recommends that Field Ops review the Capital Fund Balance Adjustment Policy in its entirety to remove outdated procedures and ensure that all aspects of the policy are up to date and reflective of the actual process. Specifically, Internal Audit recommends that: (i) section C be deleted; (ii) the language in the policy regarding the board resolutions be amended such that the policy is more reflective</p>	Yes	<p>Field Operations management agrees with the recommendation to update the Capital Fund Adjustment Policy and already plans to update the policy within FY17. The updates will include removing outdated procedures and ensuring alignment across NW America’s grant policy and procedures documents.</p> <p>As part of this review, NW America will make revisions to clarify intent and simplify which information/ approvals are needed for a complete submission overall rather than detailing what should be included in each separate piece of supporting</p>	December 2016	Internal Audit accepts Mgt.'s Response

Summarized Observation Risk Rating	Management Agreement with Observation (Yes/ No)	Internal Audit Recommendation Summary	Accept IA Recommendation (Yes/ No)	Management's Response to IA Recommendation	Estimated Date of Implementation (Month/Year)	Internal Audit Comments on Management Response
<p>equates to a specific lending pool or loan. This section also makes reference to a "Guide to the NeighborWorks Grant Agreement" that is no longer being distributed to NWOs.</p> <p>Per policy, a board resolution must be included as part of the loss of capital funds notification. The policy also requires that the board resolution authorizes the NWO's management to make a request for adjustment. In testing, however, Internal Audit noticed in some instances that the board resolution did not explicitly give "Management" the authority to make the request per the policy. Instead, the board resolution resolved that the Board of Directors make the request of NWA for the adjustment</p>		<p>of the actual intent; (iii) the review of the RLF and Real Estate portfolios requirement should be re-evaluated; and (iv) ensure that any review requirements can be substantiated with supporting documentation.</p>		<p>documentation (i.e. indication of Board of Directors' support of request rather than requiring Boards give Management authority to make request).</p> <p>Management will also pursue including the capital fund adjustment requests within the online application system similar to how it is used for capital conversion applications in order to increase transparency.</p> <p>In revisiting intent and procedures around the review of RLFs and portfolio performance relating to capital conversions, NW America will balance the recommendation to document reviews within the application system against the desire to leverage existing</p>		

Summarized Observation Risk Rating	Management Agreement with Observation (Yes/ No)	Internal Audit Recommendation Summary	Accept IA Recommendation (Yes/ No)	Management's Response to IA Recommendation	Estimated Date of Implementation (Month/Year)	Internal Audit Comments on Management Response
<p>Per policy, all organizations requesting conversions must have a review of their Real Estate and RLF portfolios. In testing Internal Audit noted that the portfolios are not included in the application or review contained within GrantWorks. The only evidence that the review took place is the reviewer's response to question 4a – which makes inquiry about unresolved issues in the portfolio.</p> <p>Risk Rating: (b) (5)</p>				<p>information rather than requiring duplicate submissions. This may include better documentation within the review process of how we are currently leveraging information that is already on hand about the organizations, including through quarterly reporting and the Organizational Health Tracking System (OHTS) process.</p>		
<p>Observation 2 – Lack of Summary/Notification Letter</p> <p>Internal Audit noted that in one application, there was a lack of explicit language detailing the adjustment request in the summary/notification letter.</p>	<p>Yes</p>	<p>Recommendation 2 – Review and Enhance Internal Controls Related to Summary/Notification Letters</p> <p>Internal Audit recommends that the controls be reviewed to</p>	<p>Yes</p>	<p>Management accepts Internal Audit's recommendation to review procedural controls and will do this as part of the overall policy and procedure review (see Recommendation 1). Management has already</p>	<p>December 2016</p>	<p>Internal Audit accepts Mgt.'s Response</p>

Summarized Observation Risk Rating	Management Agreement with Observation (Yes/ No)	Internal Audit Recommendation Summary	Accept IA Recommendation (Yes/ No)	Management's Response to IA Recommendation	Estimated Date of Implementation (Month/Year)	Internal Audit Comments on Management Response
<p>Per policy, the amount of adjustment must be in the summary letter, which essentially acts as the notification to the Region from the NWO of the loss of capital funds.</p> <p>Risk Rating: (b) (5)</p>		<p>identify where possible enhancements can be made that would allow for better detection of summary/notification letters that do not meet policy standards.</p>		<p>implemented new tools to help strengthen controls, including a checklist for use when reviewing capital fund adjustment requests that was implemented in March 2016.</p> <p>As noted above, the review will include clarifying the information needed for a complete submission rather than focusing on requirements for each piece of documentation. For example, in the case in question, the amount being requested was clearly included in the Board resolution even though it was not explicit in the summary letter as required under the policy currently. Moving to an online application may also help clarify and increase controls.</p>		

RISK Rating Legend

Risk Rating: HIGH

A serious weakness which significantly impacts the Corporation from achieving its corporate objectives, financial results, statutory obligations or that may otherwise impair the Corporation's reputation.

Risk Rating: Moderate

A control weakness which could potentially undermine the effectiveness of the existing system of internal controls and/or operational efficiency, integrity of reporting and should therefore be addressed.

Risk Rating: Low

A weakness identified which does not seriously detract from the system of internal control and or operational effectiveness/efficiency, integrity of reporting but which should nonetheless be addressed by management.

Management Responses to The Audit Review of: Capital Conversions and Grant Adjustments		
# Of Responses	Response	Recommendation #
2	Agreement with the recommendation(s)	1,2
	Disagreement with the recommendation(s)	

Background

Capital grants are permanently restricted funds which must be used for specific eligible purposes for investments in the communities served by NeighborWorks Organizations (NWO). Each capital grant received by a network organization is added to the cumulative total of the organization's Permanently Restricted Capital Fund balance which is tracked by NWA in the GrantWorks application. The use and treatment of capital funds is governed by a standard Investment and Grant Agreement (IGA) which provides the following definition:

“Permanently Restricted Capital Funds” shall mean capital funds held in perpetuity, used for purposes that will build assets for the NeighborWorks organization and the community in which the NeighborWorks organization operates. Permanently Restricted Capital Funds require that the NeighborWorks organization establish and maintain a segregated *Permanently Restricted Revolving Loan and Capital Projects Fund* to account exclusively for their use. These funds are not to be used for non-capitalizable purposes such as paying the day-to-day expenses of the organization.

Objective

The objective of this review was to obtain reasonable assurance:

- That adjustments and conversions to capital funds are appropriate and are in compliance with the policies and procedures
- That the criteria used in the approval process is being applied consistently
- That proper supporting documentation is being maintained per policy
- To ensure that the business process is executed per policy

Scope

Internal Audit conducted a review of capital conversions and grant adjustments that were approved between 10/01/2015 and 04/30/2016 to determine if the criteria used in the approval process was being applied consistently, and to ensure that the approvals were appropriate based on the policies and procedures.

Methodology

Internal Audit began this review by obtaining and reviewing the Capital Fund Balance Adjustment Policy. After reviewing the policies and procedures Internal Audit met with Field for the Introductory Meeting. At this meeting Internal Audit obtained an overview of the capital conversion and the grant adjustment processes.

Internal Audit noted that the policy was divided into sub sections. Based on the sub-sections identified within the policy, Internal Audit requested and obtained from Field, the population of all capital conversions, grant adjustments, Capital Funding for the Rehabilitation of Affordable Housing (CFRAHs), and disaffiliations that were approved between 10/1/2015 and 4/30/2016. The vast majority of the samples were selected from the population using the random number generator in Excel. The remaining samples were selected judgmentally.

For each sub-section, Internal Audit identified required steps and or actions that based on the policy, should be performed. Internal Audit then reviewed supporting documentation from each selected sample. Any instances where the business process deviated from the policy were noted. The results of this analysis were captured and summarized in a spreadsheet and analyzed.

Below are the observations and recommendations that resulted from the testing performed.

Observations and Recommendations

Observation 1 – Outdated procedures within the capital fund balance adjustment policy

Internal Audit noted that there were sections of the policy that were not reflective of the actual practice of execution. Section C in the policy referenced a specific category of capital conversions – from ‘permanently restricted capital’ to ‘unrestricted capital’ in order to support a cash loan loss reserve. However, in practice this category requires that funds be classified as a ‘temporarily restricted’ asset on the organization’s balance sheet for such a cash loan loss reserve which equates to a specific lending pool or loan. This section also makes reference to a “Guide to the NeighborWorks Grant Agreement” that is no longer being distributed to NWOs.

Per policy, a board resolution must be included as part of the loss of capital funds notification. The policy also requires that the board resolution authorizes the NWO’s management to make a request for adjustment. In testing, however, Internal Audit noticed in some instances that the board resolution did not explicitly give "Management" the authority to make the request per the policy. Instead, the board resolution resolved that the Board of Directors make the request of NWA for the adjustment

Per policy, all organizations requesting conversions must have a review of their Real Estate and RLF portfolios. In testing Internal Audit noted that the portfolios are not included in the application or review contained within GrantWorks. The only evidence that the review took place is the reviewer’s response to question 4a – which makes inquiry about unresolved issues in the portfolio.

Recommendation 1 – Update the Capital Fund Balance Adjustment Policy

Internal Audit recommends that Field Ops review the Capital Fund Balance Adjustment Policy in its entirety to remove outdated procedures and ensure that all aspects of the policy are up to date and reflective of the actual process. Specifically, Internal Audit recommends that: (i) section C be deleted; (ii) the language in the policy regarding the board resolutions be amended such that the policy is more reflective of the actual intent; (iii) the review of the RLF and Real Estate portfolios requirement should be re-evaluated, and; (iv) ensure that any review requirements can be substantiated with supporting documentation.

Observation 2 – Lack of Summary/Notification Letter

Internal Audit noted that in one application, there was a lack of explicit language detailing the adjustment request in the summary/notification letter. Per policy, the amount of adjustment must be in the summary letter, which essentially acts as the notification to the Region from the NWO of the loss of capital funds.

Recommendation 2 – Review and Enhance Internal Controls Related to Summary/Notification Letters

Internal Audit recommends that the controls be reviewed to identify where possible enhancements can be made that would allow for better detection of summary/notification letters that do not meet policy standards.

Conclusion

Internal Audit finds that the Capital Fund Balance Adjustment Policy does a fairly good job of explaining the overall flow of the grant adjustments and capital conversion business processes. However, the policy also contains language that is not in line with the department's intent, is outdated, and is not reflective of the actual business process. The result is that some aspects of the policy are unclear and confusing. The policy should be updated to correct these issues.

Appendix A: Description of Terminology Used

Adjustments

From time to time the capital fund balances of NeighborWorks organizations need to be adjusted due to losses incurred during normal and allowable business operations. Generally, if losses occur but the funds were used for eligible purposes, the NWO is not expected to repay the capital fund. If NeighborWorks America (NWA) capital is used for ineligible purposes and losses occur, NWA **may** require the Network Organization (NWO) to repay the funds.

To apply for an adjustment, NWOs are required to notify their region of the loss of capital funds in writing prior to the submission of its annual audit. The notification must include a summary letter that describes the loss and actions taken to minimize the loss. The notification must also include the amount of the adjustment and a board resolution authorizing the NWO to request the adjustment from NWA. The Regional Vice President can approve the request for the adjustment up to \$ (b) (4) or (b) (4) of the NWO capital fund balance (not to exceed \$ (b) (4)). The Senior Vice President, Field Operations can approve adjustments up to their budget authority up to \$ (b) (4). The Chief Operating Officer can approve adjustments, but must seek concurrence from the Officers.

Approvals are ultimately forwarded to the Grants Manager who processes the adjustment via an Investment and Grant Funds Letter. The Investment and Grants Fund Letter is signed by the NWO and an Authorized representative of NeighborWorks, and then returned to Field Operations before the NWO can adjust the NW capital balance. The Senior Vice President, Field Operations maintains a record of all approved adjustments.

Conversions

NWOs with exemplary or strong ratings are allowed to convert a specified portion or percentage of their Capital Fund Balance to an unrestricted asset on an annual basis. NWOs become eligible to apply if their ratings met or exceed the minimal requirements for the previous 4 OHTS rating at the time the application was released in GrantWorks and also met certain capital fund balance requirements. NWOs must submit their business strategy when requesting the conversion, have a review of their real estate and RLF portfolios, and be willing to provide a one-time report between 12 and 18 months after the conversion. Per policy NWA has the ability to allow special exceptions to this policy on a case by case basis.

Disaffiliations

As part of the disaffiliation process, NWA undertakes an assessment of the permanently restricted capital to determine how it is currently invested (i.e. loans to homeowners, invested in real estate properties, cash, etc.). In the event of a disaffiliation all NWA restricted capital assets are transferred to another NWO in the region or cash assets returned to NWA.