



Board Report

File #: 2017-0590, **File Type:** Informational Report

Agenda Number: 48.

EXECUTIVE MANAGEMENT COMMITTEE SEPTEMBER 21, 2017

SUBJECT: STREAMLINING AUDITS FOR SMALL BUSINESSES

ACTION: RECEIVE AND FILE

RECOMMENDATION

RECEIVE AND FILE report on streamlining audits for small businesses.

ISSUE

Audits are necessary to provide accountability and transparency on the utilization of Metro's financial resources. However, at the June 2017 Board meeting Director Dupont-Walker, it was noted that the audit of small businesses should not be too burdensome to the point of negatively impacting small business operations and Metro's Management Audit Services (MAS) Department was requested to report back on the policies and practices for auditing small businesses.

DISCUSSION

As stewards of taxpayers' money, Metro's MAS department completed a total of 222 contract audits in the last five fiscal years covering FY 2013 to FY 2017. The audits identified questioned costs of \$76,261,508. Audit costs for these 222 audits is estimated at \$4.4 million. Eighty-eight of the 222 audits were audits of small business enterprise (SBE) or disadvantaged business enterprise (DBE) contracts. Below is a summary of the contract audits completed and resulting questioned costs:

	Completed Audits*	Amount Questioned**
SBE/DBE	88	\$14,497,894
Other Contractors	134	\$61,763,614
Total*	222	\$76,261,508

*Completed Audits include the following types of audits: Pre-Award, Incurred Cost, Change Orders, Buy America Compliance, Indirect Cost Rates and Labor Rates.

**The amount questioned excludes the amounts for indirect cost rates, labor rates, and Buy America

Compliance because these audits only report questioned rates or compliance.

MAS completed these 222 audits in response to requests made by Vendor/Contract Management (V/CM) department based on V/CM's policy requirements. The V/CM's policy requirements are designed to comply with the audits required by funders, such as Federal Transit Administration, Federal Highway Administration, and the State, for each type of buying activity. (See Attachment A for VCM's audit request requirements). At V/CM's request, MAS initiates the audit and uses the terms and conditions provided in either the Request for Proposal (RFP), or the executed contract, whichever is applicable, as the audit criteria. (See Attachment B for MAS Audit Practices.) Metro's RFP and the contract include provisions for the contractors to comply with the Federal Acquisition Regulation (FAR) Part 31, Contract Cost Principles and Procedures either due to Federal requirements or best practice. The FAR Part 31 is also included in the flow-down provision from the Prime Contract agreement to the Subcontractor agreement.

The increasing number of audits over the last five years correlates with the increased contracts awarded to SBE/DBE contractors. From FY 2013 through FY 2017, Metro has awarded \$587.7 million in contracts to small and disadvantaged businesses; 939 prime contracts totaling \$179.6 million, and 1,191 subcontracts totaling \$408.1 million.

A. Audit Challenges for SBE/DBE Contractors

Metro's contracts require contractors to account for and bill costs in accordance with FAR Part 31. Contractors are also required to develop indirect cost rates in accordance with FAR on an annual basis for cost reimbursable contracts. However, complying with these requirements may be challenging for SBE/DBE contractors because they may lack resources to fully comply with FAR Part 31 requirements. The development of an indirect cost rate compliant with FAR Part 31 is an area that generates discussion because many SBE/DBE contractors do not hire a Certified Public Accountant (CPA) to conduct an audit of their (1) financial statements and/or (2) indirect cost rate proposal to provide assurances in compliance with FAR Part 31. As a result, many SBE/DBE contractors are unfamiliar with the audit process and the required level of documentation to support the incurred costs. Some SBE/DBE contractors also experience difficulty pulling the supporting documents for incurred costs due to the timing difference between when the audit is initiated versus the timing when the SBE/DBE contractors incurred the expenditures. V/CM's practice is to request MAS to initiate the audit once the contractor reaches the contract incurred costs of \$750,000. For some SBE/DBE contractors, it may take a few years before this threshold amount is reached, resulting in the timing difference between audit initiation and costs incurrence.

In addition, some of the SBE/DBE contractors do not sufficiently provide evidence that costs proposed or incurred comply to Metro comply with the contract requirements. For example, incentive compensation or bonuses may have a contract requirement in addition to the FAR requirement, i.e. Bonus Plan/Policy must be in place 12 months prior to contract award. Also, due to lack of resources, some SBE/DBEs do not comply with the subcontract flow down requirements from the prime contract to the subcontract agreements. As a result, complying with their contract terms proves to be difficult and challenging to many SBE/DBEs.

B. V/CM and MAS' continuing efforts with audit of SBE/DBE

Staff have identified the following improvement opportunities:

- a. Indirect Cost Rates - As part of V/CM's procurement streamlining initiative, V/CM will research options/programs to simplify the establishment of indirect cost rates for SBE/DBE contractors. Since indirect cost rates are a topic of interest to SBE/DBEs, staff will report back on this strategy at the December Board meeting.
- b. Flow-Down - V/CM will work on minimizing the call for audits and the "flow-down" of certain provisions to the SBE/DBE community when those contractors are subcontractors to larger primes.
- c. Tracking - Measures are being put in place to improve the request process that will help monitor frequency and impacts of audits with Metro's contractors.
- d. Training - At the March 2016 Transportation Business Advisory Council meeting, MAS presented an overview of the audit process and typical audit findings. In October 2017, MAS and V/CM are also partnering to educate the SBE/DBE community on the audit process, as well as, how to adequately interpret the audit provisions of their contracts. This will be an ongoing activity initiated and coordinated by V/CM.
- e. Database of Audited Indirect Cost Rates - MAS is in the process of developing a database of all contractors' audited indirect cost rates based on completed audits from the past five years. This will allow both V/CM and MAS to quickly review whether the audited indirect cost rates can be applied to other contracts before requesting/initiating another future audit. The database will be ready for use by September 15, 2017.

NEXT STEPS

In six months, V/CM and MAS will report back to the Board on the status of all improvement opportunities.

ATTACHMENT

- A. V/CM Audit Requirements
- B. MAS Audit Practices

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Requirements from VCM's policies for requesting an audit of the contractor:

Effective August 2011

VCM's Acquisition Policy and Procedure Manual, Chapter 15.17, Contract Audit Support states: "The Contracting Officer shall request assistance from Management Audit Services when the information available at the buying activity is inadequate to determine a fair and reasonable price." It is important for VCM to enact policies, procedures, and practices that are prudent to ensure compliance. Therefore, the conditions for an audit engagement are aligned with the type of procurement or buying activity as noted below. It should also be noted that the conditions outlined include steps that VCM has taken to improve the process by providing some latitude to the Contracting Officer through raising some limits for when an audit is performed, and that allows for the use of information gathered in a previously performed audit as applicable. More recent updates are also noted below by a memorandum dated April 27, 2017 that target improvements to Forward Price Contracts changes/modifications, incurred costs changes/modifications, disputes, and additional guidance regarding the use of preexisting audit information. These updates are noted under separate heading.

Conditions for Audit:

1. All **cost reimbursement type proposals** and for **all Architect and Engineer consultant contracts** funded by or through Caltrans valued \$1,000,000 or more. If not funded by or through Caltrans, the audit threshold is \$750,000. The contracting officer shall not request a separate audit of indirect costs unless the information already available from an existing audit, completed within the preceding 12 months, is considered inadequate for determining the reasonableness of the proposed indirect cost.
2. **Terminations** - Termination settlements greater than \$700,000 are subject to audit.
3. **Audit of Contract Payments** - At the discretion of the Contracting Officer, audits may be requested to determine the following:
 - Whether the contract payments are fairly supported by the value of work accomplished;
 - Whether the unpaid balance of the contract price will be adequate to cover the anticipated cost of completion, or the contractor has adequate resources to complete the contract; and
 - Whether there is any reason to doubt the adequacy or reliability of the contractor's accounting system, controls, or payment certification.

April 27, 2017 Update:

1. Forward priced contract changes/modifications of any amount do not require an audit, unless the Contracting Officer/Contract Administrator determines they are unable to perform and documents in the file an adequate cost analysis of the proposed costs.
2. Contract changes/modifications based on actual incurred cost in whole or in part, greater than \$750,000 only require an audit when the Contracting Officer/Contract Administrator is unable to validate such incurred costs or the cost proposal is of such complexity an adequate cost analysis cannot be performed and documented in the file.
3. When the parties are considering resolution of dispute or disputes, with a settlement agreement for incurred costs greater than \$500,000 the Contracting Officer/Contract Administrator will request an audit to substantiate each part of the amount before

settlement, unless an analysis is able to validate a substantial portion of each part and is accepted by the Contracting Officer/Contracting Administrator.

4. In all instances the Contracting Officer/Contract Administrator should not request a new audit effort if and when an existing audit by a cognizant audit agency, including Metro's Management Audit Services, or certified public account performed within the prior 12 months, is available to document, validate or substantiate the costs involved in accordance with FAR Part 31.

MAS Audit Practices:

1. **Audit Standards** - MAS conducts audits of contractors (SBE or Non-SBE) in accordance with Generally Accepted Government Auditing Standards and the International Standards for the Professional Practice of Internal Auditing. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives.
2. **Audit Criteria** - MAS uses the terms and conditions provided in either the Request for Proposal (RFP) for pre-negotiation/pre-award audit or the executed contract for incurred cost audit as the criteria for the audit. Additionally, both the RFP and the contract include provisions for the contractor to comply with the Federal Acquisition Regulation (FAR) Part 31, Contract Cost Principles and Procedures. The SBE can either be the Prime Contractor or the Subcontractor in the contract with Metro. Since the flow-down provision from the Prime Contract agreement to the Subcontractor agreement usually includes the FAR Part 31 requirements, the audit criteria are identical for SBE and non-SBE contractors.
3. **Audit Process** - Upon receipt of the audit request from VCM, an initial kick off meeting is held with the requesting Contracting Officer to agree on the audit objectives, timeline, and scope of the audit. Once an agreement is reached, MAS evaluates the availability of staff within the department. If staff is available, MAS initiates the audit project and assigns it to staff auditor and manager. If staff is not adequate, MAS works with VCM to procure services of consultant auditor from the audit bench. Solicitation of proposals from the audit bench and the selection of the consultant auditor follow the established procurement process for staff augmentation and/or outsourcing. Once the audit is initiated, the audit will go through the following phases:
 - a. Planning Phase - MAS sends the SBE an audit notification letter stating the audit objective, scope, timeline, and contact information of the assigned auditor. The letter also includes the request for initial documents necessary to complete the planning phase of the audit such as internal control questionnaire, copies of audited or unaudited financial statements and indirect cost rates. The planning phase includes the review of prior audit reports, determination on whether MAS can rely on the work of other auditors, preparation of the risk assessment, sampling methodology, internal control assessment, and audit work plan.
 - b. Fieldwork Phase – At the conclusion of planning, MAS performs the actual substantive/transaction testing which requires the contractors to provide relevant supporting documentation to validate the proposed costs, incurred costs, and indirect cost rates. The level of supporting documents

required from the contractors vary depending on the nature of the proposed or incurred costs (e.g. employee timesheets, payroll registers, tax returns, indirect cost rates submission) The auditors' testing are by cost elements such as direct labor, overhead, other direct costs, etc. The test results provide evidences for the auditors conclusion in determining whether 1) the costs are in compliance with the audit criteria (RFP or contract terms and FAR part 31) and 2) whether the costs are allowable, allocable to Metro contract/project, and reasonable.

- c. Reporting Phase – At the conclusion of field work, MAS holds two exit conferences 1) with the Contracting Officer/Contacting Administrator and 2) with the Contractor Management. Each of these parties receives the findings of the audit. However, the level of shared information to the contractor varies between a pre-award/pre-negotiation audit and incurred cost audit as follows:
 - i. For the pre-award/pre-negotiation audit, the auditors provide the contractors the nature of the findings without sharing the actual questioned costs. This is done to avoid compromising the Contracting Officer's position during the negotiation process. MAS issues the final report only to the requestor (Contracting Officer/Contacting Administrator) who has the option to share the report with the contractor once negotiations are completed.
 - ii. For the incurred costs audit, the auditors issue a draft audit report with all the findings, associated questioned costs and the resulting over/under payment made by Metro to the contractor. The contractor is provided at least two weeks to respond to the findings however; additional time is allowed upon request. The auditors incorporate the responses received prior to the issuance of the final audit report. If the contractor provided additional information, not previously provided to the auditor, that warrant changing the auditor's findings and conclusions, the issued final audit report will reflect the resulting changes. The final audit report is issued to the requestor (Contracting Officer/Contacting Administrator) who shares the report with the contractor if requested.