

CITY OF HAMILTON

**CITY MANAGER'S OFFICE
Audit Services Division**

TO: Chair and Members Audit, Finance and Administration Committee	WARD(S) AFFECTED: CITY WIDE
COMMITTEE DATE: October 4, 2012	
SUBJECT/REPORT NO: Audit Report 2012-03 – Construction Contracts Review (AUD12014) (City Wide)	
SUBMITTED BY: Ann Pekaruk Director, Audit Services City Manager's Office	PREPARED BY: Ann Pekaruk 905-546-2424 x4469
SIGNATURE:	

RECOMMENDATION

- (a) That Report AUD12014 respecting Audit Report 2012-03, Construction Contracts Review be received;
- (b) That the Management Action Plans as detailed in Appendix "A" of Report AUD12014 be approved; and
- (c) That the General Manager of Public Works and the General Manager of Finance & Corporate Services be directed to instruct the appropriate staff to have the Management Action Plans (attached as Appendix "A" to Report AUD12014) implemented.

EXECUTIVE SUMMARY

The 2012 Internal Audit work plan approved by Council included a review of construction contracts. The audit included a review of the adequacy of controls surrounding the tendering, awarding and management of two selected construction contracts (one for Roads and one for Water/Wastewater). Payments were tested and contractors' compliance with contract terms and conditions was evaluated. In addition, the allocation of departmental operating costs to these capital projects was examined.

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The results of the audit are presented in a formal Audit Report (2012-03) containing observations, recommendations and management responses. Audit Report 2012-03 is attached as Appendix “A” to Report AUD12014.

Alternatives for Consideration – Not Applicable

FINANCIAL / STAFFING / LEGAL IMPLICATIONS (for Recommendation(s) only)

Financial: The annual capital budget process would benefit from improved disclosure and understanding of operating cost recoveries.

Staffing: None.

Legal: None.

HISTORICAL BACKGROUND (Chronology of events)

The audit was scheduled as part of the 2012 Internal Audit work plan approved by Council. The audit fieldwork was completed in March 2012. The results of this audit are attached as Appendix “A” of Report AUD12014.

The Audit, Finance and Administration Committee receives and approves final audit and review reports as part of its responsibilities for the oversight of governance and control.

POLICY IMPLICATIONS

Capital Recovery Process & Methodology.

RELEVANT CONSULTATION

Appendix “A” to Report AUD12014 includes action plans which reflect the responses of management responsible for the contracts that were reviewed in the City’s Environment & Sustainable Infrastructure (ESI) and Water and Wastewater Engineering Divisions of the Public Works Department. The staff in the Financial Planning and Policy Division of the Corporate Services Department was also consulted.

ANALYSIS / RATIONALE FOR RECOMMENDATION

(include Performance Measurement/Benchmarking Data, if applicable)

As Internal Audit wished to review the entire process from tender and award, to contract administration, to payments and other costs, two specific, substantially completed, capital projects (identified by single “capital project ID codes” but containing at least one major construction contract) were selected for detailed examination. One Roads project (with a budget of \$2.8 million) and one Water/Wastewater project (with a budget of \$2.6 million) were chosen.

The review of files, the contracts, the accounting records and other documentation as well as discussions with relevant staff indicated good overall project management and strong controls over payments to the contractors. The two projects were assessed to ensure effective monitoring and to determine if change orders had been appropriately approved, when required.

The primary reporting mechanisms to Council for the status of capital projects are the Capital Projects Status Reports that are presented to Committee three times per year. These reports provided information on a project-by-project basis including the budget costs incurred and variance information and were used for testing of the two selected projects. Internal operating costs allocated to capital projects were reviewed to determine if they were accurately and consistently allocated and disclosed appropriately to Council in the relevant management reporting process.

A formal Audit Report (2012-03) containing observations, recommendations and resulting management action plans was issued. Two recommendations were included in Audit Report 2012-03 (attached as Appendix “A” of Report AUD12014). Both recommendations relate to the recovery of operating costs from capital projects and the resulting management reporting. The recommendations made are as follows:

- Disclosure of the actual operating cost percentage allocated to capital projects in the annual year end capital budget status report and explanations for significant variances from the original estimates.
- Development and implementation of a comprehensive and systematic methodology to support the allocation of incurred Water and Wastewater operating costs to individual projects and their disclosure to Council.

Management and staff have agreed to implement the recommendations. Specific action plans can be found in the attached Audit Report.

ALTERNATIVES FOR CONSIDERATION

(include Financial, Staffing, Legal and Policy Implications and pros and cons for each alternative)

Not applicable.

CORPORATE STRATEGIC PLAN (Linkage to Desired End Results)

Focus Areas: 1. Skilled, Innovative and Respectful Organization, 2. Financial Sustainability,
3. Intergovernmental Relationships, 4. Growing Our Economy, 5. Social Development,
6. Environmental Stewardship, 7. Healthy Community

Financial Sustainability

- ◆ Delivery of municipal services and management of capital assets/liabilities in a sustainable, innovative and cost effective manner.

APPENDICES / SCHEDULES

Appendix "A" to Report AUD12014

ap:bm

**CITY OF HAMILTON
INTERNAL AUDIT REPORT 2012-03
CONSTRUCTION CONTRACTS REVIEW - PUBLIC WORKS**

#	OBSERVATIONS OF EXISTING SYSTEM	RECOMMENDATION FOR STRENGTHENING SYSTEM	MANAGEMENT ACTION PLAN
1.	<p><u>Roads Project – Operating Costs Recoveries</u></p> <p>The Environment and Sustainable Infrastructure (ESI) Division's operating costs are recovered from the capital budget. Costs include asset management, project design, construction project management and administrative support. In 2011, these actual net costs totalled \$11 million.</p> <p>An estimate of 15% of project costs was added to the budget of each project in the 2011 Capital Budget for the cost of ESI services.</p> <p>The actual 2011 operating costs amounted to 11% of project costs. Specific details explaining this 4% gap were not disclosed in the year end budget reporting process.</p> <p>Note that the actual percentages and costs are not being disputed. There is an established detailed and systematic methodology for these calculations as a result of a previous audit.</p>	<p>That the actual operating cost percentage allocated to capital projects be disclosed in the annual year end capital budget status report to Council and any variance greater than +/- 1% from the original estimate be explained.</p>	<p>Agreed. Operating dollars recovered for the ESI division will be included on the year end capital budget status report with appropriate explanation.</p>

**CONSTRUCTION CONTRACTS REVIEW - PUBLIC WORKS
MARCH 2012**

#	OBSERVATIONS OF EXISTING SYSTEM	RECOMMENDATION FOR STRENGTHENING SYSTEM	MANAGEMENT ACTION PLAN
2.	<p><u>Water/Wastewater Project – Operating Costs Recoveries</u></p> <p>Over the years, Water/Wastewater Engineering (WWE) has approached cost allocation from a program perspective with Finance’s agreement and input. In earlier years, WWE allocated its operating budget to the ten largest accounts. As a result, no operating costs were allocated to the capital project Internal Audit selected for audit testing in 2009 or 2010 as this project was not one of the top ten largest accounts.</p> <p>Subsequently, WWE changed the approach to cost allocations to better reflect costs being applied to individual projects. However, in practice, should certain project accounts have insufficient funds to accommodate the operating appropriation and to avoid overcharging an account, other capital projects of similar category with enough funds available in their budget would be allocated the operating costs according to the program basis of cost allocation.</p> <p>This practice of allocation of operating costs may distort the accumulation of expenditures against budget without detailed documentation to support the allocation.</p>	<p>That a comprehensive and systematic methodology to support the allocation of incurred Water/Wastewater operating costs to individual projects (similar to other divisions in the Public Works Department) be developed, documented, approved and implemented by management. Disclosure of the allocated costs should be made to Council in the capital budget status reports.</p>	<p>Agreed. A formalized procedure would be beneficial. Staff will review the process being used by the other divisions in the Public Works Department in order to develop a similar process for the WWE program. WWE will create an Operating to Capital Cost Allocation Procedure with input from the appropriate sections within the Corporate Services Department. WWE will commit to have this Procedure in place no later than the next budget cycle for when cost allocations are required which will be Q1 2013.</p> <p>Corporate Services has also agreed to the concept and will work with Public Works with regard to the proposed reporting policies.</p>