



October 15, 2010

To: Finance and Administration Committee
From: Will Kempton, Chief Executive Officer
Subject: Limited Scope Review Performed in Relation to an Audit of the Santa Ana Freeway (Interstate 5) Gateway Project

Overview

The Internal Audit Department has completed a Limited Scope Review related to an audit of the Santa Ana Freeway (Interstate 5) Gateway Project. The Internal Audit Department provided four recommendations to improve management of contracts, strengthen internal controls over procurement, and ensure that Orange County Transportation Authority designated employees are properly reporting financial interests as required by the Fair Political Practices Act. Management has indicated that recommendations have been, or will be, implemented.

Recommendation

Direct staff to implement recommendations in the Limited Scope Review Performed in Relation to an Audit of Interstate 5 Gateway Project Contracts, Internal Audit Report No. 08-014.

Background

The Internal Audit Plan for fiscal year 2009-10 included a review of the Interstate 5 (I-5) Gateway Project. Through a competitive process, the Internal Audit Department (Internal Audit) contracted with professional accounting firm, Wang Professional Corporation (Wang). Wang offered recommendations to improve procedures over right-of-way administration and recommended that the Orange County Transportation Authority (OCTA) recover costs for one utility relocation agreement. The results of Wang's agreed-upon procedures were provided in a report provided to the Board of Directors.

Discussion

During its procedures, Wang identified a potential conflict of interest between an OCTA employee and an employee of the California Department of Transportation. Internal Audit and OCTA's legal counsel conducted additional procedures to validate the conflict, which was subsequently resolved when the OCTA employee tendered resignation. Internal Audit also identified issues with regard to disclosures by designated employees on Form 700. Internal Audit conducted informal interviews of designated employees and found that many were unfamiliar with reporting requirements. Internal Audit recommended that management stress the importance of accurate reporting and provide training to employees during the next reporting period. Management agreed with the recommendation and will provide training in early 2011.

Internal Audit raised concerns about impairments to objectivity when employees are empanelled for procurements and the employees' supervisors have financial or other interests in the outcome. Internal Audit recommended that the Contracts Administration and Materials Management (CAMM) Department revise its Declaration of Impartiality and Confidentiality (Declaration), signed by each procurement team member, to include affirmation that the panelists are free from impairments to their objectivity. CAMM agreed with the recommendation and revised the Declaration. Internal Audit has closed this finding.

Wang determined that invoices were approved for payment but that billed personnel were not included in the contract as required. Because these charges were for personnel of a subcontractor to OCTA's contractor, Wang recommended that the contractor better scrutinize invoices. Internal Audit has recommended that OCTA, too, improve its review of invoices because these subcontractor charges were both included in the contract and the invoice package sent to OCTA.

Finally, Wang determined that overtime charges were not preauthorized and that the contract was amended to delete this requirement. Because preauthorization is critical in managing the contract, Internal Audit recommended that the CAMM Department require written authorization for the elimination or alteration of contract provisions. CAMM agreed with the recommendation and revised its policies and procedures to require that changes to contract terms and conditions be justified in writing and approved by supervisors. Internal Audit is satisfied that the recommendation has been implemented and has closed the finding.

Summary

Based on this limited scope review, Internal Audit offered four recommendations and management has indicated that these have been, or will be, implemented.

Attachment

- A. Limited Scope Review Performed in Relation to an Audit of Interstate 5 Gateway Project Contracts, Internal Audit Report No. 08-014

Approved by:



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ORANGE COUNTY TRANSPORTATION AUTHORITY INTERNAL AUDIT DEPARTMENT



Limited Scope Review Performed in Relation to an Audit of Interstate 5 Gateway Project Contracts

INTERNAL AUDIT REPORT NO. 08-014

September 29, 2010



Internal Audit Team:

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Conclusion

The Internal Audit Department (Internal Audit) of the Orange County Transportation Authority has completed a limited scope review of issues raised during an audit of Interstate 5 (I-5) Gateway Project contracts by external audit firm Wang Professional Corporation (Wang). Specifically, Internal Audit investigated a report of conflict of interest and inaccurate Statement of Economic Interest (Form 700) disclosure. The review identified a conflict of interest between an OCTA employee and an employee of the California Department of Transportation (Caltrans) who later became employed by an OCTA contractor (OCTA Contractor). The matter was resolved during the course of this review when the OCTA employee tendered his resignation. However, Internal Audit also found evidence of possible impairments to objectivity in the procurement of services from the OCTA Contractor and recommended that policies and procedures be enhanced to prevent impairments in either fact or appearance.

Internal Audit determined that several OCTA staff had not accurately reported economic interests on Form 700 for the year ended December 31, 2008. Furthermore, Internal Audit analyzed all Form 700 filings for 2008 and 2009, and noted what may be inadequate disclosure. Internal Audit recommended that employees with known inaccuracies amend their Form 700 and that training be provided with the distribution of the 2011 Form 700 to ensure compliance henceforth.

Internal Audit also performed additional procedures related to labor charges for unapproved contractor personnel as documented in the I-5 Gateway Project Audits conducted by Wang. Specifically, Wang reviewed a sample of contractor invoices totaling \$15,270. Internal Audit reviewed the balance of unapproved contractor personnel charges. In total, billings for these unapproved personnel totaled \$754,047. Internal Audit recommended that OCTA project managers enhance their review of invoices to ensure only approved personnel are billed.

Finally, in its report, Wang found that a provision requiring that the contractor obtain approval from OCTA for overtime prior to performing overtime work was removed from a contract through amendment. Internal Audit considers this contract provision a valuable tool in effectively managing costs and contractor activity and recommended that the Contracts and Materials Management (CAMM) Department establish a policy with regard to the elimination or alteration of significant contract provisions.

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Background

The Internal Audit Plan for fiscal year 2009-10 included a review of the I-5 Gateway Project. Through a competitive process, Internal Audit contracted with professional accounting firm, Wang. Based on concerns raised by Wang during the course of its review, Internal Audit conducted additional procedures. Internal Audit has also provided supplementary recommendations herein based on the results of Wang's work and the additional procedures performed.

Objectives, Scope and Methodology

The objective of this limited scope review was to review indications that conflicts of interest existed with regard to OCTA employees. In conducting this review, Internal Audit performed the following:

- Reviewed a sample of payments to OCTA contractor Overland Pacific & Cutler (OPC)
- Reviewed contract and procurement files for the OPC agreements
- Reviewed the Form 700 Reference Pamphlet
- cursorily reviewed Form 700 for all 254 designated OCTA employees for the period covering January 1, 2008 through December 31, 2008, and all 264 designated employees for the period covered January 1, 2009 through December 31, 2009
- Reviewed Form 700's in detail for certain OCTA employees for 2008 and 2009
- Conducted real estate and business entity searches through various public records databases

The scope of the review was limited to contracts between OCTA and OPC and 2008 and 2009 Form 700's. The methodology included reviewing recent OPC invoices, 2008 Form 700's, and interviews of various OCTA personnel and other research.

This review was conducted in accordance with Generally Accepted Government Auditing Standards. 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. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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Audit Comments, Recommendations and Management Responses

Conflict of Interest

During its audit of two I-5 Gateway Project contracts, independent auditor Wang notified OCTA's Internal Audit Department that its finding related to Caltrans' lack of compliance with internal controls over payments made to contractors also identified a potential conflict of interest. Specifically, Wang determined that the Caltrans right-of-way administrator who failed to comply with Caltrans internal control procedures was the spouse of OCTA's right-of-way administrator responsible for I-5 Gateway project right-of-way activities. Internal Audit also determined that the Caltrans spouse later assumed a right-of-way administration position with Overland Pacific Cutler (OPC), a firm with three current and one recently expired contract with OCTA. Total payments to OPC for work performed by the spouse on these four OCTA contracts was \$93,402 through June 2009. The OCTA right-of-way administrator approved all of the payments to his spouse's firm in his position as Project Manager for the OCTA right-of-way group.

OCTA's legal counsel was also informed of the relationship and performed an analysis to determine if the relationship represented a conflict of interest. Based on legal counsel's analysis, the relationship does constitute a conflict of interest prohibited by the California Political Reform Act. Furthermore, both legal counsel and Internal Audit determined that the OCTA right-of-way administrator had failed to report spousal income on a 2008 Form 700. Legal counsel recommended that OCTA take immediate action with regard to this employee and/or OPC. During the course of this review the right-of-way administrator filed an amended Form 700 and resigned from OCTA effective December 14, 2009.

Income from various sources must be reported as indicated in OCTA's Conflict of Interest Code, most recently revised in August 2009. A source of income must be reported if the source is located in, doing business in, planning to do business in, or has done business during the previous two years in an agency's jurisdiction. Commonly reportable income also includes community property interest (50%) in a spouse's or registered domestic partner's income.

Incomplete Disclosures on Form 700's

During review of OPC invoices, Internal Audit also identified an OPC subcontractor whose spouse works in OCTA's CAMM Department and who maintains an office in the County of Orange (County). Internal Audit reviewed Form 700 schedules for the employee to determine if this employee's spousal income had been reported and

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determined that it had not. The employee was counseled and filed an amended Form 700.

Internal Audit was also informed of another spouse of an employee within the Rail Division whose firm had recently responded to a Request for Proposal. While the spouse was not included as a proposed project team member, the spouse's firm cites work performed primarily within the County. The firm was also recently awarded a contract with OCTA for on-call right-of-way services. Internal Audit reviewed the employee's Form 700 to determine if the employee had reported spousal income for 2008 and determined that no spousal income had been reported. The employee was counseled and filed an amended Form 700

The discovery of disclosure omissions prompted Internal Audit to review Form 700 filings for all OCTA designated employees, officers, and directors. Internal Audit compiled statistics for each disclosure category noting that certain results raise questions as to the completeness of the forms. For example, spousal income was reported by less than 11 percent of the designated employee population. Likewise, investments in stocks, bonds, and other interests were reported by less than 11 percent of the population.

Internal Audit also conducted informal interviews of designated employees to determine if there is a good understanding of the purpose of Form 700 and its requirements. Based on employee responses, designated employees do not have an adequate understanding of the requirements.

OCTA's Code of Conduct (Code) was approved by the Board of Directors on July 13, 2009, and reminds employees of the policies on accepting gifts and conflicts of interest. Each employee received a copy of the Code in October 2009. In the future, employees will receive a copy of the policy at the time of employment and will sign an acknowledgment of receipt. Thereafter, employees will receive a copy of the policy once every two years and employees will sign an acknowledgment of receipt. OCTA provided training to all employees on the Code, however, it was not specifically designed to provide detailed instructions on Form 700 disclosure and reporting.

Recommendation 1: Internal Audit recommends that, effective with the distribution of the 2010 Form 700 in February 2011, the form be accompanied by a letter from the Chief Executive Officer highlighting the importance of accurate and complete reporting, as well as consequences for failure to accurately disclose. Internal Audit also recommends that consideration be given to developing a training course highlighting the provisions of the Fair Political Practices Act, including some of the common disclosure items identified in this review.

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Management Response (Executive Office):

Management agrees with the recommendation and is committed to providing all designated employees the resources to accurately report financial interests, as required by the Fair Political Practices Act. Management will request that legal counsel provide training to all designated employees during the 2011 filing period and that this legal resource be available to any designated employee who may need additional clarification or assistance.

Potential Impairments to Objectivity

In reviewing procurement and contract files for OPC, Internal Audit noted that two of five selection team members for the procurement of two separate right-of-way service contracts were subordinates of the OCTA right-of-way administrator whose spouse became employed by OPC during the procurement period. Empanelling subordinates under these circumstances may jeopardize employees' objectivity, both in fact and appearance. Current procurement policies prohibit selection team members from having a direct financial interest in firms proposing on solicitations. Team members sign a declaration of impartiality and confidentiality (Declaration); however, there are no provisions related to possible impairments to objectivity resulting from personal and/or employment relationships.

Recommendation 2: Internal Audit recommends that the CAMM Department modify its Declaration to require that selection team members certify that they are free from personal and employment-related impairments that could jeopardize their objectivity in either fact or appearance.

Management Response (CAMM Department): CAMM agrees with the finding and has modified the "Declaration of Impartiality and Confidentiality" form to include recommended statement.

Note: Internal Audit has reviewed the revised Declaration and is satisfied that the recommendation has been implemented. No further action is required and the finding is considered closed.

Billings for Unauthorized Employees

During its review of a sample of invoices Wang discovered that Pinnacle One billed Caltrop \$15,270 for one employee who was not approved by OCTA as an authorized person in "Schedule I – Hourly Rate Schedule" of the Contract. OCTA's Project Controls

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Department identified five additional employees of Pinnacle One that were not approved. Internal Audit subsequently reviewed all of Pinnacle One invoices noting a total of 5,635.25 hours at a total cost of \$754,047 was charge for unapproved personnel.

The "Schedule I – Hourly Rate Schedule" of the Contract specifically approved and listed three Project Personnel by name and position title for subcontractor Pinnacle One. The agreement states "AUTHORITY shall reimburse CONSULTANT for the exact amount of the unit rates shown in Schedule I and II, which are directly incurred by CONSULTANT's personnel in the performance of work under this Agreement. Schedule I may be amended on an as-needed basis by letter approval issued by AUTHORITY to reflect changes in project personnel."

Recommendation 3: Internal Audit recommends that OCTA enhance its review of invoices to ensure only approved contractor and subcontractor personnel are billed.

Management Response (Capital Programs Division):

Capital Programs agrees with the recommendation that consultant invoice and payment review should be done in accordance with the provisions of the contract. Certain contracts pay invoices on a time and expense basis which are based on pre-approved, detailed lists of individual names and rates to be used by the consultant. As individuals join and leave the consultant's project team, these tables must be formally amended by CAMM to keep up to date with the personnel changes. Invoices should not be paid for individuals who have joined the consultant team until the salary tables have been updated in the contract to show the accepted rate. This fact will be clarified with Capital Programs staff responsible for reviewing and approving invoices.

Contract Terms and Conditions Should Be Strengthened

During its review of contractor and subcontractor invoices, Wang identified overtime charges that were not preapproved as required by a contract attachment (rate schedule). The rate schedule included the footnote, "*These rates were calculated using the named personnel's 2004 actual salary. Includes overhead rate of 140% and profit of 8% with a maximum 3% annual escalation. Overtime for prevailing wage and non-exempt employees will be billed at time and a half with prior written approval from OCTA's Project Manager.*"

This contract term was included by the contractor but was deleted from the contract because preapproval was found by the project manager to be impractical or impossible due to round-the-clock work.

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OCTA's standard contract language does not include provisions regarding overtime; however, Internal Audit considers this contract provision a valuable tool in effectively managing and controlling a contract.

Recommendation 4: Internal Audit recommends that the CAMM Department enhance its policies and procedures to require written justification and supervisory approval for the alteration or elimination of contract provisions. Furthermore, Internal Audit recommends that the CAMM Department consider the addition of provisions related to overtime in all contracts for capital projects.

Management Response (CAMM Department): CAMM agrees with the finding and has modified the procurement policies and procedures to require written justification and supervisory approval for the alteration or elimination of important contract provisions.

Note: Internal Audit has reviewed the revised policy and is satisfied that the recommendation has been implemented. No further action is required and the finding is considered closed.