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Date: March 26, 2015

To: Audit, Finance and Enterprise Committee

From: Jennifer Ruttman, City Auditor

Subject: Central Mesa Light Rail Project Cost Recovery Audit

cc: Mayor and Council  
Kari Kent, Deputy City Manager  
Michael Kennington, CFO  
Beth Huning, City Engineer  
Jodi Sorrell, Transit Services Director

Pursuant to the Council-approved Audit Plan, the City Auditor's office has completed a Cost Recovery audit of the Central Mesa Light Rail Project. The report is attached will be presented at the next scheduled meeting of the Audit, Finance & Enterprise Committee.

Please feel free to contact me with any questions or concerns.

## AUDIT REPORT

CITY AUDITOR

**Report Date: March 26, 2015**  
**Department: Engineering**  
**Subject: Central Mesa Light Rail Project Cost Recovery**  
**Lead Auditor: Tami Steadman**

### **OBJECTIVE**

This audit was conducted to determine whether all reimbursable light rail project costs are being captured and recovered in accordance with applicable agreements.

### **SCOPE & METHODOLOGY**

To achieve our objective, we:

- Interviewed City staff members from Engineering, Transit, and Financial Services.
- Reviewed agreements between the City of Mesa and Valley Metro Rail, Inc. (METRO).
- Reviewed applicable laws and other authoritative guidance regarding Federal Awards.
- Reviewed Right of Way and Administrative budgets, as well as the specific Cost Allocation Plan prepared for this project.
- Reviewed the Central Mesa Light Rail Extension project financial activity from fiscal year 2010/2011 through December 2014.

### **BACKGROUND**

The Light Rail Transit program (LRT) is a regional project that extends through and serves the cities of Phoenix, Tempe, Mesa, and Glendale. The cities formed a non-profit corporation, Valley Metro Rail, Inc. (METRO), and entered into a Joint Powers Agreement for the purpose of planning, designing, constructing, and operating the LRT.

METRO receives funding for the entire LRT project from the Federal Transit Administration and other federal, state, and regional sources. The City of Phoenix, as majority member of METRO, is the designated recipient for the Federal funding. METRO reimburses each city for property acquisition and other costs incurred for the project. The City of Mesa is obligated to account for all allowable costs associated with this 3.1 mile LRT segment and submit properly documented reimbursement requests to METRO.

### **Fiscal Impact**

The original approved budget for reimbursable costs to be expended by the City of Mesa for this segment was approximately \$16 million. Through December 2014, the City had incurred costs of approximately \$15.8 million and had submitted requests to METRO for

reimbursement of approximately \$15.3 million. Work on this segment is expected to continue through fall of 2015.

### **CONCLUSION**

In our opinion, the procedures and controls currently in place are not adequate to ensure that the City is recovering all reimbursable light rail project costs. We identified opportunities to improve procedures, oversight, and compliance with agreements. A summarized list of our findings and recommendations is included below. For additional details and responses from management, please see the attached Corrective Action Plans (CAPs).

### **FINDINGS & RECOMMENDATIONS**

1. No written procedures exist for calculating reimbursable costs and processing the related reimbursement requests; and there were insufficient controls in place to ensure all costs were included and/or accurately calculated. Consequently, reimbursement requests have been incomplete and calculated inconsistently. We recommend that staff develop written procedures for how to correctly calculate and obtain reimbursement for eligible project costs.
2. Through fiscal year 2013/2014, the City had incurred approximately \$1.1 million of eligible costs that were not submitted for reimbursement. When we notified Engineering staff, they immediately requested and received reimbursement for approximately \$630,000 of this amount. The remaining \$470,000 consists of approximately \$310,000 in acquisition costs deposited with the Court and roughly \$160,000 in personal services and related overhead costs. We recommend that City staff reconcile previous reimbursement requests to system reports and recalculated payroll and indirect cost amounts for the project. Any previously omitted costs should then be submitted for reimbursement.
3. Through fiscal year 2013/2014, the City had expended more than the budgeted-to-date amount; and, as of this writing, the City is on track to exceed the total original project budget by approximately \$300,000. The Design and Construction Agreement with METRO contains a budget change process, but the City has not requested a budget increase in accordance with that process. If the required budget increases are not requested and approved in a timely manner, the City may not fully recover all project costs. We recommend that the budget change process described in the Design and Construction agreement be utilized to formally request necessary budget increases as soon as possible.
4. Reimbursable fringe benefit costs for medical and dental insurance have not been directly charged to this project since May 2013. As a result, the City has not been

reimbursed for these costs. We recommend that these medical and dental insurance costs be identified and included in all reimbursement requests for the remainder of this project. We further recommend that City staff determine whether other projects have been and/or continue to be impacted by this issue.

5. City staff did not have a copy of the federal award document which would define reimbursable costs. Without referring to the award document, staff cannot be certain of compliance, which is required by all parties (not just the designated grantee) under the Joint Powers Agreement. It is also possible that additional personnel-related costs could be eligible for reimbursement. We recommend that City staff obtain a copy of the federal award document and verify which costs are eligible for reimbursement. If necessary, reimbursable payroll and indirect overhead costs should be recalculated. As a standard practice when the City participates in federally funded projects, even when not the designated grantee, staff should obtain a copy of the award document and use it to inform the process of accounting for project costs.
6. Modifications to the Design and Construction Agreement with Valley Metro Rail, Inc. have been agreed to verbally, but have not been formalized in written amendments. We recommend that these and all other changes agreed to by the City of Mesa and METRO be documented in formal amendments to the Design and Construction Agreement and signed by both parties.

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**CAP#1: Inadequate Processes and Lack of Written Procedures**

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**Observation:** There were no established processes and no written procedures for calculating reimbursable costs and submitting reimbursement requests to METRO for the Central Mesa Light Rail Extension project. In addition, the processes that were being used to identify and/or calculate reimbursable project costs did not include adequate internal controls to ensure all costs were included and/or accurately calculated.

**Criteria:** Written procedures should be maintained for significant and/or complex business processes or functions, to ensure management's objectives are achieved in a consistent, efficient and reliable manner.

**Comments:** In order to accurately account for all project costs and submit all eligible amounts to METRO for reimbursement in a timely manner, staff must have definitive direction regarding:

- Where and how to obtain accurate, complete cost data, including but not limited to staff labor and benefits costs.
- Which costs are eligible for reimbursement and which costs are excluded (if any).
- Which supporting documents are required for each type of expense.
- How to correctly apply the indirect cost allocation rate.
- Internal review processes in place to ensure accuracy and completeness prior to submission.
- How and when to submit reimbursement requests.

The staff members responsible for tracking expenses and submitting for reimbursement did not have established procedures in place to ensure the accuracy and completeness of the reimbursement requests. As a result, some costs were not included in the reimbursement requests. In addition, inconsistent methods were used to calculate labor and benefits costs; and the indirect cost allocation rate was not applied correctly.

A contributing factor in these issues was the fact that Engineering was unable to obtain clear, consistent guidance from the Accounting division with regard to the proper way to

track personal services costs and apply the indirect cost rate. Another significant factor was the learning curve associated with the financial system changes the City was undergoing at the time.

**Recommendation:** 1-1. Staff should prepare formal written procedures for calculating reimbursable project costs and submitting reimbursement requests to METRO. The procedures should include sufficient details and internal controls to minimize the risk that errors, omissions, or inconsistencies could occur and not be detected. In the future, administrative procedures should be created for each unique project or agreement, incorporating the specific requirements applicable to that arrangement.

*(Note: When designing the process or developing written procedures, any element that staff is unable to define with certainty must be escalated to the extent necessary to resolve the issue.)*

**Management  
Response:**

1-1. Agree

**Implementation Plan:**

Engineering will develop processes and procedures and to improve internal controls.

**Individual or Position Responsible:**

Sr. Fiscal Analyst, Engineering (Michele Davila)

**Estimated Completion Date:** 4/30/2015

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**CAP#2: Unrecovered Costs**

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**Observation:** From the inception of the Central Mesa Light Rail Extension project through fiscal year 2013/2014, the City incurred approximately \$1.1 million of recoverable costs which were not submitted for reimbursement. When we notified Engineering staff, they immediately requested and received reimbursement for approximately \$630,000 of this amount. The remaining \$470,000 consists of approximately \$310,000 in acquisition costs deposited with the Court and roughly \$160,000 in personal services and related overhead costs.

**Criteria:** Recital I of the Design and Construction Agreement states:  
*"METRO will reimburse the City for certain City costs including, but not limited to, engineering costs, real estate acquisition costs, staff time, overhead, and other fees and costs as further described in this Agreement."*

**Comments:** To process reimbursement requests, staff relied on copies of invoices and other documentation (provided by other staff members) for amounts expended on the project, as opposed to running system financial reports to identify all expenditures charged to the project; and there was no process in place to reconcile the reimbursement requests to financial system data.

In addition, there was no process in place to verify that the methods and amounts used to calculate allowable payroll costs and indirect overhead costs were correct.

Without additional controls to ensure errors are detected and corrected, additional costs may be incurred and not reimbursed over the remainder of the project.

**Recommendation:**

- 2-1. Staff should reconcile previous reimbursement requests to City financial reports and to recalculated payroll and indirect cost amounts. Reimbursement should then be requested for all previously omitted costs.
- 2-2. Controls should be implemented to ensure errors and omissions are detected and corrected prior to submitting additional reimbursement requests.

**Management  
Response:**

**2-1. Agree**

**Implementation Plan:**

Engineering fiscal staff will pursue reimbursement for the remaining portion (approximately \$160,000) from Valley METRO.

**Individual or Position Responsible:**

Sr. Fiscal Analyst, Engineering (Michele Davila)  
Administrative Coordinator, Engineering (Connie Lint)

**Estimated Completion Date:** 4/30/2015

**2-2. Agree**

**Implementation Plan:**

Engineering staff has identified the issues associated with reimbursement cost recovery. Going forward, staff will develop a process to ensure that errors and omissions are detected and corrected prior to submitting additional reimbursement requests.

**Individual or Position Responsible:**

Sr. Fiscal Analyst, Engineering (Michele Davila)  
Administrative Coordinator, Engineering (Connie Lint)

**Estimated Completion Date:** 4/30/2015

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**CAP#3: Budget Increases not Requested**

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**Observation:** Through fiscal year 2013/2014, the City had expended more than the original budgeted-to-date amount; and, as of this writing, the City is on track to exceed the total original budget by approximately \$300,000. Although a budget change process is included in the Agreement, the City has not requested an increase in accordance with that process.

**Criteria:** Section 10.4.3 of the Design and Construction Agreement outlines the budget change process, which requires “a forecast of planned expenditures through the end of the Project, based on the current schedule, for review and approval, as appropriate, by the City Manager and METRO’s Executive Director.”

**Comments:** As the project has progressed, City and METRO staff have been aware that costs were running over the original budget. According to City staff, METRO has increased the overall LRT budget, but has provided only verbal assurances that all City project costs will be reimbursed.

If budget increases are not requested in a timely manner and documented in an amendment to the Agreement, the City may not fully recover all project costs.

**Recommendation:** 3-1. The City should follow the budget change process described in the Design and Construction Agreement and formally request budget increases as soon as possible.

**Management Response:**

**3-1. Agree**  
**Implementation Plan:**

Develop an internal process to monitor and manage the project budget on a monthly basis in order to identify budget shortfalls and/or discrepancies.

**Individual or Position Responsible:**  
Project Manager, Engineering (Trevor Collon)  
Deputy Engineer, Marc Ahlstrom

**Estimated Completion Date:** 4/15/2015

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**CAP#4: Uncaptured and Unrecovered Fringe Benefit Costs**

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**Observation:** Reimbursable medical and dental insurance costs have not been directly charged to this project since May 2013.

**Criteria:** Attachment B of OMB Circular A-87 "Cost Principles for State, Local, and Indian Tribal Governments" addresses selected items of cost which may be allowable under Federal awards. Regarding compensation for personal services, the Circular states that compensation includes but is "not necessarily limited to wages, salaries, and fringe benefits." It goes on to define fringe benefits as including "but not limited to, the costs of leave, employee insurance, pensions, and unemployment benefit plans."

**Comments:** In the City's previous financial system, all costs (i.e. salary and benefits) associated with hours worked on a project were charged to a Work Order, which facilitated the process of reporting for grant purposes. However, with the City's new Payroll system, certain fringe benefit costs are no longer directly charged to projects. Instead, these costs are charged to a default "Admin" code and may later be allocated to projects as an indirect charge. As a result of this change, reimbursable medical and dental insurance costs have not been charged directly to the project since May 2013 and therefore have not been submitted for reimbursement.

- Recommendations:**
- 4-1. Staff should determine whether medical and dental premium costs associated with this project can be identified and documented adequately to request reimbursement from METRO for the remainder of the project.
  - 4-2. Staff responsible for tracking costs on other City projects for reimbursement purposes should be informed of this issue; and these costs, if eligible, should be identified and recovered whenever possible/practicable.

**Management Response:**

**14-1. Agree**

**Implementation Plan:**

The Engineering Department agrees that the medical and dental costs associated with the project need to be identified

and documented adequately in order to request reimbursement from Valley METRO. However, this is a system issue that has City-wide implications. As a result, Engineering met with Financial Services to request help in resolving the issue. Financial Services will work on a solution.

**Individual or Position Responsible:**

Financial Services Director, Irma Ashworth

**Estimated Completion Date:** 6/30/2015

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**CAP#5: Federal Award Document not on File**

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**Observation:** City staff did not have a copy of the federal award document which would specify the components of pay that are eligible for reimbursement, as well as define all reimbursable costs.

**Criteria:** Paragraph 4. "Federal Funding" of the Joint Powers Agreement states:

*"The Parties intend that the Corporation apply for and receive Federal funding to pay for a portion of the cost of the LRT. The Corporation is authorized to apply for and receive Federal funding. In conjunction with applying for and receiving Federal funding, the Corporation is authorized to bind the Parties to comply with applicable Federal funding requirements. Each Party agrees to execute such documents and perform such acts as are necessary to comply with applicable Federal funding requirements."*

The City cannot be certain of compliance with all applicable funding requirements for this project without having a copy of the document which details the specific requirements.

**Comments:** Since the City of Phoenix is the designated recipient of the federal funding for this project, this award is not a direct "grant" to the City. As such, staff in Accounting and Grants Management are not tracking this project, and City staff did not consider it necessary to obtain and review a copy of the federal award document.

Additionally, staff interpreted METRO's acceptance and payment of their reimbursement requests as confirmation that the requests were accurate, complete, and compliant with all requirements; no further analysis of specifically defined allowable costs was done.

**Recommendations:** 5-1. The Engineering department should obtain a copy of the federal award document and verify which costs are eligible for reimbursement. If necessary, reimbursable payroll and indirect overhead costs should be recalculated.

5-2. In the future, when receiving federal grant funding, whether directly or indirectly, staff should obtain and review a copy of the award document, and should use it to inform the process of accounting for project costs.

**Management  
Response:**

**5-1. Agree**

**Implementation Plan:**

The Project Management team will ensure that a copy of the agreements will be made available and accessible in the project file. The Project Management team will review the agreements and ensure that the City is adhering to the criteria identified in the agreements.

**Individual or Position Responsible:**

Engineering Project Manager (Trevor Collon)  
Engineering Deputy Engineer (Marc Ahlstrom)

**Estimated Completion Date:** 4/15/2015

**5-2. Agree**

**Implementation Plan:**

Going forward, the Project Management team will ensure that a copy of the agreements will be made available and accessible in the project file. The Project Management team will modify the agreement process to include Engineering fiscal staff.

**Individual or Position Responsible:**

Engineering Project Manager (Trevor Collon)  
Engineering Deputy Engineer (Marc Ahlstrom)  
Engineering Sr. Fiscal Analyst (Michele Davila)  
Engineering CIP Analyst (Craig Alteri)

**Estimated Completion Date:** 4/15/2015

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**CAP#6: Oral Amendments to the Design and Construction Agreement**

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**Observation:** Modifications to the Design and Construction Agreement with Valley Metro Rail, Inc. have been agreed to verbally, but have not been formalized in written amendments.

**Criteria:** When terms of a contract or agreement are modified, an amendment should be written and signed by all parties showing knowledge and acceptance of the changes.

**Comments:** The Design and Construction Agreement for the Central Mesa Light Rail Extension project was executed almost 4 years ago. As with any complex, long term project, circumstances can change over time making it necessary to modify the original terms.

According to City staff, while representatives from both parties were diligent in estimating budgets and drafting project documents, they anticipated that changes would most likely be necessary as the project advanced. According to City staff, however, both parties have verbally agreed to necessary changes, but have not formally amended the Agreement.

**Recommendation:** 6-1. All changes agreed to verbally by the City of Mesa and Valley Metro Rail, Inc. should be documented as amendments to the Design and Construction Agreement and signed by both parties.

**Management Response:**

**6-1. Agree**  
**Implementation Plan:**

The Engineering Deputy Engineer will review the Design and Construction agreement and document the items that were verbally agreed to deviate from the agreement. These items will be presented to METRO for their review and concurrence.

Future material changes to this and other agreements with METRO will be properly documented by amendment when necessary.

**Individual or Position Responsible:**  
Engineering Deputy Engineer (Marc Ahlstrom)

**Estimated Completion Date:** 4/30/2015