OUR Vision: To be the best place in Canada to raise a child, promote innovation, engage citizens and provide diverse economic opportunities.
OUR Mission: WE provide quality public service that contribute to a healthy, safe and prosperous community, in a sustainable manner.
OUR Values: Accountability, Cost Consciousness, Equity, Excellence, Honesty, Innovation, Leadership, Respect and Teamwork

CITY OF HAMILTON

CITY MANAGER’S OFFICE
Audit Services Division

TO: Chair & Members
Audit, Finance and Administration Committee

WARD(S) AFFECTED: CITY WIDE

COMMITTEE DATE: December 9, 2013

SUBJECT/REPORT NO:
Follow Up of Audit Report 2012-03 – Construction Contracts Review (AUD13035) (City Wide)

SUBMITTED BY:
Ann Pekaruk
Director, Audit Services
City Manager’s Office

PREPARED BY:
Ann Pekaruk 905 546-2424 ext. 4469

SIGNATURE:

RECOMMENDATION

That Report AUD13035, respecting the follow up of Audit Report 2012-03, Construction Contracts Review, be received.

EXECUTIVE SUMMARY

Audit Report 2012-03, Construction Contracts Review, was originally issued in October, 2012 and management action plans with implementation timelines were included in the Report. In October, 2013, Internal Audit conducted a follow up exercise to determine if appropriate and timely actions had been taken. Of the two recommendations that management agreed to in the original Report, the implementation of one remains incomplete and the other is in progress.

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)

Audit Report 2012-03, Construction Contracts Review, was originally issued in October, 2012. The report provided two recommendations related to the methodology used to allocate and recover operating costs from capital projects and the disclosure of such in management reports to Council.

It is normal practice for Internal Audit to conduct follow up reviews within a 12-18 month period following issuance of the original report in order to determine whether action plans committed to by department managers have been implemented.

POLICY IMPLICATIONS/LEGISLATED REQUIREMENTS

Capital Recovery Process and Methodology

RELEVANT CONSULTATION

The results of the follow up were provided to management responsible for the administration of two areas in Public Works whose projects were originally selected for review, namely Engineering Services and Water & Wastewater Engineering.

ANALYSIS / RATIONALE FOR RECOMMENDATION

(include Performance Measurement/Benchmarking Data, if applicable)

The report attached as Appendix “A” to Report AUD13035 contains the first three columns as originally reported in Report 2012-03 along with an added fourth column indicating Internal Audit’s comments as a result of the follow up work.
The one recommendation whose implementation is not completed pertains to the disclosure of the actual operating cost percentage allocated to capital projects in the annual year end capital budget status report and explanations for significant variance from the original budgeted amounts.

The other recommendation, whose implementation is in progress, called for the development and implementation of a comprehensive and systematic methodology to support the allocation of incurred Water and Wastewater operating costs to individual capital projects and the disclosure to Council.

<table>
<thead>
<tr>
<th>ALTERNATIVES FOR CONSIDERATION</th>
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<tbody>
<tr>
<td>(include Financial, Staffing, Legal and Policy Implications and pros and cons for each alternative)</td>
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Not Applicable

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<tr>
<th>ALIGNMENT TO THE 2012 – 2015 STRATEGIC PLAN:</th>
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**Strategic Priority #2**
Valued & Sustainable Services

*WE deliver high quality services that meet citizen needs and expectations, in a cost effective and responsible manner.*

**Strategic Objective**
2.1 Implement processes to improve services, leverage technology and validate cost effectiveness and efficiencies across the Corporation.

**Strategic Priority #3**
Leadership & Governance

*WE work together to ensure we are a government that is respectful towards each other and that the community has confidence and trust in.*

**Strategic Objective**
3.4 Enhance opportunities for administrative and operational efficiencies.

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<th>APPENDICES / SCHEDULES</th>
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Appendix “A” to Report AUD13035

ap:dp
CITY OF HAMILTON
INTERNAL AUDIT REPORT 2012-03
CONSTRUCTION CONTRACTS REVIEW - PUBLIC WORKS
FOLLOW UP

<table>
<thead>
<tr>
<th>#</th>
<th>OBSERVATIONS OF EXISTING SYSTEM</th>
<th>RECOMMENDATION FOR STRENGTHENING SYSTEM</th>
<th>MANAGEMENT ACTION PLAN</th>
<th>FOLLOW UP (OCTOBER 2013)</th>
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</table>
| 1. | Roads Project – Operating Costs Recoveries  
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. 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. 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. 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. | 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. | Agreed. Operating dollars recovered for the ESI division will be included on the year end capital budget status report with appropriate explanation. | Not completed. In 2012, the actual operating costs amounted to 9% of roads project costs. The estimate used in the budget was 15%, unchanged from 2011. Despite the variance between the two being greater than +/- 1%, the actual operating cost percentage allocated to the capital projects was not disclosed in the 2012 year end capital budget status report to Council. |
### CONSTRUCTION CONTRACTS REVIEW - PUBLIC WORKS
#### FOLLOW UP – OCTOBER 2013

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<td>2.</td>
<td>Water/Wastewater Project – Operating Costs Recoveries</td>
<td>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.</td>
<td>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.</td>
<td>In Progress. Water/Wastewater management has developed a systematic and comprehensive methodology to support the allocation of the current year’s water/wastewater operating costs to individual projects. However, these operating costs are allocated only to the active project IDs with the highest commitment amounts. Also, the allocated costs were not disclosed in the 2012 capital budget status report to Council.</td>
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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.

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.

This practice of allocation of operating costs may distort the accumulation of expenditures against budget without detailed documentation to support the allocation.