



DEPARTMENT OF MANAGEMENT AND FINANCE

2100 Clarendon Boulevard, Suite 501, Arlington, VA 22201
TEL 703-228-3415 DMF@ARLINGTONVA.US www.arlingtonva.us

Please note that this report was not posted at the time it was issued to due to contract close out activities.



Arlington County, Virginia

**Contract Compliance Review:
Miller Brothers, Inc.
Fiscal Year 2015**

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RSM US LLP
1861 International Drive
Suite 400
McLean, VA 22102
O: 252.637.5154 F: 252.637.5383
www.rsmus.com

May 27, 2015

Mr. Greg Emanuel
Chief Environmental Officer, Department of Environmental Services
Ms. Mary Beth Chambers
Acting Management and Finance Director, Department of Management and Finance
Arlington County, Virginia
2100 Clarendon Blvd
Arlington, VA 22201

Pursuant to the contract and related statement of work for Arlington County, Virginia (“the County”), we hereby present the Contract Compliance Review of a construction contract (contract number 596-14) with Miller Brothers, Inc. from the Department of Environmental Services. Our report is organized in the following sections:

| | |
|--------------------------------|--|
| Executive Summary | This section gives a background summary of the function and a detailed description of the issues noted during our internal audit, recommended actions, and management’s corrective action plan, including the responsible party and estimated completion date. |
| Background | This section provides an overview of the function within the process and pertinent operational control points and related compliance requirements. |
| Objectives and Approach | The internal audit objectives and focus are expanded upon in this section as well as a review of the various phases of our approach. |
| Process Map | This section illustrates the process map, which identifies data flow, key control points and any identified gaps. |

We would like to thank the staff and all those involved in assisting RSM US LLP in connection with this project.

Respectfully Submitted,

RSM US LLP

RSM US LLP

Executive Summary

Contract compliance monitoring is an integral piece of the organization’s control environment. Contract compliance encompasses all contractual agreements entered into by the County. The focus of this audit is vendor agreements. Although certain aspects of the purchasing function are centralized within the Department of Management and Finance, and vendor selection is performed in conjunction with Purchasing (for purchases greater than \$5,000), many of the high risk areas like contract compliance and monitoring are the responsibility of the individual departments/divisions/bureaus.

The objectives of this contract compliance review was to assess whether the system of internal controls is adequate and appropriate, at the department level, in the categories of compliance with contract requirements, applicable laws, administrative rules, comparable practices and any other applicable guidelines, for effective contract compliance.

Factors considered during the selection of the contracts to be reviewed included:

- Volume of change orders, purchase orders and invoices;
- Dollar value of the contract;
- Dollar value of expenditures by vendor;
- Volume of contracts with the vendor; and
- Volume of contracts within the department.

The following contract from the Department of Environmental Services (“DES”) was selected for testing based on the above factors:

| Contractor and Contract Number | Contract Amount/Board Authorization | Contract Description | Contract Execution Date | Dollars Spent as of February 28, 2015 | Contract Type | County Division/Bureau |
|--------------------------------|-------------------------------------|----------------------|-------------------------|---------------------------------------|---------------|------------------------------------|
| Miller Brothers, Inc.: 596-14 | \$6,609,929 | Construction | 03/06/2014 | \$4,108,980 | Lump Sum | Facilities Design and Construction |

** Initial approved amount from the establishment of the contract in 2012, it has since been increased to include approved budget amount for paving work.*

The specific audit period for transactional testing was from the contract April 14, 2014 to February 1, 2015.

A detail of the issues identified and their relative risk ratings is provided below, including recommendations and management’s response. We have assigned relative risk factors to each issue identified. This is the evaluation of the severity of the concern and the potential impact on the operations. There are many areas of risk to consider in determining the relative risk rating of an issue, including financial, operational, and/or compliance, as well as public perception or ‘brand’ risk. Items are rated as High, Moderate, or Low.

- *High Risk Items* are considered to be of immediate concern and could cause significant operational issues if not addressed in a timely manner.
- *Moderate Risk Items* may also cause operational issues and do not require immediate attention, but should be addressed as soon as possible.
- *Low Risk Items* could escalate into operational issues, but can be addressed through the normal course of conducting business.

| Issue | Risk Rating |
|--|-------------|
| Miller Brothers Inc. – Contract 596-14 | |
| 1. Segregation of Duties | High |
| <p>Miller Brothers, Inc. submits invoices for work performed under this contract on the 20th of each month. Invoices include line items for costs associated with approved change orders, of which there have been seven. Change orders are allowed up to the amount of the previously Board approved contingency, thus do not require additional review and approval from the County’s Board. As a part of our review we noted the following:</p> <ul style="list-style-type: none"> • The Project Officer is the only County employee reviewing monthly invoices submitted by the contractor for accuracy, contractual compliance, reasonableness and completeness of supporting documentation prior to approval for payment. • Currently, change orders for this contract have amounted to ~\$430,640 (from estimated costs on change orders) and the Project Officer is the only County employee reviewing change orders submitted by the contractor for accuracy, contractual compliance, reasonableness and completeness of supporting documentation. The Project Officer is also the only required County signatory authority for approving change orders that do not exceed the Board approved project contingency. <p>Although, additional review and approval is completed by the third-party Architect hired for execution of this construction project, this individual is not a County employee and therefore not a sufficient independent secondary review authority.</p> <p>Without proper segregation of duties, including differing levels of review within the invoice and change order review and approval processes, there is an increased likelihood that errors, misappropriation of funds, or other irregularities could occur without being detected and corrected in a timely manner.</p> | |
| Recommendation | |
| <p>We recommend that a second County employee, of the appropriate level/position and independent of the contract management process, be involved in the invoice and change order review and approval process to (1) provide for increased segregation of duties, (2) validate reasonableness of amount of the change order(s) and (3) ensure proper levels of review and approval.</p> | |
| Management’s Response | |
| <p>Response: The Management and Budget Specialist is involved at 2 levels of certification: on the front end or requisition/PO side of the ledger. Then on the payment side of the ledger in monitoring payments against the budget amount for the project. In the case of a purchase order, we process PO modifications for change orders after they have been approved by an authorizing official within the program.</p> <p>The current process for invoice processing is such that when the invoice comes to the Project Manager (PM) responsible for the project, he/she reviews it to determine if payment matches the level of work completed. If it does, the PM stamps “ok to pay” and sends the invoice directly to the invoice processing staff for payment. <u>This process will be changed immediately by adding two additional steps. After the PM indicates the invoice is ok to pay, the invoice is reviewed and approved by the PM’s immediate supervisor. It is then submitted to the Management and Budget Specialist who will conduct an independent financial review and certification of the invoice relative to the Board authorized contract amount for both base and contingency budgets. This will include an accounting of appropriate purchase order lines for payment of the invoice.</u> If there is a discrepancy, it will be returned to the PM to reconcile the issue(s) with the contractor.</p> <p>If and when approved by the Management and Budget Specialist, he/she will sign off on the invoice signifying approval. Once the invoice is certified and approved by the Management and Budget Specialist, it is then ready to go to the Administrative Assistant for payment processing.</p> <p>Responsible Party: Capital Program Manager for Facilities and Engineering</p> <p>Estimated Completion Date: Effective Immediately</p> | |

| Issue | Risk Rating |
|--|-----------------|
| County-Level | |
| 2. Contract Compliance Administration and Monitoring Policies and Procedures | Moderate |
| <p>The contract compliance administration and monitoring is decentralized to the user departments once the contracts have been issued for execution. It is up to the assigned Contract Owners to perform contract compliance administration and monitoring duties.</p> <p>We noted that the County does not have formally documented policies and procedures for the departments and Contract Owners/Project Officers to utilize in the execution of contract compliance administration and monitoring.</p> <p>Once a contract is executed, the contract performance must be monitored to ensure the goods or services received are in compliance with the contract terms and pricing schedules.</p> <p>Ineffective contract administration practices could result in payment for goods/services not received, overpayment of invoices, and violations of County policy and contract terms</p> <p>The absence of written policies and procedures increases the risk of the contract compliance administration and monitoring process being executed inconsistently or inaccurately. Also, in the event of employee turnover, addition of staff, or other interruption in normal operations, a lack of well documented department procedures increases the risk of miscommunication, error, slower “on-boarding” and more oversight required for new employees and possible internal control failure.</p> | |
| Recommendation | |
| <p>We recommend that a County-Level contract compliance administration and monitoring policy be developed and distributed with, at a minimum, guidance on the following:</p> <ul style="list-style-type: none"> • Review of periodic billings and necessary documentation to be maintained to support review; • Monitoring activities to be performed over the day-to-day execution of contracted work; • Monitoring of costs, including any Key Performance Indicators (“KPIs”), to be tracked by the Project Officer on an on-going basis during the contract period; • Process for following up on and documenting issues identified with Contractor performance or billing and subsequent resolution of the issues; • Establishment of thresholds for acceptable variances in budget to actual reviews performed as a part of monitoring responsibilities; and • Requirement for the departments to expand on the County-Level contract compliance administration and monitoring policy to provide procedures specific to their departments. | |
| Management’s Response | |
| <p>Response: The County will consider all of the recommendations provided in the report and develop a new Contract Administration Policy. This effort will be led by the Purchasing Department in coordination with key departments involved in the contract administration process. The completed policy will be posted on the County’s intranet and communicated to all concerned staff. Specialized training for select groups of project managers will be scheduled up to two times per fiscal year.</p> <p>Responsible Party: Purchasing Agent</p> <p>Estimated Completion Date: Policy completed September 2015; First training completed by March 1, 2016.</p> | |

Background

Overview

Contract compliance encompasses all contractual agreements entered into by the County. Although certain aspects of the purchasing function are centralized within the Department of Management and Finance, and vendor selection is performed in conjunction with Purchasing, many of the high risk areas like contract administration, compliance and monitoring are the responsibility of the individual departments/divisions/bureaus. These monitoring responsibilities specifically include:

- Understanding the Scope of Work and Terms and Conditions of the contract;
- Management of contract billings to avoid cost overruns;
- Validation of complete and satisfactory performance of work through physical walkthroughs and site visits, when appropriate;
- Ensuring timely performance of contracted work;
- Providing updates to the Department Director, Division Chief and Department of Management and Finance related to progress and budget, as necessary;
- Maintaining appropriate documentation, in compliance with the County level document retention policy and respective contract; and
- Review and approval of invoices for payment to the contractor in line with the payment terms and conditions outlined in the agreement.

Miller Brothers, Inc.

Contract 596-14 is a lump sum contract for the remodeling of a purchased building for the Comprehensive Homeless Services Center for a total contract amount of \$6,609,929 (\$5,508,274, plus a contingency of \$1,101,655). Per the contract, the anticipated completion date is 280 days from commencement, which is subject to extension upon identification of unforeseen work to be addressed via a formal change order(s).

Roles and Responsibilities

The following departments play key roles in the contract compliance process:

Department of Environmental Services - Facilities Design and Construction

Facilities Design and Construction (“FDC”) is responsible for providing project management and oversight services during all phases of construction, from pre-construction and design to inspection and close-out. This is generally accomplished by contracting with professional firms for all design, construction and other contract services and monitoring the projects until completion. FDC is also responsible for completing all Project Officer functions as outlined in the contract, overall contract compliance, and reviewing and approving vendor invoices for accuracy prior to payment

Department of Management and Finance

DMF oversees all the processes and record keeping of the County’s financial transactions. The Purchasing and Accounts Payable departments are part of DMF and act as support functions for departments managing vendor contracts. Specifically, Purchasing administers the competitive bid process and processes requests for procurement of services and goods by executing purchase orders for approved contractor amounts. Accounts Payable is responsible for processing payments to contractors based on invoices approved by the respective departments.

Common Definitions

Some common definitions for construction terminology used throughout this section of the report are as follows:

- *Contract Owner/Project Officer* – refers to the County representative responsible for general control, review, and approval of all aspects of the Contract, once executed. The Project Officer is appointed by the County’s Department of Environmental Services Director or designee is identified in the contract, and is the primary point of contact for the contractor in executing the agreed to services of the contract.
- *Contingency* – refers to funds included in a budget to allow for defraying the expense of unforeseen circumstances in a construction project.

Common Definitions - continued

- *Payment Application ("Pay App")* – the invoice submitted by the contractor for payment, including a detailed schedule of values to support the current billing total, including prior payments and additional costs due to change orders.
- *Change Order* – refers to an approved additional cost for unforeseen work outside of the original work plan considered in the development of the contract price. If the cost is deemed necessary and appropriate, an executed change order is established to allow the Contractor to invoice for the additional work.
- *Retainage* – refers to funds withheld from a construction contract until completion of the project, or some other agreed upon date. The amounts are held back to provide the Project Officer and the County with assurances for the quality of the work performed.
- *Lump Sum* – a construction contract typically procured through competitive solicitation, where a single low bid price is selected for contract execution.

Timeline

Below is a timeline of major events for the project.

| Date | Change Order Number | Event Description | Purchase Order Amount |
|--------------------|---------------------|--|-----------------------|
| February 25, 2014 | | The Arlington County Board approves the award of Contract Number 596-14 between the County and Miller Brothers, Inc. for construction services at the Comprehensive Homeless Services Center (HSC) for a total amount of \$5,508,274, plus a contingency of \$1,101,655, for a total contract authorized amount of \$6,609,929. A purchase order was created on March 18, 2014 for the amount of the contract excluding contingency. | \$5,508,274 |
| April 14, 2014 | | Project commenced. | |
| July 9, 2014 | CO 1 | The Purchase Order was increased by \$80,658 for installation of IBW/DAS Communication system (Change Order 1). | \$80,658 |
| July 18, 2014 | CO 2 | The Purchase Order was increased by \$20,030 for unforeseen costs related to the installation of new drywall in the restrooms and removal of existing brickwork. (Change Order 2). | \$20,030 |
| August 15, 2014 | CO 3 | The Purchase Order was increased by \$23,917 for unforeseen costs related to the repair of existing spandrel support, removal of masonry wall, patching knee walls, and furnishing and installing project signage. (Change Order 3). | \$23,917 |
| September 17, 2014 | CO 4 | The Purchase Order was increased by \$222,956 for work related to an Inspection Services Division approved conforming set. (Change Order 4). | \$222,956 |
| October 2, 2014 | CO 5 | The Purchase Order was increased by \$42,598 for unforeseen costs related to re-routing of drains, capping chiller piping, lowering of a door header, and installation of additional CAT 6 cables (Change Order 5). | \$42,598 |
| November 17, 2014 | CO 6 | The Purchase Order was increased by \$40,482 for fire alarm changes per comments from the Fire Marshall (Change Order 6). | \$40,482 |
| December 10, 2014 | | The Purchase Order was increased by \$23,631 to revise and relocate the site light pole concrete bases, substitute commercial refrigerator, remove existing coping stone for the entire 4 th floor parapet wall, and partial replacement of the curb and gutter on North 14 th street. | \$23,631 |
| Total | | Initial Purchase Order and Executed Change Orders | \$5,962,546 |

Objectives and Approach

Objectives

The objectives of this contract compliance review were to assess whether the system of internal controls around contract compliance are adequate and appropriate, at the department level, in the categories of compliance with contract requirements, applicable laws, administrative rules, comparable practices and any other applicable guidelines, for effective contract compliance.

Factors considered during the selection of the contract to be reviewed included: volume of change orders, purchase orders and invoices; dollar value of the contract; dollar value of expenditures by vendor; volume of contracts with the vendor; and volume of contracts within the department.

Approach

Our audit approach consisted of the following three phases:

Understanding and Documentation of the Process

During the first phase of our approach, we met with representatives from the Department of Environmental Services who have contract compliance and monitoring responsibilities over the selected contract and the Department of Management and Finance to discuss the scope and objectives of the process and obtain preliminary data. In order to obtain an understanding of the process and identify related controls, additional meetings were held with specific members of the contract management team to obtain detailed documentation and document the process, including existing control points. We also reviewed the applicable contract requirements, Arlington County "Purchasing Manual", and sections of the Virginia Public Procurement Act ("VPPA") related to this internal audit.

Evaluation of the Process and Controls Design and Testing of Operating Effectiveness

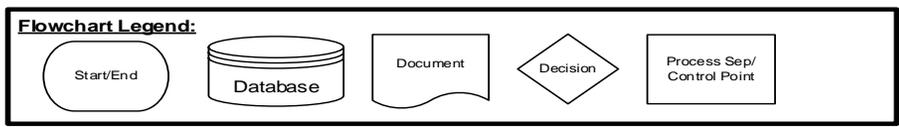
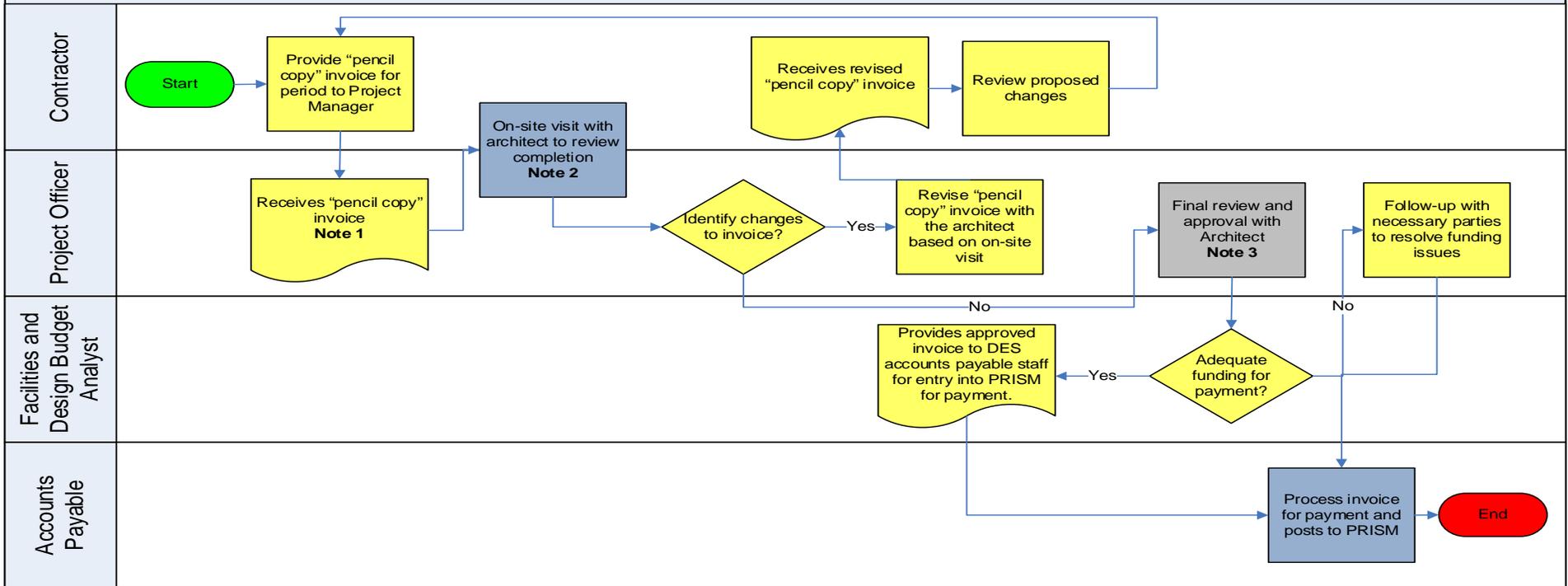
The purpose of this phase was to test compliance and internal controls. Our fieldwork testing was conducted utilizing sampling and other auditing techniques to meet our audit objectives outlined above. The specific audit period for transactional testing was from the contract April 14, 2014 to February 1, 2015. Specific testing procedures included:

- Gathering and evaluating background information on the County's contract compliance and monitoring procedures and any required controls or documentation, including County Board authorization, if necessary;
- Determining whether the selected department/division/bureau has formal contract compliance procedures;
- Obtaining background information on the selected contracts, including contract copy, contract administrator information, and detail of expenditures under each contract during our audit period;
- Obtaining board minutes evidencing County Board approval was obtained for each contract, as applicable, prior to commencement of work;
- Testing a sample of invoices for each selected contract to determine if the supporting documentation agreed to the payment amount and was mathematically accurate;
- Determining if payment was made in a timely manner and in accordance with the pricing terms of the contract;
- Determining that payments did not exceed amounts authorized through approved Purchase Orders;
- Determining whether performance under the contract was properly verified or monitored prior to payment of the invoice; and
- Assessing the overall contract compliance process and controls to determine effectiveness.

Reporting

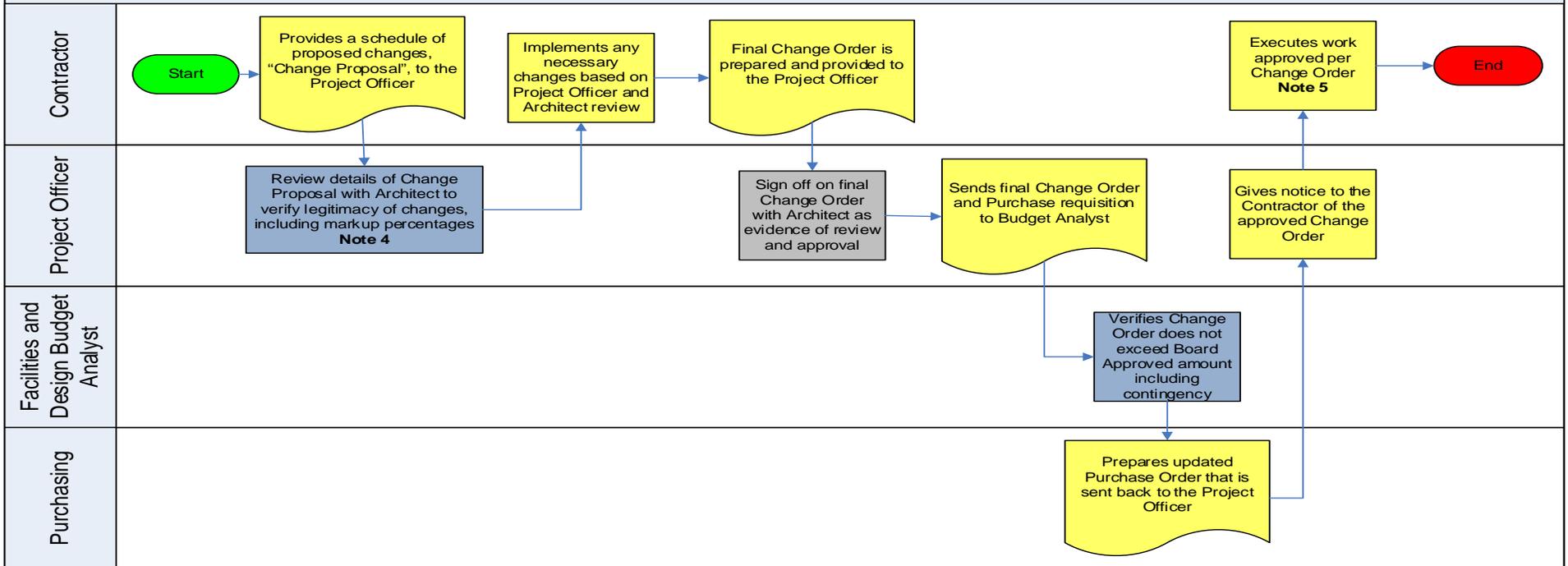
At the conclusion of this audit, we vetted the facts and exceptions noted with the Department of Environment Services – Facilities Design and Construction, along with the Department of Management and Finance. The draft report was submitted to DMF, and then to the Auditee for review. An exit meeting was held with the Auditee and County Management to formally review and discuss the draft report and modify accordingly. Management's corrective action plan with estimated completion dates has been provided and included in the report.

Process Maps



Note 1: "Pencil copy" is received on the 20th of the month.
Note 2: On-site visits to discuss completion occur twice a month.
Note 3: Project Officer is the only Arlington County employee reviewing invoice details and is also the final approval for payment.





Note 4: Change Proposal includes schedule of costs including materials, labor, and time. Project Officer will consult specialists (Mechanical, Electrical, etc) if needed to verify reasonableness of proposed changes.
Note 5: Once approved, Change Order related work is invoiced for in line with the existing, periodic invoice process. Change Order related charges are called out as a separate line item.



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