

# City of Santa Ana Indirect Cost Rate Proposal Audit



**Audit Report**  
**October 2018**

## PREPARED BY:

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# **SUMMARY, OBJECTIVES, SCOPE, METHODOLOGY, BACKGROUND, AND CONCLUSION**

## **SUMMARY**

The California Department of Transportation (Caltrans), Independent Office of Audits and Investigations (IOAI) audited the City of Santa Ana, Public Works Agency, Construction Engineering and Design Engineering (City) Indirect Cost Rate Proposal (ICRP) for fiscal year (FY) 2014/15. We found unallowable costs were included in the indirect cost rate proposal; an indirect cost rate not approved by Caltrans was used for billing; and costs were not properly identified on invoices.

## **OBJECTIVES**

The audit was performed to determine whether the City's FY 2014/15 ICRP was presented in accordance with 2 CFR Part 225 (superseded by 2 CFR 200), and Caltrans' Local Assistance Procedures Manual (LAPM) Chapter 5. The audit was also performed to determine whether the City had a financial management system capable of accumulating and segregating costs that are reasonable, allowable, and can be allocated to projects in compliance with Caltrans agreement requirements, and state and federal regulations.

## **SCOPE**

The scope of the audit was limited to select financial and compliance activities. The audit included interviews with City staff necessary to obtain an understanding of the City's financial management system, and reviews of policies and procedures of the City. It also included tests of selected accounts to the general ledger and supporting documentation to assess allowability, allocability, and reasonableness of costs based on a risk assessment and an assessment of the internal control system as related to the ICRP for the FY 2014/15. Additionally, the audit included review and tests of transactions for a more current period related to costs incurred and billed to Caltrans in FY 2014/15 to evaluate compliance with Title 2 CFR Part 225 and 49 CFR Part 18 (superseded by 2 CFR 200); Caltrans' LAPM; and requirements stipulated in the City's agreements with Caltrans. The audit field work was completed on June 20, 2018. Financial management system changes and transactions occurring subsequent to this date were not tested and, accordingly, our conclusion does not pertain to changes arising after this date. We believe that our audit provides a reasonable basis for our conclusion.

The City's management is responsible for the fair presentation of the ICRP and for ensuring costs incurred and billed to Caltrans are in compliance with applicable agreement provisions, and state and federal regulations. Further, the City is responsible to ensure the adequacy of their financial management system to accumulate and segregate reasonable, allocable, and allowable costs.



Because of inherent limitations in any financial management system, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of the financial management system to future periods are subject to the risk that the financial management system may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

## **METHODOLOGY**

IOAI conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that IOAI plan and perform the audit to obtain sufficient, and appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. IOAI believes that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. The audit was less in scope than an audit performed for the purpose of expressing an opinion on the financial statements of the City. Therefore, IOAI did not audit and is not expressing an opinion on the City's financial statements.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the data and records selected. An audit also includes assessing the accounting principles used and significant estimates made by the City, as well as evaluating the overall presentation of the ICRP.

## **BACKGROUND**

Caltrans has a legal and fiduciary responsibility to ensure that all state and federal funds are expended in compliance with state and federal laws, regulations, and agreements. IOAI performs audits to ensure Caltrans is meeting its legal and fiduciary responsibilities and that state and federal funds are properly expended by local government agencies.

## **CONCLUSION**

We determined that the City's ICRP for FY ending June 30, 2015 was presented in accordance with 2 CFR Part 225, and LAPM Chapter 5, except for the findings identified as follow:

- Unallowable costs were included in the indirect cost pool.
- Indirect costs were billed based on a rate not approved by Caltrans.
- Costs were not properly identified on invoices billed to Caltrans.

The audited rate for FY 2014/15 is:

<b>Fiscal Year</b>	<b>Proposed Rate</b>	<b>Audited Rate</b>	<b>Variance</b>
2014/15	227.3%	169.1%	(58.2%)

## **VIEWS OF RESPONSIBLE OFFICIALS**

Our findings and recommendations take into consideration the City's response dated September 21, 2018 to our August 30, 2018 draft report. Our findings and recommendations, the City's response, and our analysis of the response are set forth in the Findings and Recommendations section of this report. A copy of the City's full written response is included as Attachment II.

This report is a matter of public record and will be placed on the Caltrans webpage, which can be viewed at: < <http://dot.ca.gov/audits/ICAP.html> >.

If you have any questions, please contact Mandy Ip, Auditor, at (916) 323-7861 or Tami Gill, Audit Manager, at (916) 323-7899.

MARSUE MORRILL, CPA  
Chief  
External Audits – Local Government Agency  
Independent Office of Audits and Investigations

October 5, 2018

## FINDINGS AND RECOMMENDATIONS

### FINDING 1 – Unallowable Costs Included in the Indirect Cost Pool

The City of Santa Ana, Public Works Agency, Construction Engineering and Design Engineering (City) included unallowable indirect costs of \$310,026 in operating expenses and \$387,089 in indirect salary and wages in the indirect cost pool, and \$605,936 in their Public Works Administration (PWA) Service Cost Allocation Plan. Specifically, we identified the following unallowed indirect costs:

#### Indirect Costs – Unallowable \$697,085

- Building rental costs allocated to Construction Engineering and Design Engineering totaling \$114,015 were not supported by formal accounting records.
- Insurance costs allocated to Construction Engineering and Design Engineering totaling \$79,920 were not supported by formal accounting records.
- Transfer to the debt service fund in the amount of \$116,061 was not supported as allowable.
- Indirect labor costs totaling \$387,089 were distributed based on budget estimates rather than actual hours work. Employees who charge to more than one funding source distributed total hours based on individual pre-determined percentages (budget estimates).

#### PWA Service Cost Allocation Plan-Unallowable \$605,936

- Licensing fee of \$70,500 were applicable to an incorrect fiscal year.
- Internal department personnel charges of \$396,765 were not supported by formal accounting records.
- Total vehicle purchase costs of \$32,191 were not capitalized and depreciated over the periods of the asset's useful life.
- Building rental cost allocation to PWA Service in the amount of \$106,480 were not supported by formal accounting records.

The total disallowance of \$605,936 from the PWA Service Cost Allocation Plan resulted in a decrease of \$63,353 in the indirect cost pool for Construction Engineering and Design Engineering. See the applicable criteria below.

Unallowable Items	Criteria
Building Rental Insurance Internal Department Personnel Charge	Appendix C to 2 CFR 225 Section A.1 states, in part, that "All costs and other data used to distribute the costs included in the plan should be supported by formal accounting and other records that will support the propriety of the costs assigned to Federal awards."
Transfer to Debt Service Fund	Appendix B to 2 CFR 225 Section 23 states, in part, that "financing costs (including interest) paid or incurred which are associated with the otherwise allowable costs of building acquisition, construction, or fabrication, reconstruction or remodeling completed on or after October 1, 1980 is allowable subject to the conditions in section 23.b(1) through (4) of this appendix.
Indirect Labor	Appendix B to 2 CFR 225 Section 8. h. (5) (e) states, in part, that "budget estimates or other distribution percentages determined before the services are performed do not qualify as support for charges to Federal awards"
Licensing Fee	Appendix A to 2 CFR 225, B. 9 states, in part, that "cost" means an amount as determined on a cash, accrual, or other basis acceptable to the Federal awarding or cognizant agency  The City's governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Expenditures generally are recorded when a liability is incurred, as under accrual accounting.
Vehicle Purchase	Appendix B to 2 CFR 225 Section 15.a(2) defines "Equipment" as an article of nonexpendable tangible personal property having a useful life of more than one year and an acquisition cost which equals or exceeds the lesser of the capitalization level established by the governmental unit for financial statement purpose, or \$5,000.  The City's accounting policy defines Capital assets as assets with an initial, individual cost of more than \$5,000 and an estimated useful life of two years or more.  Appendix B to 2 CFR Part 225 Section 15.b (5) states, in part, that "Equipment and other capital expenditures are unallowable as indirect costs."  Appendix B to 2 CFR Part 225 Section 11.a. states, in part, that "Depreciation and use allowances are means of allocating the cost of fixed assets to periods benefiting from asset use."

The City staff did not understand the cost principles in 2 CFR Part 225, resulting in unallowable totaling \$697,085 in the indirect cost pool, and \$605,936 in PWA indirect cost pool. As a result, the City's FY 2014/15 indirect cost rate is reduced from 227.3 percent to 169.1 percent. See Attachment I for a summary of ICRP costs schedule.



## RECOMMENDATION

We recommend the City:

- Ensure only costs in compliance with the state and federal regulations are included in the indirect cost pool.
- Establish written policies and procedures that comply with Appendix V to Part 200 State/Local Government wide Central Service Allocation Plan (formerly Appendix C to 2 CFR 225) in identifying and allocating central service costs.
- Ensure that labor distribution is based on actual activities, not on the employee's pre-determined funding percentage (budget estimates).

## SUMMARY OF AUDITEE'S RESPONSE

The City does not concur with all the unallowable costs identified and provided additional clarification or documentation. For the City's complete responses, see Attachment II.

### Building Rental Costs

A price per square foot methodology was used to allocate building rental rates which were applied to each department in the City. The City provided the building rental cost and rates for FY 2015/16.

### Insurance Costs

The FY 2014/15 Liability and Property Insurance Fund general ledger trial balance shows the fund total expenditures as \$8,506,483.

### Indirect Labor Costs

Each staff position has a minimum 13.46 percent indirect salary and benefits, comprised of 280 hours of vacation, sick leave, and holiday hours out of 2,080 hours. The City contends 13.46 percent of the identified unallowable indirect labor cost should remain. Five positions that were disallowed for the indirect labor cost should be allowed due to the nature of their work is indirect to the operation.

## **PWA Service Cost Allocation Plan**

### Vehicle Purchase Cost

The vehicle was capitalized in accordance with the City's capitalization guidelines. The City also stated the purchase was added to the Equipment Balance Sheet Account and the ending balance ties to the amount noted on the trial balance.

### Building Rental Cost

A price per square foot methodology was used to allocate building rental rates which were applied to each department in the City. The building rental rates are allocated based on a proposed FY 2015/16 rate.

## **ANALYSIS OF AUDITEE'S RESPONSE**

### Building Rental

The City did not provide the any documentation to support the FY 2014/15 building maintenance cost. The audit finding is not about how the building maintenance budget costs are allocated to the benefiting department. The disallowed building maintenance cost is due to the City being unable to provide how the FY 2014/15 amount of \$3,725,700 was determined.

### Insurance Charge

The insurance costs allocated to Construction Engineering and Design Engineering totaling \$479,920 was not supported by formal accounting records. The City did not provide the support for insurance costs of \$8,845,895 that was used to allocate liability charges to the benefiting department since FY 2012/13.

### Indirect Labor Costs

We agree with the City's methodology to include average hours of vacation, sick leave, and holiday in the indirect cost pool of \$81,807.

Five employees were identified by the City as indirect to the operation. We agree that three employees are 100 percent indirect but the remaining two employees are not indirect since their timesheets reflect hours to projects during FY 2014/15. Therefore, \$138,884 should be included in the indirect labor costs.

Both indirect labor amounts identified above have been put back in the indirect cost pool.

## **PWA Service Cost Allocation Plan**

### Vehicle Purchase Costs

The depreciation amount was not included in the Indirect Cost Pool but was alternatively included in total as \$32,191 in machinery and equipment cost. The vehicle purchase costs should have been capitalized.

### Building Rental Cost

The City did not provide the documentation to support the FY 2014/15 building maintenance cost. The audit finding is not about how the building maintenance budget costs are allocated to the benefiting department. The disallowed building maintenance cost is due to the City being unable to provide how the FY 2014/15 \$3,725,700 was determined.

See the Attachment 1 schedule for the audited indirect cost rate. This schedule reflects updated indirect labor costs identified above. The remaining findings were not supported and remain unchanged.

**FINDING 2 – Indirect Costs Billed Using a Rate Not Approved by Caltrans**

The City billed indirect costs to Caltrans using indirect cost rates approved by Orange County Transportation Authority (OCTA) which is not their federal cognizant agency. A review of the City’s invoices that contained costs from FY 2014/15 to FY 2017/18 showed that the City used the OCTA approved indirect cost rate, not a rate approved by Caltrans on behalf the City’s federal cognizant agency, the Federal Highway Administration.

Appendix E to 2 CFR 225 Section D. 1.b requires a governmental unit to develop an indirect cost proposal in accordance with the requirements of 2 CFR 225 and maintain the proposal and related supporting documentation for audit. These governmental units must submit their proposals if requested to do so by the cognizant agency.

Caltrans Local Assistance Procedures Manual (LAPM) Chapter 5.3 states, in part, that “should any department, division or other organization unit within the local agency seek reimbursement of their indirect costs, they must receive an Approval/Acceptance Letter of the local agency’s Indirect Cost Rate Proposal (ICRP)/Indirect Cost Allocation Plan (ICAP) for the fiscal year(s) involved from Caltrans Division of Audits & Investigations (A&I) prior to billing for any indirect costs.”

The City staff were not aware of the Caltrans’ ICRP submission requirement specified in LAPM Chapter 5. By not using an indirect cost rate approved by Caltrans, the City is not eligible for reimbursement of indirect costs.

**RECOMMENDATION**

We recommend the City:

- Review all the invoices that contained FY 2014/15 costs and recalculate indirect costs using the audited rate. The City must reimburse any amounts overbilled to Caltrans.
- Obtain approval from Caltrans for FY indirect cost rates prior to FY 2014/15 where indirect costs were billed. Once the rates are approved by Caltrans, the City must review all the invoices, recalculate indirect costs using the approved rates, and reimburse any amounts overbilled to Caltrans.

**AUDITEE’S RESPONSE**

The City did not respond to this finding.

**FINDING 3 – Costs Not Properly Identified on Invoices Billed to Caltrans**

The City did not follow the required guidelines for reimbursement on their invoices to Caltrans and combined direct and indirect costs. The invoices submitted only showed direct project costs, but indirect costs were included within the direct costs.

Caltrans LAPM Chapter 5.3 states, in part, that “the costs of salaries, wages and related project costs may be reimbursable for the following activities. Indirect costs must not be combined with direct costs on invoices.”

The City was not aware they were required to segregate the direct costs and indirect costs on their invoices. Without the segregation of direct and indirect costs on invoices, Caltrans cannot determine the accurate amount of indirect costs to reimburse the City. Additionally, the City will be double billing Caltrans if their indirect cost rate is applied to direct costs that already include indirect costs.

**RECOMMENDATION**

We recommend the City:

- Follow the LAPM, Chapter 5, Invoicing and segregate the direct and indirect costs on the invoices to Caltrans.

**AUDITEE’S RESPONSE**

The City did not respond to this finding.



**Attachment I**  
**Summary of ICRP Costs**  
**City of Santa Ana**  
**Public Works Agency**  
**Construction Engineering and Design Engineering**  
**FY 2014/15**

Description of Cost	Proposed & Accepted Amounts	Audit Adjustment	Audited Amounts	Finding Reference
<b>A) Personnel Costs</b>				
Direct Salary and Wages plus benefits	1,306,622		1,306,622	
Indirect Salary and Wages plus benefits	1,775,332	(387,089)	1,388,243	Finding #1
<b>B) Other Operating Expenses</b>				
Communications	25,654		25,654	
Training, transportation, meeting	9,510		9,510	
Membership, Subscription & Dues			-	
Contract Services Professional	16426		16426	
Maint & Repair Machinery & Equip				
Operating Lease Expense				
Miscellaneous Operating Expenses	32,381		32,381	
Gas & Diesel	19,374		19,374	
Building & Rental	114,015	(114,015)	0	Finding #1
Rental City Equipment	41,532		41,532	
Insurance Charges	79,920	(79,920)	0	Finding #1
Public Administration Charge				
Indirect Costs	282,228	-	282,228	
Transfer to Fund 404-BLDG Furniture	116,091	(116,061)	30	Finding #1
<b>C) Citywide Cost Allocation</b>				
PW Admin CAP	457,165	(63,353)	393,812	Finding #1
<b>Total Indirect Costs</b>	<b>2,969,628</b>	<b>(760,438)</b>	<b>2,209,190</b>	
<b>Indirect Cost Rate</b>	<b>227.3%</b>		<b>169.1%</b>	