



Lexington-Fayette Urban County Government

Division of Internal Audit

INTERNAL AUDIT REPORT

DATE June 9, 2005

TO: Teresa Ann Isaac, Mayor

CC: Milton Dohoney, Chief Administrative Officer
Donna Counts, Commission of Finance
Brian Marcum, Director of Purchasing
DeWitt Hisle, Audit Board Chairman
Dr. David Stevens, Council Budget & Finance Committee Chairman

FROM: Bruce Sahli, Director of Internal Audit

RE: Construction Contract Change Order Procedures Audit

Background

The Lexington Fayette Urban County Government (LFUCG) enters into formal contractual agreements with outside contractors on a number of significant projects each fiscal year in order to meet its various construction obligations. These construction projects typically originate out of four Divisions: Engineering, Sanitary Sewer, Solid Waste, and Building Maintenance & Construction. Occasionally, construction projects originate out of other Divisions such as Parks & Recreation. For a variety of reasons, it is not uncommon for large construction projects to experience alterations in original construction plans which increase or reduce the original cost of the project. Such alterations typically occur as the result of design changes, unanticipated conditions or circumstances at the construction site, or changes in various materials quantities. When these alterations occur, they are accounted for via change orders. Change orders are formal documents that describe the nature and necessity of project alternations and its project cost impact. Once issued, they must be authorized by various levels of management and approved by Council via Ordinance or Resolution.

Scope and Objectives

We examined construction contract change orders occurring during the period January 2002 through December 2004. The general control objectives of the audit were to determine that:

- Construction project change orders were necessary and appropriate
- Construction project change orders were authorized and the work properly monitored
- Construction project change order costs were reasonable and supported

Statement of Auditing Standards

We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to afford a reasonable basis for our judgments and conclusions regarding the organization, program, activity or function under audit. An audit also includes assessments of applicable internal controls and compliance with requirements of laws and regulations when necessary to satisfy the audit objectives. We believe that our audit provides a reasonable basis for our conclusions.

Audit Opinion

In our opinion, the controls and procedures provided reasonable assurance that the general control objectives were being met. Opportunities to enhance controls are included in the Summary of Audit Findings.

SUMMARY OF AUDIT FINDINGS

Contract Database Needed

The Purchasing Division currently has no database or other method for tracking and evaluating contractor activity and project costs. It is recommended that a construction project database be developed by the Division of Purchasing to track project activity and costs and establish the foundation for various trend analyses. This database should at a minimum include a listing of all rejected bids and the related bidders, perform a comparative analysis of total project costs after change orders to the average of rejected bid amounts, have a detailed history of all change order activity as obtained from change order cover memorandums required by CAO Policy 15R, and include a summary of the results of Formal Contractor Evaluations (recommended in a separate finding). The database should at a minimum be used to identify any possible trends of intentional low bidding, establish a history of change order activity among Divisions, contractors, types of projects, and provide a history of contractor performance standards that can be used to evaluate future contractor selection (e.g., if a contractor consistently low bids projects but has a history of excessive change order activity and/or performance issues, this information would be available for consideration before awarding future contracts).

Division of Purchasing Management Response: The Division of Central Purchasing concurs with the recommendation to track vendor performance and will investigate information system solutions to provide for the ability to track vendor performance. During the upcoming ERP vendor demonstrations, each vendor has been asked to elaborate on their solution's ability to track

projects/contracts and any associated change order(s). The vendors have been instructed to address vendor performance tracking capabilities in the demonstrations as well.

Division of Purchasing Review of Change Orders Recommended

The current change order approval process does not require a review of change order activity by the Division of Purchasing. As a result, change orders requesting approval to purchase additional contractor services and/or materials are considered by Council without being submitted to standard Purchasing Division oversight and review. The Division of Purchasing is responsible for all procurement functions. It is therefore recommended that Blue Sheet General Procedures and Instructions and Purchasing Procedures both be amended to require change orders with a project cost impact be reviewed and approved by the Division of Purchasing prior to their being submitted for Administrative Review via the Blue Sheet process.

CAO's Office & Division of Purchasing Management Response: The CAO's Office agrees with the audit recommendation to change Blue Sheet Procedures and Instructions as stated in the finding. The Division of Central Purchasing concurs with the recommendation to review change orders prior to submittal to Council. Currently, the Division of Purchasing has limited exposure to change order requests for projects/contracts. With review prior to submittal, Purchasing would have the ability to monitor the requests and compare it to the actual bid documents and unit price schedules to substantiate the requests. Purchasing's review would allow for the collection of data pertaining to the change order in a timely manner in development of a contract database. The recommendation by your office would transfer total responsibility of change orders from the requesting divisions to a joint review responsibility by the user division and the Division of Central Purchasing.

Formal Contractor Evaluation Process Recommended

Discussions with personnel in various Divisions indicate the need for a consistent organization-wide process for documenting and reviewing contractor performance at the end of a project, and to evaluate the efficiency and effectiveness with which construction contractors dispensed their assigned responsibilities. It is recommended that a Formal Contractor Evaluation form be developed that would provide uniform evaluation criteria to be used by all Departments and Divisions within LFUCG. This document should also provide an opportunity for contractor comments regarding their performance and explanations for any changes orders occurring in their projects. Information provided on this document would be entered into the recommended Purchasing Division's Contract Database as part of the overall history of construction contractor activity and performance standards.

CAO's Office Management Response:

The CAO's Office agrees with the audit recommendation to develop a Formal Contractor Evaluation form to be used by all Departments and Divisions within LFUCG.

Mayor/CAO Approval Process Recommended

Contracts and their related change orders receive final approval from the Urban County Council. In some instances, change orders address time sensitive construction work that needs to be completed as soon as possible to minimize disruption of normal services or the extension of overhead costs to contractors. Consideration should be given to amending the change order process to formally grant the Mayor or CAO standard authority to approve time sensitive change orders that do not exceed five percent of the cumulative contract amount. These change orders would then be presented to the Council at their next meeting. If the time sensitive change order exceeds five percent of the cumulative contract amount, joint authorization from the Mayor or CAO and the Budget & Finance Chair and Vice Mayor should be considered as an approval option, with such change orders again being presented to Council at their next meeting. Such an approval process will provide reasonable assurance time sensitive construction projects are not delayed due to administrative procedures while still maintaining sufficient levels of approval and accountability.

CAO's Office & Council Members Management Response:

The CAO's Office agrees with the audit recommendation as stated. Council members Bill Farmer and David Stevens have reviewed the finding and also agree with the audit recommendation, which will be brought before the full Council in the form of a proposed Resolution.

Contracts Unavailable in Council Clerk Records

The Council Clerk's Office is required by law to keep copies of executed contracts on file as support for related ordinances and resolutions. Seven construction contracts from our total sample of 23 (30%) were not available in the Council Clerk records. We were informed by Council Clerk personnel that this typically is caused by the originating Division's failure to produce the final executed copy for retention in Council Clerk records. The Division of Internal Audit will instruct the various originating Departments or Divisions to provide the Council Clerk's Office the missing executed contracts identified during the audit. It is recommended that Departments and Divisions be formally reminded of the Administrative Review Form (Blue Sheet) procedures requiring executed originals and two copies be provided to the Council Clerk's Office for all Contracts, Agreements, Leases, Memorandums of Understanding, and Change Orders.

CAO's Office Management Response:

The CAO's Office agrees with the audit recommendation to formally remind all Departments and Divisions of Blue Sheet documentation requirements.

Contract History Form Update Recommended

Project phases and alternate bids are included in original bid proposals when applicable, with their activation being contingent upon available funding. The current design of the Contract History Form required by CAO Policy 15R does not differentiate between project phases, alternate bids, or

change orders. As such, activated project phases and alternates bids reported on this form could be interpreted as project cost overruns, when in fact such activity should be viewed as portions of the original contract activated as the result of additional funding. It is recommended that the Contract History Form be amended to reflect activated project phases and alternate bids as amended contract amounts. A recommended format is included as a report Attachment.

CAO's Office Management Response:

The CAO's Office agrees with the audit recommendation to amend the Contract History Form.

CONTRACT HISTORY FORM

Contractor: _____

Project Name: _____

Contract Number and Date: _____

Responsible LFUCG Division: _____

CHANGE ORDER DETAILS

A. Original Contract Amount: \$ _____

**B. Amount of Selected
Alternate or Phase:** \$ _____

**C. Cumulative Amount of
All Previous Alternates or
Phases:** \$ _____

D. Amended Contract Amount: \$ _____

**E. Cumulative Amount of
All Previous Change Orders:** \$ _____ %
(Line E / Line D)

F. Amount of This Change Order: \$ _____ %
(Line F / Line D)

G. Total Contract Amount: \$ _____

SIGNATURE LINES

Project Manager: _____ **Date:** _____

Reviewed by: _____ **Date:** _____

Division Director: _____ **Date:** _____