FOLLOW-UP REPORT
Contractor Hiring & Payment Practices
Wastewater Management Division
April 2020

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Audit Services Division
City and County of Denver

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April 2, 2020

AUDITOR’S LETTER

In keeping with generally accepted government auditing standards and Auditor’s Office policy, as authorized by city ordinance, the Audit Services Division has a responsibility to monitor and follow up on audit recommendations to ensure audit findings are addressed through appropriate corrective action and to aid us in planning future audits.

In our follow-up effort for the Contractor Hiring & Payment Practices examination completed by CliftonLarsonAllen LLP and issued in July 2017, we determined the Wastewater Management Division has adequately implemented three of the five recommendations made in the examination report. For two recommendations, auditors determined the risks in the examination’s initial findings — associated with completing daily inspection reports and preventing sales and use taxes charged to the city — have not been fully addressed. As a result, the Audit Services Division may revisit these risk areas in future audits to ensure appropriate corrective action is taken.

This report includes a detailed implementation status update for each recommendation.

I would like to express our sincere appreciation to the Wastewater Management Division personnel who assisted us throughout the examination and the follow-up process. For any questions, please feel free to contact me at 720-913-5000.

Denver Auditor’s Office

Timothy M. O’Brien, CPA
Auditor
RECOMMENDATION — STATUS OF IMPLEMENTATION

FINDING – Enhancing Internal Controls Over Inspection and Billing Records Will Strengthen Internal Records

Recommendation 1

We recommend the Wastewater Management Division enhance the internal controls surrounding the accurate and daily completion of inspection reports and billing records. We also recommend the development of a process to track and monitor machinery usage on construction job sites or a provision in the contract language to require the contractor to outline the daily usage of all machinery used on a specific job site. Further, establishing formal written policies or procedures for completion of daily inspection reports should include observations noted on the job site related to equipment, labor, materials, and subcontractors. The enhancement of the daily inspection reports should better corroborate the billing records provided by the third-party contractor.

Status: Partially Implemented (Original target date for completion: Aug. 1, 2018)

Agency Action

The Wastewater Management Division took steps to implement two changes to its procedures guidance for cost-plus-markup contracts to enhance the internal controls over inspection and billing records.

First, the division now requires the contractor to track labor, equipment, and materials at work sites and submit the information with its invoice. We saw evidence of this with an invoice submitted by the contractor. Second, division officials revised their cost-plus-markup procedures to now require a project inspector to prepare and record daily inspection reports at the work site. The inspection reports include observations of the work site related to equipment, labor, materials, and subcontractors and are used by the project manager to corroborate the information submitted by the contractor with their invoice. The project manager is then required to compare the inspection reports to contractor-submitted invoices and other support included, such as time sheets to ensure billings are in line with what is detailed in the inspection reports.

We examined documentation of two payments at the end of 2019 and the beginning of 2020 that had daily inspection reports as support and found that the inspection reports were signed off electronically by the project inspector two to three months after the inspection took place. However, we noted this review still occurred before the contractor was paid for the work. We also noted that the invoice for one of the payments had evidence the contractor performed work on-site for at least two days, but there was only one daily inspection report created for the last day work was done.

While the Wastewater Management Division enhanced its process to complete and review inspection reports, the issues we observed with the timing of inspection report sign-offs and a potential missing daily inspection report show some improvement is needed with the process. Therefore, we consider this recommendation to be only partially implemented.
**RECOMMENDATION — STATUS OF IMPLEMENTATION**

**FINDING** – Wastewater Management Division Is Being Charged and Paying Fringe Benefits and Burden on Overtime

Recommendation 2

We recommend revisions be made to the contract language which incorporate specific provisions to state how overtime and associated labor burden and fringe benefits are to be calculated. This will establish a set percentage to limit the labor burden and fringe benefit markup. An analytical approach based on certified payrolls, labor agreements or industry resources to establish an equitable percentage may be necessary and would remove the ambiguity and opportunity for billing in excess of actual costs.

**Status: Implemented (Original target date for completion: Aug. 1, 2018)**

**Agency Action**

Evidence submitted by the Wastewater Management Division showed revisions were made to the contract language. We reviewed the new contract language and found it now incorporates specific provisions on how overtime and associated labor burden and fringe benefits are to be calculated. Therefore, we found this recommendation to be implemented.
RECOMMENDATION — STATUS OF IMPLEMENTATION

FINDING – Sales Tax Provisions Outlined in Contract Language is Not Always Followed

Recommendation 3

We recommend the Wastewater Management Division review and enhance their internal controls over the invoice review process to ensure contractor payments and reimbursements do not include sales and use taxes as outlined in Section IB-23.¹ We also recommend modifications be made to the contract language to explicitly state certain state, RTD, and Cultural Facilities sales and use taxes will not be paid or reimbursed by the Wastewater Management Division.

Status: Not Implemented (Original target date for completion: 60 to 90 days)

Agency Action

The Wastewater Management Division modified its standard contract language that addresses sales and use tax exemptions. However, the added language allows the city project manager to waive tax exemption requirements and reimburse the contractor when it is “in the best interest of the city.” Therefore, the new language makes it easier for the city to incur a sales tax charge. When we asked why this language was added to the standard contract language, wastewater officials said there are still certain instances when it is feasible for the city to waive the tax exemption requirement. For example, a store may only allow a sales tax exemption if the purchased item is set up for store delivery and incurring a delivery charge. According to wastewater officials, the delivery charge could be substantially more than the sales tax if it is a small purchase, necessitating the need for a waiver. However, we noted the markup percentage for these contracts is typically 16% to 18% for materials and applicable taxes, which should adequately cover a contractor’s expenses.

During our review of contractor invoices in this follow-up, we did note sales tax was appropriately excluded. However, we did not see any additional evidence that the internal controls over invoice review were enhanced to ensure contractor payments and reimbursements do not include sales and use tax when not appropriate. Therefore, we consider this recommendation not implemented.

¹ Section IB-23 of the “2016 Wastewater Capital Project Support Contract” states materials used on construction projects are exempt from certain state, RTD, and cultural facilities sales and use taxes.
RECOMMENDATION — STATUS OF IMPLEMENTATION

FINDING – Ambiguity in Contract Language Allows Certain Vendors To Be Charged As Subcontractors To The Wastewater Management Division

Recommendation 4

We recommend construction contract language be modified and internal controls be enhanced to remove ambiguity and to provide more specificity on the definition of a subcontractor as one who provides physical labor on a project site from a vendor who provides materials or services but does not employ physical labor on the project site. The IRS definitions may provide the necessary guidance on enhancement and definition of who is considered a subcontractor versus a vendor.

Status: Implemented (Original target date for completion: Aug. 1, 2018)

Agency Action

The Wastewater Management Division revised its contract language to clarify the definition of a subcontractor by adding examples of who would be considered a contractor. A division official also explained their new daily inspection report further enhances internal controls, because it categorizes the services and materials delivered on a project by either a prime contractor or a subcontractor.

We also noted the Department of Transportation & Infrastructure has had a definition of a subcontractor since at least 2011 contained in the “General Contract Conditions” by which standard wastewater contract language is governed. This definition states a subcontractor is “a person or entity having a contract with the Contractor or other Subcontractor of any tier to perform work at the Work site.” By stating a subcontractor performs work at the work site, this helps distinguish them from vendors who would simply provide a good or service off-site. Therefore, we consider this recommendation implemented.
RECOMMENDATION — STATUS OF IMPLEMENTATION

FINDING – Wastewater Management Division’s Purchase of Asphalt Did Not Provide the Best Value to the City and County of Denver

Recommendation 5

We recommend the Wastewater Management Division review and strengthen their process to ensure the best value is being received regarding payment on asphalt. This could include:

• Establishing a maximum price for installation of asphalt based on historical data specific to cost plus contracts;
• Considering a contract pay provision to establish a unit price for all patching, which could be performed under a separate contract;
• Determining whether the Wastewater Management Division should prohibit the sale of asphalt from the Prime Contractor to the subcontractor, to be installed by the subcontractor; and
• Determining whether the City and County of Denver’s asphalt plant has the capacity to manufacture asphalt specifically for the Wastewater Management Division projects. If so, incorporating a contract provision that the City and County of Denver’s plant has the right of refusal to furnish asphalt due to other commitments and the subcontractor may then purchase from an outside asphalt plant, with a limitation on maximum price to be paid.

Status: Implemented (Original target date for completion: Aug. 1, 2018)

Agency Action

The Wastewater Management Division has taken steps to strengthen its process to ensure the best value is received regarding payment on asphalt and other construction materials. The division added a paragraph to its procedures on cost-plus-markup contracts that now outlines the process for confirming whether the price quoted by a contractor is competitive and consistent with current market pricing and historical costs. This procedure refers to the use of software called the Wastewater Capital Project Management Integration System, which the wastewater division has used for several years to research historical cost information on contract prices and bids. The division uses an onboarding checklist that ensures new staff receive training on this software.

We also noted the procedure says quotes exceeding market value require justification. In addition, wastewater changed its contract language for cost-plus-markup contracts to state a contractor and/or subcontractor may be required to demonstrate that the prices charged are competitive fair market rates.

The wastewater division decided not to follow the bulleted suggestions of this recommendation. We discuss each of them to document why the division chose not to take these specific actions:
• Establishing a maximum price for installation of asphalt based on historical data specific to cost plus contracts

Division officials said it is not feasible to establish a maximum price for installation of asphalt, because the material is a fluctuating commodity. The division does not want to lock contractors into a price during a three-year contract because of the fluctuating costs. When asked whether using shorter contracts — such as six-month contracts — would be an option, division officials said to keep bids coming in and ensure projects are completed quickly, they still have to be flexible with the price because of the many variables that impact price, such as the uncertainty in the cost of materials because of the varied mixes of asphalt and amounts needed.

Asphalt cost is based on an undefined scope. Specifically, a project’s need for a certain mix and amount of asphalt can vary by contract. Projects vary by type of street, location, weather, and other factors. Also, small quantities needed for patching (e.g., filling potholes) can cost more because of short-load charges added to the unit price.

• Considering a contract pay provision to establish a unit price for all patching, which could be performed under a separate contract

According to wastewater officials, there are too many variables (as mentioned under the previous bullet) that make it tough to consider a contract-pay provision to establish a unit price for all asphalt patching.

• Determining whether the Wastewater Management Division should prohibit the sale of asphalt from the prime contractor to the subcontractor, to be installed by the subcontractor

Division officials said they did not believe prohibiting the sale of asphalt from the prime contractor to the subcontractor was necessary, because in the past, the division asked for a quote to compare the unit price for past contracts with current contracts to monitor the reasonableness of the markup. Officials explained that, because the capital project management database can track the cost of projects over time, they search the database for the historical costs on projects that match in quantity and asphalt mix and determine the acceptable price range.

• Determining whether the City and County of Denver’s asphalt plant has the capacity to manufacture asphalt specifically for the Wastewater Management Division projects. If so, incorporating a contract provision that the City and County of Denver’s plant has the right of refusal to furnish asphalt due to other commitments and the subcontractor may then purchase from an outside asphalt plant, with a limitation on maximum price to be paid.

Division officials said they do not obtain asphalt from the city’s plant, because there are a lot of different asphalt mixes involved in their work. The city’s plant would have to have the flexibility to change manufacturing processes to handle the different asphalt mixes required by wastewater projects. This would not be feasible, particularly because the city’s plant is already strained on the amount of work it can handle.
Even though the Wastewater Management Division did not follow the bulleted items in this recommendation, we consider the recommendation implemented, because officials documented existing processes and further strengthened contract language to ensure they get the best value regarding payment on construction materials.
**CONCLUSION**

While the Wastewater Management Division implemented most of the recommendations made in the Contractor Hiring & Payment Practices examination report, two have yet to be fully implemented. Despite Wastewater Management’s efforts, auditors determined the risk associated with the examination team’s initial findings is not fully mitigated. As a result, the Audit Services Division may revisit this risk area in future audits to ensure appropriate corrective action is taken.

On behalf of the citizens of the City and County of Denver, we thank staff and leadership from the Wastewater Management Division for their cooperation during our follow-up effort and for their dedicated public service.
The Auditor of the City and County of Denver is independently elected by the citizens of Denver. He is responsible for examining and evaluating the operations of City agencies and contractors for the purpose of ensuring the proper and efficient use of City resources. He also provides other audit services and information to City Council, the Mayor, and the public to improve all aspects of Denver’s government.

The Audit Committee is chaired by the Auditor and consists of seven members. The Audit Committee assists the Auditor in his oversight responsibilities regarding the integrity of the City’s finances and operations, including the reliability of the City’s financial statements. The Audit Committee is structured in a manner that ensures the independent oversight of City operations, thereby enhancing citizen confidence and avoiding any appearance of a conflict of interest.