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INTERNAL AUDIT

**Audit Report
Charlotte Business Inclusion (CBI)
Construction Payments to Subcontractors – FY16/17
April 4, 2018**

**City Auditor's Office
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Purpose and Scope

The primary objectives of this audit were to determine whether prime contractors:

- Accurately reported subcontractor payments to the City
- Accurately and timely paid subcontractors

In addition to the objectives above, auditors reviewed controls over certification, goal setting, and data collection to determine the effectiveness of CBI processes. At the request of CBI, the audit focused on construction projects as they represent approximately 50% of expenditures made under the CBI program.

The audit was conducted in two phases. First, auditors reviewed all 36 construction projects that were identified as completed during FY16 and tested payments to subcontractors. Second, a sample of active projects in FY17 was tested.

The testing focused on Minority, Women, and Small Business Enterprises (MWSBEs) that are certified and registered by CBI. Small Business Enterprises (SBE) may also be certified by the State as a Minority-owned Business Enterprise (MBE) and/or a Woman-owned Business Enterprise (WBE). For purposes of this report, the term MWSBE will refer to any combination of certified business (SBE, MSBE, WSBE, and MWSBE) that holds the SBE certification.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

This report is intended for the use of the City Manager's Office, City Council, and the Management & Financial Services Department.

Conclusions

Subcontractors were paid accurately and timely. CBI documentation procedures should be improved.

Summary of Findings and Recommendations

The primary objective of the audit was to determine whether prime contractors accurately reported subcontractor payments to the City, and whether subcontractors were paid accurately

and timely. Finding #1 details a substantial effort by auditors which affirmed that these requirements were met.

Additional findings addressed various aspects of CBI administration, as follows:

CBI did not adequately document the rationale for approving subcontracting goals that deviated from an established formula. (Finding #2)

- *The CBI Office is currently reviewing both policy and programmatic enhancements as part of the City's most recent Disparity Study findings. The CBI Office will incorporate improved documentation procedures for established subcontracting goals, including those instances where the established goal differs from the results of the calculated formula.*

Additional system capability and monitoring efforts are required to ensure subcontractors are paid accurately and timely. (Finding #3)

Prime contractors should be required to provide more detailed reporting data. (Finding #4)

CBI should establish a site visit program based on risk assessment and analysis. (Finding #5)

The CBI Program Manager should ensure that consistent documentation is retained to support SBE certification decisions. (Finding #6)

- *CBI agreed with each recommendation and provides detailed responses in the remainder of the report.*

Background

The Charlotte Business Inclusion Program seeks to develop and grow small businesses in the Charlotte area, and to remediate the effects of disparity against minority and women-owned firms who participate in City contracts. The CBI Program seeks to enhance competition in City contracting and promote economic growth and development in the City of Charlotte by:

- Increasing Minority, Women, and Small Business Enterprise utilization in City contracting
- Promoting existing small business growth and profitability in the Charlotte Region
- Promoting small business start-up and development
- Monitoring, evaluating, and reporting on MWSBE participation and contract compliance with the provisions of the CBI Program

In 1989, the US Supreme Court held that in *City of Richmond v. J.A. Croson Co.* (488 U.S. 469), that a minority set-aside program, which gave mandatory preference to minority businesses in awarding municipal contracts, was unconstitutional under the Equal Protection Clause. The Court found that the City failed to identify both the need for remedial action and that other non-discriminatory remedies would be insufficient.

As a result of this and subsequent U.S. Supreme Court decisions, municipalities establishing a minority-owned business and/or women-owned business program must show that a disparity exists between the number of contracts awarded to minority-owned firms or women-owned firms related to their availability in the geographical area. Municipalities should conduct a disparity study periodically to determine if a disparity exists.

The City of Charlotte has conducted three disparity studies (2003, 2011 and 2017). The studies confirmed that a disparity did exist during each period reviewed. The 2003 and 2017 studies concluded that a minority business program was a suitable remediation. The 2011 study did not recommend race conscious remedies.

Based on recent annual reports of MWSBE Utilization, the following data has been collected related to construction:

Construction Subcontractor Spend with City Certified MWSBEs			
Annual Report Year	Total Subcontractor Spend	Total MWSBE Spend	MWSBE Subcontractor Utilization
FY15	\$148,330,318	\$34,765,577	23%
FY16	\$44,525,441	\$22,957,843	52%
FY17	\$63,008,935	\$30,420,048	48%

Source: 2015 - 2017 CBI Annual Reports

Audit Findings and Recommendations

1. MWSBE subcontractors were paid accurately and timely.

Testing was completed in two phases. The first phase reviewed all 36 construction projects that were completed in FY16. The second phase reviewed a sample of construction projects which were active in FY17. The response rate from completed projects was insufficient to allow conclusive results, with the lack of responsiveness due to some subcontractors having finished their work years prior to the project closeout.

For those subcontractors from the FY16 closeout period we were able to contact, results were favorable. When combined with the active projects tested in FY17, we were able to conclude that subcontractors were paid accurately and timely, with only minor exceptions. The details for the two phases of testing follow.

FY16 Closed Out Projects

To determine whether SBE subcontractors on City construction contracts were paid appropriately, auditors attempted to confirm with 71 unique subcontractors that payment was received timely on all 36 construction projects that were completed in FY16.

Forty-seven of the 71 subcontractors (66%) responded and confirmed the amount reported as paid by the prime contractor. Auditors performed additional review to resolve 10 discrepancies where the amounts reported by the subcontractor and prime contractor did not match.

All discrepancies were resolved with no material issues identified. Despite efforts to achieve a high response rate, the remaining 24 subcontractors did not respond to audit requests and auditors were unable to verify payments.

FY17 Active Projects

In order to achieve a much higher response rate to provide adequate assurance that MWSBE subcontractors are being paid timely and accurately for work performed, an additional test phase was performed. Auditors selected a judgmental sample of 22 current construction projects valued at \$176 million compared to a universe of 142 contracts valued at \$924 million total. Judgmental selections were used to include unresponsive primes from the original sample.

For the 22 selected projects, seventeen unique prime contractors made payments of \$7.3 million to 86 subcontractors. Auditors verified 83 of 494 (16.8%) total payments made to subcontractors by obtaining canceled checks and reviewed other available supporting documentation to determine the timeliness of payments made. Sixteen of the 17 (94%) prime contractors made all payments to subcontractors timely. For the remaining contractor, three exceptions were identified:

- all three were related to the same project
- payments were verified
- subcontractors received payments within 30 days of invoice, but outside of the State Statute requirements

Conclusion: Subcontractors have been paid timely and accurately. Of the 47 responses received in the initial sample and all 22 responses in Phase II, auditors verified that the payments were made. Only three timeliness exceptions were noted, representing 3.6% of the selected subcontractor payments.

2. CBI did not adequately document the rationale for approving subcontracting goals that deviated from an established formula.

CBI program policy (Part A, Section 3) requires that for all construction contracts of \$300,000 or more, the City shall establish one or more subcontracting goals unless the Program Manager grants an exemption. Similar requirements exist for commodities and service contracts of \$100,000 or more.

The Program Manager is responsible for establishing a methodology for setting MWSBE goals on City contracts, through the rules and guidelines for the implementation of the CBI

program. CBI has outlined a goal setting methodology which includes a formula that is incorporated into the engineer's estimate spreadsheet. The formula takes into account contract size, MWSBE availability in the City's vendor database, and the reasonably known availability of subcontracting opportunities that MWSBEs can perform on each contract. The result of this formula is considered a starting point for establishing the subcontracting goal for a contract. Calculated goals can be adjusted for a variety of reasons, (e.g., historical precedence and limited availability of MSWBEs in a commodity code), but departments must request CBI approval when not establishing the calculated goal from the engineer's estimate spreadsheet. Projects are uploaded to a SharePoint site by departments and CBI must review and approve the established subcontracting goal before a project is solicited. Departments are expected to document two to three similar projects, if available.

Auditors reviewed documentation of goal setting and waiver results for 50 projects (45 goal setting, five goal waivers) and found that departments are calculating the MWSBE goals utilizing the formula provided by CBI. However, auditors noted:

- insufficient historical support documented for 39 out of 45 (87%) projects
- lack of documentation on two of five waiver requests
- no indication of the level of review being performed by CBI related to goal setting, other than a stated "concur" or "waiver granted" determination
- the SBE goal requested by departments and approved by CBI was less than the calculated goal 44% (20 out of 45 projects reviewed) of the time, with the resultant impact of reducing the spreadsheet-calculated goal from an average 18.3% to 13.7%
- of the 20 projects above, 14 had goals hard-keyed on the engineer's estimate, altering the spreadsheet-calculated goal

In the 14 instances where goals were entered manually, the calculation on the engineer's estimate spreadsheet was altered to result in a lower goal. The department did not provide documentation to support the changes made to the spreadsheet-calculated goal. (It is considered a best practice to prohibit the alteration of results from a prescribed spreadsheet calculation and instead document the explanation and approval of any necessary deviation.) CBI did not indicate awareness that the spreadsheet calculation had been over-ridden by a hard-key entry. Rather, CBI indicated "concur" via SharePoint posting.

For example, on one project (512-15-041 – West 4th Street Extension) the calculated goal was 23%. However, the formula was replaced with a hard-keyed 15% for SBE participation, and this is the goal that was approved and established for this project. The prime contractor committed to an SBE goal of 16.69%. Without appropriate documentation explaining why the goal was altered, CBI cannot support its rationale. E&PM informed Internal Audit that CBI was aware that they had manually changed the goal; however this was not apparent from review of the approval process.

The following table summarizes the review of spreadsheet-calculated goals for the sample of 45 projects, by department:

Summary of CBI Goal Review					
SBE Goals					
Department	Total Projects	Approved Goal			% of Time Goal Reduced
		Greater than Calculated Goal	Approved Goal Equals Calculated Goal	Approved Goal Less than Calculated Goal	
E&PM	22	1	6	15	68%
Aviation	13	1	8	4	31%
CLT Water	9	-	8	1	11%
CDOT	1	-	1	-	0%
Totals	45	2	23	20	44%

Recommendation: The rationale for establishing subcontracting goals should be clearly documented. The spreadsheet-derived calculation, using an established template, should remain unchanged on the form, rather than be overwritten via hard key. When a different rate is determined appropriate, it should be recorded separately, along with a written rationale which explains the higher or lower rate decision.

Management & Financial Services Response: The CBI Office is currently reviewing both policy and programmatic enhancements as part of the City’s most recent Disparity Study findings. The CBI Office will incorporate the above recommendation into this work to implement improvements in the documentation of approved goals, including those instances where the established goal differs from the results of the calculated formula.

3. **Additional system capability and monitoring efforts are required to ensure subcontractors are paid accurately and timely.**

CBI policy requires that contractors abide by N.C. General Statute 143-124.1 (b), which states, in part:

“Within seven days of receipt by the prime contractor of each periodic of final payment, the prime contractor shall pay the subcontractor based on work completed or service provided under the subcontract.”

No evidence of non-payment was identified during interviews conducted as part of the most recent disparity study. However, the City has received some complaints that prime contractors have been slow to pay. As discussed in Finding #1 above, there were three timeliness exceptions (out of 83 payments reviewed) during the second phase of testing.

Since Munis go-live in July 2014, the City has used PRISM Compliance Management (PRISM) as its primary diversity management software. PRISM is a web-based portal that may be used for certification, goal setting, utilization tracking and other compliance functions. The City purchased the certification, compliance and labor modules. While the system appears to offer the functionality needed to provide vendor certification, outreach and monitor contract compliance, implementation decisions made by the City and low user acceptance impacted the effectiveness of the software:

- Subcontractor payment information has to be entered manually by department representatives. Auditors noted that some departments stopped entering information in PRISM and instead rely on secondary tracking systems for reporting, including Excel spreadsheets.
- Periodic CBI reporting requires additional time, effort and coordination with departments to ensure accurate results.

In March 2017, representatives from Aviation, Charlotte Area Transit System (CATS), Charlotte Water and Engineering and Property Management (E&PM) jointly recommended the purchase of a new diversity management system called B2GNow. Furthermore, staff recommended that the City consider allowing external user sign-in capabilities in order to automate compliance functions. Prime contractors would enter payments made to subcontractors and allow the subcontractors to confirm that payment was received, eliminating the need for City staff to manually enter subcontractor information.

The City prefers the use of a single sign-in function for vendors that requires implementation of a Vendor Self-Service (VSS) solution. VSS has been delayed pending resolution of Information Security concerns, but is scheduled to be operational by June 2018.

Action Planned: The transition to a new system, B2GNow, is anticipated to be complete by the end of FY18. The City is working to implement VSS and the Procurement Management division is leading a City-wide vendor cleanup project to reduce the inaccuracies in Munis and other City databases related to vendors.

Recommendation: The City should utilize a diversity management solution that facilitates the monitoring and reporting of subcontractor payments and eliminates the need and reliance on departmental “side systems.”

Management and Financial Services Response: Department agrees. Efforts are underway to transition to a new diversity compliance tracking and reporting system.

4. Prime contractors should be required to provide more detailed reporting data.

To ensure that prime contractors and MWSBEs are complying with program requirements, systems must be put in place to capture enough detail regarding subcontractor payments to facilitate verification.

Auditors noted the following challenges to verifying the timeliness of payments to subcontractors:

- Although prime contractors report payments made to subcontractors, this does not include specific information such as the date work was performed, subcontractor invoice date, date subcontractor invoice was received, and the date the prime contractor billed the City for subcontractor work performed
- Prime contractors do not report check numbers and dates for payments made to subcontractors
- A list of payments to subcontractors was not readily available in electronic form.

Auditors verified payments to subcontractors by obtaining canceled checks and reviewing subcontractor invoices. Prime contractors were able to provide checks and invoices generally within three to five business days.

The City does not currently monitor or report on the timeliness of payments to subcontractors. The City is in the process of purchasing and implementing a new diversity management system (see Finding #3) that could be configured to allow contractors and subcontractors to communicate with the City in a standardized electronic format that provides automated verification capabilities.

It is anticipated that more consistent and comprehensive use of an automated system to report (prime contractors) and confirm (subcontractors) payments may simplify the process of verifying the timeliness of payments to subcontractors.

Recommendation: The CBI Program Manager should ensure that any future diversity management system(s) will capture sufficient detail regarding subcontractor payments to facilitate the monitoring and reporting of the accuracy and timeliness of payments to subcontractors.

Management & Financial Services Response: This software requirement will be sought as part of the B2GNow business requirements review and evaluation.

5. CBI should establish a site visit program based on risk assessment and analysis.

According to the CBI Program Policy (Section E.2.8), MWSBEs must perform a commercially useful function. A business does not perform a commercially useful function if it merely acts as a conduit by passing the scope of work for which it is scheduled to perform or supply on the contract to an MWSBE or non-MWSBE firm. While the CBI Policy states that Department Directors are responsible for ensuring CBI Program compliance within their respective departments, the CBI Program Manager is responsible for oversight and monitoring the CBI program. Oversight can include the following control activities:

- Training initiative for departments
- Periodic review of department site visits
- Evaluating the overall effectiveness of the program

Recognizing the opportunity for greater partnership with departments, in July 2015 CBI hired a Construction Specialist to support efforts in monitoring MWSBE contract commitments and to build relationships with both primes and subcontractors. As part of its partnership efforts, CBI began performing site visits in October 2015, and is in the best position to oversee site visits.

A mix of random and targeted visits would best provide acceptable coverage. Auditors identified the following as potential criteria that could be used to establish a site visit schedule:

- Contract award amount
- Number of subcontractors stated on letter of intent (CBI Form 4)
- Geographic location
- Date of last site visit

With the implementation of the new diversity management solution, CBI should analyze subcontractor usage to potentially detect unknown vendor affiliations that are not allowed per Part E, section 2.11 of the CBI policy. This section defines the factors that are considered in determining whether significant relationships exists between vendors; including management control, physical proximity, shared equipment and common management or employees. Site visits play a key role in the detection of these types of relationships.

Recommendation: CBI should establish a formal site visit program to ensure MWSBEs are performing per contract terms and CBI program expectations.

Management & Financial Services Response: CBI is currently working to establish internal training initiatives for departments regarding site visits as well as establishing a procedural manual and checklist for conducting such visits.

6. The CBI Program Manager should ensure that consistent documentation is retained to support SBE certification decisions.

Part E of the CBI Program Policy addresses requirements for becoming certified as an SBE. The policy states “the Program Manager shall establish reasonable procedures and methods for the Certification of applicant Business Enterprises as SBEs and the Registration of applicant Business Enterprises as MWBEs, in order to affect the purposes of the CBI Program.”

CBI staff review vendors’ documentation. For the sample auditors reviewed, CBI staff had initialed certain items on a vendor worksheet, and some of the information (addresses, gross receipts, commodity codes) provided by vendors has been entered into Compass (MWSBE vendor management system). Additionally, emails or correspondence between the vendor and the City were included (e.g., requesting/providing more documentation). However, there was not a consistent process used to indicate review, such as a CBI staff checklist, included with any vendor. Auditors reviewed a sample of ten vendor certification files initiated between FY14 and FY17 with the following results:

- Three of the ten vendors had all of the information correct and complete with the provided documentation.
- Two vendors’ files contained only information required for recertification. The original documentation was not included.
- Five vendors had incomplete or incorrect documentation.
- There was no indication in any of the files that the SBE size eligibility was reviewed.

If consistent verification and documentation standards are not followed, vendors could be incorrectly certified as a SBE. CBI policy does not explicitly state the procedure required to document vendor qualifications.

Recommendation: CBI should establish documentation standards for the certification process, including a checklist, to ensure documentation is complete and verified. A formal approval process should be incorporated.

Actions Planned: A CBI Advisory Committee has been established to provide guidance and recommendations toward improving the CBI program. One of the goals identified by the Committee is to determine whether the certification process should be revised.

Management & Financial Services Response: Department agrees with the recommendation to strengthen the certification process. Effective February 2018, several enhancements to the certification process have been implemented, such as a mandatory CBI staff checklist and supervisory review of each SBE certification application.