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**ANNE ARUNDEL COUNTY
OFFICE OF THE COUNTY AUDITOR**

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JAN 07 2015

COUNTY COUNCIL

January 7, 2015

The Honorable Members of the County Council
The Honorable County Executive Steven R. Schuh
Anne Arundel County, Maryland
44 Calvert Street
Annapolis, Maryland 21401

Dear Members and Mr. Schuh:

I am writing to report the fiscal impact resulting from prior administrations' failure to post overhead expenditures to capital projects. I first reported this impropriety to you in my email dated November 8, 2014, at which time County Controller Julie Mussog had not yet determined the fiscal impact.

For the benefit of the new Council members and Mr. Schuh, I have included a brief explanation of the theory behind charging overhead to capital projects, and I have reiterated narrative of the incident that brought this improper procedure to my attention. At the end of this letter I have included recommendations to strengthen the internal controls to ensure compliance with generally accepted accounting principles and the County Charter.

Theory of Overhead

The County charges overhead to capital projects to reimburse the operating funds for expenses incurred on behalf of capital projects. For example, the Office of Central Services' Purchasing Division incurs costs to award contracts, the Office of Law incurs costs to review contracts for legal form and sufficiency, and the Office of Finance incurs costs to pay invoices.

The County uses its "indirect cost allocation plan" to calculate the overhead rate. If the County charges less than the calculated overhead rate, capital project expenditures are understated, and the operating funds are not fully reimbursed for the costs incurred on behalf of the capital projects. Conversely, if the County charges more than the calculated overhead rate, capital project expenditures are overstated, and the operating funds are reimbursed for more than the costs incurred on behalf of the capital projects.

Background

On October 20, 2014, former Chief Administrative Officer Karen Cook sent a memorandum to the County Council informing the Council that the Department of Public Works had encountered construction problems on the Mill Creek Sewage Pumping Station capital project (\$804700) that would increase costs by \$1,250,000. Ms. Cook's memo stated that the Neuman administration had taken the steps to keep the project on track because it was in the midst of construction, it was highly visible to the area residents, and the legislative calendar was inflexible because it was the end of the term. Ms. Cook wrote that the Administration would use \$500,000 of contingency funds available in the project to assist covering the additional construction costs, and she approved a "temporary waiver" of \$450,000 of overhead expenditures at the recommendation of the Budget Office. She also wrote "In December legislation will be submitted to increase the appropriation of the Mill Creek SPS Upgrade by \$750,000 to

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cover the additional funding requirements and to reinstate the temporary waiver of the overhead on the project.”

Ms. Cook’s memorandum was accompanied by a memorandum from Chris Phipps, Director of Public Works, to the County Council in which Mr. Phipps outlines the causes of the cost overruns. Mr. Phipps’ memo stated that DPW is able to mitigate the unforeseen change orders by using \$500,000 of existing appropriation authority reserved as a construction contingency, and that the Budget Office “temporarily released \$450,000 in County overhead” to provide additional funding until such time as a fund transfer request can be considered by the County Council. I have attached both memos for the convenience of the new Council members and Mr. Schuh.

Under Section 715 of the County Charter, it is improper for any department to spend any money or incur any liability or enter into a contract in excess of the amounts appropriated, and § 513(d) imposes on the Controller the duty to control all expenditures on the basis of authorized budget appropriations. Based on the plain language in Ms. Cook’s and Mr. Phipps’ memos, I believed that the Neuman administration intended to move forward with the Mill Creek project despite having insufficient appropriations, and I questioned the propriety of their actions. In response, Mr. Phipps notified the County Council that his memo was meant to serve as a “heads up that a fund transfer will be needed to increase appropriation [sic] in order to complete this work,” and that “in no way was it stated nor intended that we would be committing or authorizing work that exceeds the current levels of appropriation.”

Deferring overhead expenditures to a subsequent period or not posting the expenditures at all does not comply with generally accepted accounting principles (GAAP). Under GAAP, expenditures should be recorded in the period in which the goods or services are received. When I brought this improper procedure to Ms. Mussog’s attention, she assured me that she would (1) ensure compliance with GAAP by posting the Mill Creek overhead expenditures in the proper period, and (2) ensure compliance with §§ 513(d) and 715 of the Charter by not certifying the availability of funds for any contract in excess of the project’s current appropriation.

Additional Overhead Waivers and Other Improper Postings of Overhead Amounts

Additional Overhead Waivers

When reviewing this matter, Ms. Mussog’s staff advised her that it has been the practice of the Neuman administration and prior administrations to waive overhead expenditures when posting the expenditures would cause a project to exceed its appropriation. The Leopold administration also waived overhead expenditures when a project was funded with a restricted revenue source that could not be used for overhead, such as Program Open Space funding.

Ms. Mussog researched the financial records back to July 1, 2003 and found the Neuman, Leopold, and Owens administrations approved overhead waivers totaling \$787,776 from January 23, 2004 through April 28, 2014 as detailed in Exhibit 1. Ms. Mussog has taken corrective action to post the proper amount of overhead to the Fort Smallwood Park project that is still open, and the Administration will have to seek appropriations for the overhead incurred on the other two capital projects that are still open (Q509400 Cypress Creek Retrofit and N542500 Sudley CC Upgrade). Ms. Mussog is unable to correct the overhead postings to the closed capital projects.

Other Improper Postings of Overhead Amounts

Ms. Mussog’s staff also advised her that former Controller Richard Drain agreed to modify the overhead rate charged to certain large capital projects at the urging of the Budget Office beginning in fiscal year 2012. The Budget Office objected to using the calculated overhead rate because they believed doing so generated an overhead

charge to large projects that was disproportionate to the effort the operating funds provided to those projects. Consequently, Mr. Drain agreed to reverse approximately \$2 million of overhead charges posted to utility and solid waste capital projects in fiscal year 2012. Additionally, he agreed to use a modified overhead rate of only 1%, 2% or 4% for certain large projects instead of the calculated rate of 6.17% in fiscal year 2013.

In fiscal year 2014, the Office of Finance continued the policy of charging overhead of only 1%, 2%, or 4% to certain large projects. Further, the Budget Office thought the fiscal year 2014 calculated overhead rate was "abnormally low," so they recommended that Finance continue to use the fiscal year 2013 overhead rate of 6.17%. While the Budget Office's July 9, 2013 email to an Office of Finance staff member acknowledges that the decision to continue to use the higher rate from fiscal year 2013 in fiscal year 2014 is "ultimately a decision for the Office of Finance," Mr. Drain retired on June 30, 2013, and Ms. Mussog was not appointed to the Controller position until July 31, 2013. Therefore, it is unclear who in the Office of Finance made this decision.

Exhibit 2 details the cumulative effect of these misstatements on the capital project funds' expenditures and the operating funds' revenue. The cumulative misstatement was an understatement of overhead expenditures in the capital project funds and an understatement of revenue in the operating funds of \$3,824,204.

When this matter came to her attention in November, Ms. Mussog immediately stopped the practice of posting overhead at a rate other than the calculated rate, and she made correcting entries for all open projects (\$3,907,023 understatement). She was, however, unable to post correcting entries for projects that were already closed (\$82,819 overstatement).

Recommendations

Overhead Waivers

Failing to post expenditures because doing so would cause a project's expenditures to exceed its budget is indicative of management override intended to mask noncompliance with § 715 of the Charter. It also masks the incorrect application of generally accepted accounting principles that dictate expenditures should be reported in the period in which the goods or services are received. To ensure compliance with the County Charter, management should seek supplemental appropriations when it anticipates current appropriations are insufficient to cover anticipated costs, including overhead. Likewise, if a restricted funding source cannot be used for overhead, management should seek an appropriation from an appropriate funding source, such as pay-go or bonds. Finally, management should implement procedures to prevent management from overriding the controls in place that are designed to ensure expenditures are recorded in accordance with GAAP.

Determination of Overhead Rate

The Budget Office's argument that overhead should not be calculated and applied at a uniform rate to all capital projects is reasonable. For example, it is likely that the effort expended by the Office of Law and Purchasing to award a contract to buy a \$20 million parcel of land is considerably less than the effort expended to award contracts to build a \$20 million road.

The County uses its "Cost Allocation Plan and Indirect Cost Proposal" (indirect cost allocation plan) to calculate the overhead rate necessary to ensure the operating funds are made whole for the services provided on behalf of capital projects. This plan is certified by the Controller and submitted to the federal government to support cost allocations and indirect costs that may be charged to federal awards under OMB Circular A-87 "Cost Principles for State, Local, and Indian Tribal Governments." The plan uses a step-down methodology to allocate

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the costs of the service offices (Budget, Law, Finance, Purchasing, etc.) to the departments that provide services to the public (Public Works, Inspections and Permits, Recreation and Parks, etc.) This methodology is best illustrated with the following example:

Assume there are only four service offices (Budget, Personnel, Law, and Finance) and one department providing services to the public (DPW). Under the County's methodology, the Budget Office's costs would be allocated to Personnel, Law, Finance, and the DPW based on the efforts expended for those offices. In turn, Personnel's costs, including its allocation of the Budget Office's costs, would be allocated to Law, Finance, and DPW; the Law Office's costs, including its allocation of the Budget and Personnel costs, would be allocated to Finance and DPW; and Finance's costs, including its allocation of the Budget, Personnel, and the Law Office costs, would be allocated to DPW.

While this step-down methodology is a common methodology approved for use by the federal government, it is, nevertheless, flawed. It assumes Personnel, Law, and Finance provide no services to the Budget Office; that Law and Finance provide no services to Personnel, etc., when, in fact, the Budget, Personnel, Law, and Finance all provide services to each other.

Management may wish to evaluate whether a different methodology would more accurately allocate operating costs incurred on behalf of the capital projects. If management chooses to adopt a different methodology, that methodology should (1) have a rational, documented basis allocating the costs incurred in the operating funds on behalf of capital projects, (2) be applied consistently in accordance with a formal policy, and (3) ensure the operating funds are made whole for all costs incurred on behalf of capital projects.

Management's Response

Management appreciates the Auditor's discovery of this situation. As noted in your report the longstanding practice of processing "overhead waivers" based on the authority of the Chief Administrative Officer has been discontinued. Office of Finance staff has been made aware of the improper nature of such requests and understands the Chief Administrative Officer has no such authority to waive overhead charges. Any requests to alter overhead charged to a project will be brought to the Controller's attention immediately.

We have requested our outside auditor share with us some of the methodologies that other County's use for calculating indirect overhead rates and in the new calendar year plan to review these to determine if there is a better method that would more accurately allocate operating costs. If we determine that a different method is more accurate than the current it will be documented as policy.

I thank County Controller Julie Mussog for her cooperation in reviewing this matter and commend her for taking prompt corrective action. Please call if you have any questions on our findings.

Sincerely,



Teresa Sutherland, CPA
County Auditor

EXHIBIT 1 - OVERHEAD WAIVERS FROM FISCAL YEARS 2004 - 2014

Administration	Date	Project #	Project Name	Project Status	Amount	Reason
Neuman	5/20/2014	Q509400	Cypress Creek Retrofit	Open	\$45,000.00	Over budget
Neuman	9/13/2013	N542500	Sudley CC Upgrade	Open	20,000.00	Over budget
Leopold	7/13/2012	N542500	Sudley CC Upgrade	Open	40,000.00	Over budget
Leopold	5/31/2011	P378700	Davidsonville Park	Closed	593.45	Over budget
Leopold	5/31/2011	P450700	Quiet Waters Park Renovation	Closed	1,468.35	Over budget
Leopold	2/8/2011	P540000	Dealer Traceys Park Renovation	Closed	6,100.00	Restricted funding source that could not be used for overhead
Leopold	7/1/2010	H539700	Urban Design Studies	Closed	1,151.82	Over budget
Leopold	7/1/2010	S803600	Woodholme Circle Sewer	Closed	11,704.22	Over budget
Leopold	6/17/2010	P472400	South County Athletic Complex	Closed	15,000.00	Over budget
Leopold	6/17/2010	P546300	Bay Head Park	Closed	1,600.00	Over budget when correct overhead rate was charged
Leopold	6/17/2010	P546500	Jug Bay Park	Closed	11,000.00	Over budget when correct overhead rate was charged
Leopold	6/17/2010	S802400	Camp Meade Road Sewer	Closed	50,000.00	Over budget
Leopold	6/17/2010	P546400	South River Greenway	Closed	4,013.73	Over budget when correct overhead rate was charged
Leopold	6/15/2009	C543800	Rural Legacy Program	Closed	43,763.02	Restricted funding source that could not be used for overhead
Leopold	1/26/2009	P543300	Nature Preserve Wayson's Corner	Closed	303,643.73	Restricted funding source that could not be used for overhead
Leopold	6/27/2007	P482500	Patuxent Greenway	Closed	571.30	Restricted funding source that could not be used for overhead
Leopold	2/1/2007	P535900	Fort Smallwood Park	Open	787.17	Waived DPW overhead because Rec. and Parks managed project, but no offsetting overhead charged for Rec. and Parks efforts
Leopold	6/1/2007	H508000	Provinces Sidewalks/Root Guard	Closed	829.06	Over budget
Owens	12/8/2005	P503500	Franklin Point Park	Closed	3,237.61	Over budget
Owens	1/23/2004	P311200	Londontown Historic Site	Closed	227,312.07	Over budget
Total Waivers					\$787,775.53	

EXHIBIT 2 - MISAPPLICATION OF OVERHEAD RATE IN FISCAL YEARS 2012 - 2014

NET FISCAL IMPACT FROM MISAPPLICATION OF OVERHEAD RATES IN FISCAL YEARS 2012 - 2014

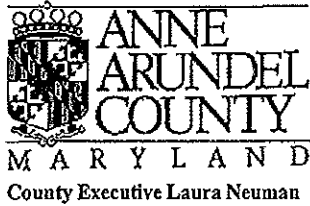
FISCAL YEAR	OVER/(UNDER) STATEMENT OF OVERHEAD EXPENDITURES IN CAPITAL PROJECTS FUNDS					OVER/(UNDER) STATEMENT OF REVENUE IN OPERATING FUNDS				
	General County	Utilities	Solid Waste	WPRF	Total	General Fund	Utilities	WPRF	Total	
FY2012	\$0	(\$1,907,651)	(\$95,309)	\$0	(\$2,002,960)	(\$2,002,960)	\$0	\$0	(\$2,002,960)	
FY2013	3,835	(1,102,271)	(49,957)	0	(1,148,393)	(1,148,393)	0	0	(1,148,393)	
FY2014	306,021	(1,001,033)	(8,850)	31,010	(672,852)	(42,337)	(650,671)	20,156	(672,852)	
Totals	\$309,856	(\$4,010,955)	(\$154,116)	\$31,010	(\$3,824,205)	(\$3,193,690)	(\$650,671)	\$20,156	(\$3,824,205)	

OPEN PROJECTS FOR WHICH THE CONTROLLER MADE CORRECTING ENTRIES

FISCAL YEAR	OVER/(UNDER) STATEMENT OF OVERHEAD EXPENDITURES IN CAPITAL PROJECTS FUNDS					OVER/(UNDER) STATEMENT OF REVENUE IN OPERATING FUNDS				
	General County	Utilities	Solid Waste	WPRF	Total	General Fund	Utilities	WPRF	Total	
FY2012	\$0	(\$1,907,651)	(\$95,309)	\$0	(\$2,002,960)	(\$2,002,960)	\$0	\$0	(\$2,002,960)	
FY2013	(38,726)	(1,097,320)	(48,239)	0	(1,184,285)	(1,184,285)	0	0	(1,184,285)	
FY2014	267,925	(1,004,431)	(14,283)	31,010	(719,779)	(87,055)	(652,880)	20,156	(719,779)	
Totals	\$229,199	(\$4,009,402)	(\$157,831)	\$31,010	(\$3,907,024)	(\$3,274,300)	(\$652,880)	\$20,156	(\$3,907,024)	

CLOSED PROJECTS FOR WHICH THE CONTROLLER DID NOT MAKE CORRECTING ENTRIES

FISCAL YEAR	OVER/(UNDER) STATEMENT OF OVERHEAD EXPENDITURES IN CAPITAL PROJECTS FUNDS					OVER/(UNDER) STATEMENT OF REVENUE IN OPERATING FUNDS				
	General County	Utilities	Solid Waste	WPRF	Total	General Fund	Utilities	WPRF	Total	
FY2012	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	
FY2013	42,561	(4,952)	(1,718)	0	35,891	37,609	(1,718)	0	35,891	
FY2014	38,097	3,398	5,433	0	46,928	44,719	2,209	0	46,928	
Totals	\$80,658	(\$1,554)	\$3,715	\$0	\$82,819	\$82,328	\$491	\$0	\$82,819	



Beth *ACM*

Karen L. Cook
Chief Administrative Officer

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kcook@aacounty.org

Arundel Center
44 Calvert Street
Annapolis, MD 21401

MEMORANDUM

To: Members of the County Council
From: Karen L. Cook, Chief Administrative Officer *KLC*
Subject: Mill Creek Sewage Pumping Station
Date: October 20, 2014

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COUNTY COUNCIL

The attached memo from Chris Phipps, Director of Public Works, concerns recently encountered construction problems pertaining to capital project S804700, the Mill Creek Sewage Pumping Station (SPS) Upgrade. Several factors outlined in Mr. Phipps' letter have driven the cost of this \$9.1 million project up by approximately \$0.75 million. Given that the project is in the midst of construction, the high visibility of the project to area residents, and the inflexibility of the legislative calendar at the end of the County Council's term the Administration has taken steps to keep the project on a construction track so as to not further delay this much need improvement.

There is currently \$500,000 available in the Mill Creek SPS Upgrade project that had been reserved as a construction contingency to assist with the additional \$1.25 million cost of the construction. Additionally, the Office of the Budget has recommended a temporary waiver of overhead of \$450,000 for the Mill Creek SPS Upgrade project. I have approved this temporary waiver so as to keep the project on track.

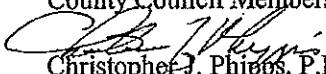
In December legislation will be submitted to increase the appropriation of the Mill Creek SPS Upgrade by \$750,000 to cover the additional funding requirements, and to reinstate the temporary waiver of the overhead on the project. The Department of Public Works has identified a related project, Cinder Cove Sewage Pumping Station Modifications (S806700) as a funding source for a portion of the additional appropriation. This project recently received favorable construction bids of \$3 million below project estimates.

If you have any questions, please contact me.



ANNE ARUNDEL COUNTY
Department of Public Works

Inter-Office Correspondence

DATE: October 20, 2014
TO: County Council Members
FROM: 
Christopher J. Phipps, P.E., Director
RE: Mill Creek Sewage Pumping Station Project

The FY 2015 capital budget included funds for upgrades to the Mill Creek Sewage Pumping Station (Project #S804700). The construction Notice to Proceed was issued on April 11, 2013 and work is ongoing. Unfortunately, the current level of appropriation for FY 2015 is insufficient to cover several change orders necessitated by multiple unforeseen conditions. This letter is to make the Anne Arundel County Council aware that emergency legislation will be submitted for consideration in December 2014.

The existing Mill Creek Sewer Pump Station, which is located in a residential area in Arnold, MD, was built in 1968. The Mill Creek SPS Upgrade project includes the design and construction of various mechanical and electrical equipment, as well as expansion of the existing wet well storage. The purpose of the upgrade is to improve the station's reliability, and prevent sanitary sewer overflows. The construction contract was awarded to Norair Engineering Corporation as the lowest responsible bidder, in April 2013. The bid by Norair Engineering Corporation exceeded the Engineer's Estimate of \$6,625,000 by approximately \$490,000. Furthermore, during the Construction phase, the contractor encountered unforeseen conditions that adversely impacted both the contract amount and duration. These unforeseen conditions include:

- Encountering significant underground concrete obstructions, approximately 20 feet below grade. Additional time was spent to delineate the extent of the encountered tier of concrete obstruction. Subsequently, a second tier of the underground concrete obstructions were encountered at 30 feet below grade. The noted concrete obstructions were in direct conflict with the proposed wet well expansion and were difficult to remove.
- BGE called for a new electrical service layout and configuration that required upgrading an existing pole, and installation of a second new pole outside the station. This review has added time and cost to the contract, as the plans had to be revised to comply with the new BGE service requirement.
- In response to public concerns, as well as the sensitivity of the Mill Creek area, the scope of work was further expanded to include a new emergency diesel pump to further enhance the reliability of the station.
- The above changes required the review and approval of the A/E and CM/I teams prior to implementation by the Contractor in the field. The extension of the contract time has also impacted the construction management and design consultants' contract durations.

The unanticipated extra work has significantly added to the construction cost and may total approximately \$1.25 million. The majority of the extra work manifested itself after the deadline for the additional funding request for the FY 2015. DPW is able to mitigate the impact of these unforeseen change orders by using approximately \$500,000 of existing appropriation authority that has been reserved as construction contingency. Furthermore, the Office of the Budget has temporarily released \$450,000 in County Overhead to provide additional funding until such time as a fund transfer request can be considered by the County Council.

To cover the remaining shortfall, we are requesting a fund transfer from another project, Cinder Cove SPS Mods (S805300). This project has recently received favorable construction bids that are approximately \$3,000,000 below the Engineer's Estimate. This provides sufficient available surplus funding to enable the requested transfer.

Existing Uncommitted Funding in Mill Creek SPS Upgrade (S804700)	\$500,000
Temporary Release of Overhead/Fund Transfer Request	\$450,000
Additional Fund Transfer Amount	\$300,000
Total to Fund. Change Orders/Shortfall	\$1,250,000

The fund transfer request will reinstate the County Overhead charges as well as increase the total appropriation for the project by \$750,000.

These adjustments to the budgetary appropriation are time sensitive because the Contractor is in the midst of the construction, and also due to the County's commitment to the neighboring communities to complete this complex project by early 2015. In addition to scale down construction operations for a short duration of time until appropriation authority is available is inefficient.

We appreciate your understanding as we work to address the funding shortfall so as to minimize the impact to this important project.

cc: Karen Cook, Chief Administrative Officer
Teresa Sutherland, County Auditor
John Hammond, Chief Budget Officer
Billie Penley, Senior Budget and Management Analyst
Christine Romans, Assistant Director, DPW
Bruce Wright, Deputy Director, Engineering
Jim DiPietro, Deputy Director, Utility Operations