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December 17, 2014

Mr. Mike McKeever
Chief Executive Officer
Sacramento Area Council of Governments
1415 L Street, Suite 300
Sacramento, CA 95814

Dear Mr. McKeever:

Audits and Investigations (A&I) audited the Sacramento Area Council of Government's (SACOG) Indirect Cost Allocation Plan (ICAP) for the fiscal year (FY) 2012/13 to determine whether the ICAP is presented in accordance with Title 2 of the Code of Federal Regulations (CFR) Part 225 and the California Department of Transportation's (Caltrans) Local Assistance Procedures Manual (LAPM), Chapter 5. SACOG management is responsible for the fair presentation of the ICAP. SACOG proposed an indirect cost rate of 44.25 percent of total direct salaries and wages plus fringe benefits which was accepted for billing purposes by Caltrans on July 19, 2012.

A&I conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that A&I 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. A&I 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 SACOG. Therefore, A&I did not audit and is not expressing an opinion on SACOG'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 SACOG, as well as evaluating the overall presentation.

The accompanying ICAP was prepared on a basis of accounting practices prescribed in Title 2 CFR Part 225 and the Caltrans's LAPM, Chapter 5, and is not intended to present the results of operations of SACOG in conformity with generally accepted accounting principles.

The scope of the audit was limited to select financial and compliance activities. The audit consisted of a recalculation of the ICAP, a limited review of SACOG's Overall Work Program for FY 2010/11, review of SACOG's audited financial reports for FY 2010/11, and inquiries of SACOG personnel. The audit also included tests of select accounts to the general ledger and supporting documentation to assess allowability, allocability and reasonableness of costs based on a risk assessment and assessment of the internal control system as related to the ICAP for the carryforward year 2010/11. Reliance was placed on the audited financial statements for FY 2012/13 for actual costs related to FY 2012/13. Financial management system changes subsequent to April 13, 2014 were not tested and, accordingly, our conclusion does not pertain to changes arising after this date. A&I believes that the audit provides a reasonable basis for our conclusion.

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.

The results of this audit were communicated to Mr. Kirk Trost, SACOG's Chief Operating Officer/General Counsel and Stacy Niccum, SACOG's Finance Manager via e-mail on February 4, 2014, March 17, 2014 and via teleconference on July 7, 2014. SACOG provided a written response via e-mail on September 29, 2014 and October 27, 2014. The finding(s) and recommendation(s) take into consideration SACOG's response.

AUDIT RESULTS

Based on audit work performed, SACOG's ICAP for the FY 2012/13 is presented in accordance with 2 CFR Part 225 and LAPM, Chapter 5 except as noted below. The audited final indirect cost rate is 44.25 percent of total direct salaries and wages, plus fringe. The rate is based on actual costs for FY 2012/13 therefore there is no carry forward.

SACOG's proposed ICAP was prepared based on budgeted costs for FY 2012/13. During the course of the audit SACOG's audited financial statements for FY 2012/13 were completed. A&I recalculated SACOG's ICAP using actual costs for FY 2012/13 to report a final audited rate. The audited rate includes an adjustment to the carry-forward from FY 2010/11 to account for unallowable costs identified during the audit. The following findings detail the disallowed costs identified in the carry-forward year of FY 2010/11 that required adjustment to the FY 2010/11 actual costs.

Audit Findings

Finding 1
SACOG's indirect cost pool for FY 2010/11 included legal costs that were for direct projects. The audit determined that SACOG included $157,106 of legal expenses in the indirect cost pool for FY 2010/11 that were direct legal expenses related to projects or other final cost objectives of SACOG. SACOG did not consistently segregate direct legal costs from indirect legal costs on consultant legal invoices. The audit noted that the legal invoices included commingled direct and indirect costs and inconsistent treatment of legal costs between direct and indirect per invoice and from invoice to invoice. Additionally, a previous ICAP audit of SACOG (FY 2009/10) reported a similar finding regarding inconsistent treatment of legal costs between direct and indirect. Federal cost principles require the segregation of costs between direct and indirect and consistent treatment of costs.

As part of the audit the audit staff interviewed the finance staff regarding SACOG's practices for segregating costs, reviewed SACOG's policies and procedures, and performed tests of select accounts. The audit found that SACOG did not have written procedures specific to segregating direct and indirect costs and through tests of the legal account the audit noted a significant number of direct legal costs charged as indirect or commingled with other legal costs that appeared indirect. The audit staff held several meetings with the finance staff to discuss our concerns and the staff acknowledged and agreed that legal direct and indirect costs had not been consistently segregated, and that SACOG did not maintain written policies regarding their charging practices. Therefore rather than disallow the entire legal account of $245,404, the audit staff communicated the concerns and requested SACOG on several occasions to review the legal invoices and segregate all direct legal expenses from indirect in a consistent manner and based on an equitable methodology. On three separate occasions, SACOG provided information to A&I; however, the information provided did not include the following:

- A defined methodology on how the legal costs were segregated and/or allocated between direct and indirect.
- Consistency in segregating direct and indirect costs.
- A thorough review of all billed legal costs.

A fourth submittal of information was based on an entirely different scenario of practices that was not supported by statements made by SACOG's finance staff during the audit interviews or by the documents reviewed and was not in compliance with the federal regulations. As explained by the Chief Operating Officer/General Counsel (who was not a SACOG employee during the period the legal costs were incurred) "it appears SACOG treated as indirect charges billing entries that included legal work relating to more than one work element. By contrast, billing entries that related to a single work element should not have been charged to indirect". This practice is an inconsistent treatment of costs as a cost may not be treated as an indirect cost if any other cost incurred for the same purpose, in like circumstances has been treated as a direct cost. To illustrate, an inconsistent treatment of

cost would exist when legal work performed for a direct purpose/project is included on an invoice in a commingled entry with other direct project work and/or indirect work and billed as an indirect cost while the same or similar direct work is performed for a direct purpose/project and billed as a direct cost.

The Audit determined $157,106 of legal costs were direct in nature and unallowable in the indirect cost pool and adjusted the indirect cost pool by $157,106 to exclude the unallowable costs.

2 CFR Part 225, Appendix A, Section E, "*direct costs" states, direct costs are those that can be identified specifically with a particular final cost objective.*

2 CFR Part 225, Appendix A, Section F. 1, *states in part, indirect costs are those incurred for a common or joint purpose benefiting more than one cost objective and not readily assignable to the cost objectives specifically benefitted, without effort disproportionate to the results achieved.*

2 CFR Part 225, Appendix E, Section A. 1, *states in part,...after direct costs have been determined and assigned directly to Federal awards and other activities as appropriate, indirect costs are those remaining to be allocated to benefitted cost objectives. A cost may not be allocated to a Federal award as an indirect cost if any other cost incurred for the same purpose, in like circumstances has been assigned to a federal award as a direct cost.*

2 CFR Part 225, Appendix E, Section D, 3 "*Certificate of Indirect Costs" states in part, (2) all costs included in this proposal are properly allocable to Federal awards on the basis of a beneficial or casual relationship between the expenses incurred and the agreements to which they are allocated.... Further, the same costs that have been treated as indirect costs have not been claimed as direct costs. Similar types of costs have been accounted for consistently and the Federal Government will be notified of any accounting changes that would affect the predetermined rate.*

Recommendation

A&I recommends SACOG do the following:

- Ensure the FY 2014/15 ICAP is calculated with no carry-forward as the FY 2012/13 audited rate is based on actual costs.
- Establish written policies and procedures for segregating direct and indirect legal costs in compliance with state and federal regulations.
- Ensure direct and indirect legal charges are properly identified and segregated and all direct and unallowable legal charges are excluded from the indirect cost pool.

Auditee Response

SACOG strongly disagrees with the draft finding that SACOG's indirect cost pool for FY 2010/11 included $157,106 in unallowable direct legal costs.

The only accurate statements in the draft finding are that SACOG did not have a written procedure for segregating legal costs, and that there were some inconsistencies in SACOG's treatment of the legal costs. SACOG acknowledged these facts in detailed worksheets and annotated legal invoices provided in February and March of this year. These materials demonstrated that the minor inconsistencies in SACOG's treatment of legal invoices necessitated an adjustment of only $10,478. A&I has never responded in detail to SACOG's submission, and have never explained why the information is inadequate.

The other statements in the draft finding are simply false. For over a year, SACOG staff has repeatedly responded to requests from the audit team. After each response, the audit team simply moved the goalposts, requesting new and different information. SACOG staff and legal counsel have spent an enormous amount of time reviewing twelve months of legal invoices in detail and correcting any items that should have been charged to a project. As noted, A&I has still failed to explain or justify why SACOG's submittals are inaccurate or insufficient.

Analysis
A&I does not agree with SACOG's response. A&I communicated with SACOG staff continuously throughout the audit and maintained the same position with regards to the treatment of legal costs. Specific responses were given to SACOG for the legal invoices provided by SACOG via emails and teleconference. As indicated in the audit report, the documentation provided by SACOG did not show how legal costs were consistently segregated and/or allocated between direct and indirect in like circumstances as required by federal requirements.

Based on SACOG's response to the draft finding A&I added language to the third paragraph of the draft finding.

Finding 2
SACOG's indirect cost pool for FY 2010/11 included $13,136 of unallowable costs related to lobbying costs paid to the California Association of Councils of Governments, food costs for staff meetings, travel costs for a non SACOG employee, late fee, and appliance purchase. Federal cost principles as noted below, require that unallowable costs be segregated and excluded from the indirect cost pool. The audit adjusted the indirect cost pool to exclude the $13,136 of unallowable costs.

2 CFR Part 225, Appendix A, C. 2 *"reasonable costs" states in part, a cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost.*

2 CFR Part 225, Appendix B, 20 "*Goods or services for personal use*" *states, costs of goods or services for personal use of the governmental unit's employees are unallowable regardless of whether the cost is reported as taxable income to the employee.*

2 CFR Part 225, Appendix B, 24 "*Lobbying*" *states in part, the cost of certain influencing activities associated with obtaining grants, contracts, cooperative agreements, or loans is an unallowable cost.*

2 CFR Part 225, Appendix B, 14 "*Entertainment*" *states, costs of entertainment, including amusement, diversion, and social activities and any costs directly associated with such costs (such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities) are unallowable.*

Recommendation
A&I recommends SACOG do the following:

- Properly identify unallowable costs and exclude from the indirect cost pool.
- Ensure all employees are required to comply with SACOG policies and procedures.

Auditee Response
SACOG concurs with the finding.

This report is intended solely for the information of SACOG, Caltrans Management, the California Transportation Commission and the Federal Highway Administration. This report is a matter of public record and its distribution is not limited. In accordance with A&I disclosure policy, this report will be posted on the Caltrans website.

If you have any questions, please contact Carvin Seals, Auditor, at 323-7965, or Teresa Greisen, Audit Manager, at (916) 323-7910

ZILAN CHEN, Chief
External Audits – Local Governments

Enclosures

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