

U.S. DOT-OIG/AASHTO Audit Subcommittee
Risk Assessment of State Transportation Agency Payment Process

Guide Used to Conduct Risk Assessments in Fiscal Year 2003

Background

The United States Department of Transportation (DOT) is investing record funding amounts to improve the transportation system's infrastructure and safety. The Transportation Equity Act for the 21st Century, or TEA-21, authorized about \$180 billion in Federal-aid highway funding to State transportation agencies (States) for the 6-year period ending in Fiscal Year 2003. This funding amount is expected to continue in future years. While testifying before the House and Senate Appropriations Committees in April 2001, Secretary Mineta stated that one of his priorities is to ensure that the Federal government receives what it pays for and that major transportation projects are managed wisely and appropriately.

States make construction progress payments to prime contractors at least once per month. Construction payment estimates, prepared by State engineers and approved by State project managers, are based on the value of work performed and materials delivered or stockpiled in accordance with the construction contract. Payment estimates are based on supporting documentation, such as inspection reports, estimate books, quantity weight tickets, and construction diaries.

States also pay consultants for various professional services, such as project oversight, project design, environmental services, and quality assurance. State project managers assess consultants' performance based on periodic meetings, status reports, and interaction with the consultants. Consultants submit monthly invoices that project managers approve before payment processing. Consultants are generally not required to provide supporting documentation with invoices, but the costs are subject to a State audit.

Risk Assessment Objective

The objective of this risk assessment is to identify internal control weaknesses and best practices related to payments for highway construction contractor and consultant services.

Scope and Methodology

This risk assessment evaluates internal controls over the Federal-aid payment process and tests a random sample of Federal-aid expenditures to determine whether Federal funds were used properly and all costs were adequately documented and supported.

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Assessing internal controls. To evaluate internal controls over the State payment process, the risk assessment uses the General Accounting Office's *Internal Control Management and Evaluation Tool*, specifically the Control Activities and Monitoring Standards. Risk assessment steps based on these Standards follow.

Testing Federal-aid expenditures. To determine whether Federal-aid payments to construction contractors and consultants are proper, this risk assessment tests a random sample of payment estimates selected from the universe of payment estimates for construction expenditures during the most recent 12-month period. Sample items should be traced to supporting source documentation such as consultant invoices, construction payment vouchers, estimate books, daily inspection reports, construction diaries, and material weight tickets, etc.

Preliminary Planning

Key documents needed at least 2 weeks before field work begins

- Amount of Federal-aid highway funds apportioned to the State for the last three Fiscal Years.
- Amount of Federal-aid expenditures during the most recent Fiscal Year, stratified by dollar value.
- Data file (preferably in Microsoft Excel) containing the universe of Federal-aid expenditures for the most recent Fiscal Year. The following fields of information are needed:
 - District number/location
 - Federal/State project number
 - Full Federal oversight or exempt from Federal oversight
 - Transaction date
 - Transaction amount
 - Type of expenditure (construction, consultant, etc.)
 - Payment voucher/invoice number
 - Payment voucher line item number
 - Contractor/consultant name
 - Contractor/consultant number
- Stewardship Agreement with Federal Highway Administration (FHWA).

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- State transportation agency organization chart and key contact points with phone numbers for personnel in project management, construction, financial and accounting, and auditing divisions. Include key contacts in District Offices.
- Current staffing levels for personnel whose responsibilities include oversight of Federal-aid projects. Classify by (1) project management, (2) construction engineers and inspectors, (3) financial and accounting, and (4) auditing. Further classify personnel by location (Headquarters and District Offices).
- Position descriptions for project managers, construction engineers, chief estimators, accounting/financial managers, auditors, and other positions with responsibility for oversight of the Federal-aid program.
- List and examples of typical supporting documents required before payment to construction contractors and consultants is approved.
- Written documentation/flowchart of State payment process for Federal-aid expenditures (from beginning to end, i.e., reviewing material weight tickets to preparing vouchers to processing payments to issuing checks to contractors). Include manual and computer controls to prevent and detect erroneous expenditures.
- List and examples of oversight reports used by State managers to monitor contractor and consultant performance and progress for Federal-aid projects.
- State DOT Auditor, State Legislative Auditor, FHWA, and Federal Department of Transportation Inspector General audits and reviews of State payment and oversight processes for Federal-aid projects, including audit reports, risk assessments, management control evaluations, process reviews, consultant reports, and other reviews issued during the last three Fiscal Years.

Risk Assessment Steps

Control Activities - Internal control activities help ensure that management directives are carried out and occur at all levels and functions of the entity. Control activities are policies, procedures, and practices for approvals, authorizations, verifications, reconciliations, and performance reviews. They ensure actions are taken to address risks and are an integral part of an entity's planning, implementing, reviewing, and stewardship of government resources. Control activities may be (1) applied in a computerized information system

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environment or through manual processes, and (2) classified by specific control objectives such as ensuring completeness and accuracy of information processing.

Controls can be either prevention or detection oriented. Both types of controls are essential to an effective internal control system. From a quality standpoint, preventive controls are essential because they are proactive and emphasize quality. Preventive controls attempt to either deter or prevent fraud and prevent loss or other undesirable events from occurring. Examples of preventive controls are separation of duties, proper authorization, adequate documentation, and physical control over assets. Detection controls play a critical role in providing evidence that preventive controls are functioning. Detection controls attempt to detect fraud, waste and abuse. They provide evidence of losses but do not prevent losses from occurring. Detection controls include reviews, inspections, analyses, variance analyses, reconciliations, physical inventories, and audits and investigations of fraud, waste and abuse.

1. Are key areas of authority and responsibility defined and communicated throughout the organization?

- (a) Is there a current and accurate organization chart? Do clear reporting relationships exist between management and employees? Are employees aware of key areas of responsibility as provided in an accurate and current position description?
- (b) How does management ensure employees execute their jobs effectively? Is responsibility for decision making clearly linked to the assignment of authority? Are individuals held accountable? Review performance standards for selected positions.

2. What audit resources do State transportation agencies have available for oversight of Federal-aid highway construction projects?

- (a) What audit resources are available to provide oversight of Federal-aid funds and construction project expenditures?
- (b) What is the audit division's workload? What are the audit priorities and why were these priorities selected?
- (c) What performance targets did audit management set? Did the audit division meet its performance targets? Document supporting information.
- (d) What audit reports are provided to the FHWA Division Office?

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3. Are there appropriate policies, procedures, techniques, and mechanisms with respect to control activities? Determine if the State established, and if so, make copies of, written policies, procedures, and practices for oversight of:

- payment process
- construction contractors
- professional services consultants
- management and oversight of project cost and schedule

4. Obtain summary data on the funding and cost of Federal-aid highway projects for the most recent Fiscal Year. Note whether the State's Fiscal Year corresponds to the Federal Fiscal Year (October through September).

- (a) How much Federal and State funds were apportioned and obligated for Federal-aid highway projects?
- (b) How much Federal and State funds were apportioned and obligated for Federal-aid projects with full FHWA oversight?
- (c) How much Federal and State funds were apportioned and obligated for Federal-aid highway projects with State oversight (exempt from FHWA oversight)?
- (d) What were the number and dollar value of reimbursements for Federal-aid highway projects and the number and dollar value of completed Federal-aid highway projects?

5. Control Activities over Payments (23 U.S.C. 121, 23 CFR Part 635.122, and 23 CFR Part 140)

- (a) Interview State project, financial and information systems managers to obtain a thorough understanding of the payment approval process. Is the process documented and flowcharted? Request a copy. If not, diagram the process (narrative and flowchart) for approving payments to Federal-aid construction contractors and consultants. Include important internal controls used throughout the process.
- (b) What process is used to create, document and approve construction pay estimates?

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- (c) What process is used to create, document and approve consultant payments?
- (d) Besides formal construction audits, how does the State ensure that Federal funds are spent appropriately? Does the State employ documentation reviewers to verify the accuracy of project records? What items do documentation reviewers verify? Are statistical samples of transactions tested? If not, how are projects selected by documentation reviewers?
- (e) Does the State have a strategy to minimize duplicate and other erroneous payments? What reports are generated to highlight duplicate and other erroneous payments? Have duplicate or other erroneous payments occurred during the previous two years? If yes, describe how these were found and what corrective actions were taken.
- (f) From the sample universe, select and test a random sample of Federal-aid highway expenditures for the most recent 12-month period. Stratify the sample universe by dollar value and randomly select sample items for a 95 confidence level and 5 percent error rate. Before beginning field work, review sample item pay estimates and judgmentally select one to three pay estimate line items to be verified.
- (g) Trace sample items to supporting documentation, such as payment vouchers, pay estimates, construction diaries, estimate books, daily inspection reports, weight tickets, etc.

6. Information System Processing - The agency employs a variety of control activities suited to information processing systems to ensure accuracy and completeness of payments.

- (a) Observe the processing of a payment voucher/invoice from billing to payment, for the State transportation agency payment system and the Statewide payment system. Compare this process to the controls listed in the payment flowchart. Are control procedures in place and followed?
- (b) Does the State DOT payment system have controls to protect against and detect possible duplicate and other erroneous payments before, during, and after payment processing? These controls should address and produce reports to identify:

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- Possible duplicate and other erroneous transactions as data is initially entered into construction and vendor information systems at the project and district level;
 - Possible duplicate and other erroneous transactions as the transactions are being extracted for transfer from the State DOT's payment system to the State Treasury's payment system; and
 - Possible duplicate and other erroneous payments after the transactions have been processed by the State Treasury's payment system.
- (c) If these controls are not present, how does the State DOT detect and prevent duplicate and other erroneous transactions?

7. Separation of Duties Related to Payments - Key duties and responsibilities are divided among different people to reduce the risk of error, waste, or fraud. No one individual should be allowed to control all key aspects of a transaction or event. Interview management and operating personnel and review organizational charts and job descriptions to establish individual duties and responsibilities.

- (a) Who estimates the amount of work completed by the contractor during the billing cycle?
- (b) Who inspects and confirms contractor compliance with construction methods and material quality? Who compensates inspection personnel?
- (c) Who authorizes payment of contractor invoices? Payment authorization should be made after work is certified as complete and in accordance with contract specifications, or after proper deductions have been made.
- (d) Who records contractor payments? The accounting department should perform this function.
- (e) Who reconciles project payments to the budget? If the same person authorizes and reconciles payments for contracts, additional monitoring by management is necessary.
- (f) Who disburses the payment to the contractor?
- (g) Who validates the expenditure after payment is made?

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8. Classifying, Recording, and Documenting Payment Transactions – Are payment transactions appropriately classified, recorded, and documented to maintain their relevance, value, and usefulness to management in controlling operations and making decisions?

- (a) Does written documentation exist for the accounts payable internal control structure? Is the documentation readily available for examination? Is documentation, whether in paper or electronic form, useful to managers in controlling operations and to auditors and others involved? Note if copies are available for use by personnel to assist in performing their duties.
- (b) Are transactions completely and accurately classified, recorded, and documented? Can the transaction be traced from initiation to completion?

Monitoring – Management should assess internal control performance over time. This assessment is accomplished by ongoing monitoring activities and by separate evaluations of internal controls. Ongoing monitoring occurs during normal operations and includes regular management and supervisory activities, comparisons, reconciliations, and similar tasks. Separate evaluations, such as peer reviews, risk assessments, and internal audits, are periodic reviews that focus directly on the effectiveness of internal controls at a specific time.

The purpose of monitoring is to determine whether internal controls are adequately designed, properly executed, and effective. Management should have reasonable assurance that operational objectives were achieved, financial information was prepared reliably, and the organization has complied with applicable laws and regulations. Managers should focus on high-risk areas and, like auditors, should use spot checks of transactions or basic sampling techniques to provide a reasonable level of confidence in the adequacy of internal controls.

9. Does State management conduct ongoing monitoring and separate evaluations to assess internal controls?

- (a) Interview State contract administration and financial managers to determine how they monitor control objectives for construction, such as ensuring projects remain on budget and within schedule and that improper payments are not made. Does management’s strategy provide for routine feedback of internal control performance? In what form?
- (b) Interview State project management and accounting personnel to identify management information systems used to provide oversight reports such as project cost and schedule variances. Does State management use these

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reports to assess achievement of objectives and monitor project performance? How do they use the reports? Do they provide the reports to the FHWA Division Office? Obtain examples.

10. Are communications from external parties used to corroborate internally generated data or identify problems with internal control?

- (a) Does the State have a hotline to which complaints or referrals of fraud, waste, or abuse can be reported? What complaints and referrals involving Federal-aid highway projects have been made? Interview hotline personnel and obtain a listing of complaints and referrals for the last three years.
- (b) What policies and procedures are used to track and report allegations of fraud, waste, and abuse concerning State and Federal-aid highway construction projects from internal and external sources?
- (c) How responsive are external State audit agencies to reviewing allegations of fraud, waste, and abuse on State and Federal-aid highway projects? How are matters of oversight coordinated with the State auditors?

11. Are the scope and frequency of separate evaluations of State internal controls appropriate?

- (a) Interview State Legislative Auditors, State DOT Auditors, and other State agencies that audit highway projects to determine whether any pertinent risk assessments or audits related to contractor payments or the payment system have been issued in the last three Fiscal Years.
- (b) Obtain copies of risk assessments and audit reports issued in the last three Fiscal Years related to:
 - Oversight of consultants
 - Oversight of construction contractors
 - State payment process
 - Project management (cost and schedule)