

2017

RISK AND CONTROL ASSESSMENT SCDOT Indirect Cost Recovery



SOUTH CAROLINA OFFICE OF THE STATE AUDITOR

INTERNAL AUDIT
SERVICES

December 12, 2017

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1 FOREWORD

AUTHORIZATION

The South Carolina Office of the State Auditor established the Internal Audit Services division (IAS) pursuant to South Carolina Code Section 57-1-360 as revised by Act 275 of the 2016 legislative session. IAS is an independent, objective assurance and consulting function designed to add value and improve the operations of the South Carolina Department of Transportation (SCDOT). IAS helps SCDOT to achieve its objectives by bringing a systematic, disciplined approach to evaluating the effectiveness of risk management, internal control, and governance processes and by advising on best practices.

STATEMENT OF INDEPENDENCE

To ensure independence, IAS reports administratively and functionally to the State Auditor while working collaboratively with SCDOT leadership in developing an internal audit plan that appropriately aligns with SCDOT's mission and business objectives and reflects business risks and other priorities.

REPORT DISTRIBUTION

This report is intended for the information and use of the SCDOT Commission, SCDOT leadership, the Chairman of the Senate Transportation Committee, the Chairman of the Senate Finance Committee, the Chairman of the House of Representatives Education and Public Works Committee, and the Chairman of the House of Representatives Ways and Means Committee. However, this report is a matter of public record and its distribution is not limited.

ACKNOWLEDGEMENT

IAS wishes to thank members of management and staff in the Accounting, Information Technology Services, and Program Controls Divisions for their cooperation in assessing risks and developing actions to improve internal control and enhance operating performance.

2 EXECUTIVE SUMMARY

ACTIVITY ASSESSED: Indirect Cost Recovery

NUMBER OF PROCESSES IN THE ACTIVITY: 4

NUMBER OF PROCESSES ASSESSED IN THIS ENGAGEMENT: 3

NAMES OF PROCESSES ASSESSED AND RESPONSIBLE DIVISIONS:

1. Indirect Cost Recovery Data – Information Technology (IT) Services Division
2. Indirect Cost Recovery Proposal – Accounting Division
3. Indirect Cost Recovery Charges – Program Controls Division

RISK EXPOSURE TO SCDOT BASED ON OBSERVATIONS (below):



RISK MANAGEMENT OBSERVATIONS:

Process 1 – Indirect Cost Recovery Data (Information Technology Services Division)

1. IT Services' staff review of requested data output from the Legacy Accounting system may not, by itself, be sufficient to reduce the risk of errors to an acceptable level (detailed in Observation 5.1.1 D1 on page 10).

Process 2 – Indirect Cost Recovery Proposal (Accounting Division)

2. Controls are not in place to ensure the timely notification of approved indirect cost rates to the IT Services and appropriate engineering divisions (detailed in Observation 5.2.0 D1 on page 13).
3. The IDCRCP does not portray potential indirect cost recoveries for non-FHWA third party activities (detailed in Observation 5.2.0 D2 on page 13).
4. Manual analysis and filtering of massive amounts of data when preparing the indirect cost rate proposal (IDCRP) creates a greater likelihood for errors to occur and diminishes the strength of detection controls (detailed in Observation 5.2.1 D1 on page 14).

EXECUTIVE SUMMARY Continued

5. The preparer's written instructions for preparing the IDCRC do not explain the logic and methodology used in the rate calculation. Without this information, preparers or reviewers who are new to the process are less likely to detect errors (detailed in Observation 5.2.2 E1 on page 15).

Process 3 – Indirect Cost Recovery Charges (Program Controls Division)

6. The authorization checklist does not effectively direct staff to a proper determination of whether a project should be exempt or nonexempt from indirect cost recovery charges (detailed in Observation 5.3.1 D1 on page 17).
7. There is not a formal process to review and update exemption guidelines on a periodic basis (detailed in Observation 5.3.1 D2 on page 18).
8. A project was not charged indirect cost even though it did not meet the guidelines for exemption from indirect cost (detailed in Observation 5.3.1 E1 on page 18).
9. Reconciliations of P2S, FMIS, and Legacy systems did not detect "flag" input errors in Legacy for two projects (detailed in Observation 5.3.2 E1 on page 19).

PERFORMANCE MANAGEMENT OPPORTUNITIES:

Process 2 – Indirect Cost Recovery Proposal (Accounting Division)

1. The base used in the IDCRC resulted in a calculated indirect cost rate perceived by FHWA as too high. This prompted SCDOT to submit a lower rate. The difference in these rates represents an additional \$3.36 million that was not available for indirect cost reappropriation for the fiscal year ended 2017. Additional recoveries do not increase federal funding to SCDOT but do provide increased flexibility for funding Agency programs. Changes in the base and rate type could yield additional recoveries resulting in increased funding flexibility (detailed in Opportunity 6.1 P1 on page 20).

Process 3 – Indirect Cost Recovery Charges (Program Controls Division)

2. Occasions exist where Management determines a project should be exempt from indirect cost recovery that are not covered by any of the current authorized exemption guidelines. A formal process for documenting and approving such exceptions is not in place (detailed in Opportunity 6.2 P1 on page 21).



3 INTERNAL AUDITOR'S REPORT

December 12, 2017

Ms. Christy A. Hall, Secretary of Transportation
and
Members of the Commission
South Carolina Department of Transportation
Columbia, South Carolina

We have completed a risk and control assessment of the Indirect Cost Recovery activity of the South Carolina Department of Transportation (SCDOT or the Agency). The objective of this assessment was to contribute to the improvement of risk management by evaluating SCDOT's exposure to risks and the controls designed by Management to manage those risks. Our engagement included two aspects:

- Facilitation of Management's assessment of risks and controls for providing reasonable assurance that significant risks have been identified and that controls are adequately designed to manage risk to an acceptable level, and
- Tests of internal controls over significant risks to determine whether the controls are operating effectively.

The results of both Management's assessment and our tests of controls are included in the *Risk and Control Assessment Results* section beginning on page 8. While our engagement was primarily focused on risk management, other matters were identified that may represent opportunities for cost savings, revenue enhancement, process improvement, strengthened control environment, or more effective performance. These matters are detailed in the *Performance Management Opportunities* section on page 20.

We planned and performed the engagement with due professional care in order to obtain sufficient, appropriate evidence to provide a reasonable basis for our observations and conclusions. Our observations as a result of our testing are described in the *Risk and Control Assessment Results* section beginning on page 8 of this report.

George L. Kennedy, III, CPA
State Auditor

4 ENGAGEMENT OVERVIEW

4.1 BACKGROUND

In an effort to improve cash flow during a period of stressed State revenues, SCDOT began an indirect cost recovery program for its federal projects in 2012. This recovery program allowed the Agency to use a portion of its federal allocation to cover eligible overhead costs attributed to its federal programs. Indirect costs include salaries, fringe benefits, and other operating costs of executive and support services. The Agency calculated its current year indirect cost rate of 223.12% based on fiscal year 2015 overhead costs of \$55,021,630. The rate was negotiated with the Federal Highway Administration (FHWA) which approved a predetermined indirect cost rate of 195%. The agreement with FHWA allows SCDOT to recover indirect costs by applying the approved rate to the approved base (direct salaries) in fiscal years 2017 and 2018. Recoveries that are greater than the actual overhead costs during those years must be included as an adjustment in the subsequent indirect cost rate proposal submitted to FHWA.



Indirect cost recoveries do not increase federal funding to SCDOT because FHWA provides a specific allocation that may be used for eligible direct and indirect costs. To recover indirect costs, the Agency reappropriates funds normally used for its federal program direct costs. By using federal funds to cover eligible indirect costs, less restrictive nonfederal resources which were budgeted for those indirect costs are made available to fund direct costs of the Agency's federal *and* state programs. This strategy affords SCDOT increased flexibility in prioritizing funding for all of its programs to more effectively achieve its strategic goals.

4.2 OBJECTIVES

Management's primary objectives with the Indirect Cost Recovery activity are to 1) recover eligible indirect costs as allowed by federal requirements consistent with the Agency's strategic goals and 2) properly charge indirect costs to projects unless those projects meet exemption guidelines. Our objective was to facilitate Management's assessment of risks that threaten the achievement of its objectives and to assess the effectiveness of controls designed to manage those risks to an acceptable level.

4.3 SCOPE

SCDOT recovers indirect costs through several rates: an overall rate, a lab rate, an equipment rate, and a fringe benefit rate. This engagement covers only the overall indirect cost rate. Through discussion with Management, we determined that the following processes are significant to the Indirect Cost Recovery activity.

	Process	Responsible Division	Included in Scope
1	Indirect Cost Recovery Data	Information Technology	Yes
2	Indirect Cost Recovery Proposal	Accounting	Yes
3	Indirect Cost Recovery Charges	Program Controls	Yes
4	Time Charging to Projects	Engineering	No

Our scope included the processes marked “Yes” above with their activities and transactions for the period July 1, 2014 through June 30, 2015. This period was selected because it provides a complete population of data used to calculate the indirect cost rate applicable to the current fiscal year 2017. The scope did not include an evaluation of the time charge system or processes which impact the direct salary base used to calculate the rate and allocate indirect costs to projects. The Engineering Division and Finance and Administration Division collaborated to refine Agency guidelines for recording time when work is performed that involves the County Transportation Committee (CTC) program and CTC projects. Departmental Directive 48 was updated and a memorandum issued as a guide to appropriately charge time to administrative activities associated with CTC work. Management plans to extend this guidance for all Agency projects and anticipates progress will be made by the close of calendar year 2017.

4.4 METHODOLOGY

For the significant processes included in the engagement scope, we performed the following procedures:

1. We facilitated Management’s completion of a process outline that documented the steps in the process and the individuals responsible for those steps.
2. We facilitated Management’s completion of a risk and control matrix used to:
 - a. identify risks which threaten process objectives;
 - b. score the risks as to their consequence and likelihood of occurrence;
 - c. determine if controls are adequately designed to manage the risks to within the risk appetite; and

- d. propose design improvements to controls when risks are not managed to within the risk appetite (Management responsible for the processes agreed to use a conservative risk appetite score of 4 as described in Appendix A).
3. We observed the discussion by key process owners and other subject matter experts performing the steps in procedure two. We evaluated Management's assessment of control design and action plans for improving inadequate controls. We believe that Management's assessment was reasonable and comprehensive.
4. We tested key controls for risks with inherent scores of 6 and above [scale of 1 (lowest) to 25 (highest) as shown in the Risk Scoring Matrix in Appendix A] to determine if the controls are operating effectively. Testing included inquiry, observation, inspection of documentation, and re-performance of process steps.
5. We collaborated with Management to develop observations based on the assessments of controls which are not adequately designed and/or operating effectively.
6. We facilitated Management's development of action plans to improve control design and/or operating effectiveness with practical, cost-effective solutions.
7. We identified opportunities to improve performance management.

4.5 CONCLUSION

In our opinion, based on our evaluation of Management's assessment of risks and controls and on the results of our testing, internal controls are generally adequately designed and generally operating effectively but require improvements, as noted in our observations, to manage the significant risks associated with the Indirect Cost Recovery activity to a prudently acceptable level. Overall risk exposure to SCDOT for this activity is assessed as medium-low.

4.6 FOLLOW-UP ON MANAGEMENT ACTION PLANS

We will follow up with designated Management Action Plan owners on the implementation of the proposed actions on an ongoing basis. We will provide periodic reports to responsible SCDOT leadership on the status of Management Action Plans and note whether those actions were effectively and timely implemented to reduce risk exposure to an acceptable level.

5 RISK AND CONTROL ASSESSMENT RESULTS

Overall Risk Exposure to SCDOT for this Activity



Risk and Control Assessment Summary by Process

	Process	Detailed in Section	Overall Control Assessment	Risk Exposure
1	Indirect Cost Recovery Data (IT Services Division)	5.1	Controls are generally good but minor improvements in design are warranted.	Medium-Low
2	Indirect Cost Recovery Proposal (Accounting Division)	5.2	Existing controls are fairly strong but some risks lack controls. The controls that are in place are working for the most part.	Medium-Low
3	Indirect Cost Recovery Charges (Program Controls and Preconstruction Divisions)	5.3	Most controls are adequately designed but additional design improvements are needed. On the whole, controls are not operating effectively.	Medium-Low

5.1 PROCESS 1 INDIRECT COST RECOVERY DATA

Responsible Division – IT Services

Process Objectives

- To extract and provide accurate financial data from the legacy mainframe accounting system (Legacy) to the Division of Accounting for preparing its indirect cost rate proposal.

Summary of Significant Process Risks and Controls

Internal Controls determined to be inadequate or ineffective are described in the Control Observations following the table.

	A	B	C	E	F	G	H
	SIGNIFICANT RISK <i>and Consequence</i>	INHERENT RISK SCORE (Before Considering Controls)	RESIDUAL RISK SCORE (After Considering Design of Controls)	MANAGEMENT'S ASSESSMENT OF CONTROL DESIGN	KEY CONTROL(S) TESTED BY INTERNAL AUDITOR (Primary Controls Which Provide Greatest Risk Treatment are in Bold)	INTERNAL AUDITOR ASSESSMENT OF CONTROL EFFECTIVENESS	CURRENT RISK EXPOSURE TO SCDOT
		1 = Low 25 = High Risk Appetite = 4 or Less (See Scoring Matrix in Appendix A)					
1	Use the wrong timeframe for data extraction. <i>Would result in erroneous rate and noncompliance with federal requirements; must adjust subsequent rate for overcharge and would lose recovery for undercharge.</i>	9	6	 Partially Adequate	1. Staff reviews data output for reasonableness including ensuring there is no data missing for each month	 Effective	Medium-Low
2	Error in software program that extracts the data. <i>Would result in erroneous rate and noncompliance with federal requirements; must adjust subsequent rate for overcharge and would lose recovery for undercharge.</i>	9	6	 Partially Adequate	1. Staff reviews data output for reasonableness including ensuring there is no data missing for each month	 Effective	Medium-Low
3	Select the wrong data file. <i>Would result in erroneous rate and noncompliance with federal requirements; must adjust subsequent rate for overcharge and would lose recovery for undercharge.</i>	9	6	 Partially Adequate	1. Staff reviews data output for reasonableness including ensuring there is no data missing for each month	 Effective	Medium-Low

Observations on Control Design and Effectiveness

Assessment of Control 1 – Staff Reviews of Output Reasonableness

Control Description: Financial Data is requested by the Accounting division to prepare its indirect cost rate proposal. The Information Technology (IT) Services division is responsible for extracting the data from Legacy. IT Services uses a software program to extract the data. To ensure that the data is complete, accurate, and pulled for the correct period, IT Services staff performs a reasonableness review by comparing the data to the prior year and verifies 12 months' data is included in the output.

Observation 5.1.1 D1 Data Accuracy Review

We noted that the reasonableness review was an effective control based on our testing. However, IT Services management and staff, in their assessment of control design, concluded that the IT Services staff review of the data output may not, by itself, be sufficient to reduce the risk of errors to an acceptable level. They believe that the recipient (user) of the report data would be able to identify errors more readily based on their deeper understanding of the data and its use.

Management Action Plan (MAP) 5.1.1 D1	
Require report recipient to perform a review for reasonableness and acknowledge that the data is accurate and complete and their acceptance of the report.	
MAP Owner:	IT Manager
Division	IT Services
Scheduled Date:	Completed October 18,2016

5.2 PROCESS 2 INDIRECT COST RATE PROPOSAL

Responsible Division – Accounting

Process Objectives

1. To accurately and timely prepare the indirect cost rate proposal (IDCRP).
2. To comply with Office of Management and Budget (OMB) Uniform Guidance.
3. To maximize indirect cost recoveries as allowed by federal requirements and management’s programming guidelines to optimize funding flexibility.

Summary of Significant Process Risks and Controls

Internal Controls determined to be inadequate or ineffective are described in the Control Observations following the table.

	A	B	C	E	F	G	H
	SIGNIFICANT RISK <i>and Consequence</i>	INHERENT RISK SCORE (Before Considering Controls)	RESIDUAL RISK SCORE (After Considering Design of Controls)	MANAGEMENT’S ASSESSMENT OF CONTROL DESIGN	KEY CONTROL(S) TESTED BY INTERNAL AUDITOR (Primary Controls Which Provide Greatest Risk Treatment are in Bold)	INTERNAL AUDITOR ASSESSMENT OF CONTROL EFFECTIVENESS	CURRENT RISK EXPOSURE TO SCDOT
		1 = Low 25 = High Risk Appetite = 4 or Less (See Scoring Matrix in Appendix A)					
1	Fail to include all allowable costs in the IDCRP. Would result in erroneous rate and noncompliance with federal requirements; loss of recovery for undercharge.	9	6	 Partially Adequate	1. Preparer and reviewers trained in and knowledgeable of allowable costs.	 Effective	Medium-Low
2. Independent reviewers trace amounts to reports, recalculate spreadsheet formulas, and review data for reasonableness.					 Effective		
3. Independent reviewers who are knowledgeable of federal requirements for compliance.					 Effective		
2	Fail to exclude all unallowable costs in the IDCRP. Would result in erroneous rate and noncompliance with federal requirements; must adjust subsequent rate for overcharge.	9	6	 Partially Adequate	1. Preparer and reviewers trained in and knowledgeable of allowable costs	 Effective	Medium-Low
2. Independent reviewers trace amounts to reports, recalculate spreadsheet formulas, and review data for reasonableness.					 Effective		
3. Independent reviewers who are knowledgeable of federal requirements for compliance					 Effective		

	A	B	C	E	F	G	H
	SIGNIFICANT RISK <i>and Consequence</i>	INHERENT RISK SCORE (Before Considering Controls)	RESIDUAL RISK SCORE (After Considering Design of Controls)	MANAGEMENT'S ASSESSMENT OF CONTROL DESIGN	KEY CONTROL(S) TESTED BY INTERNAL AUDITOR (Primary Controls Which Provide Greatest Risk Treatment are in Bold)	INTERNAL AUDITOR ASSESSMENT OF CONTROL EFFECTIVENESS	CURRENT RISK EXPOSURE TO SCDOT
		1 = Low 25 = High Risk Appetite = 4 or Less (See Scoring Matrix in Appendix A)					
3	Clerical error, math errors, inherent excel errors, and logic of allocation. <i>Would result in erroneous rate and noncompliance with federal requirements; must adjust subsequent rate for overcharge and would lose recovery for undercharge.</i>	9	6	 Partially Adequate	2. Independent reviewers trace amounts to reports, recalculate spreadsheet formulas, and review data for reasonableness.	 Effective	Medium-Low
4	Failure to submit the IDCPR to FHWA timely (by 12/31 of each year) <i>Rushing can lead to more errors; reviewers have less time.</i>	9	9	 Inadequate	No controls are currently in place	N/A	Medium-Low
5	Failure to notify IT of the new indirect cost rate. <i>Would result in improper charge of federal programs.</i>	9	9	 Inadequate	No controls are currently in place	N/A	Medium-Low
6	Failure to notify program managers of the new indirect cost rate. <i>Budget would be inaccurate.</i>	6	6	 Inadequate	No controls are currently in place	N/A	Medium-Low
7	IDCRP doesn't report the allocation of indirect costs to non-FHWA third parties. <i>Decision-makers don't know how much indirect cost applies to non-federal third parties that typically bear overhead costs; this could affect the decision to charge indirect cost and how much to charge.</i>	9	9	 Inadequate	No controls are currently in place	N/A	Medium-Low
8	Trained and knowledgeable preparers are not available to timely complete the IDCPR. <i>IDCRP may have errors and/or be submitted late.</i>	9	3	 Adequate	4. Trained and knowledgeable backup preparer	 Partially Effective	Medium-Low

Observations on Control Design and Effectiveness

Assessment of Risks Which Have No Significant Associated Controls

Observation 5.2.0 D1 Timely Notification of Approved Rates

The Accounting division notifies IT Services of a new FHWA-approved rate so that it will be programmed in the mainframe accounting system to be applied as a cost to projects. The Accounting division also notifies Program Controls staff of the new rate to accurately budget for indirect costs as a component of project cost budgeting and forecasting. The Accounting division assessed the design of controls to ensure the timely notification of approved indirect cost rates to the IT Services and Program Controls divisions and determined that there were no formal controls to ensure timely notification.

Management Action Plan (MAP) 5.2.0 D1	
Add a calendar reminder to Microsoft Outlook for notifying IT Services and appropriate engineering divisions of new approved indirect cost rates.	
MAP Owner:	Chief Financial Officer
Division	Accounting
Scheduled Date:	December 31, 2017

Observation 5.2.0 D2 Reporting Indirect Costs of Non-FHWA Third Parties

Indirect costs are an inherent and necessary cost of transportation projects. The objective of the IDCRP is to recover indirect costs on FHWA funded projects. However, other non-FHWA third parties benefit from administrative and overhead costs paid by SCDOT relative to their projects. Management typically makes the decision not to charge indirect costs to non-FHWA third parties based on qualitative rather than quantitative criteria. The IDCRP does not identify potential indirect cost recoveries for non-FHWA third party activities. Without this information, policy-makers do not have a full and clear vision of allowable recovery.

Management Action Plan (MAP) 5.2.0 D2	
Calculate indirect costs and report indirect cost allocations to all programs including non-FHWA third party activities.	
MAP Owner:	Chief Financial Officer
Division	Accounting
Scheduled Date:	March 31, 2018

Assessment of Control 2 – Independent Review of the IDCPR

Control Description: The indirect cost rate proposal comprises a complex set of spreadsheets, pivot tables, system reports, and supporting documents. Thousands of rows of data from system reports are manually analyzed and filtered to place costs in appropriate indirect and direct cost categories necessary for calculating the indirect cost rate. The rate calculation spreadsheet has numerous allocations, exclusions, and formulas. To ensure compliance with federal regulations and the accuracy and completeness of the data, independent reviewers trace amounts to reports, recalculate spreadsheet formulas, and review data for reasonableness.

Observation 5.2.1 D1 Automation of Data Analysis and Filtering

Manual analysis and filtering of massive amounts of data creates a greater likelihood for errors to occur. Additionally, the time consuming nature of this task diminishes the strength of detection controls. This analysis took the preparer three weeks to complete using Excel pivot tables. An effective independent review likely requires more time than the benefit derived. We discussed the potential for automating much of this process with IT Services staff who indicated that they could develop reports from the mainframe accounting system that would provide the information already filtered as needed saving significant time for both the preparer and the reviewer.

Management Action Plan (MAP) 5.2.1 D1	
Discuss with IT Services opportunities to automate steps in the IDCPR development process which will significantly reduce risk of errors and save time.	
MAP Owner:	Chief Financial Officer
Division	Accounting
Scheduled Date:	March 31, 2018

Assessment of Control 3 – Trained and Knowledgeable Backup Preparer

Control Description: The complexity of the indirect cost rate proposal requires not only the preparer to be trained and knowledgeable, but also a backup person in case the preparer leaves the Agency. The preparer is backed-up by the Controller who designed much of the IDC RP. We interviewed the Controller and determined that he is effectively trained and knowledgeable to prepare the IDC RP and to train a new preparer if necessary.

Observation 5.2.2 E1 Written Instructions for Preparing the IDC RP

The employee who prepares the IDC RP resigned during the course of the engagement. Prior to training a replacement, the Controller also resigned leaving the Agency without another trained and knowledgeable backup. Compounding the issue is that the Agency’s written documentation for preparing the IDC RP does not explain the logic or methodology used. This lengthens the training time for new preparers and reviewers and may preclude them from fully understanding the methodology potentially leading to errors in the rate calculation. We met with the Controller prior to his departure to obtain a step-by-step narration for preparing the IDC RP including explanation of the logic and methodology. We will share this information with the Accounting Division to aid in enhancing its written procedures.

Management Action Plan (MAP) 5.2.2 E1	
Using information gathered by IAS, enhance written step-by-step desk procedures for preparing the IDC RP with explanations for logic and methodology.	
MAP Owner:	Chief Financial Officer
Division	Accounting
Scheduled Date:	March 31, 2018

5.3 PROCESS 3 INDIRECT COST RECOVERY CHARGES

Responsible Division – Program Controls

Process Objectives

1. To appropriately allocate indirect costs to federal programs within required timeframes.
2. To maximize indirect cost recoveries while considering political risk factors (e.g. MPO Guideshare program).
3. To comply with Office of Management and Budget (OMB) Uniform Guidance.

Summary of Significant Process Risks and Controls

Internal Controls determined to be inadequate or ineffective are described in the Control Observations following the table.

	A	B	C	E	F	G	H
	SIGNIFICANT RISK <i>and Consequence</i>	INHERENT RISK SCORE (Before Considering Controls)	RESIDUAL RISK SCORE (After Considering Design of Controls)	MANAGEMENT'S ASSESSMENT OF CONTROL DESIGN	KEY CONTROL(S) TESTED BY INTERNAL AUDITOR (Primary Controls Which Provide Greatest Risk Treatment are in Bold)	INTERNAL AUDITOR ASSESSMENT OF CONTROL EFFECTIVENESS	CURRENT RISK EXPOSURE TO SCDOT
		1 = Low 25 = High Risk Appetite = 4 or Less (See Scoring Matrix in Appendix A)					
1	Fail to consistently apply guidelines to projects (exclude project that should be included). <i>Would lose recovery for undercharge.</i>	6	4	 Adequate	1. Authorization checklist is used to ensure guidelines are followed	 Partially Effective	Medium-Low
2	Fail to consistently apply guidelines to projects (include project that should be excluded). <i>Must reimburse FHWA for overcharge.</i>	6	4	 Adequate	1. Authorization checklist is used to ensure guidelines are followed	 Partially Effective	Medium-Low
3	Guidelines are not clear, comprehensive or up-to-date. <i>Error in applying guidelines; must reimburse FHWA for overcharge and would lose recovery for undercharge.</i>	6	6	 Inadequate	No controls are currently in place	N/A	Medium-Low
4	Input error to FMIS (or to Legacy by Accounting staff). <i>Must reimburse FHWA for overcharge and would lose recovery for undercharge.</i>	9	3	 Adequate	1. Authorization checklist is used to ensure guidelines are followed	 Partially Effective	Medium-Low
					2. Reconciling P2S and Legacy with FMIS by monitoring the transaction log	 Ineffective	

	A	B	C	E	F	G	H
	SIGNIFICANT RISK <i>and Consequence</i>	INHERENT RISK SCORE (Before Considering Controls)	RESIDUAL RISK SCORE (After Considering Design of Controls)	MANAGEMENT'S ASSESSMENT OF CONTROL DESIGN	KEY CONTROL(S) TESTED BY INTERNAL AUDITOR (Primary Controls Which Provide Greatest Risk Treatment are in Bold)	INTERNAL AUDITOR ASSESSMENT OF CONTROL EFFECTIVENESS	CURRENT RISK EXPOSURE TO SCDOT
		1 = Low 25 = High Risk Appetite = 4 or Less (See Scoring Matrix in Appendix A)					
5	Fail to email accounting PR2 authorization notification. Funds would not be properly set up for projects.	9	3	 Adequate	3. Automated email notification from Project Wise to accounting	 Effective	Low (Acceptable Range)
6	Projects not charged IDC based on arbitrary, faulty or unethical basis. Would lose recovery for undercharge.	9	3	 Partially Adequate	1. Authorization checklist is used to ensure guidelines are followed	 Partially Effective	Medium-Low

Observations on Control Design and Effectiveness

Assessment of Control 1 – Authorization Checklist

Control Description: Obligations Management (OM) staff in the Program Controls Division use an authorization checklist to assist in accurately entering information in the Project Programming System (P2S). This system is designed to provide all Agency users with a quick and reliable source for gathering, maintaining, and reporting pertinent project information from beginning to end. The authorization checklist includes four guidelines which, if any are met, exempt a project from indirect cost recovery charges. The guidelines are:

- Federal funds are matched by a third party.
- Project is locally administered by a third party.
- Project is funded entirely by a third party.
- Federal Guides share funds are allocated to the project.

Observation 5.3.1 D1 Authorization Checklist Design

In its assessment of control design, Program Controls management concluded that the authorization checklist does not effectively direct staff to a proper determination of whether a project should be exempt or nonexempt from indirect cost recovery charges. Additionally, the form is not designed to document OM staff completion of each step in the decision and input process.

Management Action Plan (MAP) 5.3.1 D1	
Develop specific detailed explanations on the authorization checklist for each of the four criteria to enhance OM staff decision making. Re-design the checklist to require documentation of decisions (e.g. which criteria was met) and notation of steps completed.	
MAP Owner:	Director of Program Controls
Division	Program Controls
Scheduled Date:	Completed June 2017

Observation 5.3.1 D2 Development of Guidelines

Program Controls management determined that there could be circumstances which would warrant additional guidelines or revisions to current guidelines but there is not a formal process to review and update guidelines on a periodic basis. Changes in circumstances could cause current guidelines to become incomplete or inappropriate. The analysis of circumstances should be performed at the executive level since strategic and political factors affect the determination of appropriate guidelines.

Management Action Plan (MAP) 5.3.1 D2	
Develop a process for an executive-level annual review of guidelines in the context of current operational, strategic, and political circumstances to determine if additional guidelines or revisions should be made.	
MAP Owner:	Deputy Secretary for Finance and Administration
Division	Finance and Administration
Scheduled Date:	March 31, 2018

Observation 5.3.1 E1 Application of Guidelines to Projects

We tested nineteen federally funded projects to determine if they were properly exempt from indirect cost recovery based on the guidelines. We found that one project (P027625) did not have indirect cost charges even though it did not meet the guidelines for exemption.

Management Action Plan (MAP) 5.3.1 E1a	
Procedures Manual has been updated to include decision matrix for IDC guidelines and staff was retrained in June 2017 with the release of the updated Authorization Checklist.	
MAP Owner:	Director of Program Controls
Division	Program Controls
Scheduled Date:	Completed June 2017

Management Action Plan (MAP) 5.3.1 E1b	
Research an automated solution whereby P2S includes guidelines as a decision input that would automatically flag whether indirect costs should be charged.	
MAP Owner:	Director of Program Controls
Division	Program Controls
Scheduled Date:	March 30, 2018

Assessment of Control 2 – Project Systems Reconciliation

Control Description: Project information maintained in P2S is also input to FMIS (the Federal Management Information System) by OM staff and to Legacy by Accounting staff. OM staff notifies Accounting staff that a project should be charged indirect cost by placing a comment in the “Remarks” section of P2S. This should prompt Accounting staff to “flag” Legacy to charge the project with the rate programmed into the system. To ensure the accuracy of input to both FMIS and Legacy, OM staff reconciles both systems to P2S.

Observation 5.3.2 E1 P2S and Legacy Reconciliation

For two of the nineteen federally funded projects tested, we found that the “Remarks” section of P2S and FMIS did not agree with the “flag” set in Legacy. For project P030120, the indirect cost flag was improperly set to “Yes” in Legacy. FHWA had not yet been billed for this charge and we observed Accounting staff make the correction in Legacy. For project P027445 the indirect cost flag was improperly set to “No”. OM staff took immediate action to begin reconciling P2S and FMIS “Remarks” to the Legacy “flag”.

Management Action Plan (MAP) 5.3.2 E1	
Include in the reconciliation of P2S, FMIS, and Legacy a comparison of the P2S and FMIS “Remarks” section to the Legacy indirect cost flag.	
MAP Owner:	Director of Program Controls
Division	Program Controls
Scheduled Date:	Completed May 8, 2017

6 PERFORMANCE MANAGEMENT OPPORTUNITIES

While our engagement was primarily focused on risk management, we have identified other matters that represent opportunities for cost savings, revenue enhancement, process improvement, strengthened control environment, or more effective performance.

Opportunity 6.1 P1 Enhancing Funding Flexibility Through Indirect Cost Recoveries

To recover indirect costs, the Agency reappropriates funds normally used for its federal program direct costs. By reappropriating federal funds to cover eligible indirect costs, less restrictive nonfederal resources which were budgeted for those indirect costs become available for funding direct costs of the Agency's federal *and* state programs. This strategy affords SCDOT increased flexibility in prioritizing funding for all of its programs to more effectively achieve its strategic goals. Therefore, an increase in reappropriating creates more funding flexibility. An obstacle to this strategy is that the Agency's calculated indirect cost rate of 223.12% is perceived by FHWA as too high. FHWA staff will not approve a rate that they consider too high. For this reason, SCDOT submitted a lower rate of 195% which FHWA approved. The difference in these rates represents \$3.36 million in direct costs that could not be reappropriated to indirect costs for the fiscal year ended 2017 resulting in less funding flexibility.

One of the contributing factors to the high indirect cost rate is that the rate calculation uses direct salaries and wages as the allocation base. Federal regulations allow grantees to use various expenditures in its allocation bases including direct salaries and wages plus fringe benefits. We determined that the calculated rate would have been 131.33% had the Agency included fringe benefits in the base. We discussed the alternative base with representatives from FHWA who indicated that the lower rate calculated based on direct salaries and wages plus fringe benefits would not be considered too high. This would afford SCDOT the opportunity to submit the calculated rate as a starting point for negotiations.

The Agency's indirect cost rate is a predetermined rate. According to the approval letter from FHWA, this type of rate requires SCDOT to calculate its actual indirect cost rate and compare it to the Agency's approved negotiated rate. If the negotiated rate results in reimbursement in excess of actual costs, the Agency must make an adjustment to the subsequent negotiated rate. However, if the actual indirect costs are greater than recoveries under the negotiated rate, SCDOT is not allowed to adjust its future predetermined rate to collect the shortfall. An alternative to the predetermined rate is a fixed rate in which Federal regulations allow both under and over recoveries to be included as adjustments in subsequent year proposals.

Management Action Plan (MAP) 6.1 P1a	
<p>Prepare and calculate the indirect cost rate with and without fringe benefits in the base with direct salaries for discussion with the Deputy Secretary of Finance and Administration and consideration by the Secretary of Transportation. Through a discussion with FHWA, determine the best option for SCDOT. The implementation of any change to the current rate application must be coordinated with the IT Department as programming changes may be required.</p>	
MAP Owner:	Chief Financial Officer
Division	Accounting
Scheduled Date:	March 31, 2018

Management Action Plan (MAP) 6.1 P1b	
<p>Request approval for a fixed rate with carryover adjustment instead of a predetermined rate when submitting the next indirect cost rate proposal to FHWA.</p>	
MAP Owner:	Chief Financial Officer
Division	Accounting
Scheduled Date:	March 31, 2018

Opportunity 6.2 P1 Exceptions to Guidelines

The authorization checklist used to input project information to P2S includes four guidelines which, if any are met, exempt a project from indirect cost recovery charges. There are occasions where Management determines a project should be exempt from indirect cost recovery but does not meet any of the current authorized guidelines. For example, we noted one project in our sample was for emergency repairs. Since this project may qualify for FEMA overhead reimbursement, charging indirect cost to FHWA could result in recovery from two federal agencies for the same costs. The decision to not charge indirect cost to FHWA was documented and approved by the Deputy Secretary for Finance and Administration. However, we noted that there is not a formal process for documenting the request for additional exemptions and requesting approvals. A formal process also provides reasonable assurance that exemptions are granted to similar parties in a fair and equitable manner.

Management Action Plan (MAP) 6.2 P1	
<p>Develop a formal process for documenting the need for additional exemptions and requesting approvals from the appropriate level of authority.</p>	
MAP Owner:	Director of Program Controls
Division	Program Controls
Scheduled Date:	Completed September 30, 2017

APPENDIX A

RISK SCORING MATRIX

Risk significance is rated on a scale of 1 (lowest) to 25 (highest) and is the product of the risk consequence score (1 to 5) multiplied by the risk likelihood score (1 to 5). Risks scoring 4 and below are within Management’s risk appetite and require no further risk management. The following matrix provides a color scale corresponding to risk significance scores.

Likelihood	Frequent or Almost Certain	3-5 Low	10-13 Medium	14-17 Med-High	18-21 High	22-25 Extreme
	Likely	3-5 Low	6-9 Med-Low	10-13 Medium	14-17 Med-High	18-21 High
	Possible	3-5 Low	6-9 Med-Low	6-9 Med-Low	10-13 Medium	14-17 Med-High
	Unlikely	1-2 Minimal	3-5 Low	6-9 Med-Low	6-9 Med-Low	10-13 Medium
	Rare	1-2 Minimal	1-2 Minimal	3-5 Low	3-5 Low	3-5 Low
		Incidental	Minor	Moderate	Major	Extreme
		Consequence				