



Internal Audit Report: Changes to Select Contract Terms and Conditions (2018 Flexible Work Plan Update)

Date: February 26, 2019
To: Audit and Risk Management Committee
From: Head of Internal Audit

Summary

During 2018, as Internal Audit began to identify potential construction and consultant contracts to review, the following changes to certain TTC contract terms and conditions were noted:

- A revised 'Records and Audit' clause in construction contracts that has eliminated TTC's ability to gain access to third party records for purposes of substantiating contractor claims and change orders under certain conditions, i.e., when settled as lump sum or negotiated amounts. This means the majority of TTC construction contract changes can not be verified through an independent audit of contractor supporting documentation. Since 2015, the majority (75%) of all contract changes have been settled as lump sum and negotiated amounts, valued at almost \$99 million. The revised clause is not consistent with such benchmarked comparisons as the City or Toronto, Metrolinx and Ministry of Transportation.
- The removal of the lump sum contract change valuation methodology and cost break-down framework from the contract document, as well as, the exclusion from the contract of the requirement that a contractor's submitted estimates and acceptance of a lump sum will be subject to the provision of supporting documentation. This leaves the negotiation process susceptible to inconsistencies and abuse. Also, if the expected cost elements and maximum mark-ups are not embedded in the contract, the extent of recourse and retribution available to TTC may be limited if questionable costs are determined through the audit process to have been inappropriately paid, or if a contractor is found to have negotiated with TTC representatives in bad faith.
- The elimination of maximum mark-ups stipulated in consultant contracts exposes TTC to excessive consultant fees. By paying all-inclusive billing rates, consultant firms are estimated to be earning profit margins ranging from 48% to 65% for the individuals/positions provided, which over the life of a consultant contract, can substantially escalate the overall contract costs. There is also no mechanism for reducing billing rates for those consultants working the majority of time on TTC premises to reflect less overhead being incurred by their firm. The market

conditions and justification for these high billing rates are not intuitive or explicitly evident, rendering the commercial value of the services provided questionable.

These changes were made after consultation with the construction industry and internal TTC stakeholders to promote more flexibility within construction contracts and to improve the overall quantity and quality of bidders received by the TTC. The internal Working Group tasked in 2014/15 to focus on finding the means to encourage more contractors to bid on TTC contracts reviewed and approved these changes as evidenced by action logs and tracking sheets.

In our opinion, revisions made to select construction and consultant contract terms and conditions should be revisited to ensure they are achieving their intended purpose while limiting TTC's risk exposure to excessive cost escalation and poor value for money.

Strong contract management, including change control over master contract templates, is an important element of commercial management. Going forward, Executive management needs to fully appreciate the impact of proposed changes to key contract terms and conditions prior to implementation. Benchmarking exercises should be completed and results documented as part of the proposed change evaluation process. Finally, clear rationale for final contract clause language, an assessment of related risks and the assumption of any residual risks associated with contract revisions needs to be documented and aligned to any existing and newly developed TTC commercial management policies.

Executive Management has acknowledged its need to ensure appropriate controls and risk mitigation measures are in place to improve TTC's transparency in decision making and ability to control costs. A Management Action Plan (MAP) will be prepared to address Internal Audit's observations and identified risk/control gaps and presented at a future Audit and Risk Management Committee (ARMC) meeting for discussion and evaluation.

Recommendations

It is recommended that the TTC Audit and Risk Management Committee:

1. Receive the Internal Audit Report: Changes to Select Contract Terms and Conditions (2018 Flexible Audit Plan Update) for information.
2. Forward a copy of the Internal Audit Report: Changes to Select Contract Terms and Conditions (2018 Flexible Audit Plan Update) to the TTC Board for information.

Financial Summary

The recommendations in this Report have no additional funding implications beyond the costs of the Internal Audit Department that were included in the 2018 Operating Budget and approved by the TTC Board on November 28, 2017.

Equity/Accessibility Matters

There are no accessibility or equity impacts associated with this report.

Decision History

The Internal Audit Department identified in its 2018 Flexible Audit Work Plan, approved by the Audit and Risk Management Committee (ARMC) on February 15, 2018, its intention to review a selection of capital projects and contracts. The Department is required to provide the ARMC with an update on the status of planned assurance projects.

[http://www.ttc.ca/About the TTC/Commission reports and information/Commission meetings/2018/February 15/Reports/6 TTC Internal Audit 2018 Flexible Audit Work Plan.pdf](http://www.ttc.ca/About%20the%20TTC/Commission%20reports%20and%20information/Commission%20meetings/2018/February%2015/Reports/6%20TTC%20Internal%20Audit%202018%20Flexible%20Audit%20Work%20Plan.pdf)

Issue Background

Prior to departmental headcount reductions in 2012, Internal Audit was able to dedicate a level of staff resources to the completion of a comprehensive capital audit work plan. In doing so, much audit focus was given to assessing third party adherence to certain terms and conditions stated in contracts, as well as, substantiation of project expenditures and deliverables. Depending on the capital project/program selected, attention was also given to reviewing the efficiency and effectiveness of TTC construction inspection and quality control processes, estimating and budgeting controls, scheduling and progress reporting, and overall project management.

In March 2015, TTC was directed by City Council to conduct an independent review of the TTC's Capital Program Delivery. The Study was completed in 2016 and an action plan for implementing recommendations put forth in 2017. During this period of time, Internal Audit effectively took a hiatus from completing any extensive capital audit work as it awaited the results of the Study.

In Q2 2018, Internal Audit commenced capital audit work to verify and substantiate construction contract change expenditures and consultant fee payments. This work typically involves reviewing third party construction/consultant records and comparing actual costs paid to submitted contractor cost break-downs or stated consultant billing rates. Audit results and noted trends associated with third parties can then be used by TTC management to: supplement contractor/consultant performance evaluations and internal reviews; support claw-backs due to errors and noncompliance if deemed appropriate; and assess whether effective commercial management policies are in place and value for money has been achieved. Past audit work was conducted in accordance with a standard 'Records and Audit' clause embedded in the contracts.

As Internal Audit began to identify potential construction and consultant contracts to audit, changes to certain TTC contract terms and conditions were noted that prompted a more detailed review.

Comments

The objective of our audit was to review the rationale, impact and related risks introduced by the changes made to the following three construction and consultant contract clauses in 2014/15:

- Records and Audit (construction contracts)
- Valuation of Changes in the Work (construction contracts)
- All-Inclusive Billing Rate Calculation (consultant contracts)

Comparisons were made between old and revised TTC contract language and benchmarked with other agencies, including City of Toronto, Metrolinx and the Ministry of Transportation. Construction Document Committee (CDC) minutes and other available documentation were reviewed and discussions with key TTC stakeholders from Legal, Materials and Procurement (M&P) and Engineering and Construction (ECE) were conducted.

The Terms of Reference for TTC's Contract Documents Committee (CDC) state "the purpose of the Contract Document Committee is to ensure that tender and proposed documents and procurement practices used for contracts reflect the TTC requirements in concise, consistent and effective terms in consideration of the most current industry standards and practice while guaranteeing the best interest of the TTC is served." However, the CDC is not currently governed by any internal reporting structure and was not active for the period during which Working Group sessions were held. As such, the rationale for final contract language revisions, assessment of related risks and assumption of residual risks were not clearly documented.

A detailed report has been provided to Executive Management to provide further information on the results of our audit.

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