



# **Metropolitan Saint Louis Sewer District**

## **Overhead Rate Review**

**October, 2014**

This report is intended solely for the use of The Metropolitan St. Louis Sewer District ("MSD") and is not intended to be and should not be used by any other parties without the prior written consent of MSD.

# The St. Louis Metropolitan Sewer District Overhead Rate Review

October, 2014

## Table of Contents

Introduction .....	2
Scope and Objectives .....	3
Methodology.....	4
Results and Conclusions.....	6

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## INTRODUCTION

The Metropolitan Saint Louis Sewer District (MSD) is planning for major construction over the next several years as part of the Capital Improvement and Replacement Program (CIRP). MSD plans to issue multiple contracts for this work. As part of each contract's terms and conditions, companies submit overhead rates that are applied to the direct labor costs invoiced to MSD. Management requested that Internal Audit (IA) review and report on the overhead rate structures for the following engineering companies and their subcontractors:

- **Shannon & Wilson, Inc.** - a geotechnical engineering and environmental consulting service provider that operates primarily in the US to provide construction management (CM) services.
- **Black & Veatch** - an engineering, consulting, and construction company that provides design work and construction management services under separate contracts.
  - Subcontractors (CM contract):
    - **Kwame** - a Saint Louis based construction management company.
    - **URS** - an engineering, construction, and technical services organization.
- **KAI Design & Build** - a design and build provider that offers architecture, engineering, and program management/construction management services primarily in the US.
  - Subcontractors (CM contract):
    - **CH2M Hill** - a consulting, design, design-build, operations and program management corporation.
    - **URS** - an engineering, construction, and technical services organization.
- **Burns and McDonnell** - an employee-owned engineering firm employed to provide engineering and engineering-related support to MSD.
- **Parsons** - an engineering, construction, technical and management services firm is 100% owned by their Employee Stock Ownership Trust. Parsons provides design/design-build, program/construction management, and other professional services.

Overhead rates are a major cost component of each contractor's billing rates. The CIRP is a multi-billion dollar, multi-year plan and small deviations in overhead rates can have a substantial cumulative financial impact on the total project cost. As such, Management would like a level of assurance that the overhead rates are reasonable and equitable.

Procedures to review the overhead rates were performed by IA primarily in November and December of 2013, with additional work occurring throughout the spring and summer of 2014.

## SCOPE AND OBJECTIVES

The purpose of the overhead rate review was to ensure that the calculations used in arriving at the overhead rates are based on allowable costs, that those costs are properly allocated, and that the overhead cost components are applied in a proper and accurate manner.

During the engagement, IA placed a heavy focus on the field rate for each contractor, especially for the contractors providing construction management services. Field rates are used for projects in which a contractor's employees do not work out of their own offices and do not receive office support in their day-to-day work activities. The time billed for these employees normally does not qualify for a contractor's full overhead rate. Field rates are generally used to pay for the contractor's employees' fringe benefits, employee supervision and management, and home office administrative support that are provided in support of the field employees. Federal Acquisition Regulation (FAR) 31.203(f) states, "Separate cost groupings for costs allocable to offsite locations may be necessary to permit equitable distribution of costs on the basis of the benefits accruing to the several cost objectives."

The scope of the review encompassed 2013 overhead rates, which were calculated using financial results from fiscal 2012.

## METHODOLOGY

To accomplish the objectives of this engagement, IA reviewed audit reports submitted by the contractors from transactional level audits of overhead rates performed by the contractors' external Certified Public Accounting firms as well as additional financial data provided by the contractors.

IA's review was conducted using summary financial and account-level information. The review methodology was designed to provide reasonable assurance that the contractors were providing overhead rates consistent with the accounting information submitted for review.

The total FAR allowed cost associated with personnel not engaged on the project and corporate-related allowed support costs (i.e., non-direct costs and/or non-direct labor) are the primary factors influencing overhead rates. In addition, the quality of a contractor's accounting and cost tracking systems and the accuracy of their accounting entries can affect the overhead rate calculations. The contractors' third-party audits are intended to mitigate this concern.

Utilizing the documentation provided by the contractors, IA:

- Reviewed the submitted overhead rates and the methodology behind the calculations
- Traced charges from the trial balance or general ledger to the reported overhead categories
- Reviewed the unallowed amounts for conformity with FAR 31
- Re-performed calculations and compared results to amounts contained in the submitted audited schedules
- Identified potential non-compliance or potential duplicate costs

No single calculation method can necessarily accommodate all contractors since the contractors have different corporate and accounting structures, cost categorization structures, and methodologies. As a result, it was necessary to adapt the process and approach for reviewing the overhead rate calculations for each contractor.

The following cost categories were reviewed to the extent practicable from the data submitted by the contractors:

- Acquisition Costs
- Leased airplanes
- Taxes
- Lobbying
- Goodwill
- Subscriptions
- Charitable Donations
- Insurance
- Bad debts
- Interest
- Expenses allocated from the parent
- Fines and Penalties
- Travel
- Business Meals
- Entertainment
- Employee Training
- Vehicle Expenses
- Recruiting and Relocation
- Marketing
- Public Relations
- Advertising
- Memberships
- Executive Compensation
- Labor Fringe Rates including Pension Plans, Insurances, Payroll Taxes and bonuses

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## METHODOLOGY (CONT'D)

To gain an understanding of the items that are provided by MSD for each contractor at the various field sites, IA participated in a tour of a typical job site. Based on this tour, it was determined that MSD, in some cases, is responsible for providing or covering the costs for job site items such as trailers for office space, computer equipment, telephones, internet service, furniture, utilities, office supplies, vehicles, travel expenses, postage etc. Since MSD is responsible for providing or covering the costs of such overhead items, it follows that such costs should be excluded from the overhead cost pool and the overhead rate calculation. As a result, Engineering, along with IA personnel, held meetings and discussions with the various contractors to discuss the potential reduction or elimination of certain overhead costs from the cost pools.

***The contractors' cost accounting information is confidential and the use of such information is confined to the work papers associated with this engagement. Missouri Sunshine Laws are applicable to MSD. Except to the extent disclosure is otherwise required by law, MSD is authorized to close records relating to confidential or privileged communications with its auditor, including all auditor work products. MSD considers this report to be an open public record. However, the associated work papers are confidential and closed to the public.***

## RESULTS AND CONCLUSIONS

**Shannon & Wilson, Inc.** – To the extent that MSD is providing the facilities, equipment, supplies, etc. required to support a field office, consideration should be given to adjusting the overhead rate to reflect those costs absorbed by MSD. Based on the information provided by the contractor and IA's resulting calculation, a rate reduction of 8.6 percentage points was recommended by IA.

As mentioned above in a previous section, discussions were held with each contractor. In the case of Shannon & Wilson, **a reduction of 8.6 points was agreed upon through these discussions.**

**Black & Veatch (B & V)** – Being an international firm with multiple affiliates, B & V's overhead costs include allocations from the parent company. Black & Veatch (B&V) calculates overhead rates for both office and field based labor.

It was noted that B & V will not be operating in the field until 2016. As such, only their office rate is currently applicable.

IA recommends that MSD accept the current office rate as presented; however, the field rate to be utilized for 2016, when developed, will require a review by IA.

**KAI** – To the extent that MSD is providing the facilities, equipment, supplies, etc. required to support a field office, consideration should be given to adjusting the field rate to reflect those costs absorbed by MSD. Based on the initial information provided by the contractor and IA's resulting calculation, a rate reduction of 11.97 percentage points was recommended by IA.

As mentioned above in a previous section, discussions regarding rate reductions were held with each contractor. In the case of KAI, the contractor presented additional information. Based on the additional information and discussions, **Management and IA along with the contractor agreed that a rate a reduction of 4.58 points, instead of 11.97 points, would result in a reasonable and adequately supported rate.**

**Burns and McDonnell** – Per discussions with Burns & McDonnell (B&M) they will be providing design and engineering services but not construction management for MSD. Essentially all of their work will be performed at B&M's offices and only a minor amount of work has the potential to be done in the field. Our understanding is that B&M is routinely audited for compliance to FAR since they pursue contracts with the U.S. government and various state agencies.

Based on the information submitted by B&M and the nature of their engagement with MSD, the overhead rates for B & M appear to be reasonably supported. As such, no recommendations are provided.

## RESULTS AND CONCLUSIONS (CONT'D)

**CH2M Hill** – CH2M Hill Engineers (CHE) is the corporate non-federal entity that contracts with MSD. As such, the home office and field rates reflect adjustments to CHE's overhead rate for FAR look-alike purposes. CHE does not have a published Field Overhead Rate, but CHE has proposed a project-specific Field Overhead Rate. To the extent that MSD is providing the facilities, equipment, supplies, etc. required to support a field office, consideration should be given to adjusting the field rate to reflect those costs absorbed by MSD. Based on the initial information provided by the contractor and IA's resulting calculation, a rate reduction of 11.43 percentage points was recommended by IA.

As mentioned above in a previous section, discussions were held with each contractor. In the case of CH2M Hill, the contractor presented additional information and represented that their rate as presented is reflective of their arrangement with MSD. Based on the additional information and discussions, **Management and IA agreed that the rate as presented was reasonable and a reduction would not be necessary.**

**Kwame** – To the extent that MSD is providing the facilities, equipment, supplies, etc. required to support a field office, consideration should be given to adjusting the field rate to reflect those costs absorbed by MSD. Based on the information provided by the contractor and IA's resulting calculation, a rate reduction of 11.87 percentage points was recommended by IA.

As mentioned above in a previous section, discussions were held with each contractor. In the case of Kwame, **a reduction of 11.87 points was agreed upon through these discussions.**

**URS** – To the extent that MSD is providing the facilities, equipment, supplies, etc. required to support a field office, consideration should be given to adjusting the field rate to reflect those costs absorbed by MSD. Based on the information provided by the contractor and IA's resulting calculation, it appears that a reduction of 5.67 percentage points would be appropriate.

As mentioned above in a previous section, discussions were held with each contractor. In the case of URS, the contractor presented additional information and represented that their rate as presented is reflective of their arrangement with MSD. Based on the additional information and discussions, **Management and IA agreed that the rate as presented was reasonable and a reduction would not be necessary.**

**Parsons** – Parsons was reorganized since our last audit. Parsons Water & Infrastructure (PWI) is now part of a larger corporate entity, Parsons Environment & Infrastructure (PEI). While not FAR compliant, PWI simulated their previous corporate structure by allocating costs based on direct labor. The corporate restructuring resulted in decreases to both home office and field overhead rates from what was previously experienced. Parsons work is entirely home-office based. As such, only Parsons' office rate was reviewed. Based on the information provided by the contractor and IA's resulting calculation, a rate reduction of .75 percentage points was recommended by IA.

As mentioned above in a previous section, discussions were held with each contractor. In the case of Parsons, **a reduction of .75 points was agreed upon through these discussions.**