State of California
DEPARTMENT OF TRANSPORTATION

Business, Transportation and Housing Agency

Memorandum

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To: GREGG ALBRIGHT
Deputy Director
Planning & Modal Programs

Date: August 22, 2006

File No.: P1700-1586
P1180-0041

From: DEPARTMENT OF TRANSPORTATION
Audits and Investigations

Subject: Fourth Prequalification Follow-Up – North Coast Railroad Authority

We have completed a fourth follow-up prequalification audit of the North Coast Railroad Authority's (NCRA) financial management system. We also completed a post audit of costs reimbursed under Program Supplement No. 01A0045-06 between the Department of Transportation (Department) and NCRA. Prior to this report, our office issued prequalification audit reports dated February 13, 1998, May 27, 1998, August 27, 1998, and July 13, 2000. In these reports, deficiencies related to NCRA's financial management system necessary to assure compliance with state and federal rules and regulations and contract provisions were identified. This engagement was performed in response to NCRA's request for allocations of Traffic Congestion Relief Program funds totaling $940,000. NCRA's management is responsible for maintaining an effective financial management system to meet the criteria in agreements with the Department. The criteria include, but are not limited to, the Code of Federal Regulations (CFR) 49, Part 18, Office of Management and Budget Circular (OMB) A-87, Generally Accepted Accounting Principles (GAAP) and contract provisions. NCRA is also responsible for ensuring compliance with contract provisions and state and federal regulations related to Program Supplement 01A0045-06. Our responsibility is to express an opinion on whether NCRA's financial management system is capable of accumulating and segregating reasonable, allocable, and allowable project costs and whether costs reimbursed comply with the above referenced criteria.

Our audit was conducted in accordance with the Performance Standards set forth in the Government Auditing Standards issued by the Comptroller General of the United States of America. The audit was less in scope than an audit performed for the purpose of expressing an opinion on the financial statements of NCRA. Therefore, we did not audit and we are not expressing an opinion on NCRA's financial statements.

The standards require that we plan and perform the audit to obtain reasonable assurance about whether the data and records reviewed are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the data and the records reviewed. It also includes assessing the accounting principles used and significant estimates made by NCRA, as well as evaluating the overall presentation. We believe our audit provides a reasonable basis for our opinion.

The scope of the prequalification audit was limited to financial and compliance activities. The audit consisted of a review of NCRA's Policies and Procedures Manual (P&P), interviews with applicable personnel, tests of NCRA's financial management system and financial records as of May 26, 2006, and an evaluation of compliance with the above referenced criteria.

The scope of the post audit was also limited to select financial and compliance activities. We tested on a sample basis, evidence supporting the amounts and disclosures in the data and records supporting costs billed by and reimbursed to NCRA totaling $435,243 for the period November 1, 2003 (Invoice #15) through May 26, 2006, for compliance with contract provisions and state and federal regulations.

Accounting system changes subsequent to May 26, 2006, were not tested and, accordingly, our opinion does not pertain to changes arising after this date. Our audit included such tests, as we considered necessary, to accomplish the following audit objectives:

- Determine whether NCRA's financial management system is capable of accumulating and segregating reasonable, allocable, and allowable project costs.

- Determine whether the recommendations set forth in our prior prequalification audit report dated July 13, 2000, were implemented.

- Determine whether project costs billed and reimbursed totaling $435,243 during the period November 1, 2003, through May 26, 2006, are reasonable in nature and amount, are adequately supported, and are allowable in accordance with contract provisions and state and federal regulations.

Due to 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 due to changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

Many of the issues below were discussed with NCRA's Executive Director several times during the engagement. A teleconference was also held to discuss the audit findings with the Executive Director on June 9, 2006. On June 28, 2006, a draft audit report was presented and discussed with NCRA and Department Management. A formal written response dated July 25, 2006 was received from NCRA in response to the draft audit report. We considered NCRA's response prior to report finalization. Accordingly, we revised our reported findings and recommendations to reflect NCRA's response where necessary. We also included excerpts from NCRA's response and our analysis of the response in this report. A copy of NCRA's response is attached in its entirety for additional information (See Attachment IV).

AUDIT RESULTS

In our opinion, NCRA has made little progress towards resolving the weaknesses described in previous audit reports and continues to demonstrate financial instability. The prior reports included findings pertaining to NCRA's accounting system, project costing system, and internal controls. While we continue to have these same concerns, we also identified weaknesses in the areas of property management, contract management, procurement and reliability of reports submitted by NCRA to the Department and the California Transportation Commission (CTC). In addition, the post audit identified $2,286.48 in unallowable costs.

NCRA has implemented an accounting system, maintained by Sonoma County, which appears to have the ability to segregate and accumulate reasonable, allocable and allowable projects costs. However, since NCRA does not use the payroll system to record direct project hours and the current chart of accounts does not allow for the identification and segregation of unallowable costs from allowable costs, the current accounting system is not utilized to accumulate and segregate costs as required under state and federal regulations. Also, instead of maintaining accounting records in accordance with GAAP, NCRA's accounting records are maintained on a cash basis during the fiscal year and subsidiary ledgers are not maintained. Therefore, during the fiscal year, financial records such as accounts receivable and accounts payable account balances were not current. To achieve compliance with contract provisions requiring that NCRA maintain an accounting system that enables the determination of incurred costs at interim points of completion, NCRA should maintain its accounting records in accordance with GAAP including subsidiary records to account for liabilities and receivables during the year.

We also determined that NCRA has not implemented an inventory system even though inventory purchases exceeded $695,000 this fiscal year; has a Board approved Policy and Procedures Manual (P&P) but has yet to implement it; and of additional concern, had a conflict of interest involving the current NCRA project manager.

Given the results of our audit, as detailed in the audit findings below and the attachments to this report (see Attachments I - III), it is our opinion that all funding should be withheld from NCRA until NCRA has satisfactorily addressed project management and technical oversight concerns, resolved its financial management system weaknesses, fully implemented their established P&P, identified the procedures and steps taken to address the other issues identified in this report, and demonstrated compliance with applicable laws and regulations.

NCRA should continue to be treated as a "High-Risk" recipient of state and federal funds based on CFR 49 Part 18.12, due to its history of financial instability, history of unsatisfactory performance, failure to conform to the terms and conditions of previous awards and noncompliance with the management standards set forth in CFR 49 Part 18.

NCRA should submit a plan to the CTC and the Department that details NCRA's plan to address the issues identified in this report and a date certain when the corrections will be implemented. This plan should be signed by the Chairman of NCRA's Board of Directors.

NCRA's Response
NCRA agreed with all audit recommendations set forth in the June 28, 2006 draft audit report. NCRA's Corrective Action Plan provides a detailed approach to addressing all of the findings and states that tasks necessary to satisfy 20 of the 29 findings and recommendations cited in the June 28, 2006 draft audit report is believed completed. NCRA has a plan to address the remaining nine issues in anticipation of a follow-up audit by Audits and Investigations in December 2006.

Specifically, NCRA stated, in part, "Through the adoption of the Corrective Action Plan and the Management Implementation Plan, it is NCRA's goal to fully comply with all of the aforementioned local, state, and federal requirements regarding the use of public funds." NCRA further stated, "While the NCRA takes the recommendations made by the Department of Transportation, Audits and Investigations very seriously, and has taken action to comply fully with its intent, the conclusion that the CTC should withhold project approval and funding is not commensurate with the findings of the June 28, 2006 Fourth Prequalification Follow-up Audit."

Auditor Evaluation
We commend the NCRA Board of Directors and staff on the positive steps taken to address the audit findings identified in the draft audit report. However, until sufficient transactions are processed in response to NCRA's Corrective Action Plan, validation that the actions by NCRA to resolve the deficiencies listed in this report is not possible. Therefore, until NCRA has a history of compliance with their P&P as well as state and federal regulations and provides sufficient evidence that the findings set forth in this report are resolved, we continue to recommend that NCRA remain a high-risk recipient of state and federal funding and that all funding be withheld.

Finding 1 - Project Manager Conflict of Interest
During our audit, there was a functional conflict of interest impairment with NCRA's project management. In their response, NCRA informed us that this impairment is now resolved. However prior to this action, NCRA utilized a subcontractor to its current engineering consultant (prime contractor) to perform NCRA's project management duties. There was a conflict in that the person developing and recommending the scope of work and estimates for NCRA was also a subcontractor working for NCRA's prime contractor, which will be performing the work. In prior audits, we also identified concerns that NCRA lacked staff to perform technical oversight over projects.

NCRA had no independent method to verify the reasonableness of the project management consultant work. As such, the work situation provided an increased risk for inflated scopes of work, estimated hours, and costs.

49 CFR 18.36 (b) (3) states, "No employee, officer or agent of the grantee or subgrantee shall participate in selection, or in the award or administration of a contract supported by Federal funds if a conflict of interest, real or apparent, would be involved. Such a conflict would arise when (i) The employee, officer, or agent, (iv) An organization which employs, or is about to employ, any of the above, has a financial or other interest in the firm selected for award." Also, OMB A-87, Attachment A. C. 2. Reasonable Costs states "In determining reasonableness of a given cost, consideration shall be to b. The restraints or requirements imposed by such factors as: sound business practices; arms length bargaining; Federal, State and other laws and regulations."

Recommendation:
NCRA should hire a project manager or procure a project manager independent of the current on-call engineering consultant.

NCRA's Response:
NCRA concurred with the recommendation and will procure an independent project manager within the next six months. Until a long term contract is procured for these services, NCRA entered into a short term contract for these services to eliminate the conflict of interest concern.

NCRA also recommended a change in the audit statement wording.

Auditor Evaluation:
We modified the wording of this finding to reflect that NCRA addressed the conflict of interest concern for the immediate future.

Finding 2 - Procurement
NCRA has not resolved the outstanding procurement audit findings reported in previous audit reports. NCRA has not established procedures to ensure compliance with NCRA's established procurement P&P and federal contracting regulations when procuring services.

During our audit, we sampled and reviewed the procurement of three consultants for compliance with 49 CFR Part 18.36 and NCRA's P&P. All three procurements were for non-emergency work of under $100,000 and, therefore, qualified as small purchase procedures under 49 CFR Part 18.36 (d) (1). (See Attachment I for further criteria). Within our sample, we found that:

- There is no documented evidence that NCRA followed Chapter 1205.1 of their P&P that required at least three competitive bids or proposals for each contract.

- In all three cases small purchase procedures could have applied, however procurement of the three contracts resulted in non-competitive procurements. 49 CFR Part 18.36 (d) (4) requires that non-competitive procurements must be infeasible under small purchase procedures, sealed bids or competitive proposals and that one of the four other circumstances identified in this section applies.
- The minutes of Board meetings did not document that the Board of Directors approved the three sole source contracts as required by NCRA's P&P Chapter 1212.
- NCRA reimbursed two of the consultants for costs without a valid contract. It also appears that NCRA reimbursed a consultant for work performed prior to contract execution. 49 CFR Part 18.36 – Procurement – states that "Grantees and subgrantees will maintain a contract administration system which ensures that contractors perform in accordance with the terms, conditions, and specifications of their contracts or purchase orders."
- One consultant provided the contract boilerplate that was accepted and used by NCRA despite the fact that contract provisions required by NCRA's P&P (Chapters 1105, 1106.3 and 1215) were missing from the contract. NCRA provided contract documents that failed to identify significant information such as beginning dates, termination dates and procedures, contract limits, rights to audit, record retention provisions and signatures by NCRA and the consultant.

The findings illustrate a material weakness in NCRA's internal control structure. The awarding of work without adequate competition could result in increased costs to an agency that is continually facing financial constraints. The failure to follow federal regulations in the procurement of services can result in the disallowance of federal and state participation in the contract costs, which can result in further strain on NCRA's financial stability.

Recommendation:
NCRA should:

- Terminate the consultant contracts identified above and procure the services in accordance with federal regulations and NCRA's P&P.

- Ensure that federal regulations and NCRA's P&P are followed for all future procurements.

NCRA's Response:
NCRA concurred with the recommendation and has terminated all three contracts.

Auditor Evaluation:
NCRA concurred with the recommendations, no further evaluation required.

Finding 3 - Contract Management

We identified material weaknesses in the contract management oversight practices followed by NCRA, despite prior audit recommendations for NCRA to implement an adequate contract management system.

We initially identified that NCRA paid excessive interest totaling $11,979.71 to a contractor. Based on NCRA's response to the draft audit report that included more complete information, it appears that NCRA owes the contractor $1,788.05 through June 30, 2006. The contract in question did not provide for an interest charge for late payments. However, NCRA paid interest charges of 8% and, in one instance, 108% to the contractor. NCRA's Executive Director explained that the interest was paid due to the Prompt Payment Act of the California Government Code Section 927 and, based on legal advice NCRA was obligated to make the payments.

Government Code 927 requires interest to be paid at one percent over the Pooled Money Investment Account (PMIA) as of June 30th of the prior year. The interest calculations were for invoices billed during the 2006 fiscal year (FY), therefore the correct interest rate to use was the PMIA for June 30, 2005, a rate of 2.256 percent. Therefore, the correct interest rate for the late payments was 3.256 percent.

Also, NCRA over billed the Department $1,739.48 under Program Supplement 01A0045-06 and incorrectly reimbursed contractors for $550 of insurance costs that the contract provisions specifically did not allow. Subsequent to our notification of the unallowable amounts identified during the audit, NCRA reimbursed the Department $1,739.48. These findings follow an interim audit of the same Program Supplement in which the audit disallowed $63,560 in costs due to improper contract management by NCRA.

Recommendation:

NCRA should:

- Reimburse the contractor $1,788.05 for interest due as of June 30, 2006.
- Reimburse the Department $550 in audit findings for Program Supplement 01A0045-06.
- Identify and implement procedures to ensure that adequate contract management occurs in the future.

NCRA's Response:

NCRA states that the $11,979.71 in overpaid interest referenced by the Auditors is not accurate. The highest level of overpayment at any give time was $9,367.72 in November 2005, but the mistake was detected within the month, and by December 2005 the overpayment was used to credit new interest billings. The credit was entirely applied in March 2006, prior to the Caltrans audit, and no further interest payments were made by NCRA to the contractor.

To date NCRA has paid the contractor $10,268.35 and, per the Prompt Payment Act, owes the contractor an additional $3,147.24 through June 30, 2006.

Auditor Evaluation:
NCRA's response did not address the cause of the overpayment of interest and how NCRA will ensure that overpayment in the future will be avoided. Also, the statements made by NCRA regarding the interest due and balances due are incorrect. NCRA's interest calculation schedule is incorrect, stating that the balance due as of June 30, 2006 is $3,147.25 when we believe the correct balance as of June 30, 2006 is $1,788.05. Specifically, we found:

- Incorrect payment dates used
- Calculation based on invoice date and not invoice received date
- Payment totaling $1,324.63 excluded from interest calculations
- Incorrect interest calculations

After receipt of the June 25, 2006 response, NCRA submitted a revised interest calculation and outstanding balance spreadsheet based on inquiries made by our office. A review of the revised spreadsheet identified additional errors and miscalculations.

NCRA is required to make interest payments without the contractor submitting invoices. Per Government Code 927.6, (a) NCRA is liable for interest payments without the contractor submitting an invoice. However, NCRA has not made interest payments even though interest payments were due and are growing per their own analysis since April 2006 to a balance of $1,788.05 as of June 30, 2006.

NCRA's response did not address $550 of the $2,289.48 due the Department related to Program Supplement 01A0045-06. NCRA has reimbursed the Department for $1,739.48 of the disallowed costs but a balance of $550 remains to be repaid.

<u>Finding 4 - Financial Condition</u>
Consistent with prior audit reports, we continue to have concerns pertaining to NCRA's financial condition.

NCRA reported operating losses net of depreciation expenses for Fiscal Year (FY) 2004-05 of $455,776, FY 2003-04 of $827,277 and FY 2002-03 of $679,811. In projections provided to the CTC, NCRA, assuming rail operations, expects net losses for this fiscal year and for six of the next nine years. Without rail operations, NCRA projects losses for this year and the next nine years.

Given a lack of funding, NCRA requested and received extensions for long-term liability payments due. In December 2004, NCRA obtained a $170,000 loan to remain cash solvent. Our review of NCRA's FY 2005-06 payments found that at least six payments were made late and/or costs were incurred due to late payments.

In our July 13, 2000 audit report addressing financial reporting, we recommended that the balances presented in the general ledger be presented in accordance with GAAP for the current period and all known liabilities be identified. Despite this recommendation, NCRA does not have subsidiary payable and receivable ledgers to document the actual receivables and liabilities of NCRA during the year. It is not until the end of the year that NCRA's independent auditor makes adjustments to record unrecorded liabilities and receivables. Without performing a search for unrecorded liabilities, we became aware of unrecorded liabilities with a value of over $90,000 as of February 2006. Approximately $20,000 of this amount was subsequently paid. The remaining balance and other unrecorded liabilities go unreported to both the CTC and NCRA's Board of Directors. Based on this information, it is evident that NCRA's total liabilities and receivables are not documented until the fiscal year end despite financial instability throughout the year.

We also found that NCRA does not take all available actions to reduce their level of financial instability. For example, NCRA does little management of its property leases and rentals, its one consistent source of income (See Finding #7). Despite that NCRA's rail line has not operated in over four years, NCRA has not aggressively sought additional funding from its property leases/rentals and member counties. Instead, NCRA continues to rely on state and federal funding to resolve financial concerns.

Recommendation:
NCRA should:

- Within its currently required quarterly report, provide the CTC and the Department a status of management activities regarding lease and rental income.

- Aggressively seek funding support from county members and increased property leases/rental income.

NCRA's Response:
NCRA concurred with both recommendations. Beginning with the 2007 first quarterly report to the CTC, NCRA will include their activity on the management of property lease receivables and revenues. Also, the database used to track property leases will be updated, staff will receive training on QuickBooks and the database will be brought to full accrual basis by the second quarter of fiscal year 2007.

On April 14, 2006, NCRA sent letters seeking assistance from Public Works Departments, Councils of Government (COGS) and Work Force Investment Boards.

Auditor Evaluation:
We commend NCRA on the steps taken to obtain and account for property management lease revenue and to seek additional funding. We suggest that the responses received from the Public Works Departments, COG's and Work Force Investment Boards be included in NCRA Board meeting minutes to ensure full public knowledge of commitments to NCRA.

Finding 5 - Financial Management System

Internal Controls:
Our audit testing identified over $90,000 in transactions that were not authorized in accordance with established requirements. We found numerous transactions missing required signatures. Although NCRA's P&P do not document this requirement, we were told by NCRA's Executive Director and Administrative Assistant that the approval thresholds for payments were: $0 - $2,499, Executive Director approves; $2,500 to $4,999, Executive Director and one Board Member approves; and $5,000 and above, two Board Members approve. We also found that none of the transactions processed to reimburse the Executive Director's expenditures were reviewed or approved by a Board Member. Therefore, the Executive Director approved all of his own expenses. Additionally we found that NCRA does not consistently review the journal entries made by its Accountant, Sonoma County.

49 CFR Part 18.20 (b) (3) states that effective control and accountability must be maintained for all grant and sub grant cash, real and personal property and other assets. Grantees must adequately safeguard all such property and must assure that it is used solely for authorized purposes.

Internal control P&P are essential for ensuring the integrity of data processed by the accounting system and included in financial reports. Failure to properly design, implement and/or maintain P&P calls into question the integrity of the data processed by the accounting system and included in the financial reports.

Recommendation:
NCRA should:

- Establish in its P&P the approval authority thresholds for expenditures. This should include a requirement that all Executive Director expenditure claims be approved by an NCRA Board Member.

- Implement controls to ensure that all payments are properly authorized and withhold payment if proper authorizations are missing.

- Review all journal entries made by Sonoma County and approve them consistent with established authorization requirements within a set period of time.

NCRA's Response:
NCRA concurred with the recommendation. NCRA changed the thresholds for approval to $0 to $10,000, approved by the Executive Director. Expenditures above $10,000 must be approved by the Executive Director and one Board Member. In addition, a cash disbursement journal will be approved by the Board of Directors on a monthly basis.

NCRA will also review and approve all journal entries equal to or below $10,000 within one week and over $10,000 within two weeks.

Auditor Evaluation:
NCRA concurred with the recommendations, no further evaluation required.

Accounting System
The current use of a cash basis accounting system during the fiscal year without maintaining accounts receivable, accounts payable, property and inventory subsidiary ledgers results in inaccurate interim financial reports. It appears that the reports to the CTC were not adjusted during the year (expenses & revenue reported based on budget and not actual) and the reports to the NCRA Board of Directors are incomplete and therefore inaccurate since receivables issued and not collected and payables received and not paid go unreported during the year. Although we were not performing a financial statement audit, we identified two unrecorded liabilities that, as of February 2006, were over $90,000. It appears that NCRA's Board of Directors and the CTC were not apprised of the liabilities.

NCRA is not currently using the accounting system to record direct and indirect costs. For example, the current accounting procedures and records do not result in the consistent accumulation and segregation of direct and indirect costs. Also, as currently set up, the chart of accounts does not segregate allowable and unallowable expenditures.

Agreements between NCRA and the Department require that NCRA conform to GAAP, have an accounting system and records that properly accumulate and segregate incurred project costs, and enable the determination of incurred costs at interim points of completion and provide support for reimbursement payment vouchers or invoices.

Not having a fully functional and effective accounting system could lead to possible inaccurate or fraudulent reporting. For example, not having subsidiary ledgers resulted in the write off of $102,000 in accounts receivables and inaccurate interim financial reports to the NCRA Board of Directors and the CTC. The current accounting system procedures also increase the likelihood of inaccurate year-end financial reports.

Recommendation:
NCRA should:

- Maintain accounting records on an accrual basis of accounting during the year to ensure that financial reports presented to funding agencies reflect an accurate presentation of NCRA's financial condition.

- Establish and properly use subsidiary ledgers on an accrual basis during the year.

- Make the necessary modifications to the chart of accounts to allow the segregation of allowable and unallowable expenditures.

NCRA's Response:
NCRA concurred with the recommendations and will establish subsidiary ledgers on an accrual basis effective July 1, 2006. NCRA expanded their cost coding structure to isolate all direct and indirect costs centers and the account structure to include codes for unallowable costs. NCRA also stated that a search for unrecorded payables and receivables will be performed and the results reported to their accountant to ensure that NCRA's financial reporting is presented on an accrual basis in accordance with GAAP and will train staff to prepare such accrual documentation.

Auditor Evaluation:
NCRA concurred with the recommendations, no further evaluation required.

Inventory
As reported in prior audits, NCRA does not have an inventory system. NCRA currently has an inventory of signal equipment valued over $690,000. NCRA's current P&P do not include inventory procedures. Sound business practices, GAAP and federal guidelines require that an inventory system be in place when an entity has inventory.

OMB A-87, Attachment B. 26. Material and supplies costs. B. Purchase materials and supplies shall be charged at their actual prices, net of applicable credits. Withdrawals from general stores or stockrooms should be charged at their actual net cost under any recognized method of pricing inventory withdrawals, consistently applied.

If NCRA and/or future rail operators wish to use inventory and bill state or federal projects, an adequate inventory system must be implemented. Without an inventory system in place, job costing is not possible.

Recommendation:
NCRA should implement an inventory system to track the purchases and withdrawals of materials and equipment to and from inventory.

NCRA's Response:
NCRA concurred with the recommendation and stated that on July 11 an inventory system was implemented to account for the inventory of the signal equipment acquired with FEMA and OES funds. NCRA also stated that policy and procedures were included to ensure that the inventory will be safeguarded and properly reported in NCRA's financial reports.

Auditor Evaluation:
We commend NCRA on the implementation of an inventory system and look forward to auditing the system in the future. However, NCRA's inventory system should be used to account for all materials regardless of funding source.

Timekeeping
The NCRA timekeeping system does not currently segregate direct and indirect labor and is not used to distribute labor billings to its various programs. Therefore, there was no means to assess the accuracy of the labor system for billing purposes.

During our interviews and testing, we found that NCRA's Executive Director does not fill out his own timesheet and used two timesheets for the same time periods. (See Attachment I for criteria regarding timesheets).

Specifically, the Executive Director used a second set of timesheets to bill time to a Federal Emergency Management Agency (FEMA) project. This time was not recorded on the Executive Director's official timesheets. Also, on the second timesheet, the Executive Director only recorded time worked on the FEMA project. Time worked on other projects and administrative activities was not recorded. In monthly financial reports to NCRA's Board of Directors, the time charged to the FEMA project was not reported as labor costs but was reported as administrative costs, creating the possibility for inaccurate interpretations. We also found that NCRA's P&P do not require that the Executive Director's timesheets be approved by a Board Member.

The current NCRA timekeeping practices are additional evidence that the management and internal controls at NCRA do not provide reasonable assurance of compliance with regulatory requirements. The current practices would lead to the disallowance of all direct and indirect labor billed to contracts administered by the Department. Besides the fact that a timesheet is not prepared to account for all direct and indirect labor hours during the time period, the use of two or more timesheets could lead to double billings, billing for labor that is not for the actual work performed or no billing of labor.

Recommendation:
NCRA should:

- Implement NCRA's P&P on timekeeping to include the use of one timesheet to record all hours worked on all projects and indirect activities and ensure that all labor costs are properly recorded in the accounting system.

- Change the current policy to require that the Executive Director's timesheet be reviewed and approved by an NCRA Board Member.

NCRA's Response:
NCRA concurred with our recommendations and began implementing the P&P approach to timekeeping effective July 1, 2006. However, NCRA did not agree that a Board Member should sign the Executive Director's timesheet. NCRA stated that the Board of Directors is not in a position to verify the Executive Director's daily tasks and that it is not expected that the Executive Director will be charging any direct project time. However, NCRA stated that they are willing to add this step to their procedures.

Auditor Evaluation:
NCRA's Board of Directors is responsible to ensure the proper use of all public funds expended by NCRA and this includes the activities of the Executive Director. This responsibility is evidenced by a Board Member's signature on the Executive Director's timesheet.

Property Management
We found that NCRA is not effectively managing property leases and rentals. NCRA was unable to provide a comprehensive listing of available properties for lease or rent or an accounts receivable subsidiary to document lease/rent payments due that reconciles to the accounts receivable control account in the general ledger. NCRA was also unable to provide for each rent or lease, the rent/lease amount due, date of last billing, status of rent/lease due, the date of the last physical inventory and the most recent evaluation of fair market value.

NCRA P&P 0802.5 requires that from January to March of each year, every rental/lease account will be reviewed to identify any Consumer Price Index (CPI) increases or other increases; and that an accounts receivable list would be maintained to indicate which tenants have these increases written into their lease. NCRA does not have such an accounts receivable list. In addition, we were informed that reviews are not performed during the January to March timeframe as indicated within its policy. The current NCRA staff only review the lease files when it has time to determine which lessee needs to be billed for the index adjustments.

NCRA P&P 0802.8 states that a physical inventory of property would be taken every three years, that the physical examination would be recorded in QuickBooks, and that the worksheets used to take the inventory would be retained for audit purposes. NCRA could not provide physical examination records. In addition, QuickBooks was not utilized as required, and NCRA did not provide worksheets to support evidence that a physical inventory was performed.

Overall, we determined that NCRA has not implemented the P&P for property management. NCRA is not utilizing QuickBooks and it does not appear that NCRA's staff has concentrated efforts into the management of leases and rentals by identifying the universe of current leases and rentals and available property for lease and/or rental.

The ineffectiveness of NCRA's management over its leases and rentals resulted in the write-off of over $102,000 in accounts receivable at the end of FY 2004-05. GAAP prescribes that accounts receivable are to be aged and reviewed for collectability. If a determination is made of uncollectability, the individual accounts receivable should be reduced as bad debts or uncollectible. Given the inability to assess the validity of the accounts receivable account, our understanding is that NCRA wrote off all accounts receivable as uncollectible.

Recommendation:
NCRA should:

- Implement the established P&P on property management and dedicate staff time and resources to the proper management of property and the associated leases and rents.
- Maintain a system of record keeping and internal control to account for lease/rent revenue due and write offs of receivables.

NCRA's Response:
NCRA concurred with our recommendations.

Auditor Evaluation:
NCRA concurred with the recommendations, no further evaluation required.

<u>Capital Assets</u>
NCRA is not sufficiently managing the capital assets that are reported in its Financial Statements. According to the FY 2004-05 Financial Statements, NCRA has over $7.7 million in depreciable assets. However, NCRA was unable to identify where the assets were; assess the condition of the assets; provide other information such as a detailed description of the equipment; and identify information such as license number, or serial number. Based on NCRA's independent auditors, it was at least five years since the last physical inventory of the assets was performed.

Both NCRA's P&P and OMB A-87 require a physical inventory of assets every two years. NCRA has, over the years, disposed of equipment. It is not clear whether NCRA or NCRA's

Independent Auditor verified if the disposed equipment and vehicles were properly excluded from the capital assets presented in the financial statements and accounting records.

The lack of NCRA management oversight of capital assets weakens the organization's internal control system and increases the risk that assets are missing, are unusable and/or worthless, and otherwise incorrectly reported. Also, the proper valuation of capital assets is questionable as well as the value stated in the financial statements of NCRA, since the existence and condition of $7.7 million in capital assets is currently unknown.

Recommendation:
NCRA should:

- Fully implement the P&P on capital assets; perform a physical inventory documenting location, and condition; and identify features of each piece of equipment and all material listed as capital assets.

- Provide a report to the CTC and the Department that identifies all pieces of equipment purchased with state and federal funds and the disposition of that equipment, whether it is still usable, and whether it is still in the possession of NCRA. Any amounts due should be reimbursed to the Department.

- Ensure that NCRA's independent auditor observe the physical inventory taken prior to expressing an opinion on the financial statements.

- Account for all capital assets and report depreciation expense in accordance with the NCRA P&P requirements and the results of the capital asset inventory.

NCRA's Response:
NCRA states that a mid-year inventory with observations by the auditors will be conducted during the 2007 fiscal year for financial reporting purposes for the fiscal year ended June 30, 2006.

NCRA also states that an inventory of equipment and rolling stock will be conducted once every two years beginning with the fiscal year 2007 and an annual report beginning with Fiscal Year 2007 will be made to the CTC on the status of property and equipment acquired with federal and state funds.

Auditor Evaluation:
NCRA concurred with the recommendations, no further evaluation required.

Policies and Procedures

In prior audits, we reported that NCRA did not have established P&P. NCRA now has an approved P&P in place that addresses most of NCRA's important activities except for material inventory procedures, payment approval thresholds and adopted procedures related to an indirect cost allocation plan.

As identified in the findings above, the written P&P were not implemented in practice by NCRA. Also, in some cases the P&P may not be in compliance with federal regulations. For example, the ability of NCRA's Board of Directors to reject all bids is less restrictive than federal regulations. Also, the current P&P covering procurement and contract management is split into four different chapters that do not reference each other and may contain conflicting information. Since we identified many concerns, please see Attachment II for a detailed list of NCRA P&P reviewed and issues identified.

Based on our audit work, we determined that NCRA has not implemented the approved P&P. It appears that NCRA's current Board of Directors and Executive Director have not taken steps to ensure compliance. The Executive Director and Board of Directors have a very important role in NCRA fulfilling fiduciary responsibilities of public funds and assets. NCRA management's failure to ensure that the P&P were implemented indicates a lack of management and internal controls needed to safeguard the public's funding and assets. Failure to implement established P&P can lead to increased costs due to inefficient operations and the possible disallowance of state and federal funding now and in the future. Also, the failure to have an approved indirect cost allocation plan prevents NCRA from recovering indirect costs.

Recommendation:

NCRA should:

- Make all necessary changes to the P&P to ensure compliance with state and federal regulations.

- Implement the P&P as approved by NCRA's Board of Directors.

- Certify to the CTC and the Department when the two recommendations above have been met and NCRA has operated under the implemented P&P for a minimum of six months before another follow-up audit is performed.

- Submit an indirect cost allocation plan that meets the requirements of OMB A-87.

NCRA's Response:

NCRA concurred with the recommendations and incorporated the applicable provisions of 49 CFR and OMB A-87 in the Policies and Procedures Manual. NCRA has implemented the updated Policies and Procedures Manual as approved by the Board and will request a follow-up audit by December 2006 to review the implementation of the Policies and Procedures Manual and cost coding structure.

Auditor Evaluation:
Upon assurances from NCRA that the P&P are fully implemented and sufficient data exists for audit purposes, a follow-up audit will be scheduled.

Finding 6 - Quarterly Reports to the California Transportation Commission (CTC)
Our audit identified that NCRA Quarterly Reports to the CTC are not fully accurate and were not submitted by the due date requirements. During our review of NCRA's September through December 2005 quarterly report (due January 31, 2006) that was submitted to the CTC (February 14, 2006), we found misstatements, inaccurate information, and missing information. We provided an attachment with a full list of the issues identified during our review of the quarterly report issued for FY 2005-06. (See Attachment III). Some examples of the inaccurate information are:

- The narrative states that property revenue bookkeeping has undergone major refinement in FY 2003-04 and 2004-05, that agency staff has internally reviewed each lease and built an accounts receivable list that will continue to be refined throughout FY 2005-06. Our audit disclosed that NCRA does not have a complete listing of leases.

- Comparison of property revenue reported in the audited financial statements and the property revenue/fees reported in the quarterly reports submitted to the CTC showed the following differences:

  - FY 2004-05 Financial statement - $318,068 vs. quarterly report of $194,517
  - FY 2003-04 Financial statement - $222,426 vs. quarterly report of $185,766
  - FY 2002-03 Financial statement - $222,693 vs. quarterly report of $145,896

- In a letter from NCRA's legal counsel to NCRA's independent auditors, the legal counsel states that a settlement was reached with Foss Environmental by stipulated judgment for $54,308.82 on or about September 5, 2004. This settlement is not reported in the quarterly reports.

- The December 2005 NCRA Board meeting minutes disclose the consideration and adoption of a settlement with California Redwood. The FY 2004-05 financial statements report as a subsequent event the termination of a passenger operation agreement with California Redwood for $134,937 with interest at 7%. This settlement is not listed in the December 31, 2005, quarterly report.

The information used in our review of the quarterly reports came from NCRA, so the causes for the errors, omissions, and misstatements are unknown.

NCRA's quarterly financial reports are used by the CTC and its staff as an aid in making important financial decisions regarding the approval of projects and the corresponding allocation of funds. When inaccurate information and/or incomplete disclosures are presented in these reports, there is an increased risk that the CTC could base its decisions on incorrect or incomplete information.

NCRA is required to submit quarterly financial reports to the CTC within 30 days after the end of each quarter. During our audit, we observed that NCRA was late submitting the FY 2005-06 second and third quarter financial reports. Also, the second quarter report due January 31, 2005 was dated February 14, 2006. In addition, the quarterly report for the period ending March 31, 2006, was not issued as of the end of our audit fieldwork, May 26, 2006, even though it was due April 30, 2006.

Recommendation:
We recommend that:

- The NCRA's Board of Directors, which is responsible for the reports submitted to the CTC, take measures to ensure that the reports contain the most up-to-date accurate data and appropriate informative disclosures.

- All financial data presented to the CTC should be reported in accordance with GAAP.

- The CTC should withhold all decisions regarding project approvals and allocation of funding until NCRA provides the CTC with corrected quarterly reports. The reports should be attached to a letter signed by the Executive Director and the Chairman of the NCRA Board of Directors certifying to the correctness and completeness of the reports submitted.

NCRA's Response:
NCRA concurred with our recommendations. NCRA will submit quarterly reports to the CTC that are based on full accrual accounting in accordance with GAAP beginning with the 4th quarter 2005-06 report. By instituting the full accrual accounting method, NCRA will ensure that reports contain accurate and complete data, and that information presented in all future CTC reports agrees with NCRA's records.

Auditor Evaluation:
NCRA concurred with the recommendations, no further evaluation required.

This report is intended solely for the information of the Department Management, the Federal Highway Administration, the California Transportation Commission and NCRA. However, this report is a matter of public record and its distribution is not limited.

If you have any questions, please contact Cliff Vose at (916) 323-7917 or Susan Bransen at (916) 323-7909.

Clifford R Vose
CLIFFORD R. VOSE
Auditor

Approved:

Susan Bransen
SUSAN BRANSEN
Audit Manager

Attachments

cc: NCRA
RChung, CTC
CWillis, District-01
RChittenden, TCRP
BBronte, Div. of Rail
TAbbott, Local Assistance
BBryant, FHWA