



Final Report

**Issued to:
Public Works**

February 7, 2002

**Issued By:
Performance Audit Division**



Snohomish County

Date: February 7, 2002

To: Steve Hansen, Peter Hahn,
and Gary Powell

Cc: Performance Audit Committee

From: Martin T. Standel

Subject: Contracts - Road Change Orders

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This report presents the results of our audit of Contracts - Road Change Orders (ID06-0001-2000) within the Engineering Services Division of Public Works. As defined by the approved work plan, our primary objective was to review and determine: (1) if department policies and procedures complied with County and State codes; (2) the level of risk exposure and adequacy of internal controls; (3) if added monitoring would result in net cost benefits; and (4) the effectiveness and efficiency of contracting systems, procedures, and practices.

Our approach was to examine four contracts selected from those monitored by Engineering Services – Construction. Each contract was reviewed to identify specific criteria that allowed contract change orders, and Washington State guidance for control of change orders was examined. Each selected contract's change orders were then reviewed to determine if documentation existed and supported the requirements for any changes made. We then looked at control procedures regarding payment of changes to verify separation of duties, and communicated with other auditors (primarily from Washington State) to determine their perspective regarding contract documentation and control in Snohomish County.

We concluded Engineering Services personnel were knowledgeable of the contract change order process and documentation, and could explain rationale for the change orders made. Internal controls covering the change order process were adequate.

During our review, we noted two areas where management might consider improving or expanding their documentation. While, we recognize this additional documentation may reduce time personnel use for initial contract oversight, reduced administrative costs through risk mitigation should be achieved over the long run.

We wish to thank Steve Hansen and his staff for their time and effort. Even with their busy workload, they continued to provide us with all requested records, and more importantly, the time and access to answer questions as they arose.



Executive Summary

The Performance Audit Division conducted a risk assessment analysis on Public Works Contracting and determined that during 1999 Snohomish County's Adopted Budget totaled \$494 million, and the largest percentage of contract dollars, \$50 million, was allocated to road construction and maintenance. Since County contract administration represents a high-risk area regarding the possibility of overpayments and noncompliance with federal, state and county codes, a review of contracting practices was deemed warranted.

PUBLIC WORKS BACKGROUND

Road contract oversight is a responsibility of the Public Works Engineering Services Division and specifically the Engineering Services – Construction Group, but with assistance of other Public Works Groups. In 2001, within the Construction Group, 25 engineering and support professionals monitored 17 construction contracts (road and reimbursable projects) totaling approximately \$48M. All of these contracts were the "lowest bidder/unit price" type. From the 2001 list of active construction projects, four were selected for audit: the 35th Ave SE; 2000 Overlay, Zone 3; Airport Road HOV; and the Lake Stevens Bridge #125. These are noted below with change percentages.

Questions, Risk, Objectives, Scope, Approach

The audit goal was to develop a plan that ultimately answered questions identified by the Performance Audit Committee, which included:

- Are policies and procedures documented and currently being followed?
- Are internal controls (separation of duties) adequate?
- What percentage of contract value is through change orders?
- Would a formal contract audit program be cost effective?

RISK ASSESSMENT

Our pre-project risk assessment of Public Works road contract change orders was deemed high. Over \$50 million in 1999 County Adopted Budget dollars were allocated for road construction and maintenance (including about \$15 - \$20 million in annual road construction contracts expenditures), and change orders can add to that total.

AUDIT OBJECTIVES & SCOPE

Public Works Road Change Order audit objectives were to determine:

- if department policies and procedures comply with county codes.

- department policies/procedures comply with State and Federal codes.
- level of risk exposure and adequacy of internal controls.
- if adding monitoring would result in net cost benefits.
- the effectiveness and efficiency of contracting systems, procedures and practices.

The scope of the audit included current or recently completed road contracts.

AUDITING STANDARDS, AUTHORITY

We conducted our review in accordance with generally accepted auditing standards and the Government Auditing Standards issued by the Comptroller General of the United States (1994 Revision). Those standards required we plan and perform the review to obtain reasonable assurance the Public Works Department provides critical financial management, operational controls, and oversight. Further, the standards require, if possible, we interview other auditors who may have reviewed the same area.

APPROACH

The overall audit approach was to examine the four contracts selected from those monitored by Engineering Services – Construction. The audit reviewed each contract overall to identify specific criteria for allowing contract change orders and looked at standard Washington State guidance for control of change orders. Then each selected contract's change orders were examined to determine if documentation existed and supported the requirements for the changes made. We then looked at the control procedures regarding payment of changes to verify separation of duties and communicated with other auditors (primarily from Washington State) to determine their perspective regarding contract documentation and control in Snohomish County.

Findings

During the audit of construction contract change orders monitored by Engineering Services – Construction, it appeared management fulfilled those responsibilities and overall, contract change order control and documentation appeared quite good. A Construction Change Order Justification form the office developed is a good example of the efforts management has made to insure projects are well controlled. (See Attachment 1)

It appeared during the review, management successfully negotiated settlements that benefited the County and avoided costly litigation. It also appeared department policies and procedures complied with county, State and Federal codes. Interviews with other auditors indicated they felt Engineering Services – Construction monitored contracts well. Mr. Dave Engel, a Washington State Department of Transportation Auditor, stated the documentation and program

that resulted from compliance with department policies and procedures was among the “top 5 percent of those reviewed.” (See Attachment 2)

Audit fieldwork determined the levels of management review for change orders resulted in what appears to be acceptable levels of risk exposure and internal controls appear adequate. The change order reviews appear to be based on separation of duties that limits risk exposure. This audit’s findings indicate additional monitoring of this process would not likely result in net cost benefits. The process is already audited by multiple organizations, and the existing effectiveness and efficiency of contracting systems, procedures and practices are largely summed up in Ms. Cristy Schelm’s (a Washington State Auditor) statement; their “records are very well in order.” (See Attachment 3)

It should be noted, that State Auditors, WSDOT Auditors, Federal Auditors and various funding agency auditors audit Public Works construction contracts routinely. In 2000, the 8 active construction contracts were audited by other agencies a total of 14 times.

Further, Public Works personnel were very knowledgeable of the contract change order process and documentation, and could explain rationale for the change orders made. However during the review, a few areas were noted that management might consider reviewing. While we recognize additional documentation takes critical time from personnel actually performing operations and the existing documentation in support of contract change order control is quite good, the following was found

A. CHANGE ORDER NUMBERING

In the project documentation for 35th Avenue SE, change order numbers on two changes didn’t correspond to background information regarding contractor delay settlement payments. This made contract review difficult. If this documentation was needed for a subsequent legal review of that settlement payment, the error might cause the County risk. However, in the project under review, the change orders justification documentation were not part of the legal compliance to the contract.

This discrepancy however, highlights the complex and dynamic nature of claim settlement negotiation, using the change order process negotiations resolve complex, multi-issue disputes, entitlements and compensation conflicts. The process is also made more complex by the extended time frame for settlements and resolving other issues. For the project under review, an internal settlement negotiation strategy document was used as change order justification (support documentation for multiple change orders). While this negotiation was proceeding, a separate change order was issued in the middle of the negotiation process interrupting the change order numbering sequencing described in the justification documentation.

B. FORM USAGE

In the project documentation for the Airport Road HOV, a Public Works Project Resource Modification (five-part) form was used four times to document material overrun changes on the contract. This form did not provide the more complete background and justification of a formal change order and posed questions during contract review.

The Public Works Project Resource Modification Form (RMF), is not part of the compliance requirements for the contract change order file, but is used in developing budgeting information. In the project under review, this form was placed in the contract change order file inadvertently.

Conclusions

During audit fieldwork, Engineering Services – Construction management and staff were extremely professional in support of the audit effort. As noted earlier, other auditors who had also reviewed road contracts were extremely complimentary regarding contract management controls and documentation. Based on our fieldwork, we fundamentally agreed.

Recommendations

The following recommendations are based on observations during audit fieldwork and analysis.

A. CHANGE ORDER NUMBERING

During fieldwork we noted in project documentation for 35th Avenue SE, change order numbers on two changes didn't correspond to background information regarding contractor delay settlement payments. This made contract review difficult and if the documentation was needed for a subsequent legal review of that settlement payment, the error might cause the County risk.

Recommendation No. 1. To reduce County risk of possible litigation, we recommend contract administrators ensure contract documentation numbers are correct and match supporting documents; particularly for those that deal with contractor settlement payments.

B. FORM USAGE

In the project documentation for the Airport Road HOV, a Public Works Project Resource Modification (five-part) form was used four times to document material overrun changes on the contract. While the form could be used as background to support a change order, it did not provide the more complete information and justification of a formal change order and led to questions during contract review.



Recommendation No. 2. To improve contract documentation procedures, we recommend papers (forms, documents) that don't clearly provide contract change justification not be added to contract documentation unless they are attachments to more "formal" contract documents.

VI. Responses

We conducted our Closing Conference on January 17, 2002, with Steve Hansen, Engineering Manager. We thanked the Department for their participation during our review. After reviewing the recommendations, Steve stated their concurrence. He also stated the majority (recommendations) have already been implemented. (See Attachment 4)



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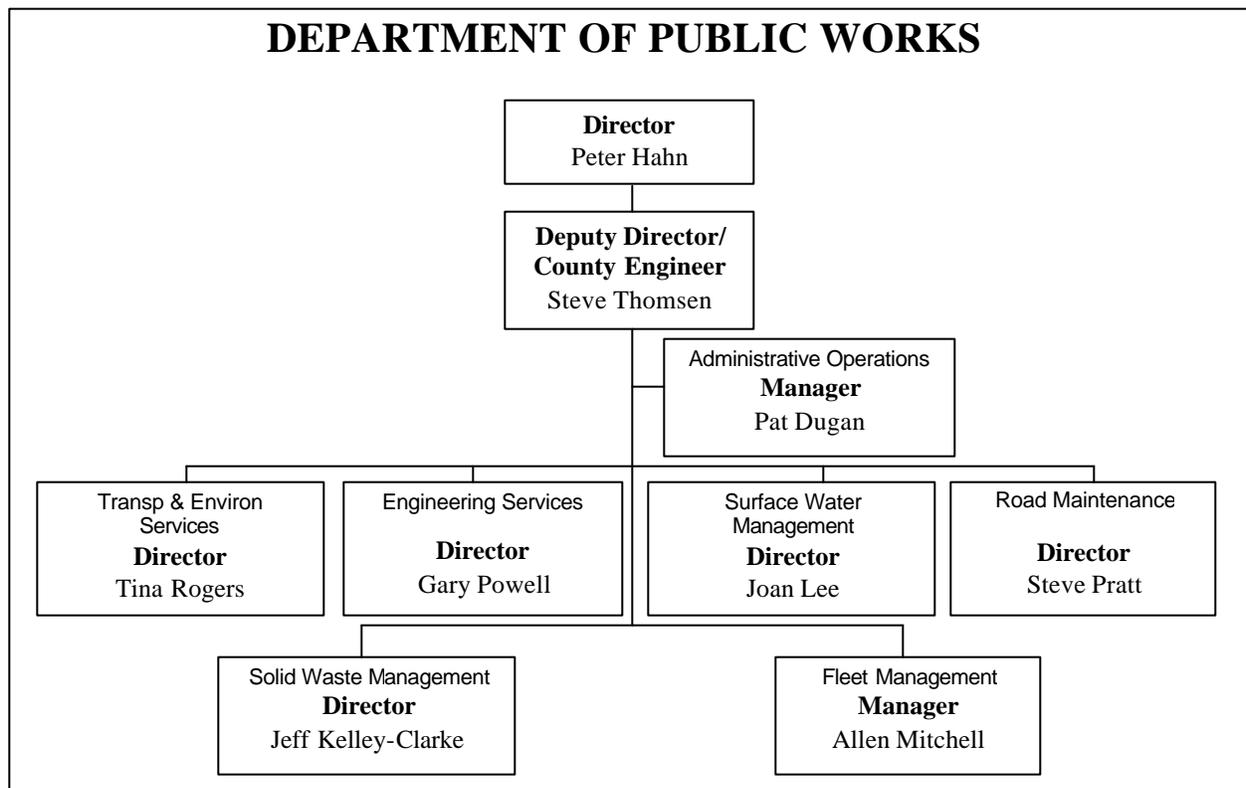
I. Introduction

As an ongoing process, the Performance Audit Division conducts risk assessments to identify and prioritize potential areas for review, which if approved, are subsequently incorporated in our annual audit plan. The Performance Audit Division conducted a risk assessment analysis on Public Works Contracting and determined that during 1999 Snohomish County's Adopted Budget totaled \$494 million, and the largest percentage of contract dollars, \$50 million, was allocated to road construction and maintenance. Since County contracts administration represents a high-risk area regarding the possibility of overpayments and noncompliance with federal, state and county codes, a review of contracting practices was deemed warranted. This review was limited to Public Works Engineering Services Division road contracts and change orders identified with each.

PUBLIC WORKS BACKGROUND

Organization:

Exhibit 1 – Public Works Organizational Chart



Source: Public Works

History:

Snohomish County road construction formally began in 1861, when the Washington Territorial legislature acted to create Snohomish County. One of the primary reasons for establishing this local governing body was to develop roads. In 1869, three “viewers and a surveyor” were appointed to view and survey proposed road locations, and this served as the forerunner of Public Work’s involvement in road work which continues today.

Today:

Road contract oversight is a responsibility of the Public Works Engineering Services Division and specifically the Engineering Services – Construction Group, but with assistance of other Public Works Groups. In 2001, within the Construction Group, 25 engineering and support professionals monitored 17 construction contracts (road and reimbursable projects) totaling approximately \$48M. All of these contracts were the “lowest bidder/unit price” type. From the 2001 list of active construction projects, four were selected for audit: the 35th Ave SE; 2000 Overlay, Zone 3; Airport Road HOV; and the Lake Stevens Bridge #125. These are noted below with change percentages.

Selected Construction Projects

Project	Original Contract Amount	Current Contract Amount	Change Orders Current Amount	Change Orders as Percent of Contract
35th Avenue SE	\$ 3,699,850	\$ 4,565,037	\$ 865,186 (21 changes)	12.19%
2000 Overlay - Zone 3	\$ 732,271	\$ 1,268,907	\$ 535,636 (9 changes)	73.28%**
Airport Road HOV	\$ 6,119,790	\$ 6,986,518	\$ 413,729 (13 changes)	6.76%
Lk Stevens Bridge #125	\$ 1,756,199	\$ 1,821,352	\$ 65,154 (10 changes)	3.71%

Exhibit 1

**Change Order value as a percentage primarily represents the work scope additions of new road overlay segments to the original contract (by Snohomish County and participating Cities within the County) because of program needs and funding becoming available during the life of the construction contract.

Road contract selection criteria included recommendations for review by the Engineering Services - Construction, the total number of changes orders by contract, and the percent of total contract dollars represented by the changes. (The higher the percentage of contract dollar changes the greater possible risk.)

ENGINEERING SERVICES - CONSTRUCTION

Public Works (PW) road and reimbursable contracts annual expenditures under the responsibility of Engineering Services – Construction increased from about \$9M in 1993 to over \$22M today while the number of full time employees decreased from 29 to 25 over the same period. In the past year, this contract oversight has also been impacted by increased



environmental requirements. (An average of approximately 20 percent of all change orders per each reviewed contract were implemented to meet mandated environmental requirements.) In addition, today the group is also designing \$4 - \$6 million annually, in biddable project plans and specifications for Public Works in support of their road overlay program and other projects.

II. Questions, Risk, Objectives, Scope, Approach

Authority to review a specific area is through approval by the Performance Audit Committee. Upon approval, the project is incorporated into the annual audit plan. More detailed risk assessments are performed, along with development of a detailed audit plan, scope and methodology. The goal is to develop a plan that ultimately answers questions identified by the Performance Audit Committee with its project approval of Public Works Road Construction Change Orders.

QUESTIONS

- Are policies and procedures documented and currently being followed?
- Are internal controls (separation of duties) adequate?
- What percentage of contract value is through change orders?
- Would a formal contract audit program be cost effective?

RISK ASSESSMENT

Risk Assessment is an audit responsibility and is the act or practice of identifying the risk drivers and their magnitude. It requires the auditor to review and identify risks that may adversely affect a department or organization. The risk assessment process enhances the audit process by identifying, analyzing, and assessing the likelihood of risk occurrence and consequences; estimating an organization's assessed risk exposure and possible impacts; and determining an acceptable risk level. As a component of pre-audit analysis, risk assessment uses previous audits and planning assessments to rank risk impact of a department or organization.

Our pre-project risk assessment of Public Works road contract change orders was deemed high. Over \$50 million in 1999 County Adopted Budget dollars were allocated for road construction and maintenance (including about \$15 - \$20 million in annual road construction contracts expenditures), and change orders can add to that total.

AUDIT OBJECTIVES & SCOPE

Public Works Road Change Order audit objectives were to determine:

- if department policies and procedures comply with county codes.

- department policies/procedures comply with State and Federal codes.
- level of risk exposure and adequacy of internal controls.
- if adding monitoring would result in net cost benefits.
- the effectiveness and efficiency of contracting systems, procedures and practices.

The scope of the audit included current or recently completed road contracts. Audits selected were primarily based on the number of change orders per contract and change order total dollars as a portion of the entire contract.

AUDITING STANDARDS, AUTHORITY

Snohomish County Code (Chapter 2.700.020) states all performance audits and or reviews are conducted in accordance with government auditing standards. Per Division policy, this review adhered to Government Accounting Office Standards concerning procedures to develop findings and for communicating results with responsible managers and officials.

According to GAO Standards, a finding or set of findings is complete to the extent that the objectives are satisfied and the report clearly relates those objectives to the finding elements. Unlike a financial audit finding, a review finding is a statement that a condition exists. This may not necessarily imply a problem or that some corrective action must be implemented.

We conducted our review in accordance with generally accepted auditing standards and the Government Auditing Standards issued by the Comptroller General of the United States (1994 Revision). Those standards required we plan and perform the review to obtain reasonable assurance the Public Works Department provides critical financial management, operational controls, and oversight. Further, the standards require, if possible, we interview other auditors who may have reviewed the same area.

PUBLIC INFORMATION

This report is intended initially to provide information to the County Executive, County Council, and to Department Directors. All of this report is a matter of public record and distribution should not be limited. **However, confidential information is not public record and shall not be distributed.** Information extracted from this report may also serve as a method to disseminate information to the public as a reporting tool to help citizens assess government operations. Responsible managers and officials review all audit division reports internally and their formal written responses are incorporated into final reports as a policy of the Performance Audit Committee and government auditing standards (GAO Standard 7.38).

APPROACH

The overall audit approach was to examine the four contracts selected from those monitored by Engineering Services – Construction. The audit reviewed each contract overall to identify



specific criteria for allowing contract change orders and looked at standard Washington State guidance for control of change orders. Then each selected contract's change orders were examined to determine if documentation existed and supported the requirements for the changes made. We then looked at the control procedures regarding payment of changes to verify separation of duties and communicated with other auditors (primarily from Washington State) to determine their perspective regarding contract documentation and control in Snohomish County.

III. Findings

Management is responsible to plan for Department operations, oversee day-to-day performance, and review results so future improvements can be planned. During the audit of construction contract change orders monitored by Engineering Services – Construction, it appeared management fulfilled those responsibilities and overall, contract change order control and documentation appeared quite good. A Construction Change Order Justification form the office developed is a good example of the efforts management has made to insure projects are well controlled. (See Attachment 1)

It appeared during the review, management successfully negotiated settlements that benefited the County and avoided costly litigation. It also appeared department policies and procedures complied with county, State and Federal codes. Interviews with other auditors indicated they felt Engineering Services – Construction monitored contracts well. Mr. Dave Engel, a Washington State Department of Transportation Auditor, stated the documentation and program that resulted from compliance with department policies and procedures was among the “top 5 percent of those reviewed.” (See Attachment 2)

Audit fieldwork determined the levels of management review for change orders resulted in what appears to be acceptable levels of risk exposure and internal controls appear adequate. The change order reviews appear to be based on separation of duties that limits risk exposure. This audit's findings indicate additional monitoring of this process would not likely result in net cost benefits. The process is already audited by multiple organizations, and the existing effectiveness and efficiency of contracting systems, procedures and practices are largely summed up in Ms. Cristy Schelm's (a Washington State Auditor) statement; their “records are very well in order.” (See Attachment 3)

It should be noted, that State Auditors, WSDOT Auditors, Federal Auditors and various funding agency auditors, audit Public Works construction contracts routinely. In 2000, the 8 active construction contracts were audited by other agencies a total of 14 times.

Further, Public Works personnel were very knowledgeable of the contract change order process and documentation, and could explain rationale for the change orders made. However during the review, a few areas were noted that management might consider reviewing. While we recognize additional documentation takes critical time from personnel actually performing

operations and the existing documentation in support of contract change order control is quite good, the following was found.

A. CHANGE ORDER NUMBERING

In the project documentation for 35th Avenue SE, change order numbers on two changes didn't correspond to background information regarding contractor delay settlement payments. This made contract review difficult. If this documentation was needed for a subsequent legal review of that settlement payment, the error might cause the County risk. However, in the project under review, the change orders justification documentation were not part of the legal compliance to the contract.

This discrepancy however, highlights the complex and dynamic nature of claim settlement negotiation, using the change order process negotiations resolve complex, multi-issue disputes, entitlements and compensation conflicts. The process is also made more complex by the extended time frame for settlements and resolving other issues. For the project under review, an internal settlement negotiation strategy document was used as change order justification (support documentation for multiple change orders). While this negotiation was proceeding, a separate change order was issued in the middle of the negotiation process interrupting the change order numbering sequencing described in the justification documentation.

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The Public Works Project Resource Modification Form (RMF), is not part of the compliance requirements for the contract change order file, but is used in developing budgeting information. In the project under review, this form was placed in the contract change order file inadvertently.

IV. Conclusions

During audit fieldwork, Engineering Services – Construction management and staff were extremely professional in support of the audit effort. As noted earlier, other auditors who had also reviewed road contracts were extremely complimentary regarding contract management controls and documentation. Based on our fieldwork, we fundamentally agreed.

V. Recommendations

The following recommendations are based on observations during audit fieldwork and analysis.

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During fieldwork we noted in project documentation for 35th Avenue SE, change order numbers on two changes didn't correspond to background information regarding contractor delay settlement payments. This made contract review difficult and if the documentation was needed for a subsequent legal review of that settlement payment, the error might cause the County risk.

Recommendation No. 1. To reduce County risk of possible litigation, we recommend contract administrators ensure contract documentation numbers are correct and match supporting documents; particularly for those that deal with contractor settlement payments.

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Recommendation No. 2. To improve contract documentation procedures, we recommend papers (forms, documents) that don't clearly provide contract change justification not be added to contract documentation unless they are attachments to more "formal" contract documents.

VI. Responses

We conducted our Closing Conference on January 17, 2002, with Steve Hansen, Engineering Manager. We thanked the Department for their participation during our review. After reviewing the recommendations, Steve stated their concurrence. He also stated the majority (recommendations) have already been implemented. (See Attachment 4)



Attachment 2

Interview (Dave Engel – 5 Dec 2001)

This is used to document telephone discussion between Steven Torrence, auditor and Dave Engel, Auditor, Washington Department of Transportation (206) 440-4733, at 4:30PM on 5 Dec.

Purpose: To verify quality of documentation provided by Public Works

Scope: Changes orders as reviewed in the following projects: 35th Avenue SE; 200 Overlay Zone 3; Airport Road HOV, and Lake Stevens Bridge #125.

Source: Washington State Department of Transportation Auditor

Conclusions: Based on discussion, Dave Engel stated that, based on his review of Public Works documentation, it appears they are in the “top 5 percent of those reviewed.” He stated that his review of PW documentation has found the organization to be professional and concerned with doing things right. He suggested I also call Larry Schofield (360) 705-7380, another WASH DOT auditor for possible information.



Attachment 3

Interview (Cristy Schelm – 5 Dec 2001)

This is used to document telephone discussion between Steven Torrence, auditor and Cristy Schelm, Washington State Auditor (425) 672-1335, at 4:40PM on 5 Dec.

Purpose: To verify quality of documentation provided by Public Works

Scope: Changes orders as reviewed in the following projects: 35th Avenue SE; 200 Overlay Zone 3; Airport Road HOV, and Lake Stevens Bridge #125.

Source: Washington State Department of Transportation Auditor

Conclusions: Based on discussion, Cristy Schelm stated that, based on her review of Public Works documentation, it appears “records are very well in order.” She stated that her review of PW documentation deals with financial aspects we generally don’t deal with, but she was impressed with the overall professionalism of the PW staff she worked with.

At the end of the conversation, she asked if she could get a copy of the final report.

MEMORANDUM

DATE: January 24, 2002

TO: Martin T. Standel
Snohomish County Performance Audit Division

VIA: Gary L. Powell, PE, Director
PW-Engineering Services Division

FROM: Steve Hansen, PE, Manager
ES-Construction Group

SUBJECT: CONTRACTS-ROAD CHANGE ORDERS
Final Draft by Snohomish County Performance Audit Division
January 11, 2002

On January 17, 2002, Martin Standel, Snohomish County Performance Auditor, and Steve Hansen, Public Works Department, Engineering Services Division - Construction met and discussed contents of the subject Final Draft and the audit process.

The following constitute our comments on the Final Draft performance audit findings of the Contracts-Road Change Orders.

General Findings

The Construction Group and other groups assisting us in the construction of the County's capital road improvement program strive to obtain a high level of constructed quality in our road projects/contracts. This includes the achievement of a high level of fairness, honesty, transparency, and financial effectiveness in managing the County's and our funding agencies' dollars spent on these projects/contracts. We are pleased to hear the general positive validation of our work by the performance auditor's review of the roads program change order process.

We wish to thank the performance auditor's staff who conducted the change order audit in the highest professional manner. The performance auditors were helpful, courteous and knowledgeable of the construction contracting process. They were quick to learn the nature of our construction contracting process and made meaningful recommendations.

Recommendations by the Performance Auditor

A. Change Order Numbering

Public Works Department Comment: We concur with the performance auditor's recommendation that ".....contract administrators should exercise care in insuring contract documentation numbers are correct and match supporting documents."

We will increase our effort to be as accurate as possible in change order justification/backup information to aid independent change order review and audit. We think the possibility of litigation risk could be low because (a) the fully executed change order is a legally binding document signed by the County and the Contractor culminating the negotiation, and (b) the change order justification documentation is not part of the actual change order but attached only to the County's copy of the change order for internal review and audit use.

The Department, in 2000, self reviewed our change order justification information and initiated a new standardized list of required justification information for all change orders to aid in review and audit. This requirement, initiated in 2001, further improved the level and content quality of justification information provided on change orders. (See Attachment 1).

B. Form Usage

Public Works Department Comment: We concur with the performance auditor's recommendation to improve contract documentation procedures by excluding papers not clearly providing contract change order justification from the record. The Department's Project Resource Modification Form (RMF) has no use in contract or change order justification.

On September 11, 2001, Engineering Services contract administration staff met with our Division Director, discussed the RMF forms use in construction contracting and adopted a new procedure dealing with construction contract unit quantity over-, and under-runs. After September 11, 2001, contract unit item quantity over-, or under-runs are to be identified, documented and managed through the change order process. This allows management of each contract's purchase order amount by means of the contract change order process, which is a standard and better-documented method.

CC: Peter Hahn, Director
Public Works Department

Pat Dugan, Manager
Public Works Administration