
PERFORMANCE AUDIT OF THE CITY'S OVERHEAD RATE CALCULATION PROCESS

Improved Documentation and
Enhanced Training Will Help
Ensure Future Overhead Rates
Continue to Be Reasonable,
Equitable and Justifiable

**Office of the
City Auditor**

City of San Diego



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THE CITY OF SAN DIEGO

February 4, 2016

Honorable Mayor, City Council, and Audit Committee Members
City of San Diego, California

Transmitted herewith is an audit report on the City of San Diego's Overhead Rate Calculation Process. This report was conducted in accordance with the City Auditor's Fiscal Year 2015 Audit Work Plan, and the report is presented in accordance with City Charter Section 39.2. The Results in Brief is presented on page 1. Audit Objectives, Scope, and Methodology are presented in Appendix B. Management's responses to our audit recommendations can be found after page 50 of the report.

We would like to thank staff from the Office of the City Comptroller, Financial Management and Public Utilities Department for their assistance and cooperation during this audit. All of their valuable time and efforts spent on providing us information are greatly appreciated. The audit staff responsible for this audit report are Shawneé Pickney, Nathan Otto, Danielle Knighten and Kyle Elser.

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Table of Contents

Results in Brief	1
Background	3
Audit Results	11
Finding #1: The Office of the City Comptroller Needs to Formalize Its Cost Allocation Process and Strengthen Guidance Provided to Departments	11
Finding #2: Financial Management Needs to Improve Documentation and Review of Non-Discretionary Budget Allocations and Strengthen Its Communication with Provider Departments	23
Finding #3: The Public Utilities Department Needs to Formalize Its Cost Allocation Review Process and Strengthen Guidance Provided to Internal Staff	36
Conclusion	39
Recommendations	40
Appendix A: Audit Recommendation Priorities	42
Appendix B: Objectives, Scope, and Methodology	43
Appendix C: Cost Classification Matrix (Element 2)	49
Appendix D: Calculations of Roll Forward (Element 4)	50

Results in Brief

Local governments use charges and fees to help fund services provided to the public. In developing these charges and fees, local governments should look at their direct and indirect costs to determine the full cost of providing these services and to ensure the charges and fees are set appropriately. Overhead costs, also known as indirect costs, are typically defined as costs which are not readily identifiable with one specific task, job, or work order. Such costs may include department management, materials, supplies and IT costs.

The importance of reviewing both the Standard Cost Allocation and Non-Discretionary Allocation methodologies is to ensure the proper stewardship of funds paid via taxpayers (for General Fund departments) and ratepayers (for Enterprise Funds). Specifically, we reviewed the City of San Diego's (City) overhead rate development processes to assess the accuracy and reasonableness of overhead rates assigned to City departments. We tested these processes from the perspective of the Public Utilities Department (PUD). Specifically, we reviewed:

The Standard Cost Allocation Process, overseen by the Office of the City Comptroller (Comptroller) – the process for developing overhead rates and recouping costs for services completed by central service departments.

The Non-Discretionary Cost Allocation Process, overseen by the Financial Management Department (FM) – the process for developing and allocating expenditures that are determined outside of the departments' control, such as IT costs and General Government Services Billing (GGSB). This process is used to allocate expenses for General Fund departments which are providing support services to non-general fund departments.

We found the Comptroller has recently taken steps for improvement by expanding training opportunities to City departments, improving the organization of the data used in the cost allocation process, and formalizing a process narrative to strengthen its institutional knowledge and capabilities. Furthermore, we found that although Comptroller's staff has accomplished the work needed to produce reasonable and equitable yearly cost allocation plans, formal documentation of the cost allocation process and additional guidance to City departments are needed to ensure rates are always fully justifiable.

We also reviewed the non-discretionary allocations assigned to PUD by examining the Citywide non-discretionary budget allocation process. Based on our review, we found that FM has developed a system that provides proper guidance to provider departments responsible for developing non-discretionary budgets. The system requires that provider departments identify and assign non-discretionary costs on a reasonable and consistent basis. However, we also found that FM could improve the process by developing a more formalized structure and enhancing communication.

Finally, we reviewed PUD's internal process for reviewing Citywide overhead rates assessed to them through the City's standard cost allocation methodology. As part of the standard cost methodology, the Comptroller requires City departments to review their own accounting and ensure that expenditures are correctly identified as direct or indirect costs. We found that PUD should formalize its cost allocation review process and strengthen guidance provided to internal staff. We also found that PUD had undergone restructure changes and did not properly document its review of the accompanying reassignment of costs resulting from the restructure. Currently, the process relies on institutional knowledge and is not equipped to maintain continuity of operations should staff turnover occur.

Altogether, we made four recommendations to address the issues identified throughout the report. Management agreed to implement all four recommendations.

Background

Local governments use charges and fees to help fund services provided to the public. In developing these charges and fees, local governments should look at their direct and indirect costs to determine the full cost of providing these services and to ensure the charges and fees are set appropriately. Along with servicing the public, the City of San Diego (City) also has centralized support services that aid departments in providing services to the public. These support services include department-level administration and central services such as the City Comptroller, Financial Management, City Treasurer, Personnel and Purchasing and Contracting. These departments must be fully or partially supported by the other City departments that they service. These costs are allocated as part of the Standard Cost Allocation Plan (for General Fund departments) or as a direct payment via the General Government Services Billing (GGSB) for Enterprise Fund departments.

To develop the Cost Allocation Plan, all costs are reviewed to determine which costs are indirect or direct costs as described below. Included in the review are the non-discretionary cost allocations.

Overhead costs, also known as indirect costs, are typically defined as costs which are not readily identifiable with one specific task, job, or work order. Such costs may include department management, materials and supplies and IT costs.

In contrast, direct costs are typically defined as costs that can be identified specifically with a particular final cost objective. Such costs may include labor from an employee working on one specific project or equipment used for one specific project.

We reviewed the City's overhead rate development processes to assess the accuracy and reasonableness of overhead rates assigned to City departments. We tested these processes from the perspective of the Public Utilities Department (PUD).

Specifically, we reviewed:

The Standard Cost Allocation Process, overseen by the Office of the City Comptroller (Comptroller) – the process for developing overhead rates and recouping costs for services completed by central service departments.

The Non-Discretionary Cost Allocation Process, overseen by Financial Management – the process for developing and allocating expenditures that are determined outside of the departments' control, such as IT costs and GGSB. These "non-discretionary costs" are a part of the formula that ultimately factors into a department's assigned overhead rate.

We utilized the Capability Maturity Model Integration (CMMI) for Development Scoring Rubric as shown in **Exhibit 1** to evaluate the processes identified above. The CMMI provides a comprehensive set of guidelines for developing services, including those within government. The scoring rubric evaluates the level of achievement within each element reviewed and enables entities to incrementally improve processes.

Exhibit 1

Capability Maturity Model Integration Scoring Rubric

Capability Level	Description
Level 0: Incomplete	Process either not performed or is partially performed One or more specific goals of the process area are not satisfied No generic goals exist
Level 1: Performed	Accomplishes needed work to produce work products Specific goals are satisfied Improvements can be lost over time if not institutionalized <i>Equivalent to saying processes are "performed processes"</i>
Level 2: Managed	Processes planned and executed in accordance with policy Employs skilled people having adequate resources to produce controlled outputs Involves relevant stakeholders Is monitored, controlled, and reviewed Is evaluated for adherence to its process description <i>Equivalent to saying, "there is a policy that indicates you will perform process, there is a plan for performing it, resources are provided, responsibilities are assigned, and training is provided"</i>
Level 3: Defined	Processes described more rigorously than Level 2 Processes clearly state purpose, inputs, entry criteria, activities, roles, measures, verification steps, outputs, and exit criteria Processes managed more proactively <i>Equivalent to saying, "organizational standard processes exist associated with that process area, which can be tailored to the needs of the project"</i>

Source: Capability Maturity Model Integration for Development, Version 1.3.

The importance of reviewing both the Standard Cost Allocation and Non-Discretionary Allocation Methodologies is to ensure the proper stewardship of funds paid via taxpayers (for General Fund departments) and ratepayers (for Enterprise Funds). Since increased indirect costs equal increased overhead rates, the method for allocating indirect costs must be reasonable, justifiable, and equitable.

The Office of the City Comptroller Oversees the Standard Cost Allocation Process

The Comptroller performs the general accounting and financial reporting function for the City.

Among its responsibilities are:

- Accounting for all funds;
- Preparing the Comprehensive Annual Financial Report; and
- Internal controls over financial reporting.

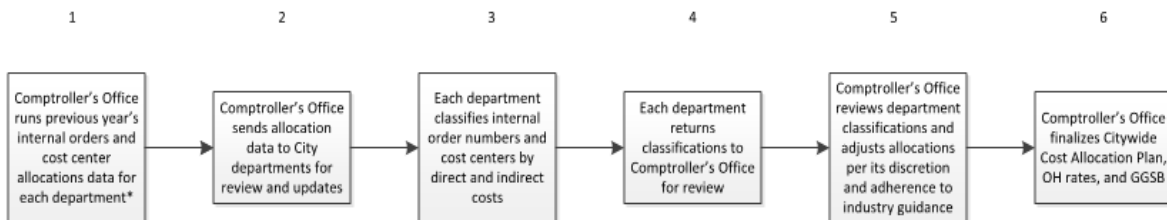
The Comptroller also oversees the standard cost allocation process used to develop the City's overhead rates for central service related expenditures.

The standard cost allocation process as described by the Comptroller is shown in **Exhibit 2**.

Exhibit 2

Standard Cost Allocation Process as Described by the Office of the City Comptroller

Standard Cost Allocation Plan Process



*For example, for 2016 cost allocations, Comptroller's Office would run data submitted by departments in 2015 that was based on 2014 Structure and Actuals.

Source: OCA analysis, based on interview with Comptroller management and staff.

This process occurs on an annual basis, and is discussed in more detail in Finding 1.

Financial Management Oversees the Non-Discretionary Cost Allocation Process

Financial Management develops and monitors the City's annual budget and comprehensive long-range financial forecast. Among its responsibilities are:

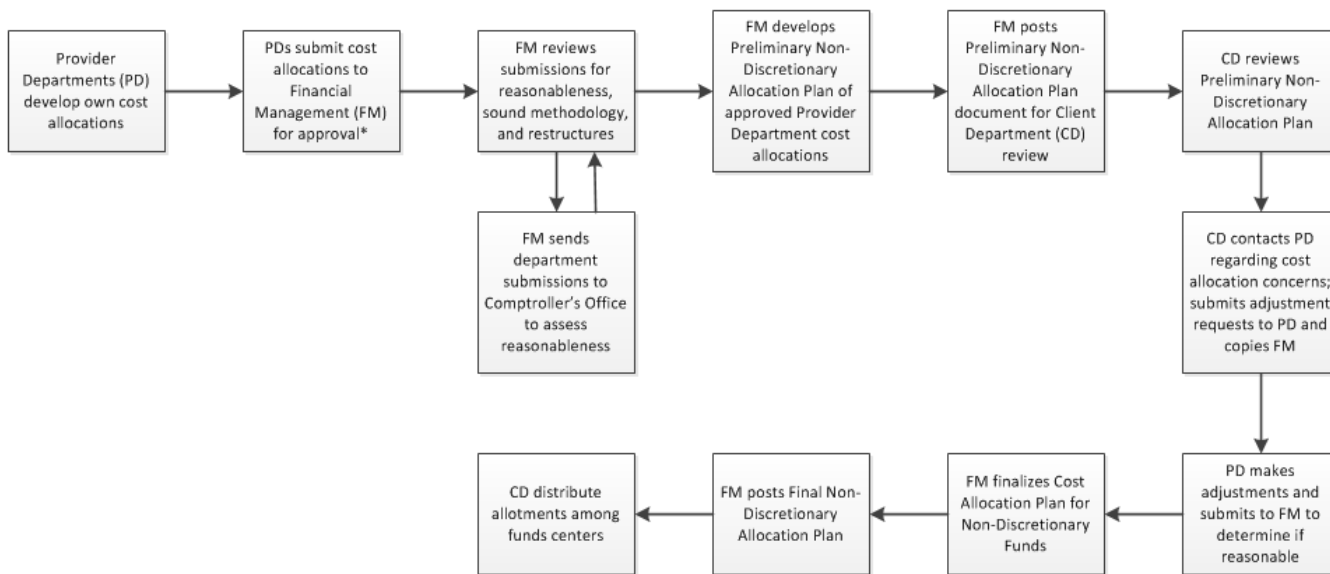
- Serving as the internal fiscal consultant to City departments; and
- Monitoring the City's expenditure and revenue receipts.

They also oversee the non-discretionary cost allocation process.

Non-discretionary expenditures are costs that are determined outside of departments' control. The non-discretionary budgets are developed by departments that either provide a service to the client department, process the payment of the non-discretionary expenditures on behalf of the client department, or are most knowledgeable of the non-discretionary expenditures and can therefore develop the most accurate projection for the non-discretionary commitment item (i.e. Department of Information Technology determines Citywide IT costs).

Exhibit 3

Non-Discretionary Cost Allocation Process as Described by Financial Management



*Provider Department submittals include non-discretionary descriptions, assumptions, methodologies to allocate costs, and any other relevant supporting documentation

Source: OCA Analysis, based on interview with Financial Management.

This process occurs yearly, and is discussed in more detail in Finding 2.

The Public Utilities Department

The Public Utilities Department (PUD) is an Enterprise Fund within the City of San Diego. As an Enterprise Fund, its revenues and expenditures are not commingled with those of the City's General Fund. Instead, its revenues come from its ratepayers and participating agencies.

PUD is responsible for the operation and maintenance of the City's wastewater and water systems. Reflecting these different responsibilities, PUD is comprised of four Business Areas (BA's) within the City's SAP accounting system.

Each Business Area and its Comptroller-assigned overhead rate is shown in **Exhibit 4**.

Exhibit 4

PUD Business Areas and Overhead Rates, FY 2016 and FY 2015

Business Area #	Business Area Name	Description	Funds Associated	FY 2016 City Overhead Rates (%)	FY 2015 City Overhead Rates (%)
2011	Municipal Wastewater ("Muni")	Collection and conveyance of wastewater from residences and businesses in the City of San Diego.	700000	50.7	45.1
2012	Metropolitan Sewerage System ("Metro")	Treats the wastewater from the City of San Diego and 15 other cities and districts.	700001	50.7	45.1
2013	Water	Provides drinking water to customers in the cities of San Diego, Del Mar, Coronado, and Imperial Beach	700011 100000	108.5	106.5
2000	Public Utilities Administration		-	-1	104.8

Source: OCA analysis.

¹ BA 2000's independent overhead rate was dissolved and reallocated to the other PUD Business Areas for FY 2016. More detail on that restructuring is provided in Finding 1.

If an overhead rate assigned to PUD is too low, it would be undercharging other City departments for work it performs; if the overhead rate assigned is too high, PUD would be overcharging other City departments.

This overhead rate is assigned to PUD each year by the Comptroller based on PUD expenditure data. We tested the data and the central service cost allocation and non-discretionary allocation processes outlined above from the perspective of PUD for the period of FY 2015 and FY 2016. More detail can be found in Finding 3.

Glossary

Allocation base: The criterion used to allocate indirect costs. It serves as a metric to create an estimate of the indirect services provided to a department. For example, the number of full-time equivalent employees is used to allocate payroll costs.

Business Area: A basic organizational unit of government that may be sub-divided into divisions, programs, activity groups, and/or activities. Also referred to as a department.

Central Service Cost Allocation Plan: The process for developing overhead rates to recoup costs for services completed by central service departments. Central service departments, such as the offices of the City Clerk, City Attorney, Mayor, etc.) provide services to departments citywide, and must be fully or partially supported by the other City departments. This support is either through direct payment via GGSB or recovered through overhead in the case of General Fund departments.

CMMI (Capability Maturity Model Integration): An evaluation model integrating a collection of best practices intended to help organizations assess and improve their processes.

Cost Center: A unit of organization used by the City of San Diego to organize its accounting detail. Smaller than a Business Area, a cost center is a unit that contains expenditures that can be classified as either Indirect or Direct costs.

Direct cost: Costs that can be identified specifically with a particular final cost objective. E.g. an internal order set up for a project

Enterprise Fund: Funds established to account for specific services funded directly by fees and charges to users such as water and sewer services. These funds are intended to be self-supporting.

Fund: A fiscal and accounting entity with a self-balancing set of accounts to record revenues and expenditures.

GFOA (Government Finance Officers Association): An organizational body of public finance officials in the United States and Canada. The GFOA's mission is "to enhance and promote the professional management of governmental financial resources by identifying, developing, and advancing fiscal strategies, policies, and practices for the public benefit."

GGSB (General Government Services Billing): A standard methodology to allocate expenses for General Fund departments providing support services to non-General Fund departments. For example, the allocation of a portion of the expenses for the City Comptroller to the Public Utilities Department.

Indirect cost: Costs incurred for a common or joint purpose benefitting more than one cost objective, and not readily assignable to the cost objectives specifically benefitted, without effort disproportionate to the results achieved. (E.g. supplies, rent, utilities, supervision, etc.). Sometimes referred to as "overhead."

Indirect Cost Rate Proposals (ICRP): The documentation prepared by a non-Federal entity to substantiate its request for the establishment of an indirect cost rate.

Internal Order: A unit of organization used by the City of San Diego to organize its accounting detail. Formerly known as a Job Order, an Internal Order is a unit that contains expenditures that can be classified as either Indirect or Direct costs.

Non-discretionary item: Non-discretionary expenditures are expense allocations that are determined outside of the department's direct control. These adjustments are generally based on prior year expenditure trends and examples of these include utilities, insurance, and rent.

Overhead rate (also called indirect cost rate): A ratio of indirect costs to total direct salaries and wages. Overhead rates are intended to recover the indirect costs of business that, by their very nature, cannot be billed directly.

Audit Results

Finding #1 The Office of the City Comptroller Needs to Formalize Its Cost Allocation Process and Strengthen Guidance Provided to Departments

We reviewed the overhead rates charged assigned to the Public Utilities Department (PUD) by examining the cost allocation methodologies used to develop overhead rates Citywide. The Office of the City Comptroller (Comptroller) is responsible for oversight of the City's standard cost allocation process used to develop overhead rates to recoup costs for services. We assessed the standard cost allocation methodology to determine if the overhead rates charged were reasonable, justifiable and equitable. Based on our review, we found that although Comptroller's staff has accomplished the work needed to produce reasonable and equitable yearly cost allocation plans, formal documentation of the cost allocation process and additional guidance to City Departments are needed to ensure rates are always fully justifiable. A more formalized structure is needed for documenting internal processes, maintaining supporting documentation for cost allocation decisions, and periodically training staff to consistently categorize costs to reduce the risk of unjustifiable overhead rates.

We also found that the Comptroller has a foundation for improvement in place with staff dedicated to improving the process. For example, the Comptroller has taken several steps recently including expanding training opportunities to City departments, improving the organization of the data used in the cost allocation process, and formalizing a process narrative to strengthen its institutional knowledge and capabilities. Many of these improvements were made during our review, and are noted throughout the report where applicable.

To assess the overhead rates, we utilized the Capability Maturity Model Integration (CMMI) to score each element and rate the Comptroller's standard cost allocation process. The CMMI describes best practices that organizations have found to be productive and useful to achieving their specific business objectives (See **Appendix A** for details on the CMMI scoring levels). Using this testing model, we scored the Comptroller's oversight and application of the

standard cost allocation process as Level 1 for each of the four elements described in **Exhibit 5**. On a scale of 0-3, with 3 as the highest possible score, Level 1 indicates that processes exist that accomplish needed objectives. Although Level 1 processes accomplish the needed work, improvements can be ultimately lost if they are not institutionalized. The cost allocation elements, CMMI scores, and our rationale for the scoring of each element are described in **Exhibit 5** below.

Exhibit 5

Comptroller Oversight of the Standard Cost Allocation Processes

Element	Description	Score	Basis for Score
Develop Cost Allocation Process	Identify the structure that will be used to develop the Citywide Cost Allocation Plan	Level 1	The Comptroller used the same allocation structure to develop Citywide standard cost plans. However, the allocation structure had not yet been formally documented in policy guidance for the period under review.
Purpose of the Cost Allocation Process Defined and Understood	Purpose of the cost allocation process clearly understood by the parties responsible for development and implementation	Level 1	The purpose of the cost allocation process could have been more clearly defined and documented. Resources and training should be implemented to make the process better understood.
Determine Cost Categorization	Identify the level of detail associated with cost allocation categories (e.g. internal orders, cost centers, etc.) and the process for determination and review	Level 1	Comptroller's supporting documentation did not sufficiently justify decisions made regarding cost allocation plans. Extensive conversations were needed to gather this information.
Periodically Review Overhead Rates	Reviews overhead rates against actual experience and makes proper adjustments	Level 1	The Comptroller has implemented mechanisms to periodically review overhead rates, such as computing roll-forward and five year average adjustments yearly for each cost allocation plan. However, similarly to Element 3, supporting details within cost plans need improvement to mitigate the risk of material mistakes.

Source: OCA, based on information from the Government Finance Officers Association "Pricing Internal Services Best Practice Model," the Capability Maturity Model Integration for Development, Version 1.3, and the FY 2015 San Diego Office of the City Auditor "Public Utilities Overhead Rate Review Audit Work Plan."

Using the CMMI scoring, we scored Elements 1–4 based on the following observations:

- Comptroller adapting to changes in the City's accounting system from the predecessor AMRIS to SAP;
- Comptroller's utilization of processes that were not formally documented at the time of our review, thus leaving departmental analysts without comprehensive guidance; and
- For final allocation decisions, Comptroller's explanations are limited in the supporting documentation, which required lengthy discussions and additional efforts to trace and verify data.

Through better documentation of internal processes and supporting documentation for cost allocation decisions, as well as enhanced training for staff involved in the cost allocation process, the Comptroller can improve to CMMI Level 2 and ultimately CMMI Level 3. The Comptroller can help ensure that improvements are maintained over time. A detailed description for the scoring of the four elements is described in the sections below.

**Element 1: Develop
Cost Allocation
Process**

When developing a cost allocation process, Government Finance Officers Association (GFOA) guidance suggests that entities identify the structure that will be used to develop the citywide cost allocation plan. Using the CMMI scoring, we scored Element 1 – Develop Cost Allocation Process – as CMMI Level 1 based on the following observations:

- The structure in use accomplished the needed work;
- The specific goal of developing the Citywide cost allocation plan was accomplished; and
- Concerns regarding the reliance on informal institutional knowledge as to the development of the structure and its implementation.

The Comptroller has a systematic and rational methodology it uses to calculate the amounts allocated. However, during the time of our review the process had only been documented in draft form, and the Comptroller has since finalized documentation on the cost allocation process. There are various guidelines on how governmental entities should calculate indirect costs. According to the 2012 California State Controller's Office *Handbook of Cost Plan Procedures for California Counties (Cost Plan Handbook)*, before indirect costs and central service charges may be claimed for reimbursement, there must be a formal means of accumulating and identifying these types of costs to all benefiting

departments. The best method of accumulating and identifying costs and any use allowances is a cost plan in accordance with the cost principles set forth in the Code of Federal Regulations² (CFR). Moreover, the GFOA states that regardless of the purpose of an indirect cost allocation, a systematic and rational methodology should be used to calculate the amounts allocated.

In order to identify a structure for developing the Citywide standard cost plan, we completed a review of four cost allocations plans.

We found that the Comptroller used a consistent allocation structure to develop Citywide standard cost plans for both General Fund and Enterprise Fund departments.

The plans used are in accordance with CFR-defined cost allocation plans. However, during the course of our review, the allocation structure had not been formally documented in policy guidance. Although the Comptroller's staff has managed to accomplish the work needed to produce yearly cost allocation plans, without formal documentation of the process there is a risk that it could not ensure business continuity should current staff leave. As of June 30, 2015, the Comptroller finalized the City Cost Rate Process Narrative effective for the FY 2017 cost allocation plan cycle. The process narrative includes an example of the standard cost plan structure.

The Comptroller has already begun the necessary improvements to move to a CMMI Level 2. They have finalized a process narrative, effective FY 2017, and provided an example of the standard cost plan structure in the narrative. To continue its progress, the Comptroller should continue to provide training on the structure to departmental analysts in order to produce controlled outputs that adhere to the policy.

Element 2: Purpose of the Cost Allocation Process Defined and Understood

After developing a cost allocation process, GFOA guidance suggests that entities clearly define the purpose of the cost allocation process. The GFOA guidance also suggests that the entities ensure that the process is clearly understood by the parties responsible for its development and implementation. While the Comptroller has used the same allocation structure to develop cost allocation plans each year, the purpose of the cost allocation process could have been more clearly defined. Additionally, resources and training should be implemented to make the process better understood going forward. Using the

² Title 2 of the Code of Federal Regulations Part 225.

CMMI scoring, we scored Element 2 – Purpose of the Cost Allocation Process Defined and Understood – as CMMI Level 1 based on the following observations:

- The Comptroller's draft process narrative provided informal internal guidance for the Comptroller to accomplish the needed work, but was not an adequate resource for use by Citywide departmental analysts; and
- Concerns regarding the process not being institutionalized via written policy or training.

There are generally three types of costs experienced by any department in conducting its operations: direct costs, indirect costs, and central service costs. As described in Element 1, the Comptroller uses the standard cost plan to calculate Citywide overhead rates. The purpose of the standard cost plan should be clearly defined and understood by staff that develop and review cost allocations plans. Without comprehensive knowledge of the allocation process, including clear definitions of indirect and direct costs, department staff may provide incorrect data that could produce overhead rates that are either too high or too low. If rates are too low, then departments are not recovering their costs. If rates are too high, then departments are overcharging their customers. In the case of Enterprise Funds, ratepayers would be overcharged.

During the period of our review, the Comptroller had not finalized guidance that explained the cost allocation plan process for City departments. The City Rate Process Narrative was in development and not available for use by department analysts. Moreover, guidance that was provided, such as the "Overhead Rates Memorandum to Departmental Analysts," was not extensive. Written frameworks for City departments were incomplete or non-existent regarding:

- Standards and polices that guide the cost allocation process;
- The data extracted from SAP to calculate overhead rates;
- How to determine if costs are correctly classified as direct or indirect; and
- Parties and role responsibilities for reviewing and verifying cost allocations.

According to the *Cost Plan Handbook*, the importance of accurate and complete narratives cannot be over-emphasized. The *Cost Plan Handbook* suggests that

process narratives include a description of the methodology used to identify amounts allocated to user departments.

The Comptroller has improved its defining of the allocation process. As of June 30, 2015, Comptroller approved a process narrative, which is in alignment with suggestions within the *Cost Plan Handbook* and includes:

- A scope and purpose section, explaining that the process is applicable to all that have a function in preparing the City Cost Rates;
- A definitions section, which describes a cost allocation plan, direct costs, and indirect costs; and
- A process description, including reports necessary to develop plans and responsibilities of Department Budget Analysts for reviewing and verifying cost information.

The Comptroller has also strengthened its training and resources to ensure that department analysts are correctly classifying costs. However, we found that during the period of our review, The Comptroller did not provide consistent and ongoing cost allocation training to department analysts. According to GFOA, staff should obtain at least a basic understanding of the process used to prepare the cost allocation plan. In addition, Comptroller staff is available to answer questions from department analysts that inquire with them.

We surveyed staff within City departments to inquire about their roles, responsibilities, and knowledge of certain aspects about the yearly standard cost allocation process. While most of the 30 respondents had three or more years of experience with the process, approximately 80 percent of all respondents stated that they had not received any training from the Comptroller between January 1, 2014 and June 30, 2015. Of the 30 respondents, approximately 70 percent thought there could be improvements to the resources, including trainings and guidelines, provided by the Comptroller.

Training would assist staff within City departments with understanding how their decisions impact the cost allocation process. For example, over 60 percent of respondents were either not familiar with, or not confident in their understanding of, the Cost Classification Matrix found in **Appendix B**.

Departments classify their expenditures within cost centers and internal orders as either direct or indirect costs. The Comptroller then uses the Cost Classification Matrix to make a final determination for each expenditure.

Increased training could help staff ensure they understand the relationships between cost centers and internal orders and how those costs are categorized.

Training would also be instrumental in defining and clarifying analysts' roles in the process. Comptroller's staff noted that departments seem to rely heavily on the expenditure data provided to them by the Comptroller. However, the Comptroller noted that in practice, departments should be reviewing data more closely.

The Comptroller has undertaken recent efforts to improve its training and resources, and notes that staffing limitations precluded them from developing and implementing training sooner. During FY 2012, the Comptroller completed internal staff training on the cost allocation process. However, the information was not shared Citywide with departmental analysts. The Comptroller indicated an additional staff member has been added to the Comptroller's Cost Section in FY 2015 to undertake these improvements.

Starting in August 2015, the Comptroller piloted another cost allocation training with the Transportation and Storm Water Department in preparation for FY 2017 cost rate plans. The Comptroller is currently expanding and offering this training to other departments throughout the City.

The Comptroller has already begun the necessary improvements to move to CMMI Level 2. They have finalized a process narrative, effective for the FY 2017 allocation process. Within the process narrative, the Comptroller has clearly defined the scope and purpose, and descriptions of key concepts, and explained the procedures necessary to complete and review standard cost plans. To continue its progress, the Comptroller should provide training on the scope and purpose, key concepts, and procedures to departmental analysts in order to produce controlled outputs that adhere to the policy.

**Element 3: Determine
Cost Categorization**

GFOA guidance suggests that as part of the cost allocation process, entities should identify the level of detail associated with cost allocation categories. GFOA guidance also suggests that entities identify the process for determining and reviewing those cost allocation categories. Using the CMMI Scoring, we scored Element 3 – Determine Cost Categorization – as CMMI Level 1 based on the following observations:

- The Comptroller produces cost allocation plans yearly, but how the data is organized when used to calculate the cost allocation rates can be improved.
- Organization of the cost allocation data has improved; however, with limited documentation and explanations on how and why the data was organized and summarized made the comparison of data from FY 2016 to FY 2015 difficult.

In addition to the direct cost of providing services, governments incur indirect costs. Indirect costs include shared expenses where a department incurs costs for support that it provides to other departments. Support includes, but is not limited to, legal, finance, human resources, facilities, maintenance, and technology assistance. According to the CFR, there is no universal rule for classifying costs as either direct or indirect under every accounting system. A cost may be direct with respect to some specific service or function, but indirect with respect to another final cost objective. Therefore, it is essential that each item of cost be treated consistently in like circumstances either as direct or indirect.

In order to ensure consistency, it is imperative that the cost allocation methodology identifies the level at which expenditures will be categorized as direct and indirect costs. The City's Cost Allocation Plan categorized direct and indirect costs at the Internal Order and Cost Center level, two elements within the SAP accounting structure. It is also necessary to document the process for reviewing categorized costs. According to the *Cost Plan Handbook*, a clear, comprehensible, and complete audit trail must be maintained that links the cost plan with all the information used in its preparation.

Analyzing FY 2015 and FY 2016 data was difficult and time consuming because of the restructuring of the source data and the way it was organized. Although the same data was issued in each year, the Comptroller did not formally document the rationale for changes. However, the organization of the data used to develop cost allocations plans has improved.

Although the Comptroller had reasonable rationales regarding the accounting details of the overhead rates, it should strengthen its documentation of those decisions. For example, the PUD overhead rate for its administrative expenditures decreased from 104.8 percent in FY 2015 to zero in FY 2016. We wanted to evaluate whether the reassignment of the administrative costs

amongst the remaining three PUD overhead rates met the criteria as defined in the CFR:

- In determining *reasonableness* of a given cost, consideration shall be given to: 1) whether the individuals concerned acted with prudence in the circumstances; and 2) significant deviations from the established practices of the governmental unit which may unjustifiably increase cost.
- A cost is *allocable* to a particular cost objective if the goods or services involved are chargeable or assignable to such cost objective in accordance with relative benefits received.
- Costs must be allocable, be accorded consistent treatment, and adequately documented.

We found that the rationale appeared reasonable per CFR standards as the Comptroller acted prudently by recognizing an opportunity to more accurately allocate PUD expenditures. We also concluded that the reassignment of administrative costs seemed allocable per CFR standards since conceptually the remaining overhead rates would be accorded consistent treatment when reassigning the administrative costs.

However, there were instances where the Comptroller should have provided more detailed documentation for its decisions. For example, we traced and verified the supporting data for the FY 2015 administrative overhead costs. Our figures reconciled to the Comptroller's calculations except for those related to the Supplies and Services General Ledger Grouping. The Comptroller indicated that manual adjustments were made and we found notations for the manual adjustments; however, the notations did not provide clear direction on how these amounts were to be used in the supporting schedule. Once conversations were held with the Comptroller and explanations for the notations were provided we were able to reconcile the data.

In initial conversations, the Comptroller noted that it uses its discretion to adjust department allocations prior to approval, which is allowed under industry guidance. However, even with discretion, guidance still requires any decisions or interpretations and the supporting rationale be thoroughly documented. GFOA guidance suggests that data should be captured and documented contemporaneously to avoid audit problems that could otherwise arise as a result of subsequent data changes. Without proper documentation, the Comptroller may be unable to comprehensively defend its decisions.

To move to Level 2, the Comptroller needs to improve its monitoring, control, and review of the cost allocation process by:

1. Documenting rationale and accounting detail to support cost allocation decisions; and
2. Providing narratives and appropriate documentation when changes in data organization, business areas, or similar structures occur.

Element 4: Periodically Review Overhead Rates After developing a cost allocation process, defining the process and ensuring it is understood by users, and determining the level of detail associated with cost allocation categories, GFOA guidance suggests that entities periodically review overhead rates. Using the CMMI scoring, we scored Element 4 – Periodically Review Overhead Rates – as CMMI Level 1 based on the following observations:

- There are mechanisms in place, including roll-forward adjustment and five-year average calculations, which allow the Comptroller to complete the tasks of periodically reviewing overhead rates.
- A lack of formally documenting decisions on some allocations required extensive auditor discussions and follow-up. The Comptroller can further improve its process with more formalized documentation on department restructures and their potential effect on overhead rates.

The GFOA recommends that governments review overhead charges periodically based on factors such as the adequacy of cost recovery and use of services.

Comptroller's staff informed us that cost plans undergo a series of reviews and quality-control checks by at least three levels of management. The expectations for review are also listed in the newly implemented Process Narrative, effective June 30, 2015.

The Comptroller also reviews overhead rates by computing roll-forward and five-year average adjustment totals yearly for each cost allocation plan. Roll forward adjustments account for the differences between actuals and estimates. Any difference is converted into an amount of indirect costs that are either added or subtracted from the current rate calculation. The five-year average adjusts for potential year-to-year volatility in the rates and it helps to stabilize rates to avoid drastic changes when possible.

We reviewed both the roll-forward adjustments and five-year averages for all four PUD overhead rates and no material discrepancies were found. However,

the Comptroller should address the concerns below in order to lessen the risk of future material findings.

The documentation that substantiates indirect cost calculations is called an IRC sheet. The Comptroller used modified IRC sheets to reflect the dissolution of the PUD administrative overhead rate in FY 2016. The sole purpose of these modified sheets was to assist in the calculation of a more accurate roll-forward adjustment for FY 2016. However, the Comptroller did not document this explanation in the rate sheets.

We also compared FY 2014–FY 2016 depreciation values in the PUD rate sheets against supporting depreciation data for each overhead rate and found a discrepancy. The Comptroller acknowledged that it used the wrong set of depreciation values in the FY 2014 modified IRC sheets.

The Comptroller recalculated the roll-forward adjustment with the proper figures, which resulted in an immaterial overhead rate change of less than one percent for each overhead rate. The Comptroller uses a one percent materiality threshold, which is based on industry guidance. With more thorough documentation within the rate sheets this error may have been avoided.

According to the *Cost Plan Handbook*, as part of a review, any significant changes to the government and its accounting procedures should be noted and recorded. While the Comptroller was able to provide an explanation regarding the usage of the retro sheets, the reason for the use of the retro documents should have been documented in the relevant supporting accounting details. GFOA guidance suggests that data should be captured and documented contemporaneously to avoid audit problems that could otherwise arise as a result of subsequent data changes. Without proper documentation, the Comptroller may find itself in a position where it is unable to comprehensively defend its decisions. Additionally, mistakes may prove to be more than an immaterial difference.

To move to CMMI Level 2, the Comptroller should improve its monitoring, control, and review of the cost allocation process by documenting rationale and accounting detail to support decisions.

- Recommendation #1** In order to formally document its cost allocation process and strengthen guidance provided to City departments, the Comptroller needs to:
- a) Provide training on the cost allocation structure, scope and purpose, key concepts, and procedures to departmental analysts in order to ensure that cost plans are developed according to established policies.
 - b) Improve its monitoring , control, and review of the cost allocation process by:
 - o Documenting rationale and accounting detail to support cost allocation decisions; and
 - o Providing narratives and appropriate documentation when changes in data organization, business areas, or similar structures occur. (Priority 2)

Finding #2 Financial Management Needs to Improve Documentation and Review of Non-Discretionary Budget Allocations and Strengthen Its Communication with Provider Departments

We reviewed the non-discretionary allocations charged to the Public Utilities Department (PUD) by examining the Citywide non-discretionary³ budget allocation process. These “non-discretionary costs” are a part of the cost allocation formula discussed in Finding 1 that ultimately factors into a department’s assigned overhead rate. Financial Management (FM) is responsible for the oversight of the non-discretionary budget process. We assessed the non-discretionary budget allocation process to determine if the overhead rates charged were reasonable, justifiable, and equitable.

Based on our review, we found that FM has developed a system that provides proper guidance to provider departments responsible for developing non-discretionary budgets. The system requires that provider departments identify and assign non-discretionary costs on a reasonable and consistent basis. However, FM needs to develop a more formalized structure for maintaining supporting documentation for non-discretionary budget allocations. FM also needs to strengthen its review of non-discretionary budgets, as well as require provider departments to certify review of their allocations prior to submittal to FM. Lastly, opportunities exist for FM to improve its communication with provider departments after non-discretionary allocations have been finalized. Specifically, FM should share, when possible, its rationale for any adjustments made to submitted budgets.

To assess the non-discretionary allocation, we divided FM’s non-discretionary budget process into four elements described in **Exhibit 6**. We then utilized the Capability Maturity Model Integration (CMMI) to score each element. The CMMI

³ Non-discretionary expenditures are costs that are determined outside of City departments’ control, such as fixed costs. Examples of non-discretionary expenditures include, but are not limited to, rent, utilities, insurance, and debt payments.

describes best practices that organizations have found to be productive and useful to achieving their specific business objectives (see **Appendix A** for details on the CMMI scoring levels). Using this testing model, for Elements 1–4, we scored FM's oversight and application of the non-discretionary budget allocation process at different levels ranging from Level 1 to Level 3. The varying scores indicate that certain parts of FM's process are more advanced than others.

On a scale of 0–3, with 3 as the highest possible score, Level 1 indicates that processes exist that accomplish needed objectives. Although Level 1 processes accomplish the needed work, improvements can be ultimately lost if they are not institutionalized. Level 2 scoring indicates that processes are executed in accordance with existing policies and relevant stakeholders are involved and have access to adequate resources. While Level 2 processes are monitored, controlled, and reviewed more closely than Level 1, improvements are necessary to maintain consistency. Level 3 processes are the most advanced and are more consistently defined and applied because they are based on organizational standard processes. Level 3 processes are managed more proactively and can adapt to organizational changes more seamlessly. The non-discretionary cost allocation elements, CMMI scores, and our rationale for the scoring of each element are described in **Exhibit 6**.

Exhibit 6**Financial Management's Oversight of Non-Discretionary Cost Allocation Methodology**

Element	Description	Score	Basis for Score
Develop Cost Allocation Process	Identify the structure that will be used to develop the Citywide Non-Discretionary Budget Allocations	Level 3	Financial Management (FM) developed the Budget Reference Manual (BRM) which provides proper guidance to departments responsible for developing non-discretionary allocations. The BRM defines a system whereby provider departments must identify and assign non-discretionary costs on a reasonable and consistent basis.
Purpose of the Cost Allocation Process Defined and Understood	Purpose of the non-discretionary cost allocation process clearly understood by the parties responsible for development and implementation	Level 2	The purpose of the non-discretionary costs process is defined and executed in accordance with policy. Responsible staff have appropriate resources and are engaged when developing allocations. However, FM should improve its level of communication with providers after allocations have been finalized. Also, FM should ensure that proper documentation is submitted by FM and provider departments to support allocation decisions.
Determine Cost Categorization	Identify the level of detail associated with non-discretionary cost allocation methodologies and the process for review	Level 2	Although not all methodologies are the same, each provider department is required to follow the same protocol. However, FM should enhance its monitoring, control, and review of the process by requiring formal signoffs by provider department management certifying review of allocations. FM should also require provider departments to include supporting documentation within its submissions explaining discretion taken or adjustments to allocations.
Periodically Review Non-Discretionary Allocations	Reviews non-discretionary allocations against actual experience and makes proper adjustments	Level 1	FM has developed a Non-Discretionary Process Tracking Sheet that provides a central repository for reviewing non-discretionary allocations. However, the guidelines for completion are not consistently followed.

Source: OCA, based on information from the Government Finance Officers Association "Pricing Internal Services Best Practice Model," the Capability Maturity Model Integration for Development, Version 1.3, and the FY 2015 San Diego Office of the City Auditor "Public Utilities Overhead Rate Review Audit Work Plan."

Using the CMMI scoring, we scored Elements 1–4 based on the following observations:

- The Citywide budget development process is iterative and prone to changes and revisions. In order to meet budget timelines, some provider departments base their budgets on preliminary figures. Once Citywide budget items are approved by City Council and the Mayor, FM makes final adjustments to submitted provider department non-discretionary budget items.
- After FM makes changes to non-discretionary budgets, little to no information is forwarded to provider departments regarding the rationale for FM's adjustments.
- There are multiple non-discretionary allocation methodologies. While each provider is required to follow the same process, each methodology needs its own level of review. Since FM is the coordinator and overseer of the process, but each provider department develops its own methodology, it is imperative that the process and roles for review are clear, consistently followed, and properly approved.

Through better documentation and supporting documentation for non-discretionary budget decisions, and improved communication with provider departments, FM can improve its CMMI scores towards the ultimate goal of Level 3. A detailed description for the scoring of the four elements is described in the sections below.

**Element 1: Develop
Cost Allocation
Process**

When developing a cost allocation process, Government Finance Officers Association (GFOA) guidance suggests that entities identify the structure that will be used to develop the cost allocation plan. FM is responsible for the oversight of the City's non-discretionary budget allocation process. Non-discretionary expenditures are costs that are determined outside of City departments' control, such as fixed costs. Examples of non-discretionary expenditures include rent, utilities, insurance, debt payments, etc.

Using the CMMI scoring, we scored Element 1 – Develop Cost Allocation Process – as CMMI Level 3 based on the following observations:

- FM's Budget Reference Manual (BRM) provides proper guidance to departments responsible for developing non-discretionary budget allocations.
- The BRM defines a system whereby provider departments must identify and assign non-discretionary costs on a reasonable and consistent basis.

- The BRM clearly states the purpose, inputs, entry criteria, activities, roles, measures, verification steps, outputs, and exit criteria necessary to properly complete the process.

According to the 2012 California State Controller's Office *Handbook of Cost Plan Procedures for California Counties (Cost Plan Handbook)*, before indirect costs and central service charges may be claimed for reimbursement, there must be some formal means of accumulating and identifying these types of costs to all benefiting departments. The best method of accumulating and identifying costs and any use allowances is a cost plan in accordance with the cost principles set forth in the Code of Federal Regulations⁴ (CFR). Moreover, GFOA states that regardless of the purpose of an indirect cost allocation, a systematic and rational methodology should be used to calculate the amounts allocated.

We reviewed the FY 2016 Non-Discretionary Budget Process in the BRM and found that FM has identified a structure to develop and implement non-discretionary budget allocations Citywide. The same process has been in place since at least FY 2013 and is in accordance with the CFR. The non-discretionary budget process consists of four major phases that are completed between late September and early January of each fiscal year. Each phase requires the completion of required forms and review of submissions by FM and stakeholder departments.

To remain at Level 3: Defined, Financial Management should continue monitoring the process proactively by making improvements to the structure as needs arise.

Element 2: Purpose of the Cost Allocation Process Defined and Understood

As described in Element 1, FM uses the non-discretionary budget allocation as defined in the BRM to assist in its oversight of the non-discretionary budget allocations process. GFOA guidance suggests that the purpose of the non-discretionary budget process should be clearly defined for and understood by staff involved. Using the CMMI scoring, we scored Element 2 as CMMI Level 2 based on the following observations:

- The non-discretionary allocation process is defined and executed in accordance with the policies and procedures as outlined in the BRM.
- The staff responsible for developing non-discretionary allocations have the resources necessary to produce controlled outputs.

⁴ Title 2 of the Code of Federal Regulations Part 225.

- Relevant stakeholders are engaged at the front-end of the non-discretionary allocation process.

Although the non-discretionary budget process is coordinated by FM, non-discretionary budgets are developed by provider departments. Provider departments: 1) provide a service to the client department; 2) process the payment of the non-discretionary expenditures on behalf of the client department; or 3) are most knowledgeable of the non-discretionary expenditures, and can therefore develop the most accurate projection for the non-discretionary commitment item.

Without comprehensive knowledge of the allocation process, staff may provide incorrect data that could produce overhead rates that are either too high or too low. As discussed in Finding 1, if rates are too low, then departments are not recovering their costs. If rates are too high, then departments are overcharging their customers. In the case of Enterprise Funds, ratepayers would be overcharged.

We found that the non-discretionary allocation development process was clearly defined by FM and understood by provider departments. However, there is an opportunity for FM to improve its communication with provider and client departments regarding changes FM makes to submitted allocation plans.

The BRM, and its supplemental forms, meet the *Cost Plan Handbook's* guidelines for documenting and organizing cost allocation plans. The *Cost Plan Handbook* recommends, and the BRM includes, process narratives that:

- Include a description of the methodology used to identify amounts allocated to client departments;
- Include a description of the types of costs that are considered to be allowable, an explanation of why these costs are allowable, and a discussion of the method(s) used to separate allowable costs from those costs considered to be unallowable; and
- Reflect standards and policies in the CFR requiring provider departments to identify and assign non-discretionary costs on a reasonable and consistent basis.

Although we found that the non-discretionary development process is understood by provider departments, an opportunity exists for FM to improve its level of communication with provider departments. We surveyed provider departments to assess their roles, responsibilities, and knowledge of certain

aspects of the process. Overall, almost 65 percent of respondents had three or more years of experience as the point of contact for developing the non-discretionary allocations. Roughly 80 percent felt fairly to very confident that their department was developing their non-discretionary methodologies in accordance with the BRM. Also, more than 90 percent of respondents indicated training and informational resources provided by FM are adequate; helpful but could be improved; or useful and allows respondents to confidently complete their tasks with completing the non-discretionary budget allocation process.

However, when asked about FM's role in the process, or recommendations that would improve departments' understanding of the allocation process, there was a general consensus that provider departments would like FM to improve its communication with provider departments. Specifically, they expressed a need for consistent notification about changes made by FM to provider department allocations after submittal. Respondents also noted that the reasons for the changes are not communicated to them.

To that end, we found that documentation of discretion taken or changes made by City departments and FM when developing non-discretionary allocations needs improvement. For example, we tested the FY 2016 allocation figures for Information Technology Services Transfer (IT Services) non-discretionary item. The IT Services allocation is used to fund coordinated information technology efforts and Citywide standards under the oversight of the Department of Information Technology (DoIT). In order to meet budget development timelines, in FY 2016 DoIT used its discretion to baseline its expenditures submitted to FM. DoIT estimated \$12 million in expenses. According to DoIT, the \$12 million was the best estimate given the snapshot in time. However, after FM made adjustments, the finalized allocation amount increased to approximately \$12.7 million. According to FM, the difference in these amounts reflected budget adjustments approved as part of the Proposed Budget and May revise.

We found no evidence of written explanations within DoIT's supporting details explaining that calculations were based on estimates in order to meet FM timelines. We also found no evidence of FM's reasoning for adjusting allocations in supporting documentation. However, after discussions with FM, the rationale for the increase was provided.

In discussions with FM, they note that adjustments may be based on: 1) provider department adjustments to their budgets, such as the addition of full time

equivalents; or 2) requests that increase or decrease expenditures, which in turn impact the operational budget and subsequently the allocation amounts.

The CFR requires that for costs to be considered allowable, they must be adequately documented. Without adequate documentation, City departments cannot properly defend their requests, and FM cannot properly defend its approval, for recouping overhead costs. FM also cannot communicate its rationale for adjustments to relevant parties.

According to FM, the BRM module currently offers high level status updates, but does not provide departments with details explaining the changes in allocations. FM noted that details are not always possible because some information is confidential and sensitive until the final budget is approved. However, FM agreed that more information could be provided.

To move to CMMI Level 3: Defined, FM should enhance its monitoring, control, and review of the non-discretionary process by:

- Proactively and systematically engaging provider and client departments at the back-end of the process by providing details about changes to budget allocations; and
- Ensuring that FM and City departments provide proper documentation for allocation decisions.

**Element 3: Determine
Cost Categorization**

GFOA guidance suggests that entities identify the level of detail associated with developing non-discretionary cost allocations. Given that non-discretionary items are developed by provider departments who provide different types of services, not all allocation methodologies are the same.

Using the CMMI Scoring, we scored Element 3 as CMMI Level 2 based on the following:

- The non-discretionary allocation process is defined and executed in accordance with existing policy that requires provider departments to submit supporting documentation for budget allocations. Although not all methodologies are the same, each provider is required to follow the same protocol.
- Relevant stakeholders, being provider departments who have the most expertise about their respective services, are engaged.

Although provider departments are responsible for developing non-discretionary budget allocations, according to the *Cost Plan Handbook*, it is

essential that FM review submissions to ensure: 1) costs are compared to the financial statements containing the actual costs upon which it was based; 2) adherence to proper costs principles and procedures; and 3) non-discretionary budget allocations are mathematically correct.

We found that FM should develop additional mechanisms that ensure provider departments properly and sufficiently support discretion taken or adjustments made when developing non-discretionary budget allocations. As of FY 2016, there are approximately 42 non-discretionary commitment items assigned to approximately 11 provider departments. Each provider department has a specific and different methodology for calculating their account which is based on the provider department's expertise.

According to FM, to manage the risk of varied methodologies, FM assigns specific analysts as liaisons to specific departments. The assigned analyst liaison is responsible for, but is not limited to, evaluating calculations, comparing year-over-year changes, and reviewing historical trends. The analyst liaison's evaluation is reviewed by at least three levels of staff and management.

When reviewing the SAP Support allocation, we found no material financial discrepancy. However, there is an opportunity for FM to improve internal controls before more costly discrepancies occur.

The SAP Support Allocation is used for the administrative, functional, developmental, and technical resources required for ongoing operations and maintenance of the City's Enterprise Resource Planning system. While reviewing the FY 2016 SAP Support Allocation, we found that General Fund data for the final allocation did not match the supporting documentation.

According to DoIT, the discrepancy in the General Fund amount is a result of the final allocation including adjustments that were not reflected in the supporting data. The final allocation is less adjustments for funds related to Engineering and Capital Projects and Parking Operations. According to DoIT, the deductions were part of the General Fund in FY 2015 and moved to Enterprise Funds in FY 2016. Thus, the analysts made adjustments to not include the funds in the FY 2016 data.

We found no evidence of written explanations within DoIT's supporting details explaining DoIT's adjustments to the General Fund allocation. Moreover, given that two departments were changed from General Fund to Enterprise Fund

departments, we would have expected some level of communication between FM and IT indicating the change was recognized in the accounting detail.

According to FM, ultimately the methodology used in the calculation is the responsibility of the provider departments. With FM's reliance on provider departments for developing non-discretionary budget allocations, it is in FM's best interest to develop a mechanism that ensures a higher level of assurance that allocations have been properly reviewed and documented. FM notes that historically there has not been a formalized sign-off or approval acknowledgment on the part of the provider department Directors when submitting materials to FM. They agreed that this is an area for improvement.

Moreover, currently FM requires that provider departments submit backup documentation that includes the calculation spreadsheets containing the budget allotments by fund and business areas, as well as any other documentation used in the calculation of non-discretionary allocations. In addition to Director sign-offs, FM should also require provider departments to include supporting documentation within its submissions explaining any discretion taken or adjustments made when developing allocations.

The addition of these controls should not be at the expense of FM continuing to improve its own internal review process. As the entity responsible for monitoring the City's revenues and expenditures, it is essential that FM improves its level of communication with departments, inclusive of providing updates when submitted allocations have been adjusted.

To move to Level 3: Defined, FM should enhance its monitoring, control, and review of the non-discretionary process by:

- Requiring provider departments Directors to formally sign-off acknowledging that non-discretionary allocations have been properly reviewed and documented;
- Requiring provider departments to include supporting documentation within its submissions explaining any discretion taken or adjustments made when developing allocations; and
- Proactively managing the process to ensure that FM is providing due care in its review of provider department submissions.

Element 4: Periodically Review Non-Discretionary Allocations After developing a cost allocation process, defining the process and ensuring it is understood by users, and determining the level of detail for developing allocations, GFOA guidance suggests that entities periodically review overhead rates. Using the CMMI Scoring, we scored Element 4 – Periodically Review Non-Discretionary Allocations – as CMMI Level 1 based on the following:

- FM's "Non-Discretionary Process Tracking Spreadsheet" is structurally organized and provides a central repository to review non-discretionary allocations; and
- Guidelines to keep the information updated are not consistently followed.

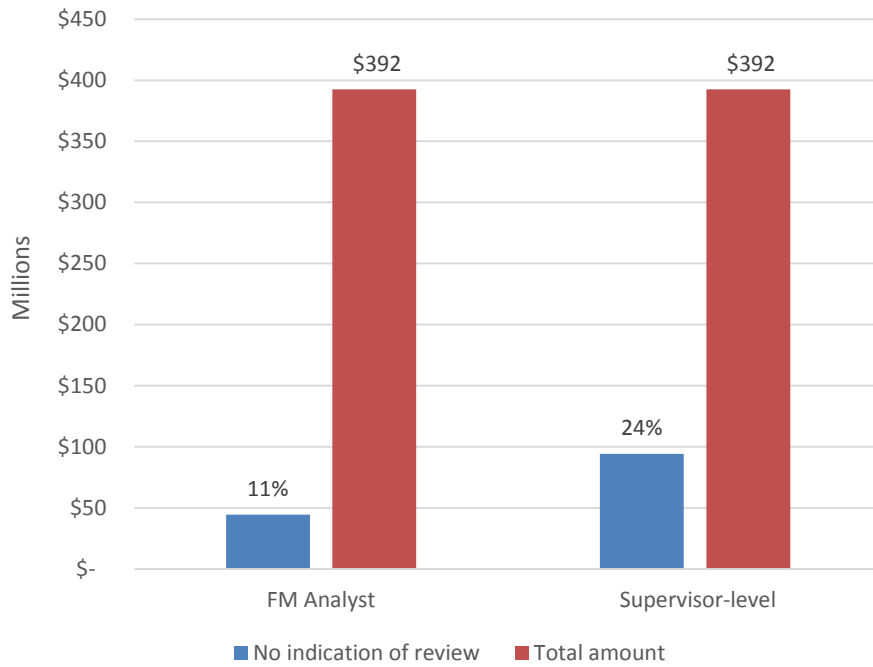
As part of its responsibilities, FM monitors the City's revenues and expenditures, oversees budget transfers and adjustments, and develops and updates the City's Five-Year Financial Outlook (Outlook). The Outlook guides long-range fiscal planning and is focused on identified Priority Initiatives for the coming fiscal years. FM also conducts quarterly Budget Monitoring, including analyses of expenditures against actuals, for prioritized strategic initiatives. Although these efforts may involve some evaluation of non-discretionary items as part of its yearlong budget monitoring, FM has developed a "Non-Discretionary Process Tracking Spreadsheet" (Tracking Sheet) for a more detailed review of all non-discretionary costs during budget formulation.

The Tracking Sheet centralizes relevant information regarding 42 different non-discretionary items. It includes information listing each non-discretionary commitment item, whether the item was reviewed by an FM analyst and supervisor, a year-over-year variance analysis, and an open-ended field for any relevant notes regarding the item.

According to FM, analysts are instructed to update the Tracking Sheet to indicate that provider department submissions have been received and reviewed. However, we found that not all fields in the Tracking Sheet had been completed. As shown in **Exhibit 7**, multiple non-discretionary items were without indication of FM Analysts' Review and supervisory-level review. The items without review indicators accounted for approximately 11 percent and 24 percent of the \$392 million of total FY 2016 non-discretionary costs respectively.

Exhibit 7

FY 2016 Amount of Non-Discretionary Items without Indication of Review



Source: OCA, based on data provided by Financial Management within the Non-Discretionary Process Tracking Sheet.

According to State Controller guidance, before approval of cost allocation plans, entities should conduct a comprehensive review with an assigned analyst. FM could improve its review process and transparency by ensuring that information within the Tracking Sheet is completed and that any outstanding issues identified on the Tracking Sheet are resolved.

To move to Level 2, FM should ensure that the Tracking Sheet, its major source of documented review of non-discretionary items, is fully completed and that any documented outstanding issues are being resolved.

- Recommendation #2** In order to develop a more formalized structure for maintaining supporting documentation for non-discretionary budget allocations and improve its communication with provider departments, Financial Management should enhance its monitoring, control, and review of the non-discretionary process by:
- a) Engaging provider departments after allocations have been formalized by providing more detailed updates in the Budget Reference Manual;
 - b) Requiring provider departments to document assumptions made, adjustments made, and discretion taken within supporting documentation submitted to Financial Management as part of its budget allocation submissions;
 - c) Requiring provider department Directors to formally sign-off acknowledgement that non-discretionary allocations submitted to Financial Management have been properly reviewed and documented; and
 - d) Assessing the feasibility of implementing SD Share to track its review of and maintain documentation for the non-discretionary allocation process. (Priority 2)

Finding #3 The Public Utilities Department Needs to Formalize Its Cost Allocation Review Process and Strengthen Guidance Provided to Internal Staff

The Public Utilities Department (PUD) is responsible for the operation and maintenance of the City's wastewater and water systems. It is imperative that PUD thoroughly and properly accounts for its expenditures to increase transparency and build public trust. We found that PUD should formalize its cost allocation review process and strengthen its guidance provided to internal staff. Currently, the process relies on institutional knowledge and is not equipped to maintain continuity of operations should staff turnover occur. We also found that PUD has undergone a series of restructures over the past two years. However, PUD has not properly documented its review of the accompanying reassignment of costs resulting from the restructure.

PUD uses internal staff when reviewing City-assessed overhead rates. As discussed in Finding 1, the City uses the standard cost allocation methodology overseen by the Office of the City Comptroller (Comptroller) to recoup costs for services.

PUD Overhead Rate Review Process

We reviewed PUD's internal process for reviewing Citywide overhead rates assessed to them through the City's standard cost allocation methodology. As part of the standard cost methodology, the Comptroller requires City departments to review their own accounting and ensure that expenditures are correctly identified as direct or indirect costs. As this relates to PUD, if a City department that provides a service to PUD incorrectly classifies expenditures, they may overcharge or undercharge PUD for services rendered. Since PUD is an Enterprise Fund, if PUD is overcharged, its ratepayers are overcharged. Conversely, if PUD is undercharged, its ratepayers would be undercharged. Similarly, if PUD provides a service to a City department and PUD's overhead rates are too high, it would be overcharging departments. If PUD's overhead rates are too low, it would be undercharging for its services, and PUD ratepayers would make up the difference.

As previously discussed in Findings 1 and 2, it is important that expenditures are correctly classified by all City departments because this affects their assigned overhead rates. In the case of PUD, we found that PUD could not articulate its internal process for tracing and classifying expenditures as direct and indirect costs. According to PUD, it works with the Comptroller to review internal orders and cost classifications. For PUD, some internal orders are easily categorized as direct costs based on a PUD/Comptroller numbering system. Certain PUD divisions are more driven by indirect costs.

We found that presently, PUD's documentation of its expenditure reviews is person-dependent. Due to staff turnover, it was unable to produce documentation from the previous FY 2016 review. PUD stated that during FY 2016 and FY 2017, classification of expenditures as direct and indirect costs were completed via verbal conversations. There is no centralized repository of relevant documentation or process instruction that can be accessed by succeeding staff should turnover occur. Reviews are conducted based on institutional knowledge. Should this knowledge base leave, the process could not be seamlessly repeated.

We also found that PUD did not properly document its review of the reassignment of administrative costs. Similarly, in Finding 1 Element 3 we found that the Comptroller did not provide enough accounting detail and supporting documentation for the allocation determination. As discussed in Finding 1 Element 3, PUD's overhead rate structure changed from four overhead rates in FY 2015 to three overhead rates in FY 2016.

According to PUD, it agreed to three overhead rates with the intention of reviewing the new structure in more detail. However, there was no formal documentation of a review. PUD stated in the interest of time and to meet deadlines, it verbally discussed and agreed with the methodology and reasoning for the change with the Comptroller.

In FY 2017, PUD is restructuring and consequently its overhead rate structure will be reduced from three to one. Since PUD has undergone two overhead rate restructures within the last two years, it is imperative that both the Comptroller's and PUD's documentation provide narratives and accounting details explaining the changes.

According to the *Cost Plan Handbook*, the ability to support cost plans with complete and accurate financial and statistical records is imperative. A clear,

comprehensible, and complete audit trail must be maintained. According to GFOA, data should be captured and documented contemporaneously to avoid audit problems. Additionally, accurate and complete narratives describing PUD's methodology for reviewing expenditures is necessary to ensure operational continuity in the event of staff turnover. Given that PUD is an Enterprise Fund department whose revenue is generated through ratepayers for services rendered, it is in PUD's best interest to formalize its review process and improve its level of documentation to continue to increase transparency and public trust.

Recommendation #3 In order to formalize its cost allocation review process and strengthen guidance provided to department staff, the Public Utilities Department should:

- a) Ensure that cost classification reviews are housed in a central repository; and
- b) Formalize the internal cost classification review process by developing a department instruction outlining the steps of the process. (Priority 2)

Recommendation #4 In order to maintain a clear, comprehensible, and complete audit trail, the Public Utilities Department, in conjunction with the Office of the City Comptroller, should properly document the Public Utilities Department's changes in overhead rate structure from four overhead rates to one and include:

- a) A narrative explaining the reasons for each change;
- b) The accounting detail showing, or an explanatory note if accounting detail is not possible, the redistribution of funds; and
- c) Directions for how the rates should be calculated going forward (such as when roll-forward adjustments and five-year averages should begin). (Priority 2)

Conclusion

Although the Office of the City Comptroller has accomplished the work needed to produce reasonable and equitable yearly cost allocation plans, formal documentation of the cost allocation process and additional guidance to City departments are needed to ensure rates are always fully justifiable. A more formalized structure is needed for documenting internal processes, maintaining supporting documentation for cost allocation decisions, and periodically training City staff to consistently categorize costs to reduce the risk of unjustifiable overhead rates.

Similarly, Financial Management (FM) has developed a system that provides proper guidance to provider departments responsible for developing non-discretionary budgets. FM can improve the system by developing a more formalized structure for maintaining supporting documentation for non-discretionary budget allocations. FM also needs to strengthen its review of non-discretionary budgets, as well as require provider departments to certify review of their allocations prior to submittal to FM. Lastly, opportunities exist for FM to improve its communication with provider departments after non-discretionary allocations have been finalized.

The Public Utilities Department (PUD) should also formalize its cost allocation review process and strengthen its guidance provided to internal staff. Additionally, PUD should properly document its review of the accompanying reassignment of costs resulting from a series of restructures over the last several years.

Each of the offices above has a foundation for improvement in place with staff dedicated to improving the overhead rate calculation process. Each entity could improve its capabilities by relying less heavily on current key individuals, and by increasing the guidance, training, and formal procedures should critical staff turnover occur.

Recommendations

Recommendation #1 In order to formally document its cost allocation process and strengthen guidance provided to City departments, the Comptroller needs to:

- a) Provide training on the cost allocation structure, scope and purpose, key concepts, and procedures to departmental analysts in order to ensure that cost plans are developed according to established policies.
- b) Improve its monitoring , control, and review of the cost allocation process by:
 - Documenting rationale and accounting detail to support cost allocation decisions; and
 - Providing narratives and appropriate documentation when changes in data organization, business areas, or similar structures occur. (Priority 2)

Recommendation #2 In order to develop a more formalized structure for maintaining supporting documentation for non-discretionary budget allocations and improve its communication with provider departments, Financial Management should enhance its monitoring, control, and review of the non-discretionary process by:

- a) Engaging provider departments after allocations have been formalized by providing more detailed updates in the Budget Reference Manual;
- b) Requiring provider departments to document assumptions made, adjustments made, and discretion taken within supporting documentation submitted to Financial Management as part of its budget allocation submissions;
- c) Requiring provider department Directors to formally sign-off acknowledgement that non-discretionary allocations submitted to Financial Management have been properly reviewed and documented; and
- d) Assessing the feasibility of implementing SD Share to track its review of and maintain documentation for the non-discretionary allocation process. (Priority 2)

Recommendation #3 In order to formalize its cost allocation review process and strengthen guidance provided to department staff, the Public Utilities Department should:

- a) Ensure that cost classification reviews are housed in a central repository;
and
- b) Formalize the internal cost classification review process by developing a department instruction outlining the steps of the process. (Priority 2)

Recommendation #4 In order to maintain a clear, comprehensible, and complete audit trail, the Public Utilities Department, in conjunction with the Office of the City Comptroller, should properly document the Public Utilities Department's changes in overhead rate structure from four overhead rates to one and include:

- a) A narrative explaining the reasons for each change;
- b) The accounting detail showing, or an explanatory note if accounting detail is not possible, the redistribution of funds; and
- c) Directions for how the rates should be calculated going forward (such as when roll-forward adjustments and five-year averages should begin). (Priority 2)

Appendix A: Audit Recommendation Priorities

DEFINITIONS OF PRIORITY 1, 2, AND 3

AUDIT RECOMMENDATIONS

The Office of the City Auditor maintains a priority classification scheme for audit recommendations based on the importance of each recommendation to the City, as described in the table below. While the City Auditor is responsible for providing a priority classification for recommendations, it is the City Administration's responsibility to establish a target date to implement each recommendation taking into considerations its priority. The City Auditor requests that target dates be included in the Administration's official response to the audit findings and recommendations.

Priority Class ⁵	Description
1	<p>Fraud or serious violations are being committed.</p> <p>Significant fiscal and/or equivalent non-fiscal losses are occurring.</p> <p>Costly and/or detrimental operational inefficiencies are taking place.</p> <p>A significant internal control weakness has been identified.</p>
2	<p>The potential for incurring significant fiscal and/or equivalent non-fiscal losses exists.</p> <p>The potential for costly and/or detrimental operational inefficiencies exists.</p> <p>The potential for strengthening or improving internal controls exists.</p>
3	<p>Operation or administrative process will be improved.</p>

⁵ The City Auditor is responsible for assigning audit recommendation priority class numbers. A recommendation which clearly fits the description for more than one priority class shall be assigned the higher number.

Appendix B: Objectives, Scope, and Methodology

Objectives In accordance with the Office of the City Auditor's FY 2015 Work Plan, we conducted a performance audit of the Public Utilities Department (PUD) Overhead Rates. Specifically, we reviewed the overhead rates assigned to PUD by examining the cost allocation methodologies used to develop overhead rates Citywide. The objectives of this audit were to:

- Assess the standard cost allocation methodology to determine if the overhead rates assigned to PUD are reasonable, equitable, and justifiable;
- Assess the non-discretionary costs allocation methodology to determine if the overhead rates assigned to PUD, specifically related to General Government Services Billing (GGSB) and IT costs, are reasonable, equitable, and justifiable; and
- Determine if the process used by PUD to develop overhead rates and which costs are passed to ratepayers, is reasonable, equitable, and justifiable.

The review of rates assigned to PUD through the City of San Diego's (City) standard cost allocation process and the development of water and sewer utility rates paid by ratepayers are two separate processes. The process to develop utility rates was not within the scope of our audit for review.

Scope and Methodology To assess the standard cost allocation and non-discretionary costs methodologies, we engaged in discussions with the Office of the City Comptroller (Comptroller) and Financial Management (FM) to understand their respective roles and responsibilities in the two methodologies. In summary, the Comptroller is responsible for the oversight of the standard cost allocation plan, which details the steps the City has undergone to calculate and apply the various rates used by all City departments. FM is responsible for the oversight of the non-discretionary allocations, which are expenditures that are determined outside of departments' control, such as fixed costs like rent and utilities.

Also, in an effort to simplify the complex subject matter of the City's overhead rate methodologies and better guide fieldwork, we developed a methodology that would allow for logical organization and summation of our analyses for

end-users to understand. We developed our methodology with adaptations based on the following:

- ***The Government Finance Officers Association's (GFOA) Pricing Internal Services Model*** – which are suggested guidelines for creating a system that assigns prices for the use of internal services such as information technology, human resources, and payroll. While we were not making a one-to-one comparison of the City's cost allocation methodology against the GFOA guidelines, we modeled our final categories based on themes and ideas presented in the element.
- ***GFOA Taking Advantage of Indirect Cost Allocations*** – In summary, this GFOA document indicates that regardless of the purpose of an indirect cost allocation, a systematic and rational methodology should be used to calculate the amounts allocated. We used concepts within the GFOA guidelines to support our descriptions of the final elements for review in our methodology.
- ***Office of the City Auditor Public Utilities Overhead Rate Review Audit Plan*** – We used our Audit Plan to support our descriptions of the final elements for review in our methodology.
- ***The Capability Maturity Model Integration (CMMI) for Development Scoring Rubric*** – provides a comprehensive set of guidelines for developing services, including those within government. The scoring rubric evaluates the level of achievement within each element reviewed and enables entities to incrementally improve processes.
- ***Office of the State Controller - Handbook of Cost Plan Procedures for California Counties*** – developed to assist California counties in the understanding and the application of the cost principles and standards established by the Federal Office of Management and Budget Rules and Regulations 2 CFR Part 225 (former title of 2 CFR Part 225) for State and local governments and federally-recognized Indian tribal governments (governmental units).
- ***Title 2 of the Code of Federal Regulations Part 225 Cost Principles for State, Local and Indian Tribal Governments*** – establishes principles and standards to provide a uniform approach for determining costs and to promote effective program delivery, efficiency, and better relationships between governmental units and the Federal Government. The principles are for determining allowable costs only.

Our methodological elements are shown in **Exhibit 8**.

Exhibit 8

Office of the City Auditor Cost Allocation Methodology

Element	OCA Description
1. Develop Cost Allocation Process	Identify the structure that will be used to develop the Citywide Cost Allocation Plan
2. Purpose of the Cost Allocation Process Defined and Understood	Purpose of the cost allocation process clearly understood by the parties responsible for development and implementation
3. Determine Cost Categorization	Identify the level of detail associated with cost allocation categories (e.g. internal orders, cost centers, etc.) and the process for determination and review
4. Periodically Review Overhead Rates	Reviews overhead rates against actual experience and makes proper adjustments

Source: OCA, based on the Government Finance Officers Association Pricing Internal Services Best Practice Model, and the FY 2015 San Diego Office of the City Auditor "Public Utilities Overhead Rate Review Audit Work Plan."

The scoring rubric for the four elements is shown in **Exhibit 9**.

Exhibit 9

Capability Maturity Model Integration Scoring Rubric

Capability Level	Description
Level 0: Incomplete	<p>Process either not performed or is partially performed</p> <p>One or more specific goals of the process area are not satisfied</p> <p>No generic goals exist</p>
Level 1: Performed	<p>Accomplishes needed work to produce work products</p> <p>Specific goals are satisfied</p> <p>Improvements can be lost over time if not institutionalized</p> <p><i>Equivalent to saying processes are "performed processes"</i></p>
Level 2: Managed	<p>Processes planned and executed in accordance with policy</p> <p>Employs skilled people having adequate resources to produce controlled outputs</p> <p>Involves relevant stakeholders</p> <p>Is monitored, controlled, and reviewed</p> <p>Is evaluated for adherence to its process description</p> <p><i>Equivalent to saying, "there is a policy that indicates you will perform process, there is a plan for performing it, resources are provided, responsibilities are assigned, and training is provided"</i></p>
Level 3: Defined	<p>Processes described more rigorously than Level 2</p> <p>Processes clearly states purpose, inputs, entry criteria, activities, roles, measures, verification steps, outputs, and exit criteria</p> <p>Processes managed more proactively</p> <p><i>Equivalent to saying, "organizational standard processes exist associated with that process area, which can be tailored to the needs of the project"</i></p>

Source: Capability Maturity Model Integration (CMMI) for Development, Version 1.3.

Using the above methodology, we reviewed the PUD business areas and funds listed in **Exhibit 10**.

Exhibit 10

Public Utilities Business Areas and Operating Funds

Description	Business Area Description	Fund
Public Utilities Administration and Management	BA 2000	700000, 700001, 700011
Metropolitan Wastewater Municipal and Metropolitan Wastewater Metro	BA 2011 and 2012	700000, 7000001
Water	BA 2013	700011, 100000

Source: OCA analysis, based on data within SAP and FY 2016 Adopted Budget.

Our period of review spans between FY 2007-FY 2016. The review of the development of the cost allocation process (Element 1) for the standard cost allocation methodology is from FY 2007-FY 2016. The current standard cost allocation structure was developed by PRM in FY 2007 and we wanted to make a comparison to FY 2016 to determine if the structure was still in use. Also most standard cost allocation plans are developed based on expenditures two years in arrears. Thus, reviewing FY 2016 and FY 2015 expenditures required data from FY 2014 and FY 2013 respectively. Lastly, non-discretionary methodologies are developed by each provider department to develop the most accurate projection. To that end, each methodology uses different snapshots in time. Our testing included, but was not limited to: 1) tracing the overhead accounting detail for GGSB costs and IT-related expenditures; 2) evaluating the level of consistency of how cost centers and internal orders were classified as direct or indirect by PUD from year to year; and 3) interviewing department staff involved in developing and reviewing overhead rates.

To determine if the process used by PUD to develop overhead rates is reasonable, equitable, and justifiable, we met with PUD management to discuss their mechanisms for tracking overhead costs and developing overhead rates. We also reviewed reports generated by outside entities, such as the 2013 Cost of Service Study for the Water Fund, and the Exhibit E audit, which represents an opinion on the fairness of the allocation of expenses for billing related to the Metropolitan Wastewater Utility.

We conducted this performance audit in accordance with Generally Accepted Government Auditing Standards. These standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on the audit objectives.

Appendix C: Cost Classification Matrix (Element 2)

As part of its standard cost allocation process, the Office of the City Comptroller uses the Cost Classification Matrix shown in **Exhibit 11** to categorize cost centers and internal orders as direct or indirect costs. The matrix provides a final determination for instances where both a cost center and internal order may exist for the same cost item. Indirect costs result in higher overhead. Therefore, it is essential that staff involved in the development and review of the Citywide overhead rates understand the relationship between cost centers and internal orders and how these costs get categorized.

Exhibit 11

Cost Classification Matrix

Classification		
Cost Center	Internal Order	Resulting
Direct	None	Direct
Indirect	None	Indirect
Direct	Direct	Direct
Indirect	Direct	Direct
Direct	Indirect	Indirect
Indirect	Indirect	Indirect

Source: City of San Diego Office of the City Comptroller.

Appendix D: Calculations of Roll Forward (Element 4)

Comptroller's computes the roll-forward adjustment as shown in **Exhibit 12**.

Exhibit 12

BA 2013 FY 2016 Roll-Forward Calculation

CITY RATE
CITY OF SAN DIEGO
FY16 COST ALLOCATION PLAN
INDIRECT RECOVERABLE COST RATE (IRC)
WATER (2013)

	<u>Total</u>	<u>Indirect</u>	<u>Direct</u>
Salaries and Wages	\$ 39,102,703	7,400,436	31,702,267
Fringes Benefits	28,630,958	5,508,138	23,122,820
Supplies/Services	84,808,828	11,180,007	73,628,821
Gen Gov't Svcs Billing	9,752,529	9,752,529	-
IT Expenditures	5,540,398	2,857,011	2,683,387
Energy/Utilities	11,797,459	253,716	11,543,743
Capital Expenditures	4,896,296	3,078,689	1,817,608
	<u>\$ 184,529,171</u>	<u>40,030,526</u>	<u>144,498,645</u>

Adjustments to Indirect Costs:

Less:

Capital Expenditures 3,078,689

Plus:

Depreciation of Equipment 5,361,761

Depreciation of Buildings -

Operation/Maintenance/Rent of Buildings -

Administrative Support -

Department Adjusted Indirect Costs 42,313,599 133.5%

FY16 Roll Forward Adjustment: (5,461,718)

FY16 Indirect Costs w/ Rollforward 36,851,881 116.2%

Five Year Average IRC Rate 108.4%

Business Area 2013 FY16 Roll-Forward Adjustment Factors

Direct Salaries and Wages \$31,702,267

FY14 Department Adjusted Indirect Costs Overhead Rate 150.7%

Department Adjusted Indirect Costs \$42,313,599

Roll-Forward Calculation = \$42,313,599 - (\$31,702,267 * 150.7%) = **(\$5,461,718)**


Source: OCA, based on the Office of the City Comptroller, Business Area 2013 (Water) Cost Allocation Plan.



The City of San Diego
M E M O R A N D U M

DATE: January 29, 2016

TO: Eduardo Luna, City Auditor

FROM: Rolando Charvel, City Comptroller
Via Mary Lewis, Chief Financial Officer 

SUBJECT: Management's Response to the Performance Audit of the City's Overhead Rate Calculation Process

This memorandum is management's response to the Performance Audit of the City's overhead Rate Calculation Process conducted by the Office of the City Auditor.

Recommendation #1: In order to formally document its cost allocation process and strengthen guidance provided to City departments, the Comptroller's Office needs to:

- Provide training on the cost allocation structure, scope and purpose, key concepts, and procedures to departmental analysts in order to ensure that cost plans are developed according to established policies.
- Improve its monitoring, control, and review of the cost allocation process by:
 - Documenting rationale and accounting detail to support cost allocation decisions; and
 - Providing narratives and appropriate documentation when changes in data organization, business areas, or similar structures occur.

Management Response: Agree with Recommendation.

The Comptroller's Office developed a formal Citywide Cost training program in July of 2015. A pilot training was provided to Transportation and Storm Water Department in August of 2015, then expanded to all City departments in October and November 2015. The training covered:

- The scope and purpose of the cost plan

Page 2
Eduardo Luna, City Auditor
January 29, 2016

- Definitions of direct and indirect cost
- How the City's accounting structure is the underlying basis for the cost allocation process
- How the department's decisions can impact the cost allocation process
- The department's role and responsibilities within the process

This training will be provided annually to ensure that responsible departmental staff throughout the City, including those new to their positions, are trained and fully able to perform their role in the cost allocation process. The Comptroller's Office plans to continuously improve the training program each year by incorporating feedback from evaluations completed by attendees.

As noted in the City Auditor's report, the Comptroller's Office "has a systematic and rational methodology it uses to calculate the amounts allocated" in its cost allocation process, in accordance with Government Finance Officers Association (GFOA) guidelines. The City Auditor's report also noted that the Comptroller's Office uses a "consistent allocation structure to develop Citywide standard cost plans for both general fund and enterprise fund departments" and that "the plans used are in accordance with the Code of Federal Regulations." The Code of Federal Regulations establishes standards for the calculation of federal overhead rates. It is important to note that the performance audit did not identify any material misstatements in the calculation of overhead rates.

The City's financial system (SAP), allows for the use of cost elements to effectively categorize financial data and calculate overhead rates. These rates can be traced back to the underlying data used to compute the rates. The current cost allocation process has been performed consistently for many years. It is a process that requires annual review by departments and the Comptroller's Office. This annual review process results in continuous and cumulative improvements to the categorization of the cost allocation data.

The cost allocation process was formally documented in Process Narratives No. 0349 and 0350 in June of 2015. Each year Comptroller's staff works to further refine and improve the cost allocation process, consistent with the Office's performance goals and objectives. With the development of the FY2017 cost allocation plan, the Comptroller's Office has already implemented the OCA recommendation and continued the multiyear effort to improve its monitoring, control, and review of the process. This was achieved by including within the cost allocation plan the documentation of decisions that are made throughout the cost allocation process, including documentation of year-over-year organizational changes and changes in rationale in the classification and categorization of data used to develop the cost allocation plan.

Page 3
Eduardo Luna, City Auditor
January 29, 2016



Rolando Charvel
City Comptroller

cc: Scott Chadwick, Chief Operating Officer
Stacey LoMedico, Assistant Chief Operating Officer
Mary Lewis, Chief Financial Officer
Paz Gomez, Deputy Chief Operating Officer, Infrastructure/Public Works
Halla Razak, Director, Public Utilities Department
Tracy McCraner, Director, Financial Management
Marshal Anderson, Director of Council Affairs, Office of the Mayor
Sarah Mayen, Deputy Director, Office of the City Comptroller



The City of San Diego
MEMORANDUM

DATE: February 2, 2016
TO: Eduardo Luna, City Auditor
FROM: Tracy McCraner, Director Financial Management
SUBJECT: Management Response to Performance Audit of the Public Utilities Department Overhead Rates

This memorandum is management's response to the Performance Audit of the Public Utilities Department's Overhead Rates conducted by the Office of the City Auditor.

Recommendation #2 In order to develop a more formalized structure for maintaining supporting documentation for non-discretionary budget allocations and improve its communication with provider departments, Financial Management should enhance its monitoring, control, and review of the non-discretionary process by:

- a) Engaging provider departments after allocations have been formalized by providing more detailed updates in the Budget Reference Module;
- b) Requiring provider departments to document assumptions made, adjustments made, and discretion taken within supporting documentation submitted to Financial Management as part of its budget allocation submissions;
- c) Requiring provider departments Directors to formally sign-off acknowledgement that t non-discretionary allocations submitted to Financial Management have been properly reviewed and documented; and
- d) Assessing the feasibility of implementing SD Share to track its review of and maintain documentation for the non-discretionary allocation process.

Management Response: Agree with Recommendation.

In response to the recommendations outlined in the City Auditor's report, Financial Management (FM) has implemented the following process improvements during the Fiscal Year 2017 budget development process:

- Implemented a procedure to notify provider department and affected client department of any change made to a non-discretionary budget allocation. Additionally, provider departments are required to approve any changes made to a non-discretionary budget allocation prior to implementing changes in the City's budget system.
- Created a non-discretionary status report that that is included in the Budget Reference Manual that provides both provider and client departments with the current status of the non-discretionary budget allocations and the date the non-discretionary budget allocation was modified.

- Explored the use cases of Cityhub (Microsoft Sharepoint) as it relates to reviewing and maintaining documentation for the non-discretionary allocation process.

FM plans to implement the following process improvements during the Fiscal Year 2018 budget development process:

- Develop a standardized workbook for provider departments to submit non-discretionary budget allocation analysis. This workbook will provide an area for provider departments to enter any assumptions, manual edits, or track changes made to the submitted non-discretionary budget allocation analysis.
- Require department director to formally sign-off acknowledgement that the non-discretionary budget allocation submitted to FM have been properly reviewed and documented.
- Deploy Cityhub (Microsoft Sharepoint) collaboration room that will provide a shared document repository for reviewing and maintaining non-discretionary allocation documentation.

While FM agrees with the City Auditor's recommendations, it should be noted that the Department does not agree with the scoring of *"Element 4: Periodically Review Non-Discretionary Allocations"* found in Exhibit 6, page 23 of the draft report. FM received a low score of "1" primarily due to the fact that an internal tracking spreadsheet was not consistently updated by FM analysts to document our "review of non-discretionary allocations". However, FM was able to provide documentation of a thorough annual review process of the non-discretionary accounts as follows:

- FM conducts a comprehensive review of non-discretionary budget allocations during the annual budget development process
- FM reviews non-discretionary allocations against actual experience at least quarterly through the budget monitoring process, and
- Immediately following the quarterly budget monitoring process, FM prepares adjustments necessary to adjust for variances in actual experience from budgetary allocations

This annual process is also documented in the Budget Policy as approved by City Council. The description of *"Element 4 states: Reviews non-discretionary allocations against actual experience and makes proper adjustments."* FM performs the annual processes above that document FM's review of non-discretionary allocations against actual experience and subsequent budget adjustments to reconcile to actual experience. The issue of staff not updating an internal worksheet seems immaterial compared to the well-documented budget process FM had established and provided to the auditor's. FM is currently reviewing the internal worksheet to identify its effectiveness and potential improvements to the process.



Tracy McCraner
Financial Management Director

cc: Scott Chadwick, Chief Operating Officer
Stacey LoMedico, Assistant Chief Operating Officer
Mary Lewis, Chief Financial Officer
Paz Gomez, Deputy Chief Operating Officer, Infrastructure/Public Works
Halla Razak, Director, Public Utilities Department
Rolando Charvel, City Comptroller
Marshal Anderson, Director of Council Affairs, Office of the Mayor
Matthew Vespi, Deputy Director, Financial Management



**The City of San Diego
M E M O R A N D U M**

DATE: January 29, 2016

TO: Eduardo Luna, City Auditor

FROM: Halla Razak, Director, Public Utilities Department

SUBJECT: Management Response to Performance Audit of the City's Overhead Rate Calculation Process

REFERENCE: Performance Audit of the City's Overhead Rate Calculation Process

The Public Utilities Department (PUD) acknowledges the Office of the City Auditor (OCA) Performance Audit of the City's Overhead Calculation Process. The following represents management's response to the two recommendations directed at PUD (listed as Recommendations #3 and #4 in the OCA Performance Audit Report).

RECOMMENDATION #3: In order to formalize its cost allocation review process and strengthen guidance provided to department staff, the Public Utilities Department should:

- a) Ensure that cost classification reviews are housed in a central repository; and
- b) Formalize the internal cost allocation review process by developing a department instruction outlining the steps of the process.

MANAGEMENT RESPONSE: Agree

To make certain that the cost allocation process and PUD identification of direct and indirect costs are not person-dependent and relying on institutional knowledge, a Department Instruction (DI) on the internal cost allocation process will be completed to ensure consistency and proper documentation. When completed on an annual basis during the overhead development process, this DI will be distributed to all divisions involved in determining direct versus indirect costs.

Additionally, the Finance division of PUD will be the central repository of backup documentation on classification of direct versus indirect costs, and additional information involved in the annual overhead rate development process.

ANTICIPATED COMPLETION: May 2016

RECOMMENDATION #4: In order to maintain a clear, comprehensible, and complete audit trail, the Public Utilities Department, in conjunction with the Comptroller's Office, should

Page 2
Eduardo Luna, City Auditor
January 29, 2016

properly document the Public Utilities Department's changes in overhead rate structure from four overhead rates to one including:

- a) A narrative explaining the reasons for each change;
- b) The accounting detail showing, or an explanatory note, if accounting detail is not possible, the redistribution of funds; and
- c) Direction for how the rates should be calculated going forward (such as when roll - forward adjustment and five-year averages should begin).

MANAGEMENT RESPONSE: Agree

To document the intention of consolidating PUD's four business areas into a singular business area for FY 2017, a descriptive narrative will be developed to properly illustrate the reasons that this consolidation occurred for historical context and knowledge retention. As previously outlined, information utilized in the determination of direct versus indirect costs for the FY 2017 singular overhead rate will be retained within the Finance division of PUD. This information will also include the PUD classification of accounting structure based on FY 2016 and prior four business areas and the "crosswalk" of this information to the new singular business area. Additionally, the DI that will be developed in response to Recommendation #3 will specifically outline how cost classification should be undertaken and provide direction going forward in future fiscal years.

ANTICIPATED COMPLETION: May 2016

Sincerely,



Halla Razak
Director, Public Utilities Department

TW/slh

cc: Scott Chadwick, Chief Operating Officer
Stacey LoMedico, Assistant Chief Operating Officer
Paz Gomez, Deputy Chief Operating Officer, Infrastructure/Public Works
Rolando Charvel, City Comptroller
Lee Ann Jones-Santos, Assistant Public Utilities Director