CITY OF SAN DIEGO

Independent Accountant's Report on Agreed-Upon Procedures Applied to Water Fund Transfers To Other Funds

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Independent Accountant's Report on Agreed-Upon Procedures
Applied to Water Fund Transfers to Other Funds

We have applied the procedures enumerated below to the City of San Diego's transfers out and interfund charges (including Service Level Agreement charges) paid by the Water Fund for the fiscal year ended June 30, 2003. These procedures, which were agreed to by the City of San Diego were performed solely to assist the City in determining whether or not interfund charges and transfers applied to the Water Fund were in accordance with generally accepted accounting principles.

This engagement to apply agreed-upon procedures was performed in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of the procedures is solely the responsibility of the specified users of the report. Consequently, we make no representations regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

The procedures performed and the results of those procedures were as follows:

1. We obtained a summary of expenses by account name for the Water Fund. We identified accounts that were likely to include charges from other funds and transfers to other funds.

   Results: Interfund activities were recorded as either transfers or expenses of the Water Fund. The expense charges can be further broken into Service Level Agreement (SLA) charges and other charges initiated by journal entries. The following summarizes the universe of interfund activities evaluated for the year ended June 30, 2003:

Service Level Agreements – Operating	$ 9,772,045
Service Level Agreements – Capital	4,400,529
Transfers to Other Funds	2,252,138
General Government Service Allocation	3,034,803
Total	$19,459,515

2. We obtained a list of the transfers out of the Water Fund for the year ended June 30, 2003 totaling $2,252,138. We tested 100% of the transfers to determine whether the transfer resulted in a benefit to the Water Fund and to determine whether the allocation methodology was reasonable in those instances where costs were allocated among various funds of the City.

Results: The transfers tested benefited the Water Fund and were allocated equitably between the funds of the City (for $1,607,932 or 71% of the transfers), except as follows:

a. $280,000 Transfer to General Fund: This budgeted transfer allocated 17.5% of construction costs for the Kiddie Hall playground. The office building adjacent to the playground is utilized by employees associated with various departments of the City, including the Water Department. However, the transfer from the Water Department does not appear to be supported by any verifiable computation of the percentage of the building utilized by employees of the Water Fund.

   Recommendation: We recommend that the General Fund reimburse the Water Fund for a portion of this transfer (based on the percentage of the adjacent building not utilized by Water Department employees).

b. $238,475 Transfer to General Fund: This transfer allocated the cost of the Equal Opportunity Contracting Program. The program pays for compliance, research, and other costs associated with providing small construction companies an equal opportunity to participate. The Water Fund paid 46% of the project costs for the year ended June 30, 2003. However, City personnel estimate that approximately 16% of these projects were Water Fund projects (based on number of projects since inception of program). The 46% allocation was determined many years ago and has not been adjusted to reflect a more equitable allocation.

   Recommendation: We recommend that the City allocate costs of this program based on the number of participating project from each department. The allocation base should be reevaluated and adjusted annually.

c. $79,629 Transfer to General Fund: This transfer allocated 19.47% of the cost of lobbying contracts. The lobbying costs are allocated to the following City funds that are regularly engaged in lobbying activities: General Fund, Airport Fund, Environmental Services, Water Fund, Development Services, and the Wastewater Fund. The allocation is based on each participating fund's expenditure budget as a percentage of the whole. The allocation does not appear to align the benefits received by each fund with the cost of the program.

   Recommendation: The allocation should be based on specific lobbying activities using information received from the lobbyist.

d. $35,085 transfer to the Special Training Fund: This was a budgeted transfer for reimbursement of the Career Development & Mentoring Program. Per discussions with City personnel, the program was specifically for "field employees" and was charged to four enterprise funds (Water, MWWD, Development Services, and Environmental Services). The four enterprise funds accounted for 46% of the transfers used to fund the program. These funds appear to have been overcharged for the benefits to City funds with other field

employees. Additionally, the share of costs between the four funds does not appear to be supported by the number of field employees in each fund.

Recommendation: We recommend that the City evaluate the current allocation methodology and modify it to better align with the benefits to the Water Fund.

e. $11,017 Transfer to Special Training Fund: This transfer allocated certain costs of the Equal Employment Opportunity Program. These costs are only funded by six of the City's enterprise funds. The Water Fund paid 30% of the costs. The allocation does not appear to reflect the benefits provided to the Water Fund since employees of non-enterprise funds were not charged for the costs of the program. The Equal Employment Opportunity Program is funded through user charges based on employee attendance at seminars. However, this additional charge (totaling $36,403 for all six enterprise funds), was intended to partially pay for the salary of the Human Resources' Director's assistant who provided the training services.

Recommendation: Since the program is funded through user charges based on employee attendance, additional transfers should not be made to cover other unfunded portions of the program. Instead, the City should change the user rates to adequately cover the costs of the program.

3. We obtained a list of all SLA agreements for the year ended June 30, 2003 and selected the three largest agreements for testing (amounting to over 50% of total expenditures for all SLAs). We obtained a copy of the three SLA agreements, met with personnel responsible for development of the SLA, and determined whether the benefit received by the Water Department was sufficient to justify the costs of the SLAs.

Cities utilize fund accounting to track specific functions or activities of the government. It is common for employee payroll costs to be charged to multiple funds based on the benefits received by each fund. There are several ways to allocate employee costs to various funds of the City. An employee's costs could be recorded in one fund of the City and a journal entry could be generated to charge another fund for a portion of that employee's payroll costs based on an estimate of time spent benefiting the other fund. A more accurate way to allocate employee costs is to have employees keep track of their time on a daily basis and directly charge the benefiting fund based on the employee's timesheet entries.

Results: The City of San Diego utilizes the timesheet method for allocating labor between funds which conforms to the "best practices" method of documentation of allocation of personnel costs. The three SLA agreements selected and the results of our testwork are as follows:

Engineering & Capital Projects / Water & Wastewater Facilities

Budgeted expenditures -	$4,239,299
Actual expenditures -	3,251,531

The SLA provides labor for the construction of 12 miles of water main and water pipeline projects. All of the charges to the Water Fund were based on employee timesheet charges. Employees working on specified projects covered by the SLA tracked actual time spent on the project on their timesheets. The payroll system allocates a percentage of the employees' payroll costs based on the employee timesheets.

Monthly meetings were held with the Water Department to discuss the progress of each project covered in the SLA. The Water Department was provided with reports documenting accumulated expenditures and project status. The Water & Wastewater Facilities Division was not able to provide us with a report providing evidence that 12 miles of water main and water pipeline projects were constructed during the year.

We selected four employees who charged their time through this SLA. We selected a pay period and tested the four employee's time cards. We traced the labor charge recorded in the City's accounting records under the SLA to the employee time cards.

We interviewed two employees who charged their time to projects under the SLA. We inquired with each employee if they were encouraged to overcharge time on their time cards for time spent on water projects. In each interview, the employee stated that only actual hours spent on each water project were charged, and that they were unaware of any other employee or department that was encouraged to overcharge water projects.

Recommendation: City documentation policies conform to accepted methodologies. In response to community concerns, we recommend that the Water & Wastewater Facilities Department augment this standard level of documentation with monthly reports describing in detail the benefits provided to the Water Department.

Engineering & Capital Projects / Field Engineering

Budgeted expenditures -	$2,270,456
Actual expenditures -	2,219,273

The SLA provides for reimbursement of labor and non-labor costs provided by the Field Engineering & Water Department for providing engineering and design support, construction management, surveying, soils, and materials testing. The department also provides construction management services. The SLA costs are divided into 95% timesheet driven labor costs and 5% non-labor charges. Meetings were held with the Water Department to discuss the progress of the projects covered in the SLA. The Field Engineering & Water Department provided detailed Excel-based reports identifying total costs by project (including by SLA charges and payments to 3rd party vendors). The

portion of these activities that are funded by SLA charges is not identified on these reports.

We selected three employees who charged their time through this SLA. We selected a pay period and tested the three employee's time cards. We traced the labor charge under the SLA to the employee time cards.

We interviewed two employees who charged their time to the SLA. We inquired with each employee if they were encouraged to overcharge time on their time cards for time spent on water projects. In each interview, the employee stated that only actual hours spent on each water project were charged, and that they were unaware of any other employee or department that was encouraged to overcharge water projects.

Recommendation: City documentation policies conform to accepted methodologies. In response to community concerns, we recommend that the Field Engineering & Water Department augment this standard level of documentation with monthly reports describing in detail the benefits provided to the Water Department.

City Attorney's Office

Budgeted expenditures -	$1,611,672
Actual expenditures -	1,583,966

The SLA provides for enhanced legal services provided by the City Attorney's Office in the following areas: Advisory & Transaction Legal Services, Capital Improvement Program Legal Services, Construction Litigation Services, Code Enforcement Unit, and Civil Enforcement Unit. The SLA costs are divided into 96% timesheet driven labor costs and 4% non-labor charges. While the SLA only covers enhanced legal services, we noted that employees in the City Attorney's office charged all time spent on Water legal issues through the SLA agreements. Since this SLA is only authorized for *enhanced* legal services, then employees in the department should only charge their time to the Water Fund when they are working on the enhanced legal issues, not all Water related legal issues.

The City Attorney's office did not provide reports to the Water Fund documenting the actual services that were provided to the Water Fund.

We selected three employees who charged their time through this SLA. We selected a pay period and tested the three employee's time cards. We traced the labor charge under the SLA to the employee time cards.

We interviewed eleven employees and former employees of the City Attorney's Office during the audit period. We inquired as to the method and practices used in charging time to water projects.

As a result of our interviews with employee's of the City Attorney's office, we found that the practice of the City Attorney's office during fiscal year 2002-03 was as follows: Each year, the City Attorney's office would make an assessment of the level of service that was required by the various departments of the City. Staffing actions would be taken to provide the resources to meet that commitment of service level. Employees were assigned to serve the various city departments based upon the planned needs of each department. These assigned employees were then instructed to charge their time on their time sheets to each fund/department in a manner consistent with their assigned areas of responsibility and planned utilization. This was done under the justification that funding for these positions should be consistent with the staffing decisions made by the City and the commitments of personnel made to the various departments of the City. These persons were then made available to the departments to which they were committed.

This practice meant that funds were allocated based on assigned areas of responsibility and *planned* utilization, rather than how the *actual* time provided by City Attorney personnel was expended in serving the various departments of the City. As a result, this practice is not consistent with generally accepted accounting principles. Under generally accepted accounting principles, labor should be charged to cost centers for only the actual service provided.

This practice fostered an environment where ethical conflicts were created between management of the City Attorney's office and employees of the department. Some employees refused to charge their time according to management instruction (based upon their assigned areas). In certain cases, management changed the time charged by employees to conform to funding assignments for those persons or instructed support personnel to code time to cost centers to make up for any undercharging by other personnel of the City Attorney's office. These practices appear to have been performed to secure the anticipated funding of the activities of the City Attorney's office. Our interviews indicated that this practice was substantially discontinued in fiscal year 2003-04 shortly after the current City Attorney took office.

When the actual utilization of City Attorney personnel approximated planned utilization, charges to the Water fund were not materially misstated. However, because the City Attorney's office time cards reflected their assigned areas of availability, rather than the actual results of their time expended each pay period, it is not possible to ascertain the extent to which the *planned* use of assigned personnel did or did not conform to the *actual* hours expended by each employee for each project/activity. [Total labor charges by the City Attorney's office to the Water Fund amounted to less than 1% of the total expenses of the Water Fund.]

The above described manipulation of the City's timekeeping system was justified to employees of the City Attorney's office as a "retainer" system. Our interviews with employees of other departments of the City disclosed no evidence that these practices of timekeeping were in place at other departments of the City during fiscal year 2002-03.

Recommendation: City Attorney personnel should be instructed to charge their time on their time cards in accordance with their *actual hours expended* rather than a predetermined allocation of time that conforms to their *planned utilization* by the various departments to which they were assigned. We recommend that the City Attorney's Office also provide monthly reports describing in detail the benefits that were provided to the Water Department that month Furthermore, since the City Attorney's service level agreements only provide for *enhanced* levels of service, City Attorney employees should be directed to only charge their time to the Water Fund when working on *enhanced* legal services. Alternatively, the City may choose to change the authorized scope of this agreement to include all legal services (rather than only enhanced levels of service, as provided in the agreement).

We recommend that the City implement procedures to emphasize the ethical integrity of City procedures and practices. This would include a clear statement acknowledging the ethical expectations of the City. Procedures should be established specifying the person/persons that employees should contact regarding questionable instructions from supervisors and other questionable activities. Training should be provided regarding ethical behavior in the workplace. We further recommend that the City evaluate any employees currently employed by the City that may have participated in inappropriate practices in the past. An assessment should be made as to whether or not those persons need to be re-trained or other appropriate action taken.

Should the City choose to continue charging the Water and Sewer Fund for salaried personnel of the City Attorney's office, we recommend that the City explore the possibility of upgrading its payroll system to provide a more accurate allocation of costs to various cost centers. This would include the identification of projects/activities, not just funds/departments on the time cards and in the labor distribution system.

We further recommend that this system allow for costing to cost centers that would accommodate hours of service for salaried personnel in excess of the standard 80 hour pay period. The pay of a salaried individual is fixed regardless of the number of hours worked that pay period. Under generally accepted accounting principles, the fixed cost of each salaried employees compensation for a given pay period should be allocated to the various funds/departments served by that employee in proportion to the hours actually expended for each fund/department.

This means that when a salaried employee works more than 80 hours in a pay period (for example, 89 hours), the effective hourly rate of that employee associated with each of the 89 hours is less than the effective hourly rate of that employee when only 80 hours of service was provided. More accurate interfund charging is accomplished when a payroll system re-computes a new hourly rate for each salaried employee for each pay period depending upon the total number of hours worked by that salaried employee that pay period. Each pay period, this re-computed hourly rate would be applied to the hours charged to each fund/department per the time card so that the total of the costs recorded for that employee that pay period would conform to his or her fixed salary amount for that pay period.

Generally accepted accounting principles provide that hours not associated with projects or activities of any specific fund of the City should be charged to the General Fund of the City or included within the general government costs of the City that are recovered though a properly structured cost allocation plan.

4. For other charges to the Water Fund that was neither a Transfer nor a SLA, we selected a sample of transactions and obtained the journal entry for testing. We determined whether the transaction resulted in a benefit to the Water Fund and determined whether the allocation methodology was reasonable in those instances where costs are allocated amongst various funds of the City.

   Results: The City allocates indirect costs of the General Fund to other City Funds through the General Government Services Charge. For the year ended June 30, 2003, the charge to the Water Fund was $3,034,803. The charge is broken into General Fund departments. We selected the largest departmental charges to the Water Fund, City Attorney's Office and Auditor-Comptroller's Office, and evaluated the allocation base and methodology as noted below.

   City Attorney's Office

   The City Attorney's indirect costs charged to the Water Fund were $458,250 for the year ended June 30, 2003. We obtained the *Departmental Allocable Costs* report from the accounting system that details the City Attorney's costs by department and expense type. This report includes all costs of the City Attorney's office. To determine the allocation base, the total of the report was reduced by the SLA charges. The remaining costs not funded through SLA's were totaled and allocated to other City Funds based on each Fund's personnel costs as a percentage of total personnel costs. This methodology is an acceptable practice under generally accepted accounting principles. We recalculated the SLA charges noted on the report for the Water Fund and agreed them to the SLA charges per the accounting system. We noted that the actual SLA charges per the accounting system were approximately $70,000 lower than the SLA charges reported on the *Departmental Allocable Costs* report. Thus, the amount allocated through the general government services charge was less than it should have been.

   Auditor-Comptroller's Office

   The Auditor-Comptroller's indirect costs charged to the Water Fund were $614,088 for the year ended June 30, 2003. We obtained the *Departmental Allocable Costs* report from the accounting system that details the Auditor-Comptroller's costs by department and expense type. This report includes all costs of the Auditor-Comptroller's office. To determine the allocation base, the total of the report is reduced by the SLA charges. We recalculated the SLA charges noted on the report for the Water Fund and agreed them to the SLA charges per the accounting system without material exception. The remaining costs not funded through SLA's are totaled and allocated to other City Funds based on

each Fund's personnel costs as a percentage of budgeted expenditures, excluding capital expenditures. This methodology is an acceptable practice under generally accepted accounting principles.

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We were not engaged to, and did not, perform an audit, the objective of which would be the expression of an opinion on the subject matter. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the use of the City of San Diego, California and is not intended to be and should not be used by those who have not agreed to the procedures and taken responsibility for the sufficiency of the procedures for their purposes.

Mayer Hoffman McCann P.C.

Irvine, California
August 2, 2006