

CITY AUDITOR

Gary W. Nystul CPA CFE
City Auditor
345 Sixth Street Suite 600
Bremerton, WA 98337-1873
360.473.5369

www.gary.nystul@ci.bremerton.wa.us

June 15, 2012

Honorable Patty Lent, Mayor
Members of the City Council

Attached is a report on the 2011 Overhead Cost Allocation. The Washington State Auditor's Office has placed this subject on their agenda for future audits. This report is intended to start the discussion of cost allocation in the City.

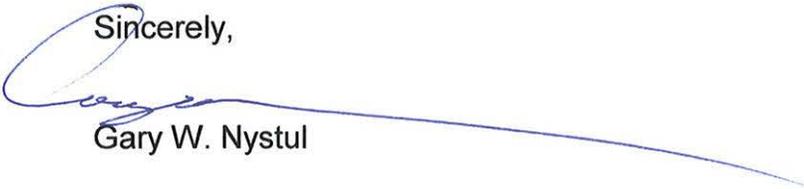
The cost allocation in 2011 was done with nine standard monthly journal entries. They are not supported by a written cost allocation plan as recommended by the State Auditors Office. Data supporting some allocations appear to contain errors. The total overhead for Equipment Services should be reviewed to determine why it is not more closely aligned with commercial operations.

Responses to observations and recommendations were provided by City Attorney Roger Lubovich and Public Works Director Katy Allen. No other responses were received.

The assistance of Risk Manager Thelma Swem, Fire Chief Al Duke, and Equipment Services Division Supervisor Chuck Ernst is greatly appreciated.

Please let me know if you have any questions.

Sincerely,



Gary W. Nystul

cc: City Attorney
Director of Financial Services
Director of Public Works

OVERHEAD COST ALLOCATION

Purpose

The City Auditor reviews various phases of city operations for compliance and performance. This review of Overhead Cost Allocation was scheduled in the 2012 work plan. This audit is to review and analyze the process and procedures used for overhead allocation.

The Washington State Auditor's Office has recently issued a report of their performance audit of Local Government Allocating Overhead Costs. This review is to also compare the SAO findings and recommendations with current practices of the City. The SAO is anticipated to be reviewing Overhead Cost Allocation procedures in future audits of the City.

Scope

This is a review of Overhead Cost Allocation for the year 2011. The financial data is as of March 16, 2012. The City will not complete the year end closing and preparation of final financial statements for several months. Therefore, some amounts used may not agree with the final financial statements.

Statement of Auditing Standards

This performance audit was conducted in accordance with Generally Accepted Government Auditing Standards, except Standard 3.50 requiring an external quality control review. Those standards require that the auditor plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for findings and conclusions based on audit objectives. The auditor believes that the evidence obtained provides a reasonable basis for the findings and conclusions based on the audit objectives.

Objective

The objectives of this audit are:

- A performance audit of Overhead Costs Allocation during 2011
- Compare methods used by the City to those recommended by the SAO

Summary of the Results

- An overhead allocation plan has not been written
- Some values used for insurance appear to be incorrect
- Cost allocation for Equipment Services needs addressing
- Some allocations follow recommended practices

Background

City governments use a number of funds to account for the revenue and expenses of city operations. These separate funds are required by law, standard or regulation. As a result, some services paid from one fund may benefit another fund. For example, some expenses paid in the General Fund benefit other funds. The Human Resources Department assists in managing personnel in all departments of the City, but it is paid from the General Fund. Many departments that benefit from HR are in the General Fund, but others, such as the Water Utility, are not. It is permissible and a good business practice for the General Fund to ask the Water Utility to pay for the fair value of the benefit it receives from HR. Several similar conditions exist for other services in the General Fund which benefit other funds.

State law at Section 43.09.210 RCW allows services rendered by one department to another to be paid at its true and full value (overhead cost allocation). The amounts can be calculated by various methods depending on the nature of the service. The method used should allocate the costs equitably.

Typical allocation methods include using the number of FTEs or number of payroll checks to allocate payroll. The use of hours worked can be used to allocate legal costs. The number of transactions could be used for accounting or accounts payable. Insurance costs could be allocated by claims or loss history, property values insured or risk factor. The method used should have a logical relationship to the service and be reasonably measured.

The BARS Manual, issued by the State Auditor's Office, is an accounting reference manual that local governments are required to follow. It states that the cost allocation process should be guided by a written overhead cost allocation plan. The City does not have a written plan.

OVERHEAD ALLOCATIONS

There are several overhead allocations in the annual budget. The following narrative describes these overhead allocations in 2011, and the methods used to calculate the various costs.

Administration

The largest overhead allocation is for administration which was budgeted at \$1,448,170. This assessment is made for services rendered by Mayor, City Council, Finance, Human Resources, Legal, Internal Auditor, and Facilities. Costs for these services are allocated to Water, Wastewater, Stormwater, Golf, ERR, and Information Technology. This overhead allocation for administration is made in two calculations. One is the ratio of the number of employees (FTEs) in a department to the total of all city employees and is used to compute 75% of the charge. The other 25% is the ratio of the department's operating budget to total of the operating budgets for Water, Wastewater, Stormwater, Golf, ERR, IT, General and Street.

For example, the amount the Water Utility is charged for HR is its percent of total city FTEs (15.1%) multiplied by 75% of the HR budget of \$338,325. In addition, 25% of the ratio of the Water operating budget to total of the budgets of the above listed funds (14.1%) multiplied by the HR budget. As a result, in 2011 Water was charged \$50,241 for HR services.

Similar calculations are made for the other departments whose costs are allocated to the listed funds. One exception is that Facilities costs include 53.36% of the owner fees paid for the Norm Dicks Government Center (city hall).

The BARS manual cautions local governments to carefully consider the assessment of costs of elected officials to utility funds. It notes some recent litigation and sources they examined suggest that elected executive and legislative costs should not be paid by utility funds.

Insurance

Various funds are assessed for the cost of Risk Management, including insurance premiums and the maintenance of a cash claims payable account. The total budget to allocate in 2011 is \$1,040,400. The city purchases commercial insurance policies for excess liability, property, pollution legal liability, employee honesty, and excess workers' compensation. The city also maintains a cash balance to pay the portion of self-insurance claims these policies do not cover.

The estimated cost of the property policy is allocated based on each funds statement of replacement values for buildings and contents. The funds include General, Water, Wastewater, Stormwater, Golf, Street, Equipment Services, Parking, and Conference Center. This method of assessment matches the risk to the premium being paid.

The allocation of the estimated cost of the liability premium is based on two computations. One computation for one half of a department's share is based on

the budget for personnel, and supplies and services of the department. This is compared to the total of personnel, and supplies and services budget for the General, Water, Wastewater, Stormwater, Golf, Street, ERR, Parking, Conference Center and IT. The other computation is the ratio of the liability losses incurred in the last five years by each fund to the total liability losses.

An amount is also calculated to assess for the cash balance of the claims payable amount in the budget. For 2011 this was \$335,000. The amount assessed is calculated using the same ratio as the liability premium which is a reasonable method.

Electronics Support

Expenditures for the maintenance of the city telephone system are paid from the Street Fund which is reimbursed by the General Fund. The costs are recorded by both project number and object code. The General Fund expenditures are not included in any overhead cost base.

Interfund Rent

The shop building used by the Equipment Services Division is owned by the General Fund. The ESD reimburses for the use of the building at a rate calculated with the assistance of a commercial real estate agent. The annual rate of \$46,080 was charged in 2009, 2010, and 2011. Using a rental rate that would be used in the private sector appears reasonable and equitable.

Vehicle Maintenance

The Equipment Services Division repairs the automobiles, pickups, trucks, fire engines and etc. of the City. It is an internal service fund which must be self supporting by recovering its costs through fees and charges.

A fixed monthly assessment is made for all departments that use the services. The annual cost estimate is made by the ESD manager who reviews historical maintenance costs for two or three years for each piece of equipment or vehicle. This projection for expected repair costs for the budget year is equal to approximately one half of the department cost. The second portion of the computation is the ratio of the historical cost of each piece of maintained equipment in a department to the total of all equipment. This ratio is used to allocate the balance of the department budget which could be considered mostly overhead items such as administrative salaries, insurance, administrative transfer, and technology.

Actual work performed as recorded on work orders would be a typical method to allocate costs. During the year all shop work is recorded on work orders which make a charge for labor, materials, sublet, and equipment costs. These are used for management information and there is no reconciliation to actual costs. In 2011 only about 50% of the department total cost would have been recovered if work orders had been used for overhead cost allocation.

Computer Maintenance

The cost of maintaining the Information Technology Department is allocated based on the number of personal computers each department has. Some departments also have additional costs for unique software they use. For example, the Finance Department is assessed for the accounting software. In addition, some departments are charged for photo copier use. The use of the number of computers is a typical method to allocate IT cost.

Facilities Maintenance

The Facilities Maintenance division maintains many city buildings, including plumbing, painting and repair, HVAC and other systems in these buildings. The overhead allocation is for the work performed by Facilities at the Harborside Parking Garage, Conference Center, downtown parking garage and city parking lots. The amount is reportedly based on the history of actual costs incurred.

FINDINGS AND RECOMMENDATIONS

1. A written overhead allocation plan.

The State Auditors Office recommends that an Overhead Allocation Plan be written. However, the City plan has not been written. One Finance Department Excel worksheet does contain notes as to how the allocation for administrative overhead was calculated.

The BARS manual states *“The cost allocation process should be guided by an overhead cost allocation plan that describes how the organization will allocate costs reasonably and equitably across funds and departments and indentifies the documentation required to support the charges.”*

Recommendation. The City should prepare a written overhead allocation plan which describes the costs being allocated, how they are calculated, and the basis for the decisions.

2. The allocation and costs for equipment services needs to be reviewed.

The Equipment Services Division is an internal service fund which provides maintenance and repair to the fleet. The expense to operate the ESD must be recovered from the users. The equitable method to recover this cost is based on the actual repair and maintenance performed during the year.

The present method uses an annual budgeted recovery that is based on estimates from prior year work orders and department overhead. The users are billed 1/12 of their allocated amount each month regardless of the amount of work performed.

Work orders are prepared for all services performed which is a procedure comparable to commercial service operations. They calculate costs for labor, repair parts, sublet work, and equipment used. The department total cost for 2011 is \$1,087,000. The amount computed using the work order system is \$546,000. The difference is \$541,000.

Had the full department cost been recovered using work orders a surcharge of \$262 per work order would need to be made. Alternatively, an increase of \$142 in the labor rate would be needed to recover all costs. The work orders used a cost of \$72 per hour for labor which would be competitive with commercial businesses. However, a total labor charge of \$214 would not be realistic.

The amount required to be allocated using the surcharge or increased labor rate in order to recover total cost indicates there are either too many overhead costs or not enough work. The labor cost computed on work orders would recover about 48% of total labor charged to the department. About 90% of the cost of parts was computed on work orders.

The following table compares the 2011 budgeted maintenance amount and the value computed on actual work orders for each department.

Fund/Dept	Budget	Work Orders	% of Budget
Community Development	\$ 7,000	\$ 1,738	24.82%
Municipal Court	6,000	3,056	50.93%
Police	253,000	126,069	49.83%
Fire	171,000	72,607	42.46%
Facilities	2,000	184	9.19%
Parks	102,000	48,202	47.26%
Engineering	8,000	2,126	26.58%
Roadway	227,000	75,410	33.22%
Golf	2,000	5,828	291.40%
IT	1,000	211	21.10%
BKAT	2,000	287	14.33%
Water	168,000	90,819	54.06%
Wastewater	93,000	63,515	68.30%
Stormwater	110,000	44,907	40.82%
Equipment Services		11,421	n/a
Total	\$1,152,000	\$546,379	

Recommendation. The Administration should review the cost of operation of the Equipment Services Division. The amount of overhead and the amount of time charged on work orders needs to be examined. Comparisons to commercial facilities will give some measure of reasonableness. The cost allocation should consider procedures used with commercial facilities where the work orders recover all of the overhead costs.

3. There are errors in the statement of values used for property insurance.

The methods of allocating insurance costs by using liability loss history and replacement values of property are equitable methods. The statement of values is a listing of the replacement cost of city buildings and contents. The total value of all buildings and contents is used to determine the premium for the insurance policy as well as to allocate the share of premium to the various departments.

The historical cost or an estimate is used in the year of acquisition to determine the value of a building. In subsequent years, a building cost index is used to determine the change in the cost to replace the building or contents. The current index is the FM Global Building Cost Index. This is a reasonable method to calculate replacement costs. However, no replacement cost appraisals have been done recently of any buildings or contents for insurance purposes.

A cursory review of the statement noted several errors in the values used. They are summarized as follows.

Fire Stations Number 2 and 3 were built approximately one year apart in the 1980's. Based on historical cost recorded in the financial accounting system, the

Station 2 cost is 1.71% more than Station 3. Improvements to the stations have been fairly equal over the years. However, in 2010 the Station 3 amount in the statement of values is 22.9% more than Station 2. This is a difference of \$444,917.

The Special Operations Group is located in a metal building formerly used as a warehouse by the fire department. The interior of the building was remodeled in 2003 and the cost of the remodel is recorded in the statement of values. However, there is no amount for the value of the building.

The Girl Scout building formerly located at 11th and Warren and valued at \$241,044 was demolished in April 2010. However, its value was used in determining the 2011 allocation.

Two John Deere graders are listed with a value of \$90,252 and \$77,203. The city only owns one grader. No other vehicles or equipment are listed on the statement. These values should not have been used.

The value of contents of the water utility building on Olympus Drive is listed at \$1,913,984. The only remaining water function in that building is Water Resources. They estimate the replacement cost of contents in their portion of the building, including SCADA, at \$125,000.

The Risk Manager sends out lists of values to the Departments to review annually. There appear to be errors in getting the value of improvements added by the Departments. There is also uncertainty about what to include as "contents."

Recommendation.

- The Risk Manager should review and make necessary corrections to the statement of values. Accurate values fairly allocate costs to all departments. Departments need to provide complete and accurate information to the Risk Manager.
- Assistance should be provided to the departments to ensure they understand what is to be included in the building value and in the contents value.
- The City should consider obtaining an appraisal of city buildings and contents for replacement value. However it is not practical to appraise all property, but some comparisons of appraisal and book values should be made.

4. The amount of overhead allocated and the methods used should be reviewed in certain areas.

The cost of the city telephone system is paid from the Street Fund. An overhead allocation is made by the General Fund each month based on estimated cost. There are two amounts to compute cost. Both a project number and an expenditure account have been used to accumulate expenditures for the phone system. These amounts should be

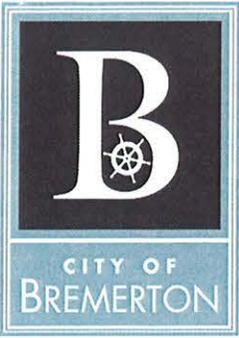
similar. However, in 2011 the expenditure accounts were \$46,138 and the project amounts were \$21,813.

Facilities maintenance is intended to be reimbursed for actual work on the Harborside Parking, Conference Center, downtown parking garage, and parking lots. The amount transferred was \$69,000 and the actual expenses incurred were \$54,476.

The SAO BARS manual, the SAO performance audit report, and OMB Circular A-87 all suggest that the number of employees is a reasonable method to allocate costs for HR. The number of transactions is appropriate for accounting costs. However, the allocation for Administration uses 75% of the computation based on FTEs and 25% on operating budgets.

Recommendation. The Administration may wish to review the procedures used to allocate these costs.

R:\City Auditor\Indirect Cost\REPORT.doc



Office of the City Attorney
Roger A. Lubovich, City Attorney

Memorandum

To: Gary Nystul

From: Roger A. Lubovich

Re: Audit Report

Date: May 15, 2012

This memo is provided in response to the Draft Audit Report regarding overhead cost allocation that you transmitted to me on April 24, 2012. My response is confined to the findings and recommendations addressed in Number 3, "There are errors in the statement of values used for property insurance."

The City of Bremerton Property Schedule for 2011 insurance renewals lists 177 properties with a total value of \$315,670,433. Responses to the discrepancies noted in the report follow:

Fire Stations 2 & 3 were built approximately one year apart in the 1980's. Based on historical cost recorded in the financial accounting system, Station 2 cost is 1.71% more than Station 3. Improvements to the stations have been fairly equal over the years. However, in 2010 the Station 3 amount in the statement of values is 22.9% more than Station 2. This is a difference of \$444,917.

The values for Fire Stations 2 and 3 have been increased by the same percentages annually since 2001. Fire Station 3 is 2,202 square feet larger than Station 2. The square footage cost calculation reveals that Station 3 is valued at \$202.36 per square foot and Station 2 is valued at \$202.43 per square foot. I believe this is a better value comparison analysis. The 2011 construction cost estimates for fire stations in the Seattle area was \$171.68, so the properties may be slightly, but not significantly, over-valued. This will be examined during the 2013 renewal cycle.

The Special Operations Group is located in a metal building formerly used as a warehouse by the fire department. The interior of the building was remodeled in 2003 and the cost of the remodel is recorded in the statement of values. However, there is no amount for the value of the building.

Prior to the remodel of this building, the current building was listed on the property schedules as a Fire Station Warehouse. The value calculated for this building (without contents) during the 2003 renewal cycle was \$162,631. The capital cost of the remodel in 2003 was \$179,379. It appears that the property schedule was not updated to reflect the remodel. Current square footage construction costs to replace this type structure range from \$56 to \$87 per square foot.

The property schedule will be updated to reflect a more accurate value during the 2013 property renewal cycle.

The Girl Scout building formerly located at 11th and Warren and valued at \$241,044 was demolished in April 2010. However its value was used in determining the 2011 allocation.

The Girl Scout building was not listed on the property schedules for the 2011 property insurance renewal that was submitted to the City's broker.

Two John Deere graders are listed with a value of \$90,252 and \$77,203. The city only owns one grader. No other vehicles or equipment are listed on the statement. These values should not have been used.

The City does only have one John Deere grader. The grader was listed (twice) incorrectly during the 2011 property insurance renewal process and removed during the 2012 insurance renewal process.

The value of contents of the water utility building on Olympus Drive is listed at \$1,913,984. The only remaining water function in that building is Water Resources. They estimate the replacement cost of contents in their portion of the building, including SCADA, at \$125,000.

Currently the Engineering Division, Water Resources Division and City record storage reside in the building located at 3027 Olympus. The value of the contents for Engineering is estimated at \$165,000. The value of the contents in Water Resources is estimated at \$125,000. Records are stored on the first floor of the facility and the value of the shelving is estimated at \$3,000. Additionally a generator supplies the building and is valued at \$50,000. A more accurate content value for this facility is \$343,000 and will be reflected in the 2013 insurance renewal submission. The value of the building and contents will be split between the Water Utility and the General Fund.

RECOMMENDATIONS.

1. The Risk Manager should review and make necessary corrections to the statement of values. Accurate values fairly allocate costs to all departments. Departments need to provide complete and accurate info to the Risk Manager.

The property statement of values is reviewed annually by the Risk Management Specialist. During the 2011 property insurance renewal cycle, the statement of values was compared to the City's capital asset list. In other years, the statement of values is provided to departments for their review and recommended changes. Changes and corrections to the schedule are made as they are identified. Risk Management is committed to providing accurate values to allocate costs to all departments.

2. Assistance should be provided to departments to ensure they understand what is to be included in the building value and in the contents value.

The Risk Management Specialist currently responds to all inquiries from departments when updating the statement of values. Additional information related to determining the difference between building value and content value will be provided in the departmental memorandum during the 2013 property insurance renewal process.

3. The City should consider obtaining an appraisal of city buildings and contents for replacement value. However it is not practical to appraise all property, but some comparisons of appraisals and book values should be made.

Appraisals are expensive and not budgeted for in the Risk Management Fund. If directed, the Risk Management Specialist will allocate funds to departments during the 2013 budget process to have buildings appraised.

It may be more practical to review and value the properties using current square foot construction cost estimates. Considering there are 177 properties on the asset schedule, review of all the properties will take a considerable amount of time. This review has been commenced and Risk Management will continue its review of sample properties using the square footage construction cost calculation method unless directed to allocate funds and begin appraising properties.

cc: Mayor Patty Lent
Katy Allen
Becky Hasart



Public Works and Utilities Department – Administration

3027 Olympus Drive • Bremerton, WA 98310 • (360) 473-2327 • FAX (360) 473-5018

MEMORANDUM

TO: Gary Nystul

FROM: Katy Allen *KA*

DATE: May 18, 2012

SUBJECT: Audit Report on Overhead Cost Allocation

This memo is provided in response to the Draft Audit Report regarding overhead cost allocation that you submitted to me on April 24, 2012. My response is confined to the findings and recommendations addressed in Number 2, "The allocation and costs for equipment services needs to be reviewed."

I agree with your recommendation. In coordination with the Finance Department, our Fleet Manager, Jim Orton, will review the cost of operation of the Equipment Services Division. The amount of overhead and the amount of time charged on work orders will be examined. As you recommend, the cost allocation mythology will be considered in comparison to commercial facilities.

cc: Mayor Patty Lent
Roger Lubovich
Becky Hasart