



CITY AUDITOR'S OFFICE

Indirect Cost Allocation

JUNE 8, 2012

AUDIT REPORT NO. 1201

CITY COUNCIL

Mayor W.J. "Jim" Lane

Lisa Borowsky

Suzanne Klapp

Robert Littlefield

Ron McCullagh

Linda Milhaven

Vice Mayor Dennis Robbins



June 8, 2012

Honorable Mayor and Members of the City Council:

Enclosed is the audit report on the City's *Indirect Cost Allocation*.

Annually, the Finance & Accounting Division prepares an indirect cost allocation plan to assign central administrative costs, such as human resources and information technology, to direct-service providers like police, solid waste, and community services. In response to City Council concerns that the Enterprise Funds were bearing more than their fair share of overhead costs, the City Treasurer has analyzed and reduced indirect costs from a high of \$14.4 million (adopted in FY 2009/10) to \$8.2 million forecasted for FY 2011/12.

This audit concluded the new indirect cost allocation methodology was generally reasonable; however, improvements can be made. For example, the indirect cost allocation should be based on the most current approved budget at the time the allocation is being prepared, rather than the initially adopted budget. Additionally, certain cost centers could be more appropriately classified or clearly defined and grant programs included in the cost pools. Certain indirect costs were not charged to the Enterprise Funds, such as a portion of the Direct facilities maintenance and utilities costs. Further, certain adjustments to the Direct and Indirect cost pools were inconsistently applied, which would result in inaccurate indirect cost allocations. And finally, the methodology for the FY 2011/12 indirect cost allocation was not well defined and management review and approval was not documented.

We would like to thank Finance & Accounting, Facilities Management, and Aviation staff for the cooperation we received throughout the course of this audit.

If you need additional information or have any questions, please contact me at (480) 312-7867.

Sincerely,

A handwritten signature in black ink that reads "Sharron Walker".

Sharron Walker, CPA, CFE
City Auditor

Audit Team:

Kyla Anderson, CIA — Senior Auditor
Lai Cluff — Senior Auditor

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EXECUTIVE SUMMARY

This audit of the *Indirect Cost Allocation* was included on the Council-approved FY 2011/12 Audit Plan. The audit was proposed to review the methodology and accuracy of the indirect cost allocation calculations and charges to divisions and/or funds.

Annually, the Finance & Accounting Division prepares an indirect cost allocation plan to assign central administrative costs, such as human resources and information technology, to direct-service providers like police, solid waste, and community services. In FY 2009/10, in response to City Council concerns that the Enterprise Funds were bearing more than their fair share of overhead costs, the City Treasurer began modifying the allocation method to produce a more equitable result.

The change to the indirect cost allocation in FY 2009/10 resulted in a reduction of \$2.7 million from the amount budgeted for Enterprise Fund indirect costs. Another \$4.1 million of reductions were realized in FY 2011/12. In total the indirect charges to the Enterprise Funds have been reduced from the Adopted Budget of \$14.4 million in FY 2009/10 to \$8.2 million forecasted for the current fiscal year.

Overall, we found that the methodology was generally reasonable; however certain improvements can be made. The indirect cost allocation plan for FY 2011/12 was based upon the FY 2010/11 Adopted Budget rather than the most current Approved Budget that was available. Further, actual FY 2010/11 costs would have decreased Enterprise Fund indirect costs by nearly \$800,000 for FY 2011/12.

Additionally, certain cost centers could be more appropriately classified or clearly defined, grant programs should be included, and indirect costs were not allocated to certain Finance & Accounting services that were paid for by the Enterprise Funds. Including the additional costs for Finance & Accounting services would have increased Enterprise Fund indirect costs by approximately \$213,000.

As well, the following adjustments to the FY 2011/12 cost pools were inconsistently treated, resulting in inaccurate indirect cost allocations:

- The CIP allocation, equipment depreciation and building usage adjustments were not made to both the Indirect and Direct cost pools. Further the CIP allocations are based on budgeted rather than actual salary amounts. Some salary amounts included in the CIP allocation were for vacant positions, increasing allocated costs by approximately \$88,000.
- Adjustments to exclude \$32.5 million of large contracts from the cost pools did not have clear criteria or support. This adjustment is estimated to increase Enterprise Fund indirect costs by about \$95,000.
- The utility cost allocation could be more accurately based upon square footage. Additionally, Enterprise programs were not directly apportioned their utility costs for space they occupy in shared buildings.

- Water and Sewer budgeted costs were incorrectly reduced by \$694,000 for direct costs that were not included in the Water and Sewer Fund adopted budgets. This adjustment is estimated to decrease their indirect costs by about \$31,800.
- The Aviation Fund may be undercharged as it is not allocated its share of certain indirect costs.

The methodology for the FY 2011/12 indirect cost allocation was not well defined and there is no documentation of management review and approval. Further, changes to the methodology for FY 2012/13 result in undercharging Enterprise Fund programs for their facilities maintenance costs.

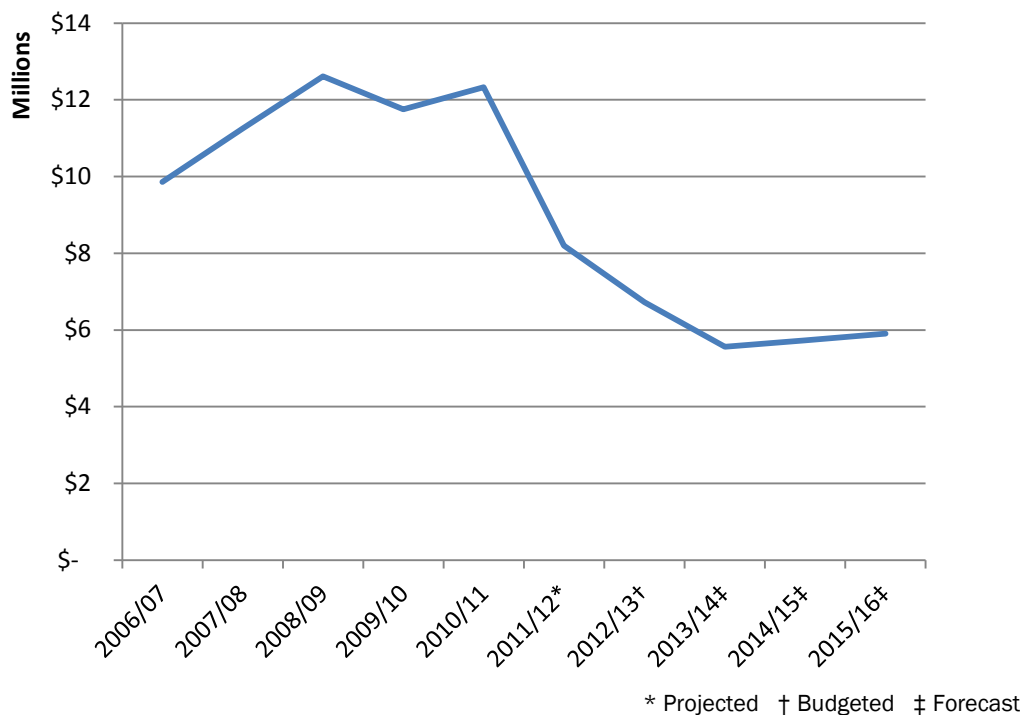
BACKGROUND

Annually, the City Treasurer's Finance & Accounting Division prepares an indirect cost allocation plan to assign central administrative function costs, such as human resources and information technology, to direct-service providers like police, solid waste, and community services. The primary purpose of this allocation is to recover indirect costs from the Enterprise Funds (Water and Waste Water, Solid Waste, and Aviation), which operate as business-type activities and are required to be self-sustaining through their user rates and fees. However, the resulting indirect cost rate is also used by other City programs, such as Parks and Recreation, to calculate the costs on which their user rates and fees are based. In FY 2009/10, in response to City Council concerns that Enterprise Fund activities were bearing more than their fair share of overhead costs, the City Treasurer began modifying the allocation to produce a more equitable result.

In FY 2009/10, the Enterprise Funds' indirect costs were reduced by \$2.7 million, which had the effect of reducing General Fund revenue by the same amount. This change, decreasing the \$14.4 million in indirect costs adopted in the FY 2009/10 budget, corrected certain on-going errors in the allocation. For example, internal service costs, such as fleet and risk management, were removed from the allocation as these costs were already being charged directly through internal service rates. Over the succeeding two years, the process has been further refined and the charge to the Enterprise Funds has continued to decrease. This audit reviews the most recent changes to the allocation model to evaluate the reasonableness and accuracy of the methodology now being used.

Indirect costs paid by Enterprise Funds decreased by another \$4.1 million from FY 2010/11 to FY 2011/12. This primarily resulted from a change in the cost basis being used in the allocation. Prior to FY 2011/12, indirect costs were allocated based solely on each department's proportionate share of the identified direct costs. The FY 2011/12 model uses a combination of several allocation bases in an effort to more closely match costs to the relative benefits received. For example, Human Resources costs are now allocated based on the number of employees in each department. Further refinements have been made to the FY 2012/13 allocation that will reduce Enterprise Funds' indirect costs by another \$1.5 million in FY 2012/13 and cumulatively \$2.8 million by FY 2013/14.

Figure 1. 10-Year Trend of Enterprise Funds' Indirect Costs Paid to the General Fund



SOURCE: Auditor analysis of City of Scottsdale SmartStream reports and FY 2012/13 Proposed Budget Book

The indirect cost rate for the Enterprise Funds has decreased dramatically since FY 2008/09, as further detailed in Table 1.

Table 1. Total Enterprise Fund Expenses

(Amounts in thousands)	FY 2008/09	FY 2009/10	FY 2010/11	FY 2011/12 Forecast	FY 2012/13 Proposed
Direct Costs	\$67,944	\$73,754	\$72,746	\$82,533	\$86,533
Direct Overhead*	4,016	3,836	3,585	3,460	3,391
Total Direct	\$71,960	\$77,590	\$76,331	\$85,993	\$89,924
Indirect Allocation	12,609	11,748	12,327	8,197	6,721
Increase (decrease) over previous FY		(6.8)%	4.9%	(33.5)%	(18.0)%
% of Direct	17.5%	15.1%	16.1%	9.5%	7.5%

*Direct Overhead includes directly assigned Finance & Accounting support (e.g. Utility Billing and Remittance Processing) for the Water and Solid Waste Funds and Fire Department support for the Aviation Fund.

SOURCE: Auditor analysis of City of Scottsdale Budget Books

The allocation methodology used for FY 2011/12 is shown in Figure 2. Further modifications for the FY 2012/13 budget resulted in a proposed indirect cost allocation of \$6.7 million, a 47% decrease from the high of \$12.6 million in FY 2008/09. The majority of this reduction results from a much smaller portion of facilities maintenance costs being allocated as indirect costs, with \$7 million now identified as a direct cost. Previously the entire facilities maintenance cost was apportioned through the indirect cost process.

Figure 2. Indirect Cost Allocation Process



SOURCE: Auditor analysis of FY 2011/12 Indirect Cost Allocation spreadsheets provided by Finance & Accounting.

OBJECTIVES, SCOPE, AND METHODOLOGY

An audit of the *Indirect Cost Allocation* was included on the fiscal year 2011/12 City Council-approved audit plan. The audit was proposed to review the methodology and accuracy of the indirect cost allocation calculations and charges to divisions and/or funds. The audit scope included the allocation for fiscal years 2011/12 and 2012/13.

To gain familiarity with the application of indirect cost methodologies, we reviewed the City's FY 1998/99 Indirect Cost Allocation Methodology developed by the previous City Auditor (a methodology no longer being used), as well as a recent audit of the City of Atlanta's indirect cost allocation plan. To understand the basis of the recent methodology changes, we reviewed Council Action Reports and interviewed Finance & Accounting staff who developed the currently-used methodology. In addition, we:

- Reviewed the City's Comprehensive Financial Policies pertaining to setting rates and fees, including the application of indirect costs.
- Reviewed indirect costs reported in the FY 2010/11 and FY 2011/12 Budget Books and the FY 2012/13 Proposed Budget.
- Researched cost allocation-related regulations for federal grants including OMB Circular A-87 (now in the Code of Federal Regulations as 2 CFR 225), *FAA Compliance Manual*, and *FAA Policy & Procedure Concerning Use of Airport Revenue*.

We obtained and tested documentation for the FY 2011/12 and 2012/13 allocations. To analyze the FY 2011/12 methodology, we:

- Tested budget amounts used in the allocation to those in the Adopted Budget, and also compared to the Approved Budget, which are the adjusted amounts after budget adoption.
- Evaluated the reasonableness of all included and excluded elements, including funds, cost centers, and large contracts.
- Evaluated the classification of costs and assets as direct, indirect, or internal service related.
- Verified calculations, formulas and pivot table used in the allocations.
- Verified whether costs were allocated only once.
- Compared to the proposed FY 2012/13 cost allocation for any changes in methodology.

We found the allocation methodology was generally reasonable, however improvements can be made. For example, the indirect cost allocation plan should be based on the most current Approved Budget at the time the allocation is prepared. Additionally, certain costs can be more appropriately classified and consistently adjusted, and some costs were not allocated or assigned to the Enterprise Funds. As well, the methodology for the FY 2011/12 indirect cost allocation was not well defined and management review and approval was not documented.

We conducted this audit in accordance with generally accepted government auditing standards as required by *Article III, Scottsdale Revised Code, §2-117 et seq.* Those 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 our audit objectives. Audit work took place from February through May 2012, with Kyla Anderson and Lai Cluff conducting the work.

FINDINGS AND ANALYSIS

1. The indirect cost allocation plan was not based upon the most current budget version, and some cost classifications may not be accurate.

- A. Although the budget had undergone several revisions by the time Finance & Accounting began working on the Indirect Cost Allocation in October 2010, it used the fiscal year 2010/11 Adopted Budget rather than the Approved Budget as the basis for the allocation. Because the Adopted Budget can be modified soon after adoption for various reasons, such as budget withholdings or vacancy savings, Finance & Accounting should use the most current version of the Approved Budget when determining indirect costs.

Table 2. Differences between Adopted and Approved Budgets per Fiscal Year

Fiscal Year	Adopted	Approved	Change
2009/10 (as of Sept)	\$ 413,124,312	\$ 407,003,946	\$ (6,120,366)
2010/11 (as of Oct)	\$ 400,377,088	\$ 398,309,435	\$ (2,067,653)
2011/12 (as of Oct)	\$ 380,625,038	\$ 379,912,827	\$ (712,211)

*Budget numbers reflect Operating Budgets and do not include Grants, Trusts, and Special Districts or Operating Projects.

SOURCE: Auditor analysis of Monthly Expenditure Reports for the fiscal years and months noted.

Further, while calculating the indirect allocation, Finance & Accounting should take into consideration the variance between budgeted and actual costs and its impact on the prior year's allocation. For FY 2010/11, significant budget savings from lower actual spending would have decreased the indirect cost to Enterprise Funds by nearly \$800,000 in FY2011/12.

- B. Several cost centers may be misclassified based on Finance & Accounting's definition of direct and indirect costs.

Direct costs were defined as those providing direct services to citizens, while indirect costs were defined as those supporting direct providers. The following are some apparent inconsistencies we noted.

Table 3. Classification of Cost Centers

Cost Center	Original Class.	Auditor Class.	FY2010/11 Budget	Reasoning
Graphics & Printing Solutions	Direct	Excluded	\$(49,354)	Graphics and Printing serves internal City departments rather than citizens. Further, this Internal Service-type operation should be recovering its costs from user departments and thus should be excluded from cost allocations.
Mail	Direct	Indirect	\$266,172	The Mail department serves internal city departments rather than citizens.
Elections	Indirect	Direct	\$323,330	Election services benefit citizens rather than internal City departments.
Mayor & City Council	Indirect	Direct	\$616,489	The Mayor and City Council represent and provide services to the citizens, rather than to internal City departments.
Trip Reduction	Direct	Indirect	\$121,811	This program serves City employees, rather than provides a service to citizens.

SOURCE: Auditor analysis of Finance & Accounting worksheets.

Based on discussions with Finance & Accounting, the definitions of Direct and Indirect costs can be further clarified to be more consistent with the classification method being used. Additionally, any exceptions to these defined categories should be documented and explained.

- C. Grant programs were excluded from the indirect cost evaluation, even though these programs also benefit from central services.

These programs, for grants received by the City, were not included in the indirect cost allocation because Finance & Accounting had not established an indirect cost allocation plan for federal programs. Therefore, the City could not recover the indirect costs of these programs.

Similar to other programs that serve City residents, grant programs also use central

services, such as accounting, payroll, human resources, information technology, and facilities maintenance. Although the types of indirect costs that can be recovered may vary for different grants, federal regulations generally will allow a fair share of indirect costs to be charged. Further, the goal of a City-wide indirect cost plan should be to accurately identify and equitably allocate indirect costs to all City programs that benefit from central services. Whether or not the indirect costs properly allocable to the Federal grants are recoverable would be a separate determination.

When the grant programs are not included in the Direct cost pool and allocated their share of indirect costs, this results in a higher allocation to other City programs, including the Enterprise Funds, and a higher indirect cost rate.

Grant activity for fiscal year 2010-2011 was budgeted at \$14.6 million. Based on auditor estimates, if the budgeted grants had been included in the indirect cost allocation, the cost to the Enterprise Fund programs may have decreased by about \$230,000 and the overall indirect cost rate may have decreased from 15 percent to 14.3 percent.

- D. Enterprise Funds were not charged the indirect costs related to certain Finance & Accounting services directly paid for by Water, Sewer, and Solid Waste.

The Water, Sewer, and Solid Waste departments directly pay a portion of costs for meter reading, remittance processing, utility billing, and revenue recovery but these costs were not included in the Enterprise cost pool for the indirect cost determination. As a result, the Enterprise Funds were not charged for indirect costs associated with these activities. Auditors estimate that if these costs had been included in the Enterprise costs, their indirect cost charges for FY 2011/12 would have increased by about \$213,000. This error appears to have been corrected in the proposed FY 2012/13 allocation.

Recommendation:

Finance & Accounting should:

- A. Base indirect cost calculations on the most current version of the City budget at the time the calculation is done.
- B. Clarify cost definitions being applied in the cost allocation and document any exceptions.
- C. Include grant programs in the indirect cost allocation calculation to ensure an accurate indirect cost allocation and rate is determined.
- D. Ensure that all costs directly paid by Enterprise Funds are included in the appropriate cost pool.

2. Adjustments to cost pools were inconsistent, resulting in potentially inaccurate indirect cost allocations.

The indirect cost allocation plan requires determining which costs to include in the Direct and Indirect cost pools prior to calculating the allocation. Although making adjustments to ensure the reasonableness of direct and indirect costs can be appropriate, the methodology used was not clearly defined and some adjustments were not consistently applied.

For the FY 2011/2012 indirect cost allocation, Finance & Accounting made the following adjustments to the cost pools:

Table 4. Adjustments made to Adopted Budget for the FY 2011/12 Indirect Cost Allocation

Adjustment Type		Amount	
Indirect Cost Pool	Equipment Depreciation	\$ 3,562,022	Estimated
	Building Usage*	\$ 1,262,147	Estimated
	CIP Allocations not reflected in FY 2010/11 budget	\$ (231,413)	Budgeted
	Utility Cost attributed to Direct Programs	\$ (6,519,489)	Estimated
Direct Cost Pool	Utilities attributed to Direct programs	\$ 6,519,489	Estimated
	Large Contracts	\$ (32,524,872)	Budgeted
	Other Direct Charges	\$ (694,400)	Budgeted

* Estimated cost to use the building – 2 percent of building acquisition cost.

Note: The FY 2010/11 Adopted Budget was used as the basis for the FY 2011/12 indirect cost allocation plan.

SOURCE: Auditor analysis of Indirect Cost Allocation worksheets provided by Finance & Accounting.

A. Capital Improvement Plan (CIP) allocation adjustments were inconsistently applied.

The CIP allocations account for a portion or all of the salaries for certain positions, such as finance, accounting, budget, and information technology, which work on capital projects. For fiscal year 2010/2011, approximately 17 full-time equivalent (FTE) positions representing \$1.7 million in salaries and benefits were allocated to CIP projects. While budgeted within their division's budgets, a portion of these positions' salaries were offset each month by revenues from the CIP funds. However, these costs do not represent a full allocation of City-wide indirect costs.

Since the CIP allocations are already being paid by CIP funds, Finance & Accounting correctly removed these costs from the Indirect cost pool. However, it did not similarly remove the costs from their program budgets in the Direct cost pool. As a result, these programs may receive a larger share of indirect costs than appropriate. Additionally, the overall Direct cost pool was overstated, resulting in a lower indirect cost rate.

Based on auditor estimates, if CIP allocations had been applied consistently for the FY 2011/12 indirect cost allocation, the overall indirect cost rate would have been slightly higher (0.1%) and indirect costs charged to Enterprise Funds would have been about \$14,800 more. After FY 2010/11, which was the basis for the FY 2011/12 plan, CIP allocations are charged out of each applicable division's budget through Work Order Credits, so an adjustment in the indirect cost allocation plan is no longer necessary.

CIP allocations are based on budgeted amounts rather than actual costs. For example, if 50 percent of a position's salary was budgeted as a CIP allocation, this charge is not modified during the year if more or less time was actually spent on CIP projects. Employees did not maintain documentation to support the time estimated as applicable to CIP projects. In a recent month's allocation, we noted that the salaries for several vacant positions were still being allocated to CIP. This practice results in CIP being charged for more salary expense than is being paid. For positions that were vacant during this fiscal year, auditors estimated a salary difference of about \$88,000.

- B. Adjustment to exclude the cost of large contracts from the cost pools did not have clear criteria.

Finance & Accounting deducted costs for contracted services over \$1 million if the contract was judged to require minimal administrative effort. This adjustment was intended to reflect that some high dollar contracts require limited support and therefore should not be allocated indirect costs. However, the decision to exclude certain contracts and not others was subjective and documentation did not demonstrate that central service requirements were fully considered.

1. Analysis was not available to show why excluding contracts over \$1 million, rather than some other amount, would be appropriate.
2. Only service contracts were evaluated. Commodity contracts, which may also require minimal administrative effort, were not reviewed.
3. "Minimal requirements" was subject to interpretation, and the notes for some excluded contracts did not support the "minimal" determination. For example, one \$4.2 million contract was noted as requiring "...continuous [contract administration] with varying levels of effort on the part of several staff members." This explanation could be construed as significant rather than minimal effort. Further, other indirect costs, such as contract reviews by the City Council, City Attorney, and/or City Auditor, were not considered. The \$4.2 million contract received frequent review by City Council and City management.

This type of adjustment can have a significant impact on the indirect cost allocation, given the large amounts being omitted. For the FY 2011/12 plan, the excluded contracts totaled \$32.5 million. Further, staff should better document the reasons for excluding specific contracts.

We estimate that the large contract adjustment in the FY 2011/12 indirect cost allocation increased the overall indirect cost rate by 1.6 percent and increased indirect costs charged to the Enterprise Funds by nearly \$95,000.

C. Process for allocating utility costs needs improvement.

Using the existing utility bill information, Finance & Accounting assigned utility costs to various departments. However, there were several areas where this process could be improved:

- A portion of utility costs that could have been identified as direct costs were not. Utility billings are tracked by meter or account number, so for facilities that serve multiple departments, these combined costs need to be assigned to the departments. Instead, utilities for many of these multidepartment buildings were labeled as Indirect and then allocated among all the Direct providers. We estimate that indirect utility costs may have been about \$514,000 lower if the multidepartment buildings, such as One Civic Center, were more accurately determined. A more typical method is to use each department's estimated square footage to allocate utilities in multidepartment buildings.
- Enterprise Fund programs were not charged directly for their share of utility costs in several shared buildings. The Enterprise Fund programs paid directly for their utility costs except for those areas housed in multidepartment buildings. For example, the Solid Waste program does not pay utilities for its share of the North Corp Yard building. Instead, utilities for these shared locations were classified as indirect costs and reallocated to all Direct providers. As a result, some Enterprise programs paid less for their share of utilities than they otherwise would have. Because Enterprise Fund programs recover their costs through rates and fees, any direct costs that can be charged directly should be so that appropriate rates and fees are established.
- Several utility accounts paid directly by Water, Solid Waste, and Westworld were allocated again through the utility adjustment. As a result, approximately \$430,000 in utility costs were paid both directly and added to the direct cost pool of these departments. This would have inflated the cost basis on which these departments were allocated indirect costs.
- Natural gas costs were inadvertently excluded from the FY 2011/12 allocation, which could impact the allocation of utilities to direct providers. However, this oversight was corrected in the FY 2012/13 allocation plan with most of these costs being assigned to Community Services.

D. Equipment depreciation and building usage adjustments were applied inconsistently.

Similar to the CIP Allocation adjustment described previously, equipment depreciation and building usage costs were added to the Indirect cost pool but not added to the Direct cost pool. Although Finance & Accounting provided some verbal explanations for treating these costs differently, the reasoning was not supported nor

documented. For example, while Finance & Accounting indicated indirect costs had already been charged through the CIP Allocation charges to the capital projects, this overhead charge has only been in place since FY 2008/09. Many capital assets were acquired prior to that fiscal year. Also, Finance & Accounting noted that the value of Enterprise assets would skew the allocation, yet it is not clear why these types of assets should be excluded.

Depreciation and building usage costs could have a significant impact on the indirect cost allocation. Therefore, further documented research is needed to support the most appropriate methodology for handling building and equipment costs, such as the types of assets to include or exclude and why. The results of this research should be documented and applied consistently to support the allocation model.

E. Adjustment for other direct charges not correctly applied.

Water and Sewer budgeted costs were incorrectly reduced by \$694,000 for “Direct Charges” which were noted to be police security costs and water association dues paid by Water and Sewer Funds but budgeted in other cost centers. These amounts should not have been deducted because they were not included in the Water and Sewer cost center adopted budgets. Further, the sources of the adjustment amounts were not documented and could not be duplicated by auditors. This error resulted in the Enterprise Funds being undercharged about \$31,800 for indirect costs.

F. The Aviation Fund may be undercharged for its share of indirect costs.

Certain indirect costs, including Elections, Government Relations, Utilities, Council Support and Municipal Security, are not being charged to the Aviation Enterprise Fund. These deductions in FY 2011/12 totaled \$52,000 and in FY 2012/13 totaled \$33,000. Finance & Accounting and Airport staff stated that these costs are deducted because the City has accepted grants from the Federal Aviation Administration (FAA), and the City is required to follow OMB Circular A-87, which provides guidelines for the types of costs allowable for federal grants.¹ However, federal FAA grants are used for capital expenditures, not Airport operations, and the Airport’s share of indirect costs would be paid from its operating budget. Further, the excluded costs appear allowable within the federal guidelines.

As a specific condition of accepting FAA grants, the City agrees to follow FAA policy on the use of airport revenue; however, the revenue policy only requires adherence to Attachment A of OMB Circular A-87.²

- Attachment A provides general principles for developing cost allocation plans, while the other attachments provide more specific requirements and define unallowable cost categories. Under the specified guidelines, the Airport’s fair share of Government Relations (other than potentially the specific state and federal lobbying contracts), Elections and Council Support appear to be

¹ Office of Management and Budget Circular A-87 Revised (05/10/04)

² Federal Aviation Administration *Policy and Procedures Concerning the Use of Airport Revenue*; Notice (02/16/1999)

allowable expenses.

- Finance & Accounting staff indicated that the Utilities and Municipal Security costs were eliminated from Airport's indirect cost allocation due to the following provision in Attachment A:

Costs must be accorded consistent treatment. A cost may not be assigned to a Federal award as a direct cost if any other cost incurred for the same purpose in like circumstances has been allocated to the Federal award as an indirect cost.

While these costs are treated as direct costs for some departments and indirect costs for others, it is due to differing circumstances. In some cases, such as water treatment facilities, a portion of these costs can be directly assigned. Therefore, the cited provision does not appear applicable and, to the extent that such costs are a portion of indirect costs, they would also be allocable to the Airport.

- G. Information Technology (IT) support and equipment depreciation could be more precisely allocated using a different cost driver

Besides utilities and building usage costs, IT costs could also be more equitably allocated using a different cost driver. In the current methodology, IT department costs and equipment depreciation are allocated to Direct providers based on their share of the City's computers. Because there are other factors that drive IT support costs, such as specialized software applications, network demands and mobile devices, the allocation basis for IT costs needs further analysis to identify the most significant cost drivers.

Recommendations:

Finance & Accounting should:

- A. Ensure that costs and FTE paid directly by capital projects are excluded from both Indirect and Direct cost pools. As well, the division should reevaluate the CIP allocation on a periodic basis to ensure that salary charges are aligned with actual costs and do not include vacant positions. Further, the staff whose salaries are being charged directly to CIP should periodically track their actual time on projects to ensure the percentages are appropriate.
- B. Eliminate the large contract adjustment unless clear guidelines and criteria are developed for this adjustment. Guidelines should include the types of contracts to be excluded and the criteria used for determining that a contract has minimal central service requirements.
- C. Allocate utility costs in multidepartment buildings on a direct basis, such as square footage, ensure that Enterprise Fund programs are charged for their direct share of utility costs, and ensure that costs already directly charged to departments are not reallocated in the indirect cost allocation.
- D. Further research methods of treating equipment depreciation and building usage costs in the indirect cost allocation and document the reasoning and methodology.

- E. Document the reasoning and process for adjustments being made to the Direct and Indirect cost pools.
- F. Allocate all costs appropriately through the indirect cost allocation plan and consult directly with the Federal Aviation Administration to determine if any of the allocable indirect costs cannot be recovered from airport revenues.
- G. Further analyze other allocation bases for information technology costs to ensure the most appropriate cost driver is applied.

3. Changes to the indirect cost allocation model for FY 2012/13 result in undercharging Enterprise Fund programs for their facilities maintenance costs.

As stated in the Background section of this report, the Enterprise Fund's indirect costs are proposed to decrease from \$8.2 million in FY 2011/12 to \$6.7 million in FY 2012/13. Although a small part of this decrease may be attributed to smaller departmental budgets and minor calculation differences, the most significant change results from a new allocation method for Facilities Management maintenance costs.

Table 5. Facilities Management Costs*

Allocation for Fiscal Year	Indirect Costs	Direct Costs	Total Costs
2011/12	\$9,605,842	\$0	\$9,605,842
2012/13	\$1,233,040	\$7,004,344	\$8,237,384

* Excludes utility costs paid through Facilities Management.

SOURCE: Auditor analysis Indirect Cost Allocation worksheets provided by Finance & Accounting.

The FY 2012/13 allocation model calculates the Indirect portion of facilities maintenance costs using the square footage occupied by Indirect departments. Although this is an improvement over the prior allocation model, only the indirect portion of facilities maintenance costs was calculated. The remaining costs were designated as direct, but not allocated to the various departments in the Direct cost pool.

As a result, facilities maintenance costs incurred by the Enterprise Fund departments were not directly charged nor allocated to them. Instead, Enterprise Fund departments were only allocated a share of the portion of facilities maintenance costs identified as indirect.

Recommendation:

Finance & Accounting should allocate Facilities Management maintenance costs designated as Direct to Enterprise Funds and other departments in the Direct cost pool. Otherwise, consider tracking Facilities Management costs specifically (such as by building or work order) and only allocate costs that cannot be traced to a specific department.

4. The methodology for the FY 2011/12 indirect cost allocation was not well defined and

management review and approval is not documented.

- A. For the FY 2011/12 budget, the process for calculating the indirect cost allocation changed from a percentage basis to one based on an actual costs allocation plan. Previously the Indirect cost pool was allocated based on each department's budget. The new methodology is more complex, also allocating costs on the basis of full-time equivalent employees, computers and certain square footage. However, the new methodology, which reduces the Enterprise Funds indirect costs by almost \$4.1 million, did not document assumptions made and options considered, which are needed to facilitate an independent review and to guide future cost allocations. Additionally, because the detailed methodology was not documented, it required more time and effort to obtain information on why certain calculations were performed and where the adjustments came from.

Further, detailed written procedures would provide assurance that there is agreement regarding the methodology to be used. The review and approval process was not documented to show that the City Treasurer approved the final allocation or that an independent person reviewed the assumptions and calculations for accuracy.

- B. Once developed, the indirect cost rate is not formally communicated to other City departments that should use the rate in calculating their program rates and fees. City financial policy requires that non-Enterprise rates and fees be periodically reviewed to determine the direct and indirect cost of service recovery. However, according to Finance & Accounting staff, the indirect cost rate is not provided to non-Enterprise City departments unless specifically requested. Further, no additional guidance or information is provided regarding which costs are already included in the indirect cost rate to ensure that costs, such as utilities, are only included once in the evaluation of rates and fees. As a result, there is less assurance that City departments use the most current or most accurate costs when calculating their rates and fees.

Recommendation:

- A. Finance & Accounting should:
- Document the indirect cost methodology, including calculations and adjustments, to facilitate consistent application.
 - Ensure the process includes an independent review of assumptions, amounts and calculations.
- B. Finance & Accounting should annually communicate to City divisions the indirect cost rate and its cost components to facilitate proper application of the indirect cost rate in rate and fee calculations.

MANAGEMENT ACTION PLAN

1. The indirect cost allocation plan was not based upon the most current budget version, and some cost classifications may not be accurate.

Recommendations:

Finance & Accounting should:

- A. Base indirect cost calculations on the most current version of the City budget at the time the calculation is done.
- B. Clarify cost definitions being applied in the cost allocation and document any exceptions.
- C. Include grant programs in the indirect cost allocation calculation to ensure an accurate indirect cost allocation and rate is determined.
- D. Ensure that all costs directly paid by Enterprise Funds are included in the appropriate cost pool.

MANAGEMENT RESPONSE:

- A. The Finance and Accounting Division disagrees with this recommendation. The Division prefers using the most current adopted budget as it has been adopted by City Council. Using the adopted budget each year for calculating the next fiscal year's indirect cost allocation provides consistency. Additionally, subsequent adopted budgets should reflect changes in spending, which will carry forward into a change in the indirect cost allocation. Using the Approved Budget is less consistent as this budget could change monthly depending on vacancy savings and other circumstances. For the above reasons, the recommendation will not be implemented.
- B. The Finance and Accounting Division agrees with this recommendation. Cost definitions applied in the cost allocation will be clarified and exceptions documented.
- C. The Finance and Accounting Division partially agrees with this recommendation. Operating grants will be included in future calculations to ensure an accurate indirect cost allocation and rate is determined. However, we will continue to exclude grants for the acquisition or construction of capital assets.
- D. The Finance and Accounting Division concurs with this recommendation. This was completed in the proposed FY 2012/13 allocation.

PROPOSED RESOLUTION:

- A. Not applicable.
- B. The Finance and Accounting Division will ensure cost definitions are clarified and exceptions are documented.
- C. The Finance and Accounting Division will include operating grants in future calculations to ensure an accurate indirect cost allocation and rate is determined.
- D. The Finance and Accounting Division will continue to ensure that all costs directly paid by Enterprise Funds are included in the appropriate cost pool.

RESPONSIBLE PARTY: Budget Office

COMPLETED BY: 6/30/2013

2. Adjustments to cost pools were inconsistent, resulting in potentially inaccurate indirect cost allocations.

Recommendations:

Finance & Accounting should:

- A. Ensure that costs and FTE paid directly by capital projects are excluded from both Indirect and Direct cost pools. As well, the division should reevaluate the CIP allocation on a periodic basis to ensure that salary charges are aligned with actual costs and do not include vacant positions. Further, the staff whose salaries are being charged directly to CIP should periodically track their actual time on projects to ensure the percentages are appropriate.
- B. Eliminate the large contract adjustment unless clear guidelines and criteria are developed for this adjustment. Guidelines should include the types of contracts to be excluded and the criteria used for determining that a contract has minimal central service requirements.
- C. Allocate utility costs in multidepartment buildings on a direct basis, such as square footage, ensure that Enterprise Fund programs are charged for their direct share of utility costs, and ensure that costs already directly charged to departments are not reallocated in the indirect cost allocation.
- D. Further research methods of treating equipment depreciation and building usage costs in the indirect cost allocation and document the reasoning and methodology.
- E. Document the reasoning and process for adjustments being made to the Direct and Indirect cost pools.
- F. Allocate all costs appropriately through the indirect cost allocation plan and consult directly with the Federal Aviation Administration to determine if any of the allocable indirect costs cannot be recovered from airport revenues.
- G. Further analyze other allocation bases for information technology costs to ensure the most appropriate cost driver is applied.

MANAGEMENT RESPONSE:

- A. The Finance and Accounting Division concurs with the recommendation that costs paid directly by capital projects be excluded from both the indirect and direct cost pools. The Finance and Accounting Division concurs with the recommendation that FTEs paid directly by capital projects should be excluded from both the indirect and direct cost pools. The Finance and Accounting Division agrees to reevaluate the CIP costs however vacant positions will continue to be included in the CIP allocation; if a position is vacant, the work is completed elsewhere by other staff members. The Finance and Accounting Division disagrees with the recommendation that employees should periodically track their actual time on projects; the CIP allocation is reviewed annually to ensure that the staff whose salaries are directly charged to the CIP have appropriate percentages.
- B. The Finance and Accounting Division agrees to consider guidelines and criteria that allow professional judgment in excluding large contracts.
- C. The Finance and Accounting Division concurs with the recommendation. The data for square footage for multidepartment buildings is slowly becoming available as Facilities Management captures the data citywide. Once the data is fully available

and defensible, the indirect cost allocation process will be enhanced to allocate utility costs in multidepartment buildings by square footage to ensure that Enterprise Fund programs are charged for their direct share of utility costs and ensure that costs already directly charged to departments are not reallocated in the indirect cost allocation.

- D. The Finance and Accounting Division agrees to further research methods of treating equipment depreciation and building usage costs in the indirect cost allocation and document the reasoning and methodology.
- E. The Finance and Accounting Division will document the reasoning and process for adjustments being made to the direct and indirect cost pools.
- F. The Finance and Accounting Division will seek guidance from the Aviation Department regarding consulting with the Federal Aviation Administration.
- G. The Finance and Accounting Division will undertake further analysis of other allocation bases for information technology costs to ensure the most appropriate cost driver will be done.

PROPOSED RESOLUTION:

- A. The Finance and Accounting Division will work to ensure that FTEs that are paid directly by capital projects be excluded from both the indirect and direct cost pools.
- B. The Finance and Accounting Division will work to formalize the indirect cost allocation process to include documentation of the reasons large contracts were excluded.
- C. The Finance and Accounting Division will work to formalize the process. Once the data is fully available and defensible, the indirect cost allocation process will be enhanced to allocate utility costs in multidepartment buildings by square footage to ensure that Enterprise Fund programs are charged for their direct share of utility costs and ensure that costs already directly charged to departments are not reallocated in the indirect cost allocation.
- D. The Finance and Accounting Division will further research methods of treating equipment depreciation and building usage costs in the indirect cost allocation and document the reasoning and methodology.
- E. The Finance and Accounting Division will work to formalize the process. The reasoning and process for adjustments being made to the direct and indirect cost pools will be documented.
- F. The Finance and Accounting Division will work with the Aviation Department and consider consulting directly with the Federal Aviation Administration.
- G. The Finance and Accounting Division will further analyze other allocation bases for information technology costs to ensure the most appropriate cost driver.

RESPONSIBLE PARTY: Budget Office

COMPLETED BY: 6/30/2013

3. Changes to the indirect cost allocation model for FY 2012/13 result in undercharging Enterprise Fund programs for their facilities maintenance costs.

Recommendation:

Finance & Accounting should allocate Facilities Management maintenance costs designated as Direct to Enterprise Funds and other departments in the Direct cost pool. Otherwise, consider tracking Facilities Management costs specifically (such as by building or work order) and only allocate costs that cannot be traced to a specific department.

MANAGEMENT RESPONSE:

The Finance and Accounting Division concurs with the recommendation when data becomes available. Currently Finance & Accounting is unable to allocate Facilities Management maintenance costs designated as Direct to Enterprise Funds and other departments in the Direct cost pool as the data is not available.

Facilities Management has implemented a new software system that does have work order tracking capabilities. If/when Facilities Management begins using the work order tracking system; the indirect cost allocation process can be enhanced to capture facilities maintenance costs directly to Enterprise Funds and other departments in the direct cost pool.

The city currently does not use an integrated cost accounting system.

PROPOSED RESOLUTION:

The Finance and Accounting Division staff will work with Facilities Management to utilize the work order tracking system; the indirect cost allocation process will be enhanced to capture facilities maintenance costs directly to Enterprise Funds and other departments in the direct cost pool.

RESPONSIBLE PARTY: Budget Office

COMPLETED BY: 6/30/2013

4. The methodology for the FY 2011/12 indirect cost allocation was not well defined and management review and approval is not documented.

Recommendation(s):

A. Finance & Accounting should:

- Document the indirect cost methodology, including calculations and adjustments, to facilitate consistent application.
- Ensure the process includes an independent review of assumptions, amounts and calculations.

B. Finance & Accounting should annually communicate to City divisions the indirect cost rate and its cost components to facilitate proper application of the indirect cost rate in rate and fee calculations.

MANAGEMENT RESPONSE:

- A. The Finance and Accounting Division concurs with the recommendation. The indirect cost methodology, including calculations and adjustments, to facilitate consistent application will be documented. The process will include an independent review of assumptions, amounts and calculations.
- B. The Finance and Accounting Division disagrees with the recommendation. The Division prefers that departments contact Finance & Accounting for the fiscal year's indirect cost rate. By doing so, Finance & Accounting will have a dialogue regarding how and what the rate is used for to ensure proper application.

PROPOSED RESOLUTION:

- A. The Finance and Accounting Division will formalize the indirect cost methodology, including calculations and adjustments, to facilitate consistent application will be documented. The process will include an independent review of assumptions, amounts and calculations.
- B. Not applicable.

RESPONSIBLE PARTY: Budget Office

COMPLETED BY: 6/30/2013

City Auditor's Office

4021 N. 75th St., Suite 105
Scottsdale, Arizona 85251
(480) 312-7756

www.ScottsdaleAZ.gov/departments/City_Auditor

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