



MEMORANDUM

City of Fort Smith
Internal Audit

TO: City of Fort Smith Board of Directors
Carl Geffken, City of Fort Smith City Administrator

FROM: Tracey Shockley

DATE: November 2019

SUBJECT: City Allocation Remediation Audit

Background

The City of Fort Smith uses a cost allocation method to determine and assign the cost of central services (non-generating revenue departments) to the internal-government users of those services. Cost allocation enables local governments to more accurately account for the complete cost of the services it provides to the city departments. Included in cost allocation are direct and indirect costs.

Direct costs are specifically identified with a particular cost objective. Indirect costs are incurred for common or joint purposes such as services that benefits more than one cost objective but are not steadily assignable to a specific cost objective. Payroll, human resources, information technology, and auditing are examples of such services. The direct cost and indirect cost for such services should be identified in a Cost Allocation Plan (CAP). Direct costs are identified by the City's program approach to budgeting.

A Cost Allocation Plan simply shares indirect costs across programs, activities, funds, departments, grants and other cost objectives. The term "allocation" implies that there is no overly precise method available for charging a cost object, so the entity is using an approximate method for doing so. However, a CAP should be designed to provide a consistent, reasonable and equitable means to estimate and allocate costs.

The CAP identified all benefiting funds and departments, and recognizes the full cost of services. It identifies the documentation required to support the allocations, the cost to operate each department, and the amount charged to each benefiting fund/department. It also identified the data sources used for allocation calculations. The allocations should be reviewed and supported each year at the beginning of the budget preparation process.

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In 2015, Internal Audit performed an audit of the City's allocation and reported the following findings:

- 1) There were no written policies and procedures for establishing a formal Cost Allocation Plan.
- 2) The allocations were not reviewed and updated annually.
- 3) No methodology for uniform application of allocation methods.
- 4) No support for allocation calculations; the allocations are based on unsupported estimates.

A review of allocation process identified that the Finance Department does not review the allocations annually, and the Finance Department does not document that the approach being used results in a fair and equitable allocation. The allocations should be owned by the Finance Department and reviewed by the Internal Audit Department.

The Internal Audit Department could not perform the allocation testing because methodologies, allocation calculations, and policies and procedures could not be provided. In order for Internal Audit to perform the testing, there must be established methodology and calculated approach in order to verify that the calculations were fair and equitable.

The following recommendations and management responses were documented in the report:

- 1) The Finance Department should implement written policies and procedures that provide a framework and background for financial allocations and methods used.

Management response was that the last formal CAP for the city was provided in 1986 by DMG and that the city did not adopt written policies for the CAP. The CAP has not been formally updated since that time and has not been a high priority in the department. It is proposed that Finance management prepare written policies and procedures for the CAP. These policies and procedures will be comprehensive and will include identification of costs to be allocated and will provide the supporting documentation for applying the CAP to the various cost centers. Once these are prepared, the CAP will be reviewed and amended as necessary. Projected completion date is September 20, 2015 so that implementation may be coordinated with the 2016 Budget.

- 2) The Finance Department should create a Cost Allocation plan detailing the compilation of the input data so that the legitimacy of the allocations cannot be questioned. The plan should include relevant, current information, should describe each overhead cost center, should describe which costs are allocable and which are not. Additionally, the plan should describe the decision made and the rationale for those decisions. The plan should be reviewed and updated annually.

Management response was that the Cost Allocation plan would be included in the comprehensive written policies and procedures.

- 3) The Finance Department should include the annual evidence and support for each specific allocation to show that the allocation methodology is logical, fair, and equitable. The support for each calculation should be maintained for at least five years plus the current year. Additionally, if the calculations have a significant change and/or have a specific reason for the change, the support should be maintained for at least ten years. Finance should at least annually prepare the spreadsheets as support for the allocation percentages which are identified in the Budget. Best practice would be to perform the allocations after the CAFR review is completed by the External Auditors, this will provide the most accurate numbers when applying the allocation methods used to calculate the percentages from each revenue stream.

Managements responded that this would be included in the comprehensive written policies and procedures.

Remediation Testing

IA contacted the Finance Department to obtain the written policies and procedures for CAP, Cost Allocation plan detailing the compilation of the input data, and annual evidence and support for each specific allocation to show that the allocation methodology is logical, fair, and equitable.

The Finance Department, specifically the Treasurer, looked for the documentation and could only locate a word document that appeared to be an attempt to write the allocation policies and procedures. Additionally, a spreadsheet that appears to be an attempt at allocations/percentages, however the cells do not contain formulas or notation of how the percentages were achieved.

IA spoke with the City Administrator and he confirmed that he was informed by the prior Finance Director that an Allocation Study was being performed by Przybysz Associates, except for one small piece that would be handled by Finance. IA relayed to the City Administrator that it appears it did not happen. IA contacted Przybysz via email regarding any work, contract, invoice that they did for the City of Fort Smith regarding an allocation study. Przybysz replied back that they had not and found an email dated 2/27/2017 that contained allocation workpapers from 2015 that were a review of allocations prior to Kara Bushkuhl retirement in 2015 but were never implemented. This email was provided to the City Administrator.

Conclusion

IA recommendations and management's responses were not implemented. It is critical for the Finance Department to create and implement written policies and procedures that include a Cost Allocation plan detailing the compilation of the input data so that the legitimacy of the allocations cannot be questioned. The plan should include relevant, current information, should describe each overhead cost center, should describe which costs are allocable and which are not. Additionally, the plan should describe the decision made and the rationale for those decisions. The plan should be reviewed and updated annually.

cc:
Audit Advisory Committee

Management Responses:

IA meet with Carl Geffken regarding the remediation testing findings. Carl stated that he would have this as one of the top priorities for the new Finance Director. Carl was also able to provide support (emails) from the prior Finance Director that stated the study was not complete (70% complete) and the plan was to have it completed before the budget meetings in Sept/Oct 2017. Additionally, another email had the allocation CIP attached; however, it did not provide supporting documentation or formulas for the allocation percentages.