



Internal Audit Report

City of Fort Smith Allocation Report

2015-1

Full Report:

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From:

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Executive Summary

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 to 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 identifies 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 identifies the data sources used for allocation calculations. The allocations should be reviewed and supported each year at the beginning of the budget preparation process.

Objective and Scope

Conduct a review of the allocation policies and procedures and verify that the current allocations are fair and equitable sharing of indirect costs. Review to ensure that the support for the allocations were methods that are clear and concise. Review that the City of Fort Smith is adhering to federal, state, and/or local requirements. Recommend improvements to avoid further discrepancies, where necessary.

Conclusion

After a reviewing the allocation requirements and current allocation percentages, it was determined that:

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- 1) There are no written policies and procedures for establishing a formal Cost Allocation Plan.
- 2) The allocations are 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.

Summary of Deficiencies

1. **Written Policies and Procedures** – The Finance Department could not provide written policies and procedures for allocations.
2. **Allocation Plan** – The Finance Department could not provide a Cost Allocation Plan which identifies which costs are allocable, which are not, and identifies the data sources used for allocation calculations.
3. **Support for allocation calculations/methods** – The Finance Department could not provide the allocation calculations/methods used.

Detail Findings and Observations

1. Written Policies and Procedures (High)

Issue

The Finance Department could not provide written policies and procedures for allocations.

Risk

Without written policies and procedures the city employees do not have the ability to immediately refer to what is the correct procedure. This leads to inconsistencies and increases the risk of incorrect reporting.

Evidence

During the allocation review, the Finance Department was asked to provide the written policies and procedures or allocation plan. The Director of Finance replied that she did not have a copy of the prior report by the former Internal Auditor.

Cause

The Finance Department could not provide written policies and procedures for allocations, therefore, Internal Audit could not assure that the methods or steps taken were fair and equitable.

Recommendation

The Finance Department should implement written policies and procedures that provide a framework and background for financial allocations and methods used. Such framework provides the steps to be followed, achieves standardization for reoccurring activity, and sets policies and procedures to assist in creating a consistent and accurate work product.

Management Response:

During the early 1980's, the city contracted with DMG, Inc. for preparation of an annual CAP report and review. The CAP was prepared for the purpose of charging CDBG for overhead costs. The last formal CAP for the city was provided in 1986 by DMG. Due to lower than normal funding from HUD for the CDBG program, the contract with DMG was discontinued. The Finance Department continued to update the CAP for several years. However, the city did not adopt written policies for the CAP. Sometime in the past, the previous Internal Auditor (IA) provided an updated CAP wherein interviews were performed and statistical parameters were provided to review and update the CAP. The CAP has not been formally updated since that time, as it has not been a high priority in the department. Auditing standards have changed since the prior IA provided the review and application of the CAP so the original plans to have the current IA perform this duty is not acceptable. It is proposed that Finance management prepare

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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 30, 2015 so that implementation may be coordinated with the 2016 Budget.

Owner: Kara Bushkuhl, Director of Finance

Completion Date: 5/07/15

2. Allocation Plan (High)

Issue

The Finance Department could not provide a Cost Allocation Plan that identifies which costs are allocable, which are not, and identifies the data sources used for allocation calculations.

Risk

Without a Cost Allocation Plan the Finance Department cannot describe how the organization will allocate costs reasonably and equitably across funds and departments. In addition, the Finance Department could not identify the documentation required to support the charges.

Evidence

During the allocation review, the Finance Department was asked to provide the written policies and procedures and allocation plan. The Director of Finance replied that she did not have a copy of the prior report by the former Internal Auditor.

Cause

The Finance Department could not provide the Cost Allocation Plan, therefore Internal Audit could not assure the methods or compilations were fair and equitable, nor could Internal Audit determine what allocation factors and data sources were used to calculate the allocations.

Recommendation

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. It should also include what allocation factors and data sources will be used to calculate the allocations. Additionally, the plan should describe the decisions made and the rationale for those decisions. The allocation plan should be reviewed and updated annually.

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The creation and implementation of the allocation process should be the responsibility of the Finance Department and cannot be performed by the Internal Audit Department. The Internal Audit Department is not authorized to perform any operational duties for the City, and shall have no direct responsibility or authority over financial compliance or operational issues that may be subject to review.

Management Response:

This will be included in the comprehensive written policies and procedures referred to in the response for recommendation 1.

Owner: Kara Bushkuhl, Director of Finance

Completion Date: 5/07/15

3. Support for allocation calculations/methods (High)

Issue

The Finance Department could not provide the allocation calculations or methods used. Additionally, the allocation percentages are not reviewed each year to ensure that the allocations are still distributed fairly and equitably

Risk

Failure to provide the support for allocation calculation or methods used and failure to re-examine the percentages annually could potentially have an adverse effect on the City's financial statements.

Evidence

During the allocation review, the Finance Department was asked to provide the written policies and procedures, allocation plan and allocation calculation support. The Director of Finance replied that she did not have a copy of the prior report by the former Internal Auditor.

Also during the review of allocation percentages for each overhead department it was noted through the Comprehensive Annual Financial Reports (CAFR) that the percentages were the same from 2008 through 2015. One exception was noted, Parks (Personnel and Operation Accounts) percentages changed in 2013 and again in 2014. However, the Finance Department could not provide documentation to support the changes.

Cause

The allocations calculations were not reviewed annually and the Finance Department did not maintain the support used to perform the calculations in previous years. The Director of Finance supplied the Internal Audit Department with a spreadsheet, however, the spreadsheet did not have sufficient evidence or support to determine how the calculations were performed or how the resulting percentages were determined.

Recommendation

The Finance Department should include the annual evidence and support for each specific allocation calculation 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.

The Finance Department should at least annually prepare the spreadsheets as support for the allocation percentages which are identified in the Budget. The allocations should be based on current and accurate information. 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.

Management Response:

This will be included in the comprehensive written policies and procedures referred to in the response for recommendation 1.

Owner: Kara Bushkuhl, Director of Finance

Completion Date: 5/07/2015