

**F
I
N
A
L

R
E
P
O
R
T**

CITY OF HOUSTON
Sylvia R. Garcia, City Controller

CITYWIDE INDIRECT COST



February 2002
Report 01-12



McCONNELL JONES LANIER & MURPHY_{LLP}
CONSULTANTS & BUSINESS ADVISORS

11 Greenway Plaza, Suite 2902
Houston, Texas 77046



OFFICE OF THE CONTROLLER
CITY OF HOUSTON
TEXAS

SYLVIA R. GARCIA

March 29, 2002

The Honorable Lee P. Brown, Mayor
City of Houston, Texas

SUBJECT: Citywide Indirect Cost Review (Report No. 01-12)

Dear Mayor Brown:

In accordance with the City's contract with McConnell Jones Lanier & Murphy LLP (MJLM), MJLM has completed a Citywide Indirect Cost Review. The primary purpose of the review was to determine whether the City's indirect costs are allocated in accordance with Office of Management and Budget's Circular A-87 and to determine the reasonableness and allocability of indirect costs among city departments, grants and enterprise and other funds.

The report, attached for your review, contains recommendations on how the allocation processes and related controls can be improved and strengthened. Draft copies of the matters contained in the report were provided to Department officials. The views of the responsible Department officials as to action taken or being taken are appended to the report as Exhibit I.

We appreciate the cooperation extended to the MJLM's auditors by City personnel during the course of the audit.

Respectfully submitted,


Sylvia R. Garcia
City Controller

xc: City Council Members
Albert Haines, Chief Administrative Officer
Oliver Spellman, Jr., Chief of Staff, Mayor's Office
Philip Scheps, Director, Finance and Administration Department



McCONNELL JONES LANIER & MURPHY, LLP
CONSULTANTS & BUSINESS ADVISORS

February 11, 2002

The Honorable Sylvia R. Garcia, City Controller
City of Houston
901 Bagby, 8th Floor
Houston, Texas 77002

Dear City Controller:

I am pleased to present McConnell Jones Lanier and Murphy's (MJLM) final report of the compliance review of the citywide indirect costs allocations of the City of Houston. This review was conducted in accordance with the Engagement Letter between the City and our firm dated September 14, 2000.

The purpose of the audit was to perform a review of city-wide indirect costs for the City of Houston to determine whether the City's indirect costs are allocated in accordance with Office of Management and Budget's (OMB) Circular A-87 and to determine the reasonableness and allocability of indirect costs among city departments, grants and enterprise and other funds. We designed procedures, including interviews with responsible officials, to document our understanding of the processes and procedures used in preparing the city's cost allocation plans and indirect cost rates. We also recomputed allocations, tested and traced expenditures to their source documents to determine whether the costs are allocable under OMB Circular A-87 and determined whether the indirect cost rates for federal programs were calculated based on the approved methodology and in accordance with A-87.

Our report contains recommendations on how the allocation processes and related controls can be improved and strengthened.

We are grateful for the cooperation of the management team and staff personnel who assisted us during this review. We are especially grateful to the Department of Finance and Administration who generates the cost allocation plans and all other city departments included in our scope for their help in providing us with the necessary information in order for us to complete the review.

Very truly yours,

TABLE OF CONTENTS

	<u>Page No.</u>
1.0 EXECUTIVE SUMMARY.....	1
2.0 BACKGROUND.....	2
3.0 SUMMARY OF THE CITY’S COST ALLOCATION PLAN AND METHODOLOGY.....	4
4.0 SCOPE AND OBJECTIVES	5
5.0 PROCEDURES.....	6
6.0 FINDINGS AND RECOMMENDATIONS.....	8
VIEWS OF RESPONSIBLE OFFICIALS	EXHIBIT I

1.0 EXECUTIVE SUMMARY

McConnell, Jones, Lanier, & Murphy (MJLM) completed a compliance review of citywide indirect costs of the City of Houston (the “City”) for the fiscal year ended June 30, 2000. This review was conducted in accordance with the Engagement Letter between the City and MJLM dated September 14, 2000. This report summarizes the results of the review in the following sections:

- 1.0 Executive Summary
- 2.0 Background
- 3.0 Summary of Cost Allocation Plan and Methodology
- 4.0 Scope and Objectives
- 5.0 Procedures
- 6.0 Findings and Recommendations

The following is a summary of findings and recommendations included in this report:

FINDING

F&A does not perform a reconciliation of the full cost allocation plan to the cost allocation plans under OMB Circular A-87.

We performed a reconciliation between the plans and, as a result, costs in the amount of \$92,388, with no basis or supporting records was excluded from the OMB A-87 Plan. Total supported costs excluded from the OMB A-87 Plan were \$58,286,292 and, therefore, the \$92,388 (.16%) is considered immaterial.

The exclusion of these costs from the full cost allocation basis, in order to arrive at costs allowed for allocation under OMB Circular A-87, resulted in an under allocation of costs to federal programs and a related decrease in revenues to the City.

Recommendation

Reconcile cost on a full cost allocation basis to cost as allowed under OMB Circular A-87 before finalizing each annual cost allocation plan under OMB Circular A-87.

FINDING

A reconciliation process is not performed by expense classification to ensure that expenditure amounts are properly classified in the City's cost allocation plans. The performance of this reconciliation process would provide assurance that the cost allocation plans and indirect cost rates that are calculated based on these expenses are correct.

F&A, the responsible department for preparation of the cost allocation plan, extracts a customized expenditure report from the general ledger by department, organization and object code disclosing those expenses to be included in the cost allocation plan.

During our review, we noted only one instance of misclassification. Salaries were misclassified as benefits. The amount was considered immaterial and did not have an effect on the indirect cost rates. We also compared the customized expenditure report extracted by F&A to the general ledger in total and by department. There were no material differences noted.

Recommendation

Prepare a reconciliation of all customized reports extracted from the general ledger by expense classification to the City's official general ledger report by expense classification, as well as in total.

2.0 BACKGROUND

Office of Management and Budget (OMB) Circular A-87 (the "Circular") establishes principles for determining the allowable costs incurred by State, local, and federally-recognized Indian tribal governments under grants, cost reimbursement contracts, and other agreements with the Federal Government (collectively referred to as "Federal Awards"). The principles are only for the purpose of determining allowable costs and are not to determine the extent of Federal or governmental participation in the financing of a particular program. The Circular is issued under the authority of the Budget and Accounting Act of 1921, as amended; the Budget and Accounting Procedures Act of 1950, as amended; the Chief Financial Officers Act of 1990; Reorganization Plan No.2 of 1970; and Executive Order No. 11541 ("Prescribing the Duties of the Office of Management and Budget and the Domestic Policy Council in the Executive Office of the President").

To properly perform a compliance review of the City's indirect cost, we determined whether the City's Cost allocation plans complied with the Circular and that the related indirect costs were billed to federal programs in accordance with the same.

Indirect costs as defined in the Circular are those: (a) incurred for a common or joint purpose benefiting more than one cost objective and (b) not readily assignable to the cost objectives specifically benefited, without effort disproportionate to the results achieved. Indirect costs, as defined by the Circular, applies to costs originating in the grantee department, as well as those incurred by other departments in supplying goods, services, and facilities.

To facilitate equitable distribution of indirect expenses to the cost objectives served, indirect costs are identified within city departments along with benefiting city departments and these costs are distributed to benefited cost objectives utilizing an

allocation basis that will produce an equitable result in consideration of relative benefits derived.

The City accomplishes this through the preparation of a City Wide Cost Allocation Plan, a Fire Department Cost Allocation Plan and a Police Department Cost Allocation Plan, all prepared on a full cost allocation basis. The city use these full cost allocation plans to allocate cost to other city departments only.

For purposes of charging indirect cost to federal programs, a second set of cost allocation plans are prepared using the full cost allocation plan as a base, but revised to exclude all cost not allowed under the Circular. A summary of the City's cost allocation plans and methodology will immediately follow this section of the report.

The City uses the pool of indirect costs, usually for a department or major function within a department, found in the cost allocation plan under the Circular, in relationship to a distribution base, usually total direct salaries and wages for that function or department, in order to determine a special indirect cost rate. This indirect cost rate is applied to indirect costs related to federal awards in order to determine the amount chargeable.

The City also calculates a single indirect cost rate (city wide), where a special indirect cost rate is not required, in order to distribute costs aggregated in a common pool. However, both indirect cost rate types are a result of separate cost pools developed during the course of the regular allocation process.

Exhibit 1 is a listing of the City's central service departments with their respective special indirect cost rate and the City's citywide indirect cost rate for fiscal year 2000:

**Exhibit 1
The City's Indirect Cost Rates
FY 2000**

Department	Indirect cost Rate (percent)
Aviation Dept.	7.57
Citywide	12.19
Health & Human Services Dept.	35.54
Parks & Recreation Dept.	13.33
Police Dept.	52.49
Public Works & Engineering Dept. Traffic Control Fund 224	35.87
Public Works & Engineering Dept. Fleet Management Fund 118	22.83

3.0 SUMMARY OF THE CITY'S COST ALLOCATION PLANS AND METHODOLOGY

The City's cost allocation plans for fiscal year 2000 are based on actual expenditures for the fiscal year ended June 30, 1998. The plans prepared for use in charging indirect cost to federal programs were prepared in accordance with the Circular.

While David M. Griffith (DMG) initially prepared the City's A-87 Indirect Cost Allocation Plan (OMB A-87 Plan), the Department of Finance and Administration (F&A) has oversight responsibility for the appropriate allocation of indirect costs. More specifically, the Financial Services Group of F&A uses DMG's proprietary cost allocation software (NGCS II Cost allocation Software, Version 1.18) to input data necessary to keep the OMB A-87 Plan current and calculate the appropriate indirect cost rates to be applied to Federal grants by the Grants Administration Group. Each year, prior to the City's filing of the plan with the Department of Housing and Urban Development (HUD), DMG reviews the input to the A-87 Plan and sends the City a letter indicating its findings. A copy of this letter is included with the HUD filing.

The City followed a consistent approach to the treatment of direct and indirect costs included in these plans and based on our work performed the City's costs have not been charged as both direct and indirect to federal programs. Allocation bases used are from full base years or from an equivalent period's data.

The City employs software that uses a double step-down allocation procedure to distribute costs of central services to other user departments that are cost beneficiaries. The first step requires a sequential ordering of departments before the allocation process begins. Departmental indirect costs are then allocated to each user department in the sequence ordered in the first allocation process.

A second step-down allocation is made from each central service department to capture costs related to cross-benefit of services among central service departments not identified in the first allocation. The user department is subsequently closed and not allowed to receive any additional allocation.

The costs allocated from each central service department consists of cost accumulated in a two-step allocation process as follows:

1. First allocation - the actual operating expenditures incurred in the central service department, plus all central service costs allocated from other central service departments.
2. Second allocation - Central service costs not previously identified and allocated by other central service departments.

The cost allocation plan for the city-wide cost allocation presents three summary schedules on a central service departmental basis, whereas the Police and Fire cost

allocation plans are on a divisional basis. The three summary schedules for all plans summarizes the data as follows:

1. Allocated Costs by Department (1st schedule) - reports the costs allocated in total by department from each central service department to each corresponding user department.
2. Summary of Allocated Costs (2nd schedule) - presents the total expenditures and cost adjustments allocated by central service departments. Additionally, it shows the total dollar amount of expenditures allocated to each user department.
3. Summary of Allocation Basis (3rd schedule) - lists the distribution basis used to allocate the costs for each function of every central service department.

The cost allocation plans further details the results of each central service departments cost allocations on four schedules. A description of each schedule presented for each central service department is as follows:

1. Costs to be Allocated - presents in summary the total costs to be allocated based on the actual expenditures reported in the City's financial statements plus allocated costs from other central services.
2. Costs to be Allocated by Function - costs for each central service department are listed by function as a result of their accumulation of incurred and allocated cost. This process better ensures the application of these costs to user departments on a benefit objective basis.
3. Detail Allocation - this schedule provides a detail of the allocation of each function except General Administration. General administration costs are first allocated to all other user departmental functions in proportion to functional costs.
4. Departmental Cost Allocation Summary - a summary schedule of costs allocated by function with the corresponding user departments is the last schedule shown for each central service department.

4.0 SCOPE AND OBJECTIVES

The time period covered by our review of indirect costs and the related cost allocation plans was July 1, 1999 through June 30, 2000. The review objectives were to determine whether:

- The City's cost allocation plans complied with the Circular.
- Indirect costs allocated among the City departments were reasonable, allocable and properly supported.

- The basis upon which costs are allocated among city departments and ultimately to federal programs were reasonable and in accordance with the Circular.
- Indirect costs allocated to federal awards were similarly allocated and consistent with those allocated to non-federal awards.
- The City's cost allocation plans properly identifies, accumulates, and allocates only allowable indirect costs for distribution to federal programs.
- The city-wide and special indirect cost rates were calculated in accordance with the Circular.
- Indirect costs charged to federal programs were based on the indirect cost rates calculated and approved in accordance with the Circular.

5.0 PROCEDURES

MJLM selected central services departments for further testing based on total costs allocated to user departments except for the central service departments within the Police and Fire departments. We selected only the central service departments of the Police and Fire departments that allocate costs to departments outside of their respective departments. Furthermore, we selected only one central service department from the Police and Fire departments, respectively.

Exhibit 2 is a summary of allocated indirect costs by selected central service department and percentage coverage achieved in the testing of expenditures.

**Exhibit 2
Sample Central Service Departments
(Amounts In Millions)**

Department	Costs allocated To User Departments
General Citywide Services	\$11.6
F&A Information Services	7.1
Controller	5.1
Legal	8.8
Health Administration	9.2
Police - City Marshall	6.7
Fire - Chief Administration	.6
Total	\$49.1
Total Externally Allocated Costs	\$81.5
Percentage coverage	60%

To accomplish our review objectives related to the City's cost allocation plans MJLM performed the following procedures:

- Documented our understanding of the processes and procedures used in preparing the city's cost allocation plans.
- Documented our understanding of the processes and procedures used in preparing each allocation basis used in the City's cost allocation plans.
- Reviewed source documentation in support of allocation bases for each central service department to ensure that the allocation basis was reasonable and allowed for an equitable distribution of costs in accordance with the Circular.
- Determined that the allocation bases used for each central service department were properly calculated, accurate and appropriate for the type of costs being allocated.
- Recomputed the amounts for the allocation of expenditures among central service departments and user departments to ensure that they were accurate and in agreement with the allocation basis documented.
- Traced expenditures included in the City's cost allocation plans from the central service departments to the city's audited financial statements and general ledger to ensure that expenditures included were complete and properly included in accordance with the Circular and generally accepted accounting principles.
- Examined and tested expenditure transactions from selected central services departments, shown in Table 1 above, to ensure that proper supporting documentation existed, that they were properly authorized, allowable and allocable based on provisions of the Circular. Based on our assessment of controls and our preliminary review of the cost allocation plans, a sample size of 200 transactions was calculated for the selected departments, with the number of transactions selected from each department based on it's allocated cost as a percentage of total allocated costs for all selected departments as shown in Table 1 above.
- Examined the supporting documentation for each indirect cost rate calculated for central service departments to ensure that the rates were calculated in accordance with the Circular.
- Recomputed the indirect cost rates and agreed data utilized in the calculation of the citywide and special indirect cost rates to supporting documentation to ensure that they were determined in accordance with the Circular.

- Tested the application of the city's indirect cost rates to major federal programs to ensure that costs were charged to federal programs based on approved indirect cost rates in accordance with the Circular.
- Examined the general ledger of selected departments with federal grants to ensure that amounts charged to federal programs as indirect costs were not also charged as direct costs.

6.0 FINDINGS AND RECOMMENDATIONS

FINDING

F&A does not perform a reconciliation of the full cost allocation plan to the cost allocation plans under OMB Circular A-87.

F&A indicated that the process of producing a cost allocation plan in accordance with the Circular (OMB A-87 Plan) is done automatically through David M. Griffiths' (DMG) proprietary software and, therefore, should not require them to perform additional procedures to ensure that only allowable costs are included and that unallowable costs are eliminated from the full cost allocation basis to arrive at the cost allocation plan under the Circular.

We performed a reconciliation between the plans and, as a result, costs in the amount of \$92,388, with no basis or supporting records was excluded from the OMB A-87 Plan. Total supported costs excluded from the OMB A-87 Plan were \$58,286,292 and, therefore, the \$92,388 (.16%) is considered immaterial.

The exclusion of these costs from the full cost allocation basis, in order to arrive at costs allowed for allocation under OMB Circular A-87, resulted in an under allocation of costs to federal programs and a related decrease in revenues to the City.

Recommendation

Reconcile cost on a full cost allocation basis to cost as allowed by the Circular, before the finalization of the annual cost allocation plan prepared under the Circular (OMB A-87 Plan). This reconciliation would ensure that no costs are excluded from the cost allocation plans.

FINDING

A reconciliation process is not performed by expense classification to ensure that expenditure amounts are properly classified in the City's cost allocation plans. The performance of this reconciliation process would provide assurance that the cost allocation plans and indirect cost rates that are calculated based on these expenses are correct.

F&A, the responsible party for preparation of the cost allocation plan, extracts a customized expenditure report from the general ledger by department, organization and object code disclosing those expenses to be included in the cost allocation plan.

F&A performs a reconciliation between the extracted report and the official general ledger report, B050, (Budget versus Actual By Department With Year To Date Comparison), to determine that the reports agree in total; however, there is not a reconciliation by expense classification. The reconciliation by expense classification, as well as in total, would ensure that the data was extracted correctly as to classification and amount.

During our review, we noted only one instance of misclassification. Salaries were misclassified as benefits. The amount was considered immaterial and did not have an effect on the indirect cost rates. We also compared the customized expenditure report extracted by F&A to the general ledger in total and by department. There were no material differences noted.

Recommendation

Prepare a reconciliation of all customized reports extracted from the general ledger by expense classification to the City's official general ledger report by expense classification, as well as in total.

EXHIBIT 1



CITY OF HOUSTON
Finance & Administration
Department

Interoffice

Correspondence

To: The Honorable Sylvia R. Garcia
City Controller, City of Houston

From: Philip Scheps, Ph.D., Director
Finance and Administration Department

Date: January 23, 2002

Subject: **AUDIT FINDINGS - FY 2000 COST
ALLOCATION PLANS**

Below please find responses to the audit findings related to Finance and Administration Department's implementation of the City's FY 2000 Cost Allocation.

1. F&A does not perform a reconciliation of the full cost allocation plan to the cost allocation plans under OMB Circular A-87.

We have reviewed the reconciliation performed by the auditors that supports the variance of \$92,388 noted in the audit report. As demonstrated by the reconciliation process, variances between the Full Cost Plan and OMB A-87 Plan trace back to the "excludable" functions for OMB A-87 purposes. Based on our discussions with Maximus, who owns the allocation software, the unsupported variance noted between the plans is legitimate and is a result of the overall allocation process, which can be complicated to trace. In response to your audit findings, we will review the software and explore the possibility of retrieving data from the program to act as supporting documentation or a basis for any *material* variances between the plans.

2. A reconciliation process is not performed by expense classification to ensure that expenditure amounts are properly classified in the City's cost allocation plans.

Personnel expenditures are classified into two distinct categories, salaries (1A) and benefits (1B), however, due to a system oddity, one department's salaries were being rolled into benefits. The systems staff could not provide any explanation for the occurrence but was able to verify that all other departments were grouped properly. In addition, my staff was able to confirm that no errors of this kind occurred in the two previous fiscal years. Since the audit did reveal a system error in the grouping of personnel expenditure data extracted from the financial system, my staff will reconcile the grouping of the personnel expenditures for the future cost allocation plans.

If you have questions or need additional information, please let me know.

A handwritten signature in black ink, appearing to read "P. B. Scheps".

Philip B. Scheps, Director
Department of Finance and Administration

*Views of Responsible
Officials*