Internal Services

Develop Principle-based Policies and Procedures

March 2017

Multnomah County Auditor's Office

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To: Chair Kafoury; Commissioners Meieran, Smith, Vega Pederson, & Stegmann; District Attorney Underhill; Sheriff Reese; COO Madrigal

From: County Auditor Steve March

Re: Internal Services

Whether a county or a corporation, internal services are a pervasive and necessary part of doing business. They range from the cost of providing and maintaining a facility or office space, to telephone service, computers, or even vehicles driven to meet clients. Internal services are included in every department's budget but create tension when there is an overall lack of agreement about how they should be managed.

The Department of County Assets is responsible for most internal services and has been working on documenting their own processes; we encourage them in their efforts. At a County-wide level, internal service charges should be allocated to departments based on a set of sound principles. This report details a principle-based framework and applies it to several current issues. Since there are tradeoffs among principles that must be made at the County level, we encourage the Chief Operating Officer to seek agreement among departments on how these principles should be best applied to allocate internal service costs and document it in administrative procedures.

We would like to again thank DCA and the COO for their assistance and cooperation, as well as their response. This audit was performed by Craig Hunt, CPA, of our office and joined by Heather Drake of the Department of County Management's General Ledger team.

C: Dir. Swackhamer & Budget & Finance Planning Mgr. Lisa Whedon; Dept. Dirs.

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Executive Summary

The County uses internal service funds (ISFs) to centrally account for providing support services to its departments on a cost-reimbursement basis. The County uses five ISFs but our audit focused on the Facilities Management (FM) and Information Technology (IT) ISFs because these account for 90% of ISF resources managed by the Department of County Assets (DCA). We also looked at Fleet asset replacement reserves.

The primary objectives of our audit were to:

- Identify key principles the County can use to develop internal service fund policy and procedures.
- Determine whether the FM, IT and Fleet ISFs are recovering the full cost of their services.

With regards to the first objective, we found the County lacked written policy and procedures to help prevent or resolve departments' concerns. Once strong policy and procedures are in place, the DCA Budget Unit will be better equipped to administer a stable, well-defined cost allocation process regardless of staffing changes or any pressure from departments. Likewise, departments will have better defined expectations and constructive recourse to resolve any concerns.

Based on our research of internal service fund literature and practices in other jurisdictions, we developed a principle-driven framework the County can use to improve ISF policy and establish administrative procedures. This report discusses some current ISF issues within the context of this framework.

Addressing the second objective, ISFs should recover their costs and have sufficient reserves to operate from one billing cycle to the next (working capital reserves) and to make sure that funds will be available to purchase assets (asset replacement reserves) when needed. Over the last four years, the FM ISF did not recover its costs and its working capital reserves were well below reasonable levels. In contrast, the IT ISF did recover its costs and had sufficient working capital and asset replacement reserves.

We could not determine whether the Fleet ISF recovered its costs because the DCA Budget Unit was working to determine the amount of asset replacement reserves on hand. Until this is resolved, the Fleet ISF is at risk of having insufficient reserves to replace vehicles. There is also a risk that the Fleet ISF spent replacement funds on operations.

During the time of our audit, the DCA Budget Unit was making positive changes to internal service funds. For example, the Budget Unit recently analyzed existing FM ISF processes and made changes where needed. Departments received cost driver information earlier and the Budget Unit communicated better during last year's budget development. The DCA Budget Unit is also working to document the finer details of ISF allocation models.

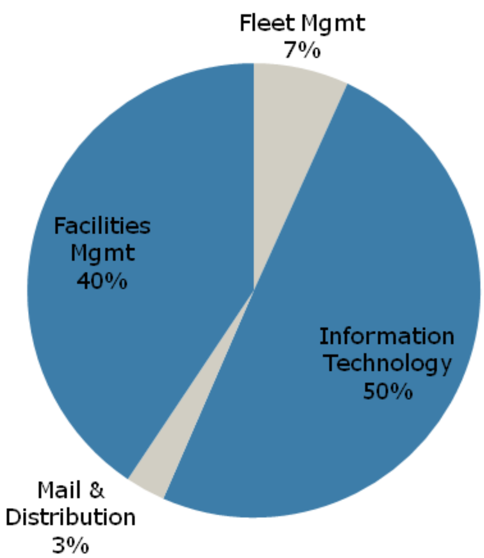
Based upon the results of our work we recommend the County establish a work group to develop principle-based ISF policy and administrative procedures using the framework in this report as a guide. In addition, the DCA Budget Unit needs to determine the amount of Fleet ISF asset replacement reserves that should be on hand before making a planned transfer of the reserves to a new, separate Fleet Asset Replacement ISF.

Background

The County uses ISFs to centrally account for providing support services to County departments on a cost-reimbursement basis. The County charges the full cost of internal services to departments including any funds that are needed to replace assets or to maintain a working capital reserve.

The County uses five ISFs: Risk Management, Information Technology, Facilities Management, Fleet Management, and Mail and Distribution. The Department of County Assets (DCA) manages all of these funds except Risk Management which the Chief Financial Officer oversees. This audit excludes the Risk Management Fund and focuses on the Information Technology and Facilities Management ISFs as well as Fleet Management asset replacement reserves. As shown below, Information Technology and Facilities Management account for 90% of the ISFs managed by DCA.

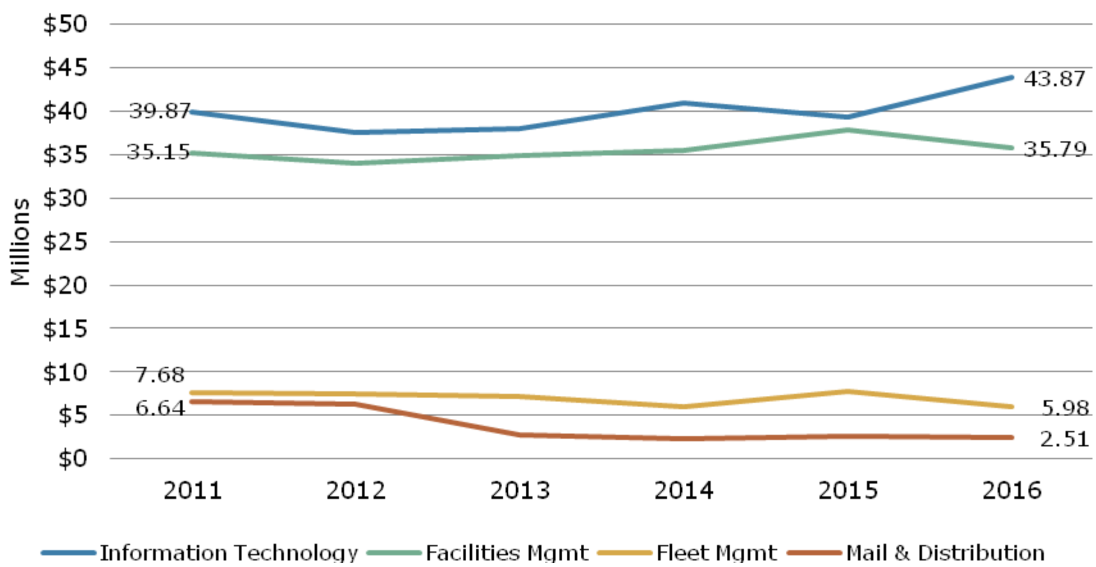
IT and FM accounted for 90% of the ISFs that DCA managed in FY2016



Source: Auditor's Office analysis of SAP information

Excluding the Risk Management Fund, the County spent approximately $88 million for internal services in FY2016. As shown below, Information Technology and Facilities Management ISFs increased from FY2011 to FY2016 while the Fleet Management and Mail & Distribution ISFs decreased.

IT and FM ISF costs increased over the last five years



Source: Auditor's Office analysis of the County's annual financial statements and SAP. The basis of accounting is modified accrual. The numbers are adjusted for inflation.

Oregon Revised Statutes section 294.393 allows the County to establish internal service funds and, if established, requires the County to compute charges to recover its costs. The County is also required to periodically revise internal service charges to eliminate any profit or loss. In line with Oregon law, the County's financial policy requires full cost reimbursement of internal services.

The requirement that ISFs must operate on a cost reimbursement basis (no profit or loss) applies to the operations of these funds over time. An ISF may incur a profit in one year only to have it offset by a loss in the next. However, consecutive profits or losses over three or four years may indicate departments were over or under charged for services.

Facilities Management

Facilities Management manages over three million rentable square feet of offices, libraries, courts, detention centers, shops, clinics, and other types of leased and owned space in over 130 locations. The FM ISF includes costs for:

Operations. These services are for operating, repairing and maintaining the mechanical, electrical, and structural systems of all County buildings. The FM ISF averages operations costs for owned property and bills departments monthly.

Building lease. The County leases 14% of its total space. For example, the Lincoln, Rockwood Community Health Center and the Tabor Square Office buildings are included in building lease costs.

Utilities. The DCA Budget Unit bills utilities to departments at actual cost one month in arrears.

Debt service. Debt service costs are easily estimated and are billed monthly at 1/12th the annual amount due. The Multnomah and Multnomah County East buildings are examples of buildings with debt.

Work orders. Enhanced services and service requests flow through the FM ISF budget. Enhanced services are typically for additional janitorial or security services. Departments submit service requests for repair or maintenance to the interior or exterior of County-owned facilities.

All departments share the costs of space used by FM and vacancy costs based on square feet. The DCA Budget Unit allocates vacancy costs according to administrative procedure FAC-7.

Information Technology

Information Technology provides telecommunication, network, and hardware support. It manages over 8,000 personal computers, laptops, and tablets; 7,500 phone numbers; 500 virtual servers and 300 business applications. The IT ISF includes costs for:

Application services. These are IT costs that are directly traceable to a department.

Help desk and desktop support. The help desk provides computer support for all County employees. A desktop support team supplies hardware and software support to the County including installation, upgrades, maintenance, asset management and proper disposal of all devices. Desktop support includes charges for hardware and software replacement.

Network services and security. Network services include costs directly traceable to departments as well as wide area network charges, including asset replacement, that are allocable to all departments. The cost of keeping the network secure is allocable to all departments.

Enterprise application services and SAP support. IT costs for web, email applications and various project and support costs are spread to all departments. A SAP support team provides technical support, and training for County SAP users.

Data and reporting services. These IT services include the cost of database and information support to County departments.

Other IT services. These costs include project and portfolio management, GIS services, telecommunications, IT business services as well as server and storage costs.

See Appendix B for additional background information.

Results

The purposes of internal service funds (ISFs) are to recover the full cost of services, allocate these costs to County departments, take advantage of economies of scale, avoid duplication of efforts, maintain capital, and recover funds from restricted resources. However, the County does not have written, principle-driven policy and procedures in place to define and achieve these purposes.

Our report first addresses the overall environment in which the FM and IT ISFs have operated and highlights several key aspects of current internal service cost allocations. Based on our research, we discuss key components of a framework the County can use to develop policy and procedures that will document and guide ISF processes and decisions. Finally, we look at the adequacy of reserves in the FM, IT and Fleet ISFs and whether these ISFs are recovering the full cost of services.

Internal Services Environment

The DCA Budget Unit has been in a constant state of change since it was created in April 2011. Except for the IT ISF, budget analysts lacked experience with their assigned ISF and had little or no documentation to help explain past practices. The high level of turnover in the DCA Budget Unit, combined with a lack of procedures and documentation, created a substantial risk that internal service funds would not achieve all of their purposes.

Without sufficient policy and procedures in place, the County Operations Council made important ISF decisions. Recently disbanded, the Operations Council was made up of representatives from each department, and the Sheriff and District Attorney Offices. According to its revised charter in October 2014, the Operations Council only had the authority to develop, review and recommend County policy regarding operational activities. Nevertheless, the Operations Council had significant influence on internal services. Unfortunately, the Operations Council did not keep minutes of their meetings or document decisions.

Departments felt that, in the past, they did not have enough time to fully analyze ISF information provided by the DCA Budget Unit before preparing their budgets. The Central Budget Office sets the County's budget deadlines and DCA has met them in recent years.

Departments told us that their present concerns were not always satisfactorily addressed, there were too many billing errors, billings did not always have enough information and end-of-year adjustments were large and not predictable. Departments did not have full confidence in the DCA Budget Unit's information and stated that cost allocation models for the IT and FM ISFs were difficult to understand.

The DCA Budget Unit is beginning to make positive changes. For example, the Budget Unit recently analyzed FM ISF existing processes and made changes where needed. Departments received cost driver information earlier and the Budget Unit improved communication during 2017's budget development process. The DCA Budget Unit also indicated they were working to document the finer detail of ISF allocation models.

The next sections describe key aspects of how internal service cost allocations currently function.

Department Level of Control over FM and IT ISF Costs

Overall, departments have little control over their IT and FM ISF costs. Departments can influence their costs before the budget is completed by managing their cost drivers such as the number and type of personal computers, number of phones or amount of square footage. But once set, these budgeted cost drivers generally do not change until the next year's budget cycle.

For IT costs, the DCA Budget Unit bills the IT ISF's actual costs applied to departments' budgeted drivers throughout the year. This means, for example, a department's IT ISF costs would not increase during the year if they purchased more computers. We were told the Operations Council made the decision to hold IT cost drivers constant throughout the year.

For FM costs, departments have no control over, on average, approximately 72% of their FM ISF costs once space needs are finalized for the budget. This includes operations, lease costs, debt, allocated Facilities Management Division space, and vacancy costs. These costs are billed at 1/12th each month throughout the year. For example, if a department's total debt for the year is $120,000, the DCA Budget Unit bills it $10,000 each month. FM averages operational costs so departments will not incur a large increase in costs due to a major building event such as a pipe burst during the winter.

Departments have varying levels of control over the remaining 28% of their FM ISF costs. This includes utilities, enhanced services (additional janitorial or security services) and service requests.

Utilities, a direct pass-through expense, are approximately 16% of total FM ISF costs. Departments have a small amount of control over their utility costs by taking steps to reduce consumption. The DCA Budget Unit bills utilities using actual costs which will generally be comparable to the prior year. Although their level of control varies, departments generally have considerable control over their enhanced services and service requests which are about 12% of FM ISF costs.

Friction between Internal Service and Program Service Costs

Departments have an incentive to maximize funding for their programs but, as described in the previous section, have limited ability to control FM and IT internal service costs. Generally, when internal service costs increase relative to other costs, the amount of funds available for program services decline. It is also true that an inadequate level of internal services support could harm program services. This tradeoff creates friction between amounts departments can spend on their program services and the internal service costs used to support them.

Internal service support costs could exert pressure on departments' program services in several ways. At a Countywide level, growth in FM or IT costs charged to departments could outpace the growth in other County expenditures. From FY2013 through FY2016, all internal services managed by DCA grew 14.3% compared to County-wide expenditure growth of 11.8%. Over the same timeframe IT costs grew at 17.7% while FM costs grew at 7.2%. Management stated that some of the IT ISF growth was due to specific department requests.

A general fund constraint may also result in friction between ISF and program spending. A general fund constraint is an imposed budgetary limit on the total amount of general funds a department can spend relative to the prior year. If, for example, a department is required to meet a 2% general fund constraint and internal services paid with general funds increase by 4%, program services must be reduced to meet the constraint. The Central Budget Office sets any general fund constraints after the internal service rates are published.

The proportion of internal services costs that are recovered from restricted funding sources can also influence the level of friction. If a department's internal services are paid for largely by restricted funds rather than general funds, the general fund constraint will be less difficult to manage. When internal service costs increase, that increase can be recovered outside of the constraint rather than within its limit. For example, the Health Department and Department of County Human Services have a higher proportion of grant resources than the Departments of Community Justice and Community Services. The latter two departments thus feel more strain when internal service costs increase because they must pay for the increase mostly from within the general fund constraint.

Remaining Internal Service Funds at Year-End

Under current practices the County allows departments to spend any remaining internal service funds at year-end (savings) on other program costs. However, some departments we spoke with commented internal service savings are difficult to forecast and spend by year end because of late adjustments. Aside from the uncertainty caused by late adjustments, under the current practice, departments have not always been able to spend internal service savings that could have been spent on program services.

From another perspective, the County could require any internal service savings departments have at year end go back to the general fund. In other words, departments would not be allowed to spend internal service savings on program services. Whether departments should be allowed to spend internal service savings or not, the County should revisit the issue and document it as a policy. In doing so the County should consider several factors:

- *Department level of control over ISF costs.* After the budget is set departments have little control over most FM or IT ISF costs. Therefore, any savings generated are largely the result of effective ISF management at the County level rather than departmental level efficiencies.

- *Adjustment of internal service drivers.* Under current practices the IT ISF does not adjust internal service drivers for consumption throughout the year. The FM ISF generally does not change its allocation for any reductions of square footage.

- *Department consequences for any overspending of its budgeted ISF allocation.* Under current practices the IT ISF pools funds from all departments' service reimbursements to ensure any one department does not exceed their budgeted allocation.

- *Other budget impacts.* Budgeted ISF general fund costs could reduce departments' budgeted program services. As described above, ISF growth may exceed the general fund constraint.

Internal Services Framework Components

Based on our research of internal service fund literature and practices in other jurisdictions, we assembled components of a framework that the County could use to develop strong, principle-based policy and procedures for all ISFs. To illustrate concepts, this section also discusses some current issues within the context of the framework's components. The ten components are:

- Transparency
- Reasonableness
- County-wide perspective
- Fairness
- Simplicity
- Accuracy
- Consistency and predictability
- Timeliness
- Communication
- Compliance

<u>Transparency.</u> ISF allocations should be well-documented. Departments should be able to understand calculations, monitor allocations for errors, and make cost control decisions.

Policy and procedures. As noted above, although there is still much work left to do, we observed the DCA Budget Unit moving towards documenting its internal processes. But numerous ISF allocation practices are not well-documented and are not procedurally driven. At a policy level, there is no framework to base decisions and to guide ISF allocations. Many of the standard ISF practices are inherited, unwritten rules on how to maintain the existing allocations. For example:

- ISFs cannot change budgeted IT ISF cost drivers until the following budget cycle. Actual drivers vary during the year.
- The FM ISF allocates its costs based on space type rates. For example, a warehouse costs less than a health clinic.

- The reasons for exceptions to existing practices for the FM ISF were not documented in the past. There is a risk that undocumented changes were made to allocation models to benefit one department at the expense of others that are still in place.
- Due to a variety of reasons discussed below, department staff reported they have had difficulty understanding allocation models and monitoring ISF charges.

Once strong policy and procedures are in place, the DCA Budget Unit will be better equipped to administer a stable, well-defined cost allocation process regardless of staffing changes or any pressure from departments. Likewise, departments will have better defined expectations and constructive recourse to resolve any concerns.

Reasonableness. ISF allocations should achieve full cost recovery of operations, future asset replacement, and a working capital reserve. No long-term deficits or accumulation of resources should occur.

Cost recovery. We found that the FM ISF did not recover its costs for each of the last four years and its working capital reserves are well below reasonable levels. The FM ISF was unable to pay its budgeted Capital Improvement and Asset Preservation Fund contributions in FY2016. The DCA Budget Unit informed us that a budgeting error masked earlier detection of the problem. In addition, the FM ISF may also be under billing its cost of operations.

In contrast to the FM ISF, about six years ago, the IT ISF had built up its reserves by over charging departments. Because some of these billed internal service charges were allocated to federal grants, the County was required to refund the federal government. The IT ISF lowered its reserves to acceptable levels in subsequent years.

County-wide perspective. ISF allocations should serve the best interests of the County as a whole rather than any particular department or program and should maximize funding from restricted resources.

Use of County ISFs. From a County-wide perspective it makes sense that purchasing rules require departments to use County internal services even though it may be possible to lower their own costs by purchasing from private vendors. The Sheriff’s Office and District Attorney’s Office provide some of their own IT services because of external requirements that the remainder of the County is not subject to. The Division of Assessment, Recording and Taxation also provides some of its application services. Otherwise, departments exclusively used FM and IT ISF services.

Fixed costs. Most of a department's FM and IT internal service costs are fixed. Simply stated, total FM ISF costs do not decrease when, for example, Department A decides to use less space in a building resulting in 5,000 square feet of vacant space. In this case the cost of the 5,000 square feet is spread to all County departments. What lowered costs for one department raised costs of other departments—costs for the County as a whole remain the same.

To go a step further, Department A decides to lease 5,000 square feet for a lower price than it was paying for FM ISF costs. Now, costs for the County as a whole increase because it is paying for 5,000 square feet of vacant space and a lease for 5,000 square feet.

Annual updates to cost drivers also impact the distribution of costs among departments. To illustrate, Department A eliminates 20 computers and expects a modest reduction of their IT ISF costs. However, Department B eliminates 100 computers. Department A's costs increase because internal service fixed costs are spread among fewer computers.

Restricted resources. Addressing the second part of the County-wide perspective component, one of the main reasons the County uses ISFs is to have a defensible mechanism in place to charge costs to programs supported by restricted resources such as grants. Approximately 42% of internal service costs are charged to programs supported by restricted resources. As discussed earlier under reasonableness, internal service allocations should achieve full cost recovery. This means they must recover the full cost of internal services paid by both the general fund and restricted resources. If programs supported by restricted resources are not charged their full internal service costs, the general fund must make up the difference.

Single rate. How FM ISF charges operations costs to departments further illustrates the County-wide perspective component. Operation costs average about 42% of all FM ISF charges. The FM ISF currently allocates its costs based on the type of space a department uses. Using space-type rates, Health Clinics, Libraries and General Use space is more expensive than Shop, Warehouses and Jail space.

From a County-wide perspective using a single rate for all County-owned properties may make more sense than space type rates. We could not verify whether space type rates accurately represent the operational costs of buildings. According to management, FM cannot track building costs by space type with current resources. Given that FM ISF is not recovering its costs, the current space type rates might be too low.

The County must assess any impact on restricted resources when evaluating whether to use a single rate or other alternative in place of space type rates. Further, if internal service costs increase for a department because of a Countywide change in how internal service costs are allocated, general funds should be shifted to compensate. Departments should not financially “win” while others “lose” from any ISF allocation changes. For illustrative purposes, we discuss the single rate alternative in some of the remaining principles.

Fairness. ISF allocations should allocate cost to the department that caused it or benefited from it. No departments should receive special treatment.

Single rate. If the FM ISF were to charge all departments the same rate for all owned buildings regardless of the type of space used or its condition, some could raise the issue of fairness. Applying the fairness component, as long as departments are appropriated sufficient funds to cover their building costs, it makes no difference whether a department using a particular space type is getting charged the same as another department using a different space type. Likewise, whether a department is occupying a nice building instead of a less desirable building is also an issue independent of FM internal service costs.

Allocation Cap. The County has a rule in practice that if a department’s billed IT ISF expenditures exceed its budget allocation, funds from other departments which are under their budget allocation are used to cover budget overages. In FY2015 three departments exceeded their budgeted allocations by a combined total of $231,486. This shortage was covered by six departments who were under their allocations.

Although the amounts were not material, from a department’s perspective this practice may not be fair. If departments know the amount of their remaining funds at year end and are allowed to spend these funds on program services, covering another department’s allocation is a lost opportunity. From a County-wide perspective, DCA must budget their expenses at the fund level to have the flexibility they need with departmental allocations to respond to the changing service requirements of the County as a whole.

Simplicity. ISF allocations should be easy to understand, administer, and monitor. The costs of any allocation should not exceed its benefits.

Best practices developed by the Government Finance Officers Association suggest that the County requires a low level of cost detail because it is allocating costs only to the department level and for a central purpose of obtaining reimbursement from programs supported by restricted resources. For both the FM and IT ISF there are several issues that illustrate simplicity concepts:

Single rate. FM could use one rate to capture operations costs for all owned buildings. FM could compute costs more easily and better monitor full cost recovery.

Billing one cost object. Departments provide cost objects to the DCA Budget Unit for FM ISF billings. Billing to a single cost object for each department may help simplify cost allocations. For example, the DCA Budget Unit had problems keeping up with the volume and frequency of program space changes made by the Health Department. Because of the many changes, the Health Department decided the DCA Budget Unit should only bill its department-level cost object. The Health Department would then allocate that cost out to its programs' cost objects.

Disconnect between accounts used for budgeting versus billing. The way FM ISF enhanced services and service requests are budgeted and billed is confusing. Both are budgeted in one cost element and then billed in a different cost element. The DCA Budget Unit has tried to change this practice. Departments also commented that using separate cost elements for distribution and records would be easier to follow.

IT allocation model. The current IT ISF allocation model is complex. Historically, the DCA Budget Unit added more detail to the allocation model because departments wanted to know more about their costs. The DCA Budget Unit is now investigating a simpler model to see if a lower level of detail will be both easier to understand and meet cost allocation objectives.

IT billing. During our audit the DCA Budget Unit investigated a simplified IT ISF billing method that charges departments on a monthly basis as follows:

$$\frac{\text{Department Budgeted Allocation}}{\text{All Department's Budgeted Allocations}} \text{ X Actual Monthly IT Costs}$$

We compared actual IT ISF billings for FY2013-FY2016 to what IT ISF billings would have been using the simplified billing methodology. This comparison confirmed the simplified methodology is a viable alternative for an easier and more practical way to bill that should also make IT ISF costs more predictable.

Accuracy. ISF allocations should be based upon and produce information that is correct and free from error.

There is a tradeoff between accuracy and simplicity. Charging one rate for all owned buildings, a simpler IT allocation model or a simplified IT ISF billing methodology may all be less accurate than current practices. Even so, they might still satisfactorily accomplish ISF objectives.

Billing accuracy. Departments did not trust that ISF billings were accurate and showed us examples of past billing errors. Departments stated that ISF billings were improving but also thought the DCA Budget Unit should better monitor the accuracy of its bills. To improve accuracy the DCA Budget Unit recently hired a person with an accounting background to handle billings.

We conducted a five-year test (FY2012-2016) of billings for the IT and FM ISFs and found a high percentage of changes to the accounting records, although we could not determine what percentage of these changes were the result of errors versus planned reallocations. The high number of adjustments increases the risk of errors and is inefficient.

During FY2016, the DCA Budget Unit improved its billing accuracy by properly classifying personnel costs. The Budget Unit moved approximately $323,000 out of the FM ISF that should have been charged to Capital Improvement Program and Asset Preservation Funds projects. Capital Improvement Funds are used to upgrade and improve the County's substandard (Tier 2 and Tier 3) buildings. Asset Preservation Funds are used to maintain the County's Tier 1 buildings.

Consistency and Predictability. ISF allocations should be standardized across departments and stable over time. Departments should be able to reliably predict their costs and make cost control decisions.

Documentation of internal processes. Strong documentation of DCA Budget Unit internal processes should improve consistency and predictability. Better documentation of all cost allocations should improve consistency if the DCA Budget Unit experiences staff turnover. In the past former DCA Budget Unit staff made undocumented changes to the FM ISF allocation model which had to be reversed the following year. In contrast, IT ISF cost allocations are documented and have been consistently applied for the past several years.

True-ups. If the IT ISF were to make periodic adjustments to charge departments based on actual instead of budgeted cost drivers, the IT allocation would be more accurate and fair but less predictable. From a cost-benefit standpoint, the DCA Budget Unit would need to evaluate if the additional work to gather actual cost drivers and make billing adjustments would produce material benefits.

Forecasting costs. Also a timeliness issue, departments struggled with forecasting internal service costs due to large year-end adjustments. Departments could have spent any remaining ISF savings on program services.

Timeliness. ISF allocations should reliably meet department deadlines.

Reviews. Departments must complete their budgets within a tight timeline and rely on receiving cost drivers and allocations from the DCA Budget Unit on time. Departments were generally pleased with receiving cost driver information earlier in FY2016 than FY2015.

Grants. Year-end adjusting entries, discussed in the consistency and predictability section, also affect grants. If a department bills a grant before an adjustment is recorded, the general fund may have to absorb the cost of internal services that could have been paid for by the grant. This situation is even more likely to happen for grants that are on a different fiscal year than the County. Either way, even though DCA has no control over grant due dates, the County is most likely losing money because of timing problems.

Communication. ISF allocations should make open, clear communication with departments a high priority in order to prevent communication gaps or breakdowns.

Problem solving. Communication between departments and the DCA Budget Unit is improving but still has a ways to go. We heard several cases where problems took too long to resolve. Some attributed communication problems to a disconnect between ISF service providers and the DCA Budget Unit's staff. In some cases departments could not understand their internal service charges and were frustrated because it took multiple calls to receive a satisfactory explanation of the charges or get them changed. As a result, departments lose confidence in their internal service charges and feel the need to spend more time monitoring their accuracy.

The DCA Budget Unit and FM are working to improve communication:

- The DCA Director worked with direct report managers to establish a single point of contact for each department during allocation model development and driver verification.

- The Budget Unit also set up a central e-mail account to improve communication with departments.

- FM recently began posting all work orders on the County's internal website to improve access to enhanced services and service request detail.

Compliance. ISF allocations should comply with relevant laws, regulations, third-party agreements, and County policy.

Working capital reserves. The current internal service fund policy limit for working capital reserves is unclear and does not align with federal standards. The County's policy states: "The charges may include a contingency or reserve amount not to exceed 10%..." See Appendix A for the full text of the current internal services policy. The Auditor's Office recommended this change in 2011 in our Financial Condition Report.

Federal requirements under 2 CFR Chapter I, Chapter II, Part 200, Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards; Final Rule Appendix V to Part 200 G, Other Policies, Section 2 Working Capital Reserves states:

> "Internal service funds are dependent upon a reasonable level of working capital reserve to operate from one billing cycle to the next. Charges by an internal service activity to provide for the establishment and maintenance of a reasonable level of working capital reserve, in addition to the full recovery of costs, are allowable. A working capital reserve as part of retained earnings of up to 60 calendar days cash expenses for normal operating purposes is considered reasonable."

The County's policy for working capital reserves should align with federal guidelines which allow a slightly higher reserve than current County policy. DCA should set its ISF working capital reserve targets within the federal guideline limits.

Internal Service Reserves

This section discusses internal service reserves in the FM, IT and Fleet ISFs. ISFs should have sufficient reserves to operate from one billing cycle to the next (working capital reserves) and to make sure that funds will be available to purchase replacement assets (asset replacement reserves). ISFs should bill departments each month for their reserve needs.

Working Capital Reserves

The sufficiency of reserves directly relates to the reasonableness objective of ISFs. Generally, if reserves are too high, the ISF is charging departments too much and should charge less in the future. Further, if reserves are too high and federal grants were charged, the ISF may be required to refund the federal government for any excessive charges. Conversely, if reserves are too low, the ISF may not be charging departments enough.

As it relates to cost recovery, the FM and IT ISF reserves were discussed above in the reasonableness section. The working capital reserves in both funds were within federal guidelines and County policy. The FM and IT ISFs working capital reserves were both below 10% of cash expenses for FY2014 through FY2016. However, the DCA Budget Unit could not provide us with the Fleet ISF working capital reserves for FY2014 through FY2016.

Asset Replacement Reserves

We could not determine whether the Fleet ISF recovered its costs because the DCA Budget Unit could not verify the amount of asset replacement reserves on hand. Until proven otherwise, in addition to a risk of insufficient asset replacement reserves, there is also a risk that asset replacement funds collected from departments were spent on operations.

Once the DCA Budget Unit determines the proper amount of reserves on hand, we agree with the County's plans to transfer Fleet asset replacement reserves to a separate fund. Using a separate fund to account for Fleet asset replacement reserves will prevent the Fleet ISF from subsidizing operations with amounts set aside to replace assets.

The IT ISF bills departments for various asset replacement reserves such as hardware, software and telecom at 1/12th of the expected needs per month. In this way, IT ISF asset replacement charges reinforce consistency and predictability. Historically, when the IT ISF charged departments for the full replacement cost during the year, it was a shock to departments' budgets.

Properly accounting for asset replacement reserves in SAP has been difficult for both the IT and Fleet ISFs. To compensate, the DCA Budget Unit analyst with multiple years experience kept good track of its asset replacement reserves in a spreadsheet for IT. Unfortunately, DCA budget analysts assigned to Fleet have frequently turned over and Fleet asset replacement reserves have not been adequately tracked.

Other Reserves

For a number of years, IT has accumulated resources and accounted for long-term capital projects in the IT ISF. The IT ISF did not bill departments for these long-term capital projects. Instead, funding came from Board approved general fund transfers. In FY2017, DCA transferred long-term capital projects included in the IT ISF to a separate fund. This transfer will help make the IT ISF and IT long-term capital projects easier to account for and more transparent. IT asset replacement reserves will remain in the IT ISF.

Recommendations

1. The Chief Operating Officer should establish a work group to develop principle-based internal service policy and procedures using the framework in this report. The workgroup will need to resolve any conflicts between framework components. For example, a simpler allocation model will be less accurate, but may still be accurate enough to meet County needs. The workgroup will need to work out conflicts between *County-wide focus* and *fairness* as well as take into account any impact that changes might have on internal service recoveries from restricted resources.

To be *fair* we believe the County must be willing to reallocate resources to compensate for any shifts of internal service costs from one department to the next as a result of any changes. Time is of the essence if the County wants to have policy and procedure established before the FY2019 ISF allocation process begins in July 2017.

2. The work group should make sure that Multnomah County's policy for working capital reserves aligns with federal guidelines which allow a slightly higher reserve than current County policy. DCA should set its ISF working capital reserve targets within the federal guideline limits.

3. The DCA Budget Unit should determine the amount of Fleet ISF asset replacement reserves that should be on hand before transferring the reserves to a separate internal service fund. If Fleet has spent a portion of asset replacement reserves on operations, the work group will need to determine how the shortage will be replenished.

4. The DCA Budget Unit should continue documenting its internal processes.

Objectives Scope and Methodology

The objectives of this audit were to:

- Identify internal service fund principles that can be used as a framework to guide objective, procedurally-driven decisions and processes.
- Determine whether the FM, IT and Fleet ISFs are recovering the full cost of services and if its working capital reserves are in compliance with the County's Internal Service Funds policy and federal guidelines.

To accomplish these objectives we:

- Interviewed DCA Budget Unit staff, department financial managers, financial staff and budget analysts.
- Conducted a survey of County staff involved with internal services.
- Analyzed ISF budgets and other financial information.
- Reviewed FM ISF LEAN charts.
- Researched ISF literature and other jurisdiction's audit reports and internal service funds practices.
- Gained and understanding of IT and FM allocation models.
- Performed a trend analysis of IT and FM ISF charges to departments from FY2013 through FY2016 and compared program services to internal services growth.
- Examined periods 13 and 14 yearend adjustments to department's internal service expenditures for FY2013 through FY2016.
- Attempted to quantify the number and amount of IT and FM ISF errors from FY2012 through FY2016.
- Analyzed the impact of IT ISF budgeted allocation caps for FY2015 and FY2016.
- Determined the percentage of all DCA ISFs paid with restricted resources.
- Studied how internal service costs can differently impact departments.
- Analyzed the IT, FM and Fleet working capital and asset replacement reserves for FY2014 through FY2016.

For this audit, we analyzed financial data for the time period of FY2013 through FY2016 and the first four months in some cases of FY2017 from SAP, the County's enterprise resource planning system. Based on the annual review of SAP datasets by the County's external auditor, our office has determined that the data were sufficiently reliable for the purposes of this report.

We conducted this performance audit in accordance with generally accepted government auditing standards. 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.

Appendix A Current County Internal Service Policy

The purpose of establishing internal service funds is to identify and allocate costs related to the provision of specific goods and services within the County.

Internal Service funds will be used to account for business operations and charge for goods or services provided to other departments or agencies on a cost-reimbursement basis. Periodically the rates charged will be compared to other public or private sector operations to ensure that pricing is competitive. The internal service fund charges will include asset replacement charges (depreciation) to ensure that adequate funds will be available to purchase replacement assets.

The charges may include a contingency or reserve amount not to exceed 10% as recommended in the Auditor's 2011 Financial Condition Report to ensure that service reimbursements charged to other departments are maintained at a relatively constant level. Rates will be trued up on an annual basis, thereby eliminating excess reserves.

Unreserved fund balances in Internal Services funds will be reported annually in a memo to the Board of County Commissioners from the CFO at the time the Comprehensive Annual Financial Report (CAFR) is completed but not later than December 31st.

Appendix B Additional Background Information

Advantages and Disadvantages of Using ISFs

ISFs have several benefits. The ISF allocation and cost recovery processes create a defensible mechanism that is used to recover costs from programs funded with restricted resources such as grants. Approximately 42% of ISF costs are charged to restricted resources. ISFs take advantage of economies of scale, avoid duplication of effort, and identify the full program costs of specific governmental services. ISFs also accumulate resources to replace assets.

ISFs also have drawbacks. The County incurs administrative expenses for collecting and tracking cost drivers, setting rates, allocating costs, and billing for services. All of these functions can be difficult to understand, require a lot of managerial energy and can result in diminished trust if not done right. Communication and follow-up on any ISF issues encountered will take time and can be frustrating. Finally, departments may not have much control over their internal service costs, creating even more discontent.

How ISF Budgeting Works

DCA's Budget Unit manages County-wide internal service allocations and bills departments. One manager, four budget analysts, and one financial specialist spend a large portion of their time administering ISFs.

DCA must estimate its ISF costs before departments can complete their proposed budgets. The DCA Budget Unit began gathering cost driver information, communicating with departments and building their FY2017 FM and IT ISF budgets shortly after FY2015 ended.

In early September 2015, the DCA Budget Unit sent County departments the amount of their occupied square feet, number of computers and other cost driver information that would be used in cost allocation models for any necessary adjustments. After the departments updated this information, the DCA Budget Unit finalized FY2017 cost drivers by the end of September 2015.

The DCA Budget Unit prepared budgets for the ISFs in October 2015. After it finished the cost drivers and ISF budget templates, the DCA Budget Unit completed allocation models for each ISF. Allocation models distribute each ISF's budgeted costs to departments. After a series of reviews by DCA, Central Budget and departments, the

DCA Budget Unit completed and published the allocation models by mid-December 2015 for the FY2017 budget.

How Allocations & Billing Work

Departments receive allocations for ISF services which, in total, should equal the ISF's projected expenses. Throughout the year, generally on a monthly basis, the DCA Budget Unit uses journal vouchers to bill internal services to departments. No cash changes hands. Departments record expenditures for the services while the ISFs record revenues.

Internal service funds are allocated at a department level. In some cases the DCA Budget Unit uses the ISF allocation methodology to bill departments' ISF costs down to the program level. In other cases the DCA Budget Unit bills at the department level and then departments allocate ISF costs to their programs using a methodology different from that used by the ISF allocation. For example, the Health Department is billed its total FM allocation based on square footage and then distributes it to its programs based on FTEs.

How ISF Reserves Work

There are two types of ISF reserves: working capital reserves and asset replacement reserves. The FM, IT and Fleet ISFs use working capital reserves to carry on from one billing cycle to the next. County policy allows ISFs to charge departments an amount not to exceed 10% for working capital reserves. Federal guidelines allow ISFs to charge departments a working capital reserve of up to 60 calendar days' cash expenses (16%) for normal operating purposes.

The IT and Fleet ISFs bill departments for asset replacement reserves. IT asset replacement reserves include amounts for hardware, software, and telecom replacement. The IT ISF prorates departments' estimated asset replacement costs monthly over several years instead of charging the full amount when the assets are purchased. For example, when a department needs to purchase 50 computers, funds are already set aside so it will not have a large expense in any one year.

Fleet charges departments the estimated replacement cost of vehicles. Any surplus caused by accumulating funds to replace vehicles does not conflict with the cost reimbursement objective of the Fleet ISF.

Historically, the IT ISF included amounts appropriated for long-term projects that had the effect of inflating ending reserves. The IT ISF did not bill departments for these long-term projects. DCA transferred long-term project resources to a separate capital project fund starting in FY2017.

Response to Audit

March 16, 2017

Auditor Steve March
501 SE Hawthorne Blvd, Ste 600
Portland, OR 97206

Subject: Internal Service Audit Management Response

Dear Auditor March,

Thank you for the opportunity to comment on the Internal Service Audit. We appreciate your careful analysis of the County's internal service fund cost recovery and the associated policies and procedures. We've reviewed the report and discussed the recommendations with you and your team. Your recommendations are timely and we have been working on a number of them over the last year.

In particular, we've been working to build up the Fleet operating reserves and improve our documentation of internal processes. We will continue to work on these items. We will also work with the CFO and the newly formed Finance Managers Forum to evaluate the internal service policies and procedures and the working capital reserves policy as you recommended.

We appreciate the work performed by you and your team.

Sincerely,

Travis Graves

Travis Graves
Chief Human Resources Officer
Department of County Management, Deputy Director

cc: Deborah Kafoury
Nancy Bennett
Sherry Swackhamer
Mark Campbell
Lisa Whedon