Management Audit Report
of the
San Francisco
Controller's Office

Prepared for the

Board of Supervisors
Of the City & County of San Francisco

By the

San Francisco Budget Analyst

September 15, 2003

BOARD OF SUPERVISORS

BUDGET ANALYST

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Honorable Tony Hall, Chair of the Rules Committee
And Members of the Board of Supervisors
City and County of San Francisco
Room 244, City Hall
1 Dr. Carlton B. Goodlett Place
San Francisco, CA 94102-4689

Dear Supervisor Hall and Members of the Board of Supervisors:

The Budget Analyst is pleased to submit this *Management Audit Report on the San Francisco Controller's Office.* This management audit was authorized by the Board of Supervisors of the City and County of San Francisco on May 13, 2003, pursuant to its powers of inquiry defined in Charter Section 16.114. Motion Number M03-81 directed the Budget Analyst to "conduct a management audit of the Controller's Office on a priority basis." The stated purpose of the management audit was "to ensure that the entity providing advice and counsel to other City departments about efficient management and performance (the Controller) is itself managed efficiently and performs efficiently . . ."

As part of this management audit, the Budget Analyst interviewed the Controller, Deputy Controller and managers from each of the seven divisions in the Department; section managers; and, selected unit managers and staff. The Budget Analyst also interviewed representatives from other City and County Departments, responsible Controller officials from other jurisdictions, and representatives from the State Controller's Office who have certain regulatory responsibility over Controller activities.

In addition to interviews, the Budget Analyst reviewed the City Charter, various State statutes and local codes; examined various documents, reports and work products prepared by the Controller's Office; reviewed the audited financial statements for the City and County of San Francisco, including the management letters prepared by the outside auditors for each of the last three fiscal years; obtained and analyzed various data and financial reports from the City's FAMIS accounting system; and evaluated the effectiveness of the various tools used by the Controller, his managers and staff to oversee the activities of the organization.

The management audit was conducted in accordance with *Government Auditing Standards, 1994 Revision,* by the Comptroller General of the United States, U.S. General Accounting Office. In accordance with these standards, we have noted a number of the more significant accomplishments of the Controller's Office during the past several years, which are described below:

Expansion of the Controller's Role

During recent years, the current Controller's Office has assumed a greater analytical, management reporting and consulting role in the City. While many of these added functions have stemmed from requests made by the Mayor and the Board of Supervisors, others have resulted from the Controller's professional goals to enhance financial management and the performance of departments within the City. Although these activities are largely non-mandated, the efforts made by the Controller and his staff are commendable.

Implementation of GASB 34

The Controller's Office successfully converted to a new financial reporting model, pursuant to Governmental Accounting Standards Board (GASB) 34 provisions affecting financial reporting, a year before the required deadline. The conversion significantly changed the ways in which financial data is reported within the City's Comprehensive Annual Financial Report (CAFR), given the unique requirements of GASB 34. Further, the Controller's Office successfully implemented alterations to its financial reporting processes to meet the new accounting standards of GASB and provided training to all departments on the GASB 34 model. The Controller's Office received a *Government Finance Officers Association Certificate of Achievement* for these efforts.

Accountant Intern Program

The 1649 Accountant Intern Program that was devised by the Controller's Office, has been recognized as a successful mechanism for improving the quality of accounting personnel throughout the City. Designed, operated and maintained by the Controller's Office, the program was created to improve accounting staff training and abilities. The program offers beginning accountants extensive training for 18 months, with two 9-month rotations in different departments. Since its inception in 1995, the Intern Program has graduated 59 of 67 participants. Approximately 40 percent of those participants were already City employees when they entered the program.

Payroll and Personnel Services Division

The Payroll and Personnel Services Division has been successful in attaining its goals and meeting performance measures. The division met their 98 percent accuracy target in the disbursement of approximately 29,000 paychecks for each of the 27 pay periods in FY 2002-03. The Payroll and Personnel Services Division also successfully issued all W-2 forms to City employees within 14 days of the calendar year, approximately two weeks ahead of the deadline.

Budget and Financial Analysis

The Controller continues to produce monthly, 6-month and 9-month Budget Status reports that provide useful tools for City policy makers and financial managers. These reports provide reasonable projections of revenue and expenditure trends, and in combination with the three-year budget projection report prepared jointly with the Mayor and the Budget Analyst, provide the basis for assessing the overall financial health of the City and financial planning.

Controller's Response

The Controller states in the cover letter to his response that "The Controller is pleased that there are few or no findings or recommendations regarding most of the core functions of the office, such as budget preparation and monitoring, property tax operations, payroll, vendor payments, and bond and financial statement reporting activities." This management audit includes findings and recommendations on many of the more significant responsibilities of the Controller's Office, including its primary function of overall financial management of the City. Many of the recommendations focus on key activities of the department and the infrastructure that is necessary to ensure that the financial integrity of the City remains strong. It is unfortunate that the Controller's written response does not specifically address each of the 69 recommendations contained in the report, instead of focusing on his reaction to the evidence which the Budget Analyst has used to support the findings and conclusions contained herein.

He also states that, "We apologize in advance if the comments do not exactly match the text of the Analyst's final report due to the rushed nature of this audit and the limited time available for both the Analyst to prepare and the Controller to respond to this audit." The Budget Analyst would like to point out that the management audit was not "rushed." Although the project was expedited at the request of the Board of Supervisors, the Budget Analyst was able to accomplish the required work in accordance with professional standards by dedicating a highly qualified and senior group of auditors. The project team included a manager with over 22 years of experience managing audits in San Francisco and in other jurisdictions throughout the western United

States, a CPA with experience working in an Auditor-Controller's Office in another California County, and other senior Budget Analyst staff with considerable experience providing audit services to the San Francisco Board of Supervisors. Because the Budget Analyst was able to dedicate exceptionally well qualified personnel, the management audit was successfully accomplished in the expedited manner requested by the Board of Supervisors.

The Controller also suggested that findings related to increased reimbursement of costs would likely yield insignificant additional revenues for the City. Specifically, the Controller stated that "The Analyst spent a considerable amount of time looking at how we could increase the ability of the City to increase reimbursement for costs from other agencies or within the city structure. . The Analyst's report, <u>while not finding any significant items that have been missed</u>, encourages us to focus on this area."

In fact, we believe that "significant items" have been missed by the Controller. For example, although the Controller dismisses the impact from excluding $17 million in general liability settlement costs from the Countywide cost allocation plan, it is clear from discussions with the State Controller, cost allocation plan practices in other jurisdictions, and our review of financial data available from the City Attorney, that significant reimbursement could potentially be received from federal and State grants by including general liability costs in the Countywide cost allocation plan. As discussed in this report, until the Controller goes through the exercise of allocating all allowable costs, the true financial impact of our recommendations related to cost reimbursement will be unknown.

This management audit report includes 13 findings and 69 related recommendations prepared by the Budget Analyst, that encompass major areas of the Controller's operations. Included are findings and recommendations related to the department's organization, financial management, budgetary controls, fund management, indirect costs, mandated cost claiming and internal audit. The report also identifies at least $1.1 million in potential annual savings, including reduced costs and increased revenues, as well as one-time available resources of approximately $2.4 million. Additional resources and revenues could be realized if the recommendations in this report to conduct a full analysis and reconciliation of funds and cost reimbursement opportunities are implemented. Further, the report focuses on methods for improving internal controls, capturing additional revenue for the City and County and accomplishing other systemic improvements to the operations of the Department. The following sections describe our findings. Where appropriate, we have integrated comments into the section descriptions, on statements made by the Controller in his written response.

1. Organization

Over time, the management structure of the Controller's Office has evolved, as new functions and responsibilities have been added and business lines have been redefined. During this evolution, sections have been created to perform non-traditional services and units have been established which provide questionable benefit to the organization. This has had the effect of expanding the number of management positions within the Controller's Office organization. In summary:

- Approximately 17.3% of the Controller's Office personnel perform management or director functions, equating to one manager for every 5.8 employees. These computations exclude four project manager positions in the City Projects Division, since these individuals do not directly manage the activities of other staff but instead may only act as leads on more complex analyses. The computations also exclude five supervisory personnel within the Payroll and Personnel Services Division and the Finance and Administration Division.

- The number of subordinate personnel and number of direct reports to managers vary significantly. For example, the Compliance Manager (a fourth tier manager) directly manages the activities of 21 Fund Accountants who are responsible for ensuring that financial transactions are appropriately processed by the departments. At the other extreme, the Performance Management Director (a second tier manager) directly manages the activities of only one staff person. While the roles and responsibilities of these individuals differ significantly, the contrast is stark and will be discussed further in this report.

While clearly beneficial to the City organization, the major activities of the City Projects Division are not mandated. With the exception of the activities performed to accomplish the mandates included in Charter Section 3.105, the activities of the Division are primarily discretionary. Of the 8,744 productive annual hours of service estimated from Division records, only 1,969, or 22.5 percent were expended providing services that are generally mandated. Approximately 77.5 percent of the Division's services are generally non-mandated. Approximately 30 percent of the Division's paid time is for leave, administration or training. The Board of Supervisors should reconsider whether it wishes to continue non-mandated functions performed by the City Projects Division. If 4.5 FTE positions associated with these non-mandated functions were eliminated, the savings to the City would be over $400,000 per year. The Board could once again fund these functions in the future, if determined to be an appropriate priority for the City.

As with the City Projects Division, the Board of Supervisors should determine whether the non-mandated Citizen Survey and performance measurement support activities conducted by the Performance Management Division should be continued during this period of economic downturn. Annual cost of the unit is approximately $201,732. Assuming that additional consultant resources would be required to perform the triennial survey of parents and youth, net savings to the City would amount to approximately $150,000 per year.

During interviews, the Controller stated that his decision to place the Performance Management functions at the division level stemmed from his perceived need to have a manager available to directly interact with departments, in order to gain departmental cooperation. Accordingly, the Controller's Office established an 0931 Performance Management Director position, with only one subordinate position, to perform these functions. The Performance Management Director supervises only one employee.

We do not agree with the Controller's opinion in this regard. Every employee in the Controller's Office carries the authority of the Controller, whether the employee is a fund accountant in the Accounting Operations Division or an analyst. That authority can be communicated in many ways, without establishing a two-person division. For example, the Controller could (a) directly communicate with department managers in writing, requesting cooperation; (b) place the two-person function under one of his other division managers, who has the same organizational stature as the incumbent manager of the Performance Management Division; or, (c) request the Board of Supervisors to grant authority to the Controller's Office in the Administrative Code. Accordingly, the Controller should restructure the Department organization, by disbanding the Performance Management Division and merging functions under the City Projects Division.

The Controller established a Grants Management Unit in the mid-1990's, in response to a finding of material weakness identified by the City's financial auditors. Grants require a certain degree of specialization to ensure that grants are accurately accounted for and reported. However, much of this responsibility has been divested to the departments with the Controller's Office providing routine approval, audit, and reporting functions.

Additionally, a grants unit should ensure that grant revenues are maximized by verifying all allowable costs are claimed and reimbursed, and by compelling departments to file claims in a timely manner. However, the Grants Management Unit does not fulfill this role. While the Grants Management Unit has attempted to establish procedures for departments to complete a quarterly reconciliation of grant revenues and expenditures, which ensures that all grant costs have been appropriately accounted for, the first attempt in April 2003 has met with limited success. This effort was instigated by a 2001 independent financial audit finding by KPMG that found significant errors in grant data and information reported by departments. In fact, KPMG actually conducted training for City departments in January 2003 on the reconciliation process.

With respect to ensuring all allowable costs are claimed and pursuant to Section 10.170-1 (d) of the Administrative Code, the Grants Management Unit should be reviewing and certifying whether the appropriate indirect cost reimbursement has been included in the grant budget. As noted in Section 10 of this audit report, the Grants Management Unit is not providing this level of review. Finally, the Grants Management Unit does not monitor department claims to verify they are being completed in a timely manner and therefore obtaining reimbursement as quickly as possible. Based on this assessment, the Grant Management Unit in Accounting Operations should be eliminated and current functions merged with those performed by other staff within the organization.

In regards to this latter recommendation, the Controller has stated that "The Analyst's assertion that these duties should be performed in other divisions would not streamline the functions, but rather would increase the workload among fewer employees." In fact, this statement by the Controller distorts our report conclusions and recommendations. As stated above, we have recommended that the staff associated with the core grants management and Countywide cost allocation activities be reassigned to the units which would be assuming the transferred workload. Accordingly, implementation of the recommendations would not "increase the workload among fewer employees." As demonstrated in our report, we believe that functions performed by the current Unit Manager could be absorbed by other management personnel within the Controller's organization with minimal impact on their workload.

At a minimum, these organizational changes would result in $24,576 in annual savings by replacing one 0931 Performance Management Director with an 1805 Associate Performance Auditor. Potentially, an additional $98,032 in annual savings could be achieved by eliminating one 1824 Principal Administrative Analyst position, which is acting as a manager over the Grant Management Unit. Total savings related to these two changes would amount to $122,608 per year. Additional savings potentially could be achieved by discontinuing non-mandated functions currently performed by the City Projects and Performance Management Divisions.

The Controller should:

1.1 Disband the Performance Management Division;

1.2 Reassign responsibilities for producing the Citizen's Survey to the City Projects Division;

1.3 Reassign responsibilities for assisting departments with the development of performance measures to the City Projects Division.

1.4 Disband the Grant Management Unit; and,

1.5 Reassign the Grant Management Unit duties and responsibilities to the staff within the Compliance Unit, the Financial Reporting Unit, and the Budget and Analysis Division.

The Board of Supervisors should:

1.6 Eliminate one 0931 Performance Management Director position;

1.7 Add one 1805 Associate Performance Auditor position;

1.8 Eliminate one 1824 Principal Administrative Analyst position; and,

1.9 Consider funding alternatives which would narrow the mission of the City Projects Division to include only mandated functions.

There would be no cost to implement these recommendations. The management structure of the Controller's Office would be streamlined, functions would be more suitably aligned, and the City and County would achieve estimated annual savings of approximately $122,608 per year. Additional savings of $550,000 could potentially be achieved by discontinuing non-mandated functions currently performed by the City Projects and Performance Management Divisions.

2. Financial Administration

As Chief Financial Officer for the City and County of San Francisco, the Controller is responsible for establishing the necessary framework to facilitate sound financial management and accounting practices. Sound financial and accounting practices are contingent upon authoritative and comprehensive policies and procedures that guide financial processes, and a financial accounting system and structure that can produce useful financial reports for the monitoring and control over the City's finances and operations.

The Controller's Office has made significant strides toward providing departments guidance through financial system on-line access to screen inquiries, help menus, real-time edits and other technological improvements. The Controller also asserts that policies and procedures that guide departments and promote sound financial practices are contained in the City's Administrative Code and the *Governmental Accounting, Auditing and Financial Reporting* text published by the Government Finance Officers Association and otherwise known as the "Blue Book." However, individually, these resources do not provide a comprehensive overview of the City's financial and accounting policies and procedures to ensure departments are utilizing sound and consistent financial management practices. Written policies and procedures do not exist for several accounting and finance processes, such as the preparation of indirect cost rates and the reconciliation and monitoring of funds and sub-funds. Accordingly, the Controller's Office does not have a document that brings all of the various resources together and expands on areas that may not be addressed anywhere else.

The Controller is critical of the Budget Analyst's assessment of the Controller Office's need for comprehensive policies and procedures. The Controller states "…some of the Analyst's comments come from a lack of familiarity with how the City's financial systems and their inherent controls are designed to work." While, of course, the Budget Analyst does not have the same familiarity with the financial systems that the Controller's Office has, the Budget Analyst is familiar enough to note that the financial systems and the inherent controls designed in the system are transaction based. Such controls are not a substitute for policies and procedures, nor do they provide staff with a comprehensive understanding of the underlying financial and accounting principles and practices. One of the main reasons for comprehensive policies and procedures is so that finance and accounting staff in the City's operating departments, who may have less familiarity with the City's financial system, understand the basis for their activities and are not merely performing their jobs by rote.

A review of the Controller findings with respect to routine audits of financial transactions found a decrease in the adherence by City departments to the City's policies and procedures from calendar year 2001 to the first three months of 2003. A review of the more recent Post-Audit statistics shows that overall the Compliance Unit found an exception for every 4.00 documents, an overall decrease in adherence to City policies and procedures of 13.9 percent from a Post-Audit conducted the previous fall. Excluding exception categories that the Controller believes do not impact financial integrity, the exception ratio for the recent period is one exception for every 8.47 documents, a decrease in adherence to policies and procedures of 15.7 percent from the Post-Audit conducted the previous fall.

The Controller states "The Analyst does not consider that the dollar value of the errors dropped significantly, nor recognizes that the Controller focused its last review solely on those departments with the most exceptions in the prior year." As noted in the report, the focus of the Budget Analyst review was on the practices of departments, and therefore, any exception, whether for $10 or $1.0 million, represents a lapse in internal controls. With respect to the Controller's selection of the departments for its Post-Audit, our analysis of those departments or agencies that were not included in the Controller's last review totaled only 5.5 percent of the review conducted in the previous year, based on total document population. Accordingly, the Budget Analyst states that the results of the Controller's last review are representative.

With respect to reporting issues, departments have created parallel applications, spreadsheets and other duplicative procedures to obtain financial data and information in a format that is useful. For example, the Department of Human Resources (DHR) creates excel spreadsheets to monitor expenditures by index code and sub-objects. Additionally, DHR creates excel spreadsheets for monitoring the Health Service System, for analysis during the budget development process, and for position control. The Department of Children, Youth and Their Families re-enters transaction data into excel spreadsheets to track expenditures by index code and by lower levels of detail, such as purchase order. The Recreation and Park Department has developed their own monthly report by index code to track revenues and expenditures. These efforts by departments require considerable resources to essentially recreate financial data and information in a useable format. The Recreation and Park Department reports that it takes 50 percent of one accountant's time just to produce the monthly financial reports that the Department needs for the Recreation and Park Commission.

The Controller states in his response that "The Controller believes the Analyst misunderstands the reporting needs of the various departments and how they are being met." Further, the Controller states that "The Controller's office has addressed the real need for more flexible use of financial data at the department and other levels on multiple fronts." (Page 3, Paragraph 1) The Controller has developed many tools to meet the City's reporting needs. For example, the Controller reports that it has developed the Executive Information System (EIS) and provided it to 13 departments. However, these tools are not currently available to all departments or readily accessible. Several departments reported to the Budget Analyst that they have created duplicative applications and spreadsheets to meet specific departmental needs. Two of the departments the Budget Analyst interviewed are also on the Controller's list of departments with access to EIS. Accordingly, it appears that either the departments have not fully accessed the functionality of EIS or it does not meet their needs.

Further, the lack of centralized monitoring of the accounting structure by the Controller's Office has led to the existence of unnecessary funds, unreconciled financial activity, the accumulation of resources, and accounting structures that do not necessarily meet the needs of departments. Departmental "recasts" are customary, where a department's accounting structure is significantly revised and prior year financial data must be "recast" to conform with the revised structure. Recasts are an intensive process that requires considerable Controller and departmental resources. Additionally, recasts are generally problematic. Historical information is restated and reported in a way that was never intended, impairing the quality and comparability of financial data and departmental activities over time. There are valid reasons why a recast may be necessary, such as fundamental changes in the operating environment. However, departmental structures should remain relatively stable and not be subject to shifting policies or personalities, such as when changes in department heads and fiscal officers occurs.

Finally, incomplete and untimely reviews of user security allows for unauthorized access to financial systems and weakens the integrity of financial activity. As part of the security review for FY 2002-2003, the Controller's Office distributed a list of staff with FAMIS, ADPICS or FAACS access and instructed department heads or chief financial Officers to respond by July 31, 2003 with updated information on which staff are authorized to access the financial systems to: (a) initiate transactions, (b) approve transactions, or (c) make inquiries on transactions. The Controller's Office stated that "users whose status is not confirmed or updated by July 31, 2003 may then be denied system access." However, of six department user security surveys selected for review, one department's survey was never submitted and a second department's survey was incomplete. There was no indication that any users were denied system access as a result of non-compliance with the security policy.

The Controller correctly states that "It should be noted that in reviewing the Controller's process, the Analyst <u>did not</u> find any cases of inappropriate user access to the system." However, the Budget Analyst reviewed the security review process and did not test for any cases of inappropriate user access to the system. Nonetheless, the Budget Analyst found weaknesses in the Controller's internal control process designed to prevent unauthorized access.

The Controller should strengthen the financial management framework by developing authoritative and comprehensive policies and procedures, addressing departmental financial reporting needs, ensuring consistent and stable departmental accounting structures, and verifying that only appropriate personnel have user access to the financial systems.

The Controller should:

2.1 Develop and make available to departments, physically or electronically, written, authoritative and comprehensive policies and procedures for all aspects of the financial and accounting processes;

2.2 Perform an assessment of departmental financial reporting needs, and develop a strategic plan for meeting those needs, by June 30, 2004;

2.3 Consider the long-term structural stability of departmental accounting structures when developing departmental accounting structures and conducting recasts;

2.4 Designate the following responsibility to oversee the accounting structure to a specific unit in the Financial Systems and Reporting Units or to a consistent working group, including:

i. Being the sole authority for the creation of funds, sub-funds, organization and index codes;

ii. Being the sole authority for the recast of a department's accounting structure; and

iii. Ensuring that the accounting structure is appropriate and is in accordance with sound financial management and accounting practices; and

iv. Being accountable for the monitoring of funds and sub-funds.

2.5 Ensure that annual user security reviews are conducted in a timely manner; and

2.6 Deny system access for users whose status is not confirmed or updated by the deadline in order to enforce compliance with the security policy.

The development of a policies and procedures manual should be achieved through the assignment of existing resources. Oversight of the accounting structure can be achieved through the reallocation and consolidation of the current assignments. An assessment of reporting needs and strategic planning will require additional resources which should be obtained through a reallocation of existing staff as current projects are completed, rather than with new staff. The benefits which are realized from these recommendations include operational efficiencies and enhanced controls at the departments and at the Controller's Office, which will exceed the costs of implementation.

3. System Planning

The City Charter charges the Controller with the responsibility for establishing accounting records, procedures and internal controls necessary to facilitate sound financial management and accounting practices. In order to perform these basic duties, the Controller is responsible for establishing and maintaining a financial accounting system that can provide for the monitoring and control over the City's finances and operations; and, produce accurate, timely and useful financial reports.

The City's current financial accounting system, FAMIS, and supporting financial and reporting systems are inadequate to meet the financial reporting and fiscal management needs of City and County of San Francisco departments. In an effort to compensate for the weaknesses in the financial system, the Controller and departments have implemented an ad hoc system of databases and reporting software. However, many departmental reporting and financial management needs are still left unmet. Further, the current system is inflexible, resulting in delays in meeting basic reporting needs and the duplication of work.

For example, the Department of Human Resources (DHR) creates excel spreadsheets to monitor expenditures by index code and sub-objects. Additionally, DHR creates excel spreadsheets for monitoring the Health Service System, for analysis during the budget development process, and for position control. The Department of Children, Youth and Their Families re-enters transaction data into excel spreadsheets to track expenditures by index code and by lower levels of detail, such as purchase order. The Recreation and Park Department has developed their own monthly report by index code to track revenues and expenditures. These efforts by departments require considerable resources to essentially recreate financial data and information in a useable format. The Recreation and Park Department reports that it takes 50 percent of one accountant's time just to produce the monthly financial reports that the Department needs for the Recreation and Park Commission.

The estimated cost of updating FAMIS is $500,000 to $1.7 million. At least one California jurisdiction, the County of Santa Clara, replaced its general ledger system for $13 million. The significant cost of updating FAMIS, or acquiring a new system, has resulted in a decision by the Controller to continue operating the current system and develop enhancements to the system in the immediate future.

The Controller should perform an assessment of the short-term financial reporting and accounting needs of the departments, and the City and should develop a strategic plan for meeting those needs. In addition, the Controller should assess the impact on the City's financial management resulting from the continued long-term use of the FAMIS financial accounting system and develop a strategic plan for replacing the current system.

The Controller should:

3.1 Perform an assessment of the City's financial systems needs and report back to the Board of Supervisors by June 30, 2004;

3.2 Develop a strategic plan for meeting identified departmental and City needs; and

3.3 Be prepared to move forward with a replacement system when it becomes either necessary or financially feasible.

The estimated cost of updating FAMIS is $500,000 to $1.7 million. The Controller has estimated that the cost to replace the City's general ledger, budget and purchasing systems would be approximately $30 million, not including hardware or in-house implementation costs. As noted above, at least one California jurisdiction, the County of Santa Clara, recently replaced its general ledger system for $13 million. A new accounting system would provide long-term operational efficiencies in the Controller's Office and in the City's operating departments.

4. Internal Control Reporting and Financial Auditor Independence

Although the Sarbanes-Oxley Act, which increases oversight over publicly-held private companies, does not apply to government agencies, the principles underlying the Act do apply to government agencies. The Sarbanes-Oxley Act strengthens the role of audit committees in the financial reporting process and increases the level of auditor independence. The Board of Supervisors Audit Committee, which is known as the Finance and Audits Committee, already has a direct reporting relationship with the City's financial auditors. By adopting policies consistent with the Securities and Exchange Commission's rules under the Sarbanes-Oxley Act (such as requiring pre-approval by the Finance and Audits Committee of all non-audit services to be performed by the contract financial auditor, requiring that the audit partner be rotated every five years, and requiring conflict of interest standards), the Board of Supervisors would increase its oversight over financial statement audits and non-audit services provided by the financial auditor.

In his response, the Controller states that "The Controller wants to make it clear that at no time has the City's external independent auditor been out of compliance with any legal or industry rule or regulation in any work conducted on behalf of the City. The Controller is quite comfortable that the City's independent auditor is selected by the Board and the Board is free to make whatever rules they would like in this area."

"The Controller believes that the City's external auditors have always complied with all legal and industry rules and practices related to their independence. The Analyst lists several projects that the City's current auditor has done for the City. We want to make it completely clear that this work was not and is not out of compliance with any regulation."

The Budget Analyst did not audit the work of the external financial auditor and therefore cannot comment on external financial auditor compliance with legal and industry rules and practices related to independence. However, as stated previously, we recommend that the Board of Supervisors amend the Administrative Code to include provisions of the Federal Sarbanes-Oxley Act of 2002 that would strengthen the role of the Board's Finance and Audits Committee as it pertains to financial reporting processes and increased controls over auditor independence.

The provisions of the Sarbanes-Oxley Act to evaluate and report on internal controls could be costly for the City to implement. However, if the City were able to reduce its risk of loss from inefficient or fraudulent activities through strengthening internal controls, the reduced loss could offset the increased costs of implementing a comprehensive policy to evaluate and report on internal controls.

The Board of Supervisors should:

4.1 Propose an amendment to the Administrative Code, adopting the policies of the Sarbanes-Oxley Act and giving the Audit Committee authority to:

- i Pre-approve all non-audit services performed by the City's financial auditor, and
- ii Require the City's contract financial auditor to report to the Board of Supervisors' Audit Committee prior to issuing the final audit report on the City's financial statement, in order to apprise the Board of Supervisors on (a) all critical accounting policies and practices used by City management; (b) all alternative accounting treatments of financial information that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm; and (c) other material written communications between the accounting firm and City management.

The Controller should:

4.2 Develop and present a policy, within 60 days, for Board of Supervisors adoption, on auditor independence, including (a) standards on conflict of interest, and (b) financial auditor partner rotation.

4.3 Develop and present a cost estimate, including expenditure details, within 60 days for Board of Supervisors' consideration, of a feasibility study to assess and report on the City's internal controls.

4.4 If the Board of Supervisors approves the feasibility study, conduct and report on the feasibility of a policy to evaluate and report on the City's internal controls, prior to June 30, 2004, to be implemented for the fiscal year ending June 30, 2005.

The City's costs to implement policies consistent with the Sarbanes-Oxley Act provisions on audit committees and auditor independence would be negligible. The provisions of the Sarbanes-Oxley Act to evaluate and report on internal controls could be costly for the City to implement, but could result in a reduced risk of loss from inefficient or fraudulent activities, offsetting the increased costs.

5. Budgetary Control

The Controller's Office does not always enter appropriation reserves into FAMIS in a manner that will achieve the Board of Supervisors' policy objectives. Departments have been able to expend against reserves because the Controller's Office did not enter the reserve against the work order or subproject for which it was established.

For example, in the past year there have been two instances when Board-authorized appropriation reserves were expended without prior Board of Supervisors approval. In March of 2003, the Department of Administrative Services requested retroactive release of $3,088,926 reserved by the Board of Supervisors in the FY 2002-2003 budget for the maintenance and repair of City-owned vehicles. Because the Department of Administrative Services provides vehicle maintenance services on a work order basis to City departments, the Controller's Office placed the appropriation reserve on the requesting departments. Between July of 2002 and March of 2003, when the Finance and Audits Committee authorized the retroactive release of reserves, the Controller's Office City Projects staff worked with the Department of Administrative Services to address the Board of Supervisors' policy issues. Also, a March 19, 2003 memorandum to the Budget Analyst from the Department of Administrative Services states that the Department had been in regular contact with the office of the sponsoring supervisor "for the last three months in regard to the timing and substance of the release of reserve request".

Although the monies were on reserve, the Administrative Services Central Shops performed the work and charged $836,484 against the $3,088,926 reserve prior to authorization by the Finance and Audits Committee to release the funds. According to the Budget and Fiscal Operations Manager, requesting departments should notify performing departments if insufficient funds are available to pay for the work. According to the Accounting Operations Manager, the reserve was entered into FAMIS at the high work order level for the requesting department and not on the specific work order between the requesting and performing department. Therefore, the

Accounting Operations and Systems Division fund accountants could only identify if monies were expended against all the requesting departments' work orders, up to the level of the reserve, and could not identify if monies were expended against the specific work order for which the reserve had been placed.

In April of 2003, the Department of Public Works requested retroactive release of reserves for completed Fire Department capital projects. In 1996, the Board of Supervisors appropriated $14,233,588 in General Obligation Bond Fund monies for 20 Fire Department capital projects and had reserved $7,864,100 of the $14,233,588 appropriation. From 1996 until 2003, the Board of Supervisors released $4,340,872 of the $7,864,100 reserve, with a remaining balance of $3,523,228. The remaining reserves were designated for capital projects at three fire stations. However, the Department of Public Works expended other bond funds for the three fire station projects, even though the Board of Supervisors had designated specific reserves for these projects. According to the Deputy Controller, the capital project appropriation was entered into FAMIS at the higher project level, and the Controller's Office was unable to monitor reserves placed on sub projects.

Regarding reserves established by the Mayor's Office, the Controller's Office procedures for entering Mayor's Office reserves or contingencies into FAMIS is redundant. Both the Budget and Analysis Division and the Accounting Operations and Systems Division enter reserves or contingencies into FAMIS to control departments' expenditures, resulting in a process that is inefficient and could lead to errors in FAMIS entries.

For example, during FY 2002-2003, the Budget and Analysis Division and the Accounting Operations and Systems Division both entered the Mayor's appropriation reductions into FAMIS, either as a reserve or a contingency. In one instance, the Budget and Analysis Division entered a $1.5 million reserve for the Department of Administrative Services into FAMIS on September 16, 2002, as part of the Mayor's "Capital Reserve List". The Accounting Operations and Systems Division entered a $340,943 reserve into FAMIS for the Department of Administrative Services on April 11, 2003 as part of the Mayor's savings initiative. According to a May 11, 2003 FAMIS journal entry, the $340,943 "was part of $1,500,000 reserve placed on JECO03000268-03 on 9/16/02 and recorded again on JECO03018086 on 4/11/03".

The Accounting Operations and Systems Division released the $340,943 on reserve, and entered into the FAMIS notepad that the transaction was to "release portion of reserve that was duplicated". Despite documentation to the contrary, the Controller's Office has stated that the entry was not a duplicated entry and that the monies were released only after discussion with the Mayor's Office.

The Controller's Office does not closely monitor General Fund appropriation reserves for ongoing projects. Our review of the listing of appropriation reserves produced by the Controller's Office at the request of the management audit found that several appropriation reserves on continuing projects had already been released and expended. For example, as of June 30, 2003, there were $18,144,792 in appropriation reserves for continuing projects in City departments (1G AGF ACP). The majority of these projects were multi-year capital or information system projects, although a few of the projects were for other types of programs. More than half of these monies, or $9,728,296, were listed as appropriation reserves for continuing projects established in FY 1999-2000 or earlier. We reviewed the details for the 16 projects that were established in FY 1999-2000 or earlier, and based on our interviews with the respective departments, found that several of these appropriation reserves had been released and expended. For example, of the five Department of Public Works projects, three of the appropriation reserves had been released and expended and the projects closed, one project had been closed and the monies returned to the fund balance, and one project from FY 1993-1994 was still open. Both Recreation and Park Department appropriation reserves had been released and expended.

At least two of the appropriation reserves that we reviewed should be returned to fund balance.

- Documentation showed a $22,063 appropriation reserve, established in FY 1996-1997, for which the Medical Examiner's Office was able to identify the entry into FAMIS in April 1997 and the enabling Ordinance 101-97, but was not able to identify the associated project. Because the revenue source was Jail Overcrowding Fine Revenue, which is not a revenue source for the Medical Examiner's Office, the Medical Examiner's Office thought that this could be an incorrect journal entry.

- Documentation showed a $61,210 appropriation reserve, established in FY 1993-1994, for the Department of Public Works Civic Center Steam System Improvement Project. According to the Department of Public Works, the balance in this account, including the $61,210 reserve, is $177,995. Although the Department of Public Works owns the steam system loop in Civic Center, a private contractor provides the actual steam heat. The Department of Public Works is reviewing the feasibility of transferring the steam system to the private contractor, and therefore, the appropriateness of the $177,995 account, including the $61,210 reserve, needs to be reviewed.

Although we have recommended further review by the Controller, based on our review, we believe these two appropriation reserves should be closed and available revenues returned to the General Fund.

The Controller's Office approves most City department requests to carry forward unexpended appropriations from one fiscal year to the next. Carry forward requests are generally only denied if the department does not have sufficient funds to balance its budget, or if the department has funding for the same purpose in the next fiscal year. The Controller's Office approves departments' requests to carry forward funds although some of these requests exceed the Controller's Office written policy for carry forward approval.

The Controller stated in his response, that "The Analyst reports that the Controller approves most of the Departments' requests to carry forward unexpended funds from one year to the next when they meet the Controller's guidelines implying this indicates inadequate review. However, the Analyst has not substantiated his opinion that in some instances, approvals granted to carry forward funds have exceeded the Controller's policies."

The Controller's Office has three key criteria for approving the carry forward of funds: (a) monies must be for specific non-recurring items or services; (b) the department can not have funds budgeted in the next fiscal year for the specific purpose; and (c) the department must spend the money in the next fiscal year for the same purposes for which it had been appropriated in the prior fiscal year. In our sample of six Departments, we found one instance in which the Controller authorized the Department of Public Health to carry forward funds to purchase bulk medications, although funds for the specific purpose were budgeted in the next fiscal year.

We found another instance in which the Controller's Office approved a request by the Department of Public Health to fund a purpose in FY 2002-2003 that differed from the appropriation in FY 2001-2002. The Department of Public Health used $254,000, appropriated for professional services in FY 2001-2002 and carried forward into FY 2002-2003, to pay off the mortgage balance of the Women's and Children's Family Services facility at 15 Bishop Street. Although the funds were used to pay off the mortgage balance for the non-profit organization, these monies continued to be identified in FAMIS as monies for a professional services contract. According to the City Attorney's Office, the title to the building will be transferred to another non-profit organization, the Mission Neighborhood Development Corporation. Because the transaction involves the transfer of property between two non-profit organizations rather than the purchase or transfer of the property to the City, the proposed transaction has not been submitted to the Board of Supervisors for approval. We believe that this violates the Controller's established policy of approving funds for the same purpose. Although the Board of Supervisors had appropriated funds for a service contract in FY 2001-2002 for the operating expenses of the Women's and Children's Family Services, which included the mortgage payment, we do not believe that the Board of Supervisors intended to appropriate these funds to pay-off the mortgage and transfer title to another non-profit organization.

Further, the Controller made the statement that "The Analyst also implies but has not shown any instance that the carry-forward process circumvented the Board's appropriation authority. In no instance has the Controller allowed Departments to carry-forward funds that were not already approved by the Board of Supervisors, or circumvented the appropriation process of the Mayor and the Board of Supervisors. As noted in the above example, the Controller authorized the Department of Public Health to carry forward funds, which had been budgeted for contractual services, to purchase a building and transfer the title to another non-profit organization. This use of funds does not appear to have been consistent with the Board of Supervisors original intent.

The City needs a clearly stated policy on the carry forward of appropriations from one fiscal year to the next. Currently, the Administrative Code is silent on the process. Although the Controller's Office has a documented policy to carry forward one-time monies if there is no new appropriation in the next fiscal year and if the purpose is unchanged, the Controller's Office approves the carry forward of funds for many reasons not included in the Controller's documented procedures.

The Controller's Office should:

5.1 Work with the Board of Supervisors to ensure that the Board's policy objectives are met in authorizing appropriation reserves, including defining such procedures as (a) placing work order reserves on both the performing and requesting departments, and (b) establishing separate project accounts to account for reserves placed on sub projects.

5.2 Define the policies and procedures for establishing reserves and contingencies and the responsibilities of the Budget and Analysis Division and the Accounting Operations and Systems Division for placing and monitoring reserves and contingencies, including the responsibility for the Budget and Analysis Division in overseeing Board of Supervisors and Controller's reserves, and the responsibility of the Accounting Operations and Systems Division in overseeing the Mayor's reserves to achieve savings targets.

5.3 Work with the Board of Supervisors to (a) define the policy objectives and scope of carrying forward annual appropriations from one year to the next, and propose Administrative Code changes, as needed; and (b) define the policies and procedures for reviewing and approving the carry forward of unexpended annual appropriations into the next fiscal year.

Our recommendation to redefine the responsibilities of the Budget and Analysis and Accounting Operations and Systems Divisions in monitoring reserves and contingencies would increase efficiency by reducing duplicative efforts in establishing and monitoring appropriation reserves.

Our recommendation to increase the Controller's role in monitoring and recommending closure of continuing General Fund projects, including projects with appropriation reserves, would release additional revenues to the General Fund for alternative uses. Closing out the $22,063 Medical Examiner appropriation reserve would clear the books but may not result in additional revenues if no revenues were received from the Jail Overcrowding Fines. However, by working with the Department of Public Works to close out prior year continuing projects, approximately $177,995 could be available for other uses.

Our recommendation to increase oversight over the approval of departments' requests to carry forward unexpended appropriations would ensure that departments' appropriations in the next fiscal year did not exceed the appropriation levels and purposes intended by the Board of Supervisors.

6. Fund Maintenance

Funds are the accounting instruments by which governmental entities record financial activities and resources. A governmental entity may have many funds to separate disparate activities and restricted resources. Sound financial management and governmental accounting practices prescribe that funds be kept to the minimum number necessary to prevent unwarranted complexity and inflexibility. Accordingly, the Controller's Office has structured the financial accounting framework so funds are comprised of numerous sub-funds, which are the level at which the Controller records financial activities and resources that are segregated for specific uses.

Historical records on the creation of sub-funds have not been maintained by the Controller's Office. Accordingly, for any given sub-fund, there is limited documentation on the purpose, source of revenue, authorization, and department(s) responsible for the sub-fund. A review of selected special funds maintained by the Controller's Office has identified sub-funds that are not necessary. Some funds are not legally required. Other funds are required by the City and County of San Francisco Code, but do not appear to otherwise meet the criteria for a separate fund. These activities may be accounted for and separately tracked in the General Fund or other primary operating fund, using special accounts. Further, financial activities are not necessarily monitored at the sub-fund level. For example, a number of sub-funds had inappropriate deficit or residual fund balances. Other sub-funds should be closed due to lack of activity as required by Administrative Code Section 10.100-1 and the Annual Appropriation Ordinance.

The following are examples of the types of issues identified during the review of funds and sub-funds:

- The Public Works, Transportation and Commerce – DPW Personnel Fund is used to account for errors made by DPW employees when billing projects. The year end fund balance for FYs 1999-2000, 2000-2001, and 2001-2002 of this sub-fund was a negative $569,480. According to DPW, this negative balance was created in the conversion to on-line FAMIS in FY 1995-1996. Otherwise, DPW does not know the source of the negative balance. According to DPW, the Controller asked DPW to recover these funds through charging for these costs through DPW's overhead account. However, according to DPW, the Department has forgotten to do this and the negative fund balance remains.

- According to Controller files, the Civil Service Special Revenue Sub-Fund is to record revenues received from the lease of examination material and the provision of consulting services for the purpose of examination research and development. The Civil Service Commission was unaware of this fund and believed that fund management might be the responsibility of the Department of Human Resources (DHR). However, DHR stated that the fund is not in their purview, and noted that the only activity in the sub-fund was posted by the Controller's Office. However, according to Controller staff, this sub-fund is the responsibility of the Civil Service Commission.

- The fund and sub-fund used to account for gifts to the City include approximately $191,075 in insurance settlements for earthquake damaged art, which clearly are not gifts or donations to the City. Further, according to the Fine Arts Museum, the repair and replacement of earthquake damaged art for which these funds were intended, has been completed.

The Controller's Office should review all sub-funds, closing those that have not had activity or those for which activity is not required to be recorded separately. The Controller's Office should also establish comprehensive written policies and procedures for the establishment, maintenance, and monitoring of sub-funds. Internal and external policies and procedures should be developed, clearly defining the roles and responsibilities of the departments as well as of the Controller's Office.

Our management audit identified approximately $2,193,114 in funds that can potentially be transferred to the primary operating funds of the City, including the General Fund. However, some, but not all, of these funds may continue to be restricted for certain activities. The remaining special and fiduciary sub-funds that have not been reviewed would almost certainly have additional monies that could be transferred to the primary operating funds of the City, including the General Fund. A thorough analysis of the remaining 227 special funds is required to address the issues discussed in this review and would likely identify additional fund balances available to support General Fund or other primary operating fund activities. In addition to identifying available resources, operational and financial management efficiencies would be realized.

The Controller notes "However, the Analyst spent most of their time reviewing selected sub-funds and accounts. . . " This is correct. The reason the Budget Analyst reviewed funds at the sub-fund level is because this is the level at which, as noted in our report, the Controller has chosen to record disparate financial activities and resources. The Controller asserts that the City controls its budget at the fund level. However, in any given fund, which is a compilation of any number of sub-funds, there may be numerous departments as well as numerous unrelated and restricted financial activities (some of these explicitly restricted by the City's Codes or State law). To manage these financial activities at the fund level, rather than sub-fund levels, invites the kind of discrepancies identified in our report.

The Controller believes "It is by no means "certain" the process of reconciling all special and fiduciary funds will produce surplus monies - both because there are negative as well as positive balances to be analyzed, and because restrictions attached to fiduciary funds must be honored before the criteria of closing inactive funds is applied." The Budget Analyst's report includes not only positive balances, but negative balances in our assessment of sub-funds and in our estimate of the monies that appear likely to be able to be transferred to the primary operating funds of the City. In fact, negative balances are more troubling than positive in that they are more likely to represent either an over-expenditure of funds or incomplete financial activity. With respect to the restrictions on fiduciary funds, the Budget Analyst's review identified monies that were inappropriately held in fiduciary funds and that were not restricted by fiduciary obligations.

The Controller should:

6.1 Establish formal policies, procedures and criteria for the establishment of special revenue and fiduciary funds and sub-funds, in accordance with Generally Accepted Accounting Principles; and, develop specific criteria for funds that are necessary to meet "sound financial administration" principles;

6.2 Conduct a thorough review and reconciliation of special revenue and fiduciary funds and sub-funds by June 30, 2004, including an analysis of departments' subsidiary financial accounting systems that record detail on special revenue or fiduciary fund activities;

6.3 Conduct a review and reconciliation by June 30, 2004 of all gift and bequest funds, identifying monies where:

- i Recording in the gift or bequest fund is not warranted and the resources/activity can be recorded in the primary operating fund; and
- ii Gift purpose has been achieved and residual gift balances must be disposed.

6.4 Close and transfer any residual fund balances for those funds and sub-funds that do not meet the criteria established by Recommendation 6.1, above, and for which the activity can be sufficiently tracked and monitored in the primary operating fund;

6.5 Resolve or dispose of any inappropriate residual or deficit fund balances identified by the reviews performed pursuant to Recommendation 6.2 and 6.3 above; and,

6.6 Establish periodic and year-end procedures for the reconciliation and review of all special revenue and fiduciary funds and sub-funds.

The Board of Supervisors should:

6.7 In order to assure departmental activities are monitored while retaining adequate controls, consider the use of special accounts rather than special funds as an acceptable and preferable mechanism by which activities can be segregated, tracked and monitored.

While the recommendations above will require both one-time and limited on-going resources, the costs will be significantly exceeded by the identification of available resources resulting from 1) residual balances identified by the Controller's review which may be returned or escheated to the General Fund and 2) operational and financial management efficiencies. A minimum of approximately $2,193,114 in funds can potentially be transferred to the primary operating funds of the City, including the General Fund. Review of the remaining 227 special and fiduciary sub-funds almost certainly will identify additional funds. While some of these funds may be restricted for certain activities, many of these funds are not restricted or can be used to subvent General Fund subsidies of the specified activity.

7. Cash Revolving Funds

According to the San Francisco Administrative Code Sections 10.100 and 10.125, the Controller is charged with the responsibility to administer, monitor use, and authorize exceptions to Cash Revolving Funds. As part of its responsibility to monitor the use of Cash Revolving Funds, the Controller's Office is responsible for periodically auditing Cash Revolving Funds, assessing the appropriateness of authorized amounts and recommending changes to authorized amounts of such funds.

Currently, there are a total of 58 Cash Revolving Funds with a total authorized amount of $765,950. In FY 2002-03, the Controller's Office approved a total of $3,499,150 in transactions through Cash Revolving Funds. While some Cash Revolving Funds were closed out or reduced following the issuance of Departmental Instructions Numbers 1051 and 1052 and the Controller's review of usage in 1996, the Budget Analyst has identified a total of 19 Cash Revolving Funds that showed no activity for FY 2002-2003 and an additional 37 Cash Revolving Funds that showed transaction activity that did not appear to justify the level of the authorized fund amount.

Because the Controller's Office does not have clear policies and procedures regarding the appropriate number and authorized amount for Cash Revolving Funds some Cash Revolving Funds are replenished as infrequently as once a year (or not at all) and some are replenished multiple times in one day, based entirely on the frequency of requests by departments. The Controller's Office Audits Division periodically audits Cash Revolving Funds. However the Controller's Office considers such audits a lower priority. The Audits Division performed a total of three audits out of a total of 58 Cash Revolving Funds in FY 2001-2002.

There is a $200 limit on how much can be expended for each fund at one time. The Elections Department Cash Revolving Fund is an example of the risk associated with revolving funds. Certain departments and funds have exemptions from the $200 limit on purchases, including the Municipal Transportation Authority, the Department of Public Works, the Airport Commission and the Elections Department. For example, the Administrative Code provides for a $500 Cash Revolving Fund for the Elections Department and states that the Elections fund "may also be used, with the approval of the Controller, to reimburse election judges, inspectors and other poll workers" (Sec. 10.162). In FY 2002-03, the Elections Department's Cash Revolving Fund was replenished for $465,000 with individual replenishments of $450,000, $5,000 and $10,000. The Controller's Office has stated that "due to the volume of details, expenditures are not verified at the time reimbursements are made. The revolving fund is subject to periodic audit by the Controller's Internal Audit."

The City's risk for loss from potential unauthorized expenditures is unnecessarily high due to the proliferation of unnecessary Cash Revolving Funds and Cash Revolving Funds with authorized amounts set higher than necessary. In addition, in the absence of a clear policy regarding frequency and amount of replenishments for Cash Revolving Funds, the workload associated with replenishing the funds is not being kept to a minimum by the Controller's Office.

The Controller's Office should implement standards for the replenishment of Cash Revolving Funds, which would reduce and standardize the Controller's Office workload associated with maintaining such funds. In addition, the Controller's Office should annually assess the necessity for Cash Revolving Funds and recommend the elimination of those funds with zero transactions occurring during a fiscal year and the reduction of the authorized amounts for underutilized Cash Revolving Funds. Cash Revolving Funds should be set at the minimum amount necessary for departments. Implementation of our recommendations would reduce Cash Revolving Funds by $487,100, and would reduce the risk associated with cash disbursements in the affected departments.

The Controller should:

7.1 Conduct an annual risk assessment of Cash Revolving Funds;

7.2 Conduct an annual analysis of Cash Revolving Fund utilization;

7.3 Develop and implement clear policies on frequency of replenishments to Cash Revolving Funds;

7.4 Develop and implement clear policies on disbursement of cash among locations within departments;

7.5 Request that the Board of Supervisors repeal the Administrative Code authorization for the 19 Cash Revolving Funds listed in Section 7, Table 7.1 of this report, resulting in reduced authorization of $29,600; and

7.6 Request that the Board of Supervisors reduce the authorized amount for the 38 Cash Revolving Funds listed in Appendix 7.1 of this report, resulting in reduced authorization of $457,500.

Our recommendations can be accomplished within the normal management responsibilities within the organization. Our recommendations would result in tighter controls over Cash Revolving Funds and reduce cash authorizations by a total of $487,100.

8. Countywide Cost Allocation Plan

The Controller's Office is responsible for preparing the Countywide Cost Allocation Plan which allocates the costs of support and administrative services to benefiting programs, departments and agencies. These allocated costs are then able to be appropriately reimbursed either through direct billing or by including the costs in claims for reimbursement, typically through federal or State programs, and in fees charged to the public. In today's environment of decreasing budgets, it is increasingly important for the City, in general, and the Controller, specifically, to accurately identify the true costs of services being provided and to aggressively maximize revenues.

The Controller has not approached the Countywide cost allocation plan and cost recovery in a systematic and comprehensive manner. Accordingly, the current cost allocation plan, as it is prepared, is incomplete and does not represent the actual cost of City support services and administration. Allowable costs have not been included in the Countywide cost allocation plan's preparation and additional entities may be able to be billed for their costs. For example, according to Section 4180 of the State Controller's handbook, a county is considered non-insured for General Liability if it has not established a self-insurance program but rather finances any losses through current appropriations, issuance of debt, or other "spur-of-the- moment" financing. According to the State Controller's Office, the City is considered non-insured for general liability costs pursuant to OMB Circular A-87 guidelines, because it has not established a self-insurance program. Accordingly, the City cannot be reimbursed by federal or State programs for the actual costs of liability claims.

The State Controller's Office reported that the City along with the County of Los Angeles are the only two counties in the State that are considered non-insured. However, both entities were "grandfathered-in" under A-87 cost allocation guidelines with respect to workers' compensation costs and can receive reimbursement under their "pay-as-you-go" systems. For general liability, however, the State Controller's Office asserts that it has repeatedly advised the City of the "millions of dollars" that it has forgone in reimbursements by not establishing a self-insurance program and liability reserves, but the City has chosen to continue in a non-insured status since the late 1970's. Because the issue is over 20 years old, neither the State Controller's Office nor the City Controller's Office could provide the Budget Analyst with information or documentation of this issue, including the State Controller's recommendations. These deficiencies have resulted in lost revenues every year and potentially could result in non-compliance with A-87 guidelines and other legal issues with regard to billing cost plan allocations.

Potentially, an additional $29,271,533 in allowable costs could be included and allocated through the Countywide cost allocation plan, which represents an increase of 36.6 percent in allocated costs. These costs would be allocated among City activities including those reported in the General Fund, special revenue funds and enterprise funds. To the extent that the Controller can identify additional entities and programs that receive support and administrative services which can be billed, costs will be reimbursed and revenues will be increased.

The Controller's response states that "The Controller concurs with a recommendation to perform further work in this area to determine if additional costs may be allocated. However, the Controller believes the Analyst overstates the potential benefit of this work." The Budget Analyst does not believe that we have overstated the potential benefits of conducting a comprehensive assessment of the cost plan. The Budget Analyst explicitly did not estimate the General Fund impact of increasing allocable costs because we understand the complexities of the cost plan. Rather, we provide an estimate of potential increased allocable costs to merely provide an order of magnitude and state these costs may be allocable to all City activities, including those reported in the General Fund, special revenue funds, and enterprise funds.

Further, the Controller states "The Analyst's discussion of additional costs that could be included in the cost allocation plan is inaccurate and largely overstates the potential benefits. . . . We pointed out to the Analyst that a substantial majority of liability claim amount listed in their table relates to enterprise activities such as the MUNI Railway, are already directly billed to them and therefore would not be processed through our cost allocation plan." With respect to the inclusion of all liability claims as an allocable cost, the Controller is correct that these costs are direct billed to departments and agencies, specifically MUNI. However, for purposes of this analysis, whether or not the cost is direct billed is irrelevant. At issue is that none of these costs are currently claimed against federal and State funding sources because the City has been deemed uninsured. Even if the costs are direct billed, MUNI cannot claim them for cost reimbursement purposes until the City and the Controller address this issue.

Lastly, the Controller notes "The Analyst incorrectly implies it is the Controller's decision regarding which agencies are billed for allocated costs when in fact this decision is made by the Mayor and the Board of Supervisors in the budget process." The Budget Analyst agrees that it is a policy decision for the Mayor and the Board of Supervisors whether or not to bill agencies and other funding sources for indirect costs. However, the Controller is responsible for calculating and processing the billings. It is not clear which agencies and other funding sources incur indirect costs, and which agencies and other funding sources are or are not billed pursuant to the direction of the either the Mayor or the Board. The Controller should:

8.1 Perform a comprehensive assessment of Citywide support services and administration and treatment in the Countywide cost allocation plan and report back to the Board of Supervisors by June 30, 2004;

8.2 Assess and address the issues noted in this report and report back to the Board of Supervisors by June 30, 2004, on the following areas:

- i Self-insurance and general liability costs;
- ii Treasurer-Tax Collector functions;
- iii Equipment use allowance;
- iv Retirement billing;
- v County Office of Education billing;
- vi Other Special Revenue Fund billing; and
- vii Cost of Living Adjustment.

8.3 Request that the City's independent financial auditors review the application of the Cost of Living Adjustment and roll forward methodology for computing cost plan billings, and report back to the Board of Supervisors on their findings;

8.4 Establish written internal policies and procedures for the preparation and billing of the Countywide cost allocation plan;

8.5 Consolidate the preparation and billing of the Countywide cost allocation plan in the Budget and Analysis Division; and

8.6 Require the Budget and Analysis Director to supervise the preparation of the Countywide cost allocation plan, annually review the Countywide cost allocation plan document, and be actively involved in the State Controller's annual review of the City's Countywide cost allocation plan, including participating in discussions with the State Controller's Office on any identified issues and findings.

While there are costs associated with the comprehensive assessment of the Countywide cost allocation plan and its application, there will be increased revenues by addressing the issues outlined in this report. The Controller should utilize existing Controller analytical resources other than the current staff responsible for Countywide cost allocation plan preparation.

9. Multi-Tiered Cost Plans

The Controller's Office annually prepares a Countywide cost allocation plan pursuant to federal Office of Management and Budget regulations that are contained in Circular A-87 and State guidelines. Local governments must comply with these regulations when charging indirect costs to grants or other programs that are funded by the federal and State governments.

Pursuant to Circular A-87, certain costs cannot be claimed on grants or programs funded by the federal and State governments. Appropriately, the Controller's Office has identified certain costs as unallowable in the Countywide cost allocation plan.

However, the City also applies Circular A-87 regulations when allocating indirect costs to programs that are not funded by federal or State governments. This is not required. In other California jurisdictions, full multi-tiered cost plans have been developed and are used to ensure that the maximum amount of eligible indirect costs are allocated to programs other than those governed by federal or State cost allocation regulations. A multi-tiered cost allocation plan serves to maximize indirect cost reimbursement to the General Fund from user fee, enterprise and special fund activities, and is endorsed by the State Controller.

As an example, Los Angeles County reports that it annually prepares a multi-tiered full cost allocation plan, including (1) an A-87 plan for State and federal programs and grants; (2) an enterprise fund plan; (3) a plan for internal use with other County funds; and, (4) a plan for use when charging non-County government entities. The City and County of San Francisco currently prepares a single plan which generally conforms with the regulations contained in OMB Circular A-87. According to the Controller, the preparation of a full multi-tiered cost plan would yield very little benefit to the County, since much of the A-87 unallocated cost is either recovered through direct charges to departments or would be charged to General Fund departments or other funds which are incapable of reimbursing the General Fund.

While there is some merit to the Controller's comments, these assertions were not convincingly demonstrated or documented during the course of this management audit. For example, if the full cost allocation were to yield an average increase of only one percent on the $81.2 million in fees collected by the City each year, over $800,000 in additional income would be realized.

The Controller states in his response that "We also note that the State Controller does not 'endorse' this method, but merely suggests it as an option for counties." The California State Controller's *Handbook of Cost Plan Procedures for California Counties,* Section 1460 and 1470 states (in part), "Non-grantee departments should note the cost recovery limits set by OMB A-87 and, if necessary, adjust their costs to recover as nearly as possible the total costs of doing business. Although the cost plan as approved by the State Controller's Office includes only those costs considered reimbursable for federal and state purposes under the current cost principles, it is the best tool available to accomplish the task described above. A county could prepare a "full costing plan" to identify all county overhead costs to the appropriate departments, including those costs that are currently considered unallowable (e.g., general government costs)." This statement by the State Controller appears to the Budget Analyst to be an endorsement of the full cost allocation plan methodology that is described.

As a result, the Controller's Office may have missed opportunities to maximize reimbursement for the legitimate cost of providing support services to programs that are not funded by the federal or State governments. If such costs are allocated to these programs in FY 2002-03, additional revenues could be recovered by the General Fund.

The Controller should:

9.1 Direct staff to conduct a test allocation of A-87 unallocated costs, to determine potential General Fund revenues that could be realized from implementing a multi-tiered cost plan;

9.2 If appropriate based on the results of the test plan, direct staff to prepare multi-tiered full cost plans, in accordance with State Controller guidelines and modeled after similar plans in other counties, such as Los Angeles; and,

9.3 Allocate full costs to departments and non-General Fund activities in order to maximize reimbursement to the General Fund.

The Board of Supervisors should:

9.4 Based on the results of the Controller's test plan, consider adoption of legislation that would require the Controller to annually prepare multi-tiered full cost plans, which appropriately allocates costs to departments and non-General Fund activities. The full cost plans would include allocations of costs that are not allocable for federal or State claiming purposes under Circular A-87 regulations.

The Controller will incur some additional staff time during the development of the full cost plan models. Staff from the Internal Audit Division or City Projects Division can be temporarily diverted to assist the Cost Plan Accountant during the development phase. Accordingly, there should be no incremental costs associated with the implementation of these recommendations.

The General Fund will recover additional revenue annually in reimbursements from user fees and charges to other funds and agencies, although the actual amount of revenue can not be estimated until the Controller's Office identifies and distributes the unallocated costs.

10. Departmental Indirect Cost Rates

The San Francisco Administrative Code charges the Controller with the responsibility to direct and approve indirect cost rates for each City department. Such rates are applied to user fees and grants in order to reimburse the City for administrative and support costs associated with fee and grant activities.

The Controller's Office has not established consistent methodology for calculating departmental indirect cost rates and their application to City fees. In some cases, the departments calculate their own indirect cost rates and the Controller merely checks for reasonableness. For the remaining departments, the Controller has three different methods for calculating departmental indirect costs. These methods are either calculated at the program level or by department. In addition, some are based on budgeted costs and some are based on actual costs.

The Controller states in his response that "The Controller issues technical instructions to guide departments in proposing fee increases and fee revenues in their budget." However, the Budget Analyst notes that these technical instructions do not provide information on developing indirect cost rates for those departments for which the Controller has not provided a rate calculation. Out of 70 departments (and divisions) for which the Controller records an overhead rate, the Controller's Office calculated only 18 rates for FY 2002-03. The remaining 52 departments or divisions either calculated their own rates, or rates have not yet been determined. For departments that calculated their own rates, the Controller's Office does not offer formal policies or training to departments regarding indirect cost allocation principles or methodologies. According to an analyst in the Controller's Budget and Analysis Division who works with fee administration, the check for reasonableness consists of reviewing individual cost computations to ensure that the rate prepared by the department is "reasonably accurate".

The Controller states in his response that "The Controller believes the City uses appropriate methodologies for calculating departmental indirect cost rates. It would not be reasonable to require MUNI Railway, the Public Utilities Commission, the Airport, the Department of Public Works and others with very different 'businesses' to use one consistent methodology when various ones are legally available and maximize revenue.'

We concur with the Controller that departments such as MUNI, which has a contract with an outside consultant to develop their departmental indirect cost rates in compliance with A-87 guidelines, should continue to use their current methodology. Our recommendation is to develop clear and consistent policies and procedures for the calculation of departmental overhead rates, using actual costs rather than budgeted costs. In our analysis of the 11 highest revenue producing user fees in the City, indirect cost methodologies varied. Two of these eleven fees, charged by the County Clerk's Office, applied an indirect cost rate that was calculated by the department based on budgeted costs. Five fees charged by the Department of Public Health's Food program applied an indirect cost rate that was calculated by the department based on actual costs. The remaining four fees, charged by County Medical Examiner and the Fire Department, applied indirect cost rates that were calculated by the Controller using budgeted costs. These 11 fees represented $6.5 million in fee revenues in FY 2002-2003.

As is illustrated in this small sample of high revenue generating fees, the indirect cost rate methodology managed by the Controller's Office is highly inconsistent and allows potential for inaccuracies. The Controller's Office methods of calculating indirect cost rates are inefficient, as some departments calculate their own rates using actual numbers and some departments use budgeted numbers. Similarly, the Controller's Office, when calculating rates in-house, uses both budgeted and actual numbers, depending on what is available. Such discrepancies could yield entirely different indirect cost rates. Such differences could result in over-charging for fees and potential legal liability, and some could result in under-charging for fees and lost revenue to the City.

For example, the Controller's Office calculates a departmental overhead rate for the Police Department from budgeted costs (not actual costs) included in the Annual Appropriation Ordinance. The Police Department's rate is calculated at 22.55 percent for FY 2002-03. The rate was obtained by dividing their total Operations and Administrative budget of $49,667,012 by total salaries and benefits (less administration salaries and benefits) of $220,293,945. However, in some instances budgeted costs differ significantly from actual costs. In the Police Department's Operations and Administrative budget, costs were $1.36 million dollars less than actual costs in FY 2001-02, and $4.49 million dollars less in FY 2002-03. If actual costs had been used in the indirect cost rate calculation, a significantly lower rate would have been produced. Thus, if the Controller sets the indirect cost rate too high, as is evident in this example, the Police Department might be overcharging for its fees, a potential legal liability for the City.

The Controller's Office has no involvement with the analysis or application of indirect cost rates for grants. The Grants Management Unit only checks to ensure the completeness of grant documentation before grants are forwarded to the Board of Supervisors for approval. The Controller's Office does not certify that provisions for appropriate indirect cost reimbursement are included in grant budgets, pursuant to Section 10.170-1 of the Administrative Code.

The Controller's Office should develop consistent policies and procedures for calculating departmental indirect cost rates. The Controller's Office should also perform analyses of grant budgets to determine whether indirect cost amounts are accurate; and, if not included in the grant budget, that such costs are accurately disclosed. While it is a policy matter for the Board of Supervisors to decide whether grant applications should include indirect costs (if allowable), the Controller's Office should ensure that the Board of Supervisors has complete information prior to grant approval.

The Controller should:

10.1 Develop clear and consistent policies and procedures for the calculation of departmental overhead rates, using actual costs rather than budgeted costs;

10.2 Develop standards to determine when individual programs or divisions require individual indirect cost rates, or whether department-wide rates are sufficient;

10.3 Develop and disseminate procedures for departments to follow when calculating indirect cost rates. Such procedures should mirror Controller's procedures for calculating indirect cost rates;

10.4 Develop procedures for the Controller's Office to certify that provisions for appropriate indirect cost reimbursement are included in the grant budget, as pursuant to Section 10.170-1 of the Administrative Code; and,

10.5 Require that all indirect costs be disclosed on the Grant Information Form, even if costs will not be paid by the grantor. This will enable the Board of Supervisors to make a more informed decision regarding how grant money should be allocated and whether administrative costs should be absorbed in order to benefit the direct program costs.

There would be no new costs to implement these recommendations.

The recommendations would increase the Controller's ability to manage indirect cost rate development. Additionally, the recommendations would ensure that the Controller's Office provides full disclosure of indirect costs associated with grant administration to the Board of Supervisors.

11. Cost-Based Fees for Service

In FY 2002-03, the City and County of San Francisco generated approximately $77.4 million in fee revenue, and departments estimate fee revenues will generate $81.2 million in FY 2003-04. Some of these fees are set by statute while others are set based on market rates. A significant number of these fees are cost-based.

San Francisco City Charter Section 3.105 charges the Controller with the responsibility to provide "general supervision over the accounts of all officers, commissions, boards and employees of the City and County charged in any manner with the receipt, collection or disbursement of City and County funds." As an extension of this general mandate, the Controller has established some procedures for tracking, controlling and annually evaluating cost-based fees charged by the departments.

Despite these efforts, the Controller's Office has not yet compiled a comprehensive fee schedule for information or control purposes, nor has the Office provided City departments with written standards or procedures to ensure that fees are annually reviewed or consistently analyzed based on generally accepted cost accounting principles. Further, no criteria have been established to guide departmental fee-setting, so that costs are accurately computed and maximum revenue is recovered.

To better control and manage fee development and analysis throughout City departments, the Controller should create, publish, and actively maintain a master fee schedule of all fees charged in the City. A comprehensive fee schedule will act as a tool to record and analyze extensive fee information. Such a control document would therefore allow administrators and policy makers to manage the fee development process with more accurate and timely information. Additionally, a master fee schedule would provide the public with more timely information about fees. It is imperative the Controller establish a master fee schedule as a basis for a comprehensive fee analysis and review, as mandated by the City Charter.

Section 3.7 of the Administrative Code requires departments to submit a comprehensive schedule of fees and estimates of fee revenue with each year's budget submission, except for fees regulated by federal or State law. In the Controller's Technical Instructions for Budget Year 2003-2004, the Controller requested all departments that budget revenue from licenses, permits, fines and or service charges to complete and submit to the Controller's Office a "Form 2b." Form 2b contains a brief description of the fee, authorizing Code citation, whether the authorizing code provides for an automatic CPI adjustment, sub-object number, index code, fee per unit in previous year, estimated quantity in units for the previous year, estimated percentage of the overall cost of the service recovered in the previous year, proposed fee per unit of service, estimated quantity in units for the budget year, estimated percentage of the projected cost of the service in the budget year that will be covered by the proposed fee, the date of the last increase, and the fee prior to the last increase. In the Budget Technical Instructions, the Controller stated that all departments were required to submit a completed Form 2b to the Controller's Office by Friday, January 10, 2003.

The Controller's Office was unable to provide the Budget Analyst staff with exact receipt dates of submitted Form 2b's. However, by March 13th, 2003, only 21 of 35 applicable departments had submitted a Form 2b to the Controller's Office. Two other departments submitted general fee information to the Controller by March 13th, but not on the Form 2b. Instead, these two departments submitted less formal analysis and fee proposals. Out of the 21 Form 2b's submitted by March 13th, only 14 departments included cost recovery analysis, as specifically requested on Form 2b. Cost recovery and other fee analysis was obtained from 10 departments directly by the Budget Analyst's Office, after the Controller's Office was unsuccessful in obtaining documents directly from departments.

The Controller states that "We have repeatedly reminded departments of this requirement; however, some have not complied." Although we understand the difficulty in gaining cooperation from some City departments, the Budget Analyst was able to get information from departments by assertively calling and following up with departments for information. We believe that the Controller should take a more assertive stance toward obtaining such information from departments.

Since a comprehensive fee analysis or schedule has not been presented to the Board of Supervisors on an annual basis, the Board of Supervisors has not been provided with a regular opportunity to consider the question of full cost recovery for many City departments. As a consequence, the Board of Supervisors' fee policies for City department activities are inconsistent. Further, policy decisions by the Board of Supervisors to determine which fees should fully recover cost and which fees should be subsidized by the General Fund or other funding sources, have not been made on a City-wide basis.

The Controller's Office should annually produce and maintain a comprehensive fee schedule, which can be used as a control document to ensure that fees are appropriately evaluated and submitted for consideration by the Board of Supervisors each year.

In addition, the Controller should establish and disseminate written criteria, standards and procedures for cost-based fee analysis to all City departments. Such procedures should provide methods for compiling direct costs, analyzing and applying indirect costs, and analyzing cost recovery information. Included within the Controller's responsibilities of overseeing fee administration is cost analysis. As the Chief Financial Officer of the City, the Controller's Office should be the authoritative agency in determining costs of departmental fees. However, the Controller's Office does not determine or develop the cost of fees. Rather, such determinations are left to the operating departments. Further, the Controller's Office does not provide procedures or guidelines to City departments in terms of determining the cost of fees. Departments independently determine the cost of providing services with no training or guidance from the Controller's Office. Some departments find determining the cost of fees to be difficult.

For example, legislation to require a license for fortunetellers was proposed by the Board of Supervisors in November of 2002. The Police Department's Permits Division was charged with determining direct costs of the fortuneteller license fee. The cost of the license was calculated and submitted to the Controller by the department at least three times over the course of several months. Each time, the Controller's Office checked for the "reasonableness" and then certified the fee. However, the cost of the fortuneteller license ranged from $240 to $295 and the direct costs associated with providing a fortuneteller license ranged from $188 to $33,957 amidst the three cost submissions. Each submission was subsequently certified by the Controller's Office and forwarded to the Budget Analyst's Office for a budget analyst report. The Controller's Office was not involved with the calculation of the direct costs. Rather, the Controller's Office only checked such costs for reasonableness. Clearly, the calculation of direct costs was unreliable, if not inaccurate.

The Controller states that "the Analyst points out that proposed fees related to a particular project—licensing of fortunetellers—changed dramatically over the course of several months. The report implies that these changes mean that the numbers were incorrect in the earlier versions and not caught by the Controller. As we pointed out to the Analyst, the program's parameters changed considerably over the course of the Board's deliberations so it is not surprising the costs also changed." The Budget Analyst agrees with the Controller that the proposed fee was initially submitted as a one-time fee, and then was resubmitted as on ongoing fee. However, the Police Department submitted three different fee proposals for the ongoing fee with very different cost estimates for a program with consistent service parameters. Although the Controller attested to the reasonableness of each fee proposal, the Controller did not review the expenditure estimates supporting the fees.

The Police Department acknowledges that its staff have insufficient background calculating direct costs, and often uses time and motion studies that have not been reviewed since the mid-1980s, as their basis for current fee costs. With no training or expertise provided by the Controller's Office, departments must estimate costs to the best of their ability. But as in the case of the Police Department, such estimates can be highly inaccurate. Such inaccuracies can lead to over or under charging of fees.

Likewise, the Controller's Office has not established a consistent methodology for calculating indirect cost rates to be applied towards departmental fees. In some cases, the departments calculate their own indirect cost, or overhead rate, and the Controller checks for the reasonableness of their rates. For the remaining departments, the Controller has three different methods for calculating departmental overhead, some of which are calculated by program, some by department. Some are calculated using budgeted numbers, some are calculated using actual numbers. These inconsistent methods are discussed in more detail in Section 10 of this report.

Many City departments were unable to provide or compute a cost recovery analysis for individual fees. Therefore, it is not clear whether departments currently possess the tools or expertise to determine those fees which fully recover costs. The departments' general difficulties conducting full cost recovery fee analyses results in an inability to fully advise the Board of Supervisors with information regarding the need for General Fund discretionary program support. The Controller should provide procedures and guidance for these departments. In the absence of such guidance, several issues can arise.

The potential exists for some City departments to be overcharging for their services. For example, in a memo dated April 15, 2003 written to the Budget Analyst from the Assessor/Recorder, department staff indicated that a cost recovery analysis of services has not been conducted. Yet, based on documentation provided by the Assessor/Recorder's Office, the FY 2002-2003 projected actual revenue from fees is nearly double the budgeted amount, even though the Assessor/Recorder's Office budgeted fee revenue equal to the full recovery of fees. Therefore, it appears very possible that the Assessor/Recorder's Office is in excess of full cost recovery for services. In the absence of detailed cost recovery analyses, it may prove difficult for the City to defend against litigation that may claim that fees are generating more than the cost of providing services. Therefore, the development of a full cost recovery plan should be required and reviewed by the Controller's Office for all City departments.

There is also a significant cost to the City that results from undercharging, or not fully recovering the costs of providing services. In a small sample of nine City departments, our research indicates that City departments could collect an additional $4.2 million in revenue, assuming the selected fees were set at full cost, or 100 percent recovery. The analysis was adjusted to consider a more conservative list of 34 fees in six departments, where increases were not considerable, thus a more realistic analysis. The additional revenue in this narrowed sample of fees would still be approximately $880,000 annually for the City[1]. The Controller's Office should ensure that complete cost recovery analysis is presented to the Board of Supervisors and all City Commissions that have fee-setting authority. Full cost recovery analysis is essential to understand the degree to which discretionary resources are being used to subsidize services.

The Controller states that "the Board has had full information about the major fees the Analyst recommends be raised to full cost recovery and made the decision not to do so." Although not subject to Board of Supervisors approval, the Municipal Transportation Authority approved an increase of the Tow Administration Fee from $30 to $50 based on a proposal presented by the Department of Parking and Traffic to increase the fee to $50. However, the actual fee required for 100 percent cost recovery equals $59.24, which was not presented to the Municipal Transportation Authority for approval. The Board of Supervisors approved the Medical Examiner's Removal of Remains and Storage of Remains fees during the FY 2002-2003 budget review based on a proposal of $175 and $50 respectively, which were less than cost recovery. The Budget Analyst's report to the Board of Supervisors identified that these fees were below cost recovery. However, neither the department nor the Controller independently provided that information to the Board of Supervisors. The Street Artist fee increase is pending before the Board of Supervisors. The Budget Analyst will present a report to the Board of Supervisors which identifies that these fees will be below cost recovery.

[1] The Budget Analyst notes that one of the departmental fees included in this analysis, the Street Artist's Certificate Fee, is proposed for an increase and is pending before the Board of Supervisors. Such proposed fees do not fully recover costs.

Comparatively, in some instances where the Budget Analyst was able to conduct full cost recovery analyses, it was clear there may be valid policy reasons for not increasing fees to full cost recovery levels. For instance, the Board of Appeals attempted to implement a fee increase of approximately 105 percent per fee for FY 2003-2004. Such proposed fee increases would only recover approximately 29.4 percent of these costs, based on total FY 2003-2004 costs of $433,534 and fee revenue projections of $127,459. According to the Board of Appeals, the Board of Appeals did not propose to increase their FY 2003-2004 fees to be 100 percent cost recovery because such fees would be prohibitively high. According to the Board of Appeals, significantly higher Board of Appeals fees would discourage ordinary residents, neighborhood associations, business operators and other individuals, other than the most wealthy, from having access to the administrative review process that the Board of Appeals offers for appealing City permits and other department actions.

The Controller commented on statements in our report related to a fee proposal submitted by the Planning Department which would have recovered revenues far in excess of costs. In his response, the Controller stated "Finally, the Analyst has stated that the Budget Committee placed $1.38 million of Planning department fees on reserve since they were 'illegal.' The Controller is not aware of any determination that these fees were illegal, though was aware that as of the time of the Board's review the department had not provided to our office the necessary fee materials for review."

The Budget Analyst notes that the Planning Department proposed fee increases in the FY 2003-2004 budget, resulting in cost recovery ranging up to 493 percent, clearly violating California Government Code Section 66016. The Controller's Office repeatedly stated that they were not involved with the Planning Department's FY 2003-2004 fee proposals. Because the Planning Department's FY 2003-04 budget was balanced on illegal fee proposals, the Budget Committee placed $1.38 million of the Planning Department budget on reserve, pending receipt of proper fee analysis.

By (a) establishing formalized control mechanisms; (b) creating formal fee development criteria, standards and procedures; and, (c) monitoring compliance and reporting to the Board of Supervisors, the City and County would be provided greater assurance that fees recover full costs, when appropriate. If a sample of only six Departments increased a total of 34 fees to full cost recovery levels, the City could generate at least $880,000 in additional fee revenues annually.

The Controller's Office should:

11.1 Develop and maintain a Master Fee Schedule for all City Departments to be reviewed on an annual basis;

11.2 Develop and disseminate written procedures to City departments detailing methodologies for direct costs, indirect costs, and cost recovery analysis for fees;

11.3 Provide training to City departments on fee cost analysis methodology and cost recovery analysis;

11.4 Continue to work with Departments to ensure that analysis of cost recovery is conducted for each individual fee; and,

11.5 Provide quality control by reviewing fees submitted to the Board of Supervisors for conformity with State law, City policy, and cost accounting guidelines.

City Departments should:

11.6 Work cooperatively with the Controller's Office to analyze fees, analyze cost recovery, and develop recommendations for fee changes.

These recommendations can be accomplished within the normal management responsibilities of the organization. Our recommendations would increase the Controller's ability to analyze fee revenues and, therefore, forecast more accurate revenues for the City. In a small sample of total cost recovery of fees in six departments, we estimate that the City could generate at least an additional $880,000 annually.

12. Monitoring Claims for State-Mandated Costs Reimbursements

The Controller contracts with an outside contractor for the preparation and submission of the City's mandated cost claim to the State. The Controller oversees the claiming activities performed by the contractor. The Controller's Office does not exercise sufficient oversight over the City departments, which file claims for reimbursements for State-mandated programs, known as the SB 90 program. The Controller's Office does not monitor the quality of the SB 90 claims prepared and submitted by the contractor.

In his written response to our recommendations, "The Controller agrees that a written report on the City's SB 90 claims with more detailed information would be informative and will make such a report available to the Board of Supervisors. However, the Controller disagrees with the Analyst's assertion that the City has lost significant revenue and may be subject to auditing and disallowance of costs."

The Budget Analyst does not assert that the City has lost significant revenue. However, the Budget Analyst believes that errors in the filing of SB 90 claims could result in the disallowance of claim costs by the State Controller's Office. The Controller's Office does not monitor the quality of the SB 90 claims prepared and submitted by the contractor. A review of four SB 90 claims, filed by the Controller with the State for FY 2001-2002, revealed inconsistent methodology and errors in the claims. For example, the contractor used a methodology for calculating the Election Department's indirect cost rate that was inconsistent with the methodology used for other departments' indirect cost rates. The Budget Analyst estimates that the City would have received an additional $21,000 in departmental indirect cost reimbursements for the Absentee Ballot program if consistent methodology had been used.

The management audit also found errors in the calculation of hourly staff rates. These errors resulted in inaccurate amounts being claimed for reimbursement and could result in the disallowance of claim costs by the State Controller's Office during a desk audit. Specifically, the management audit found multiple errors in the actual calculation of productive hourly rates for the Mandate Reimbursement Process, the Domestic Violence Arrest Policies and Standards program, and the Peace Officers Procedural Bill of Rights program. We reviewed the average hourly productive rates for Election Department positions, which were mostly temporary positions, and found them to be generally accurate. However, we reviewed 26 positions, for which claims were filed under the Peace Officers Procedural Bill of Rights program, the Mandate Reimbursement program, and the Domestic Violence Arrest Policies and Standards program and found errors in the calculation of productive hourly rates for nine of the 26 positions reviewed, or an error rate of 35 percent.

- One principal administrative analyst pay rate was entered into the claim as $31.22 per hour when the actual rate was $46.99;

- One police officer III position was entered into the claim as a police officer II;

- Seven positions had hourly pay rates entered into the claim form which differed from the hourly rate reported by the Department, although the reason for the difference was not identifiable.

In FY 2001-2002, the City filed reimbursement claims for 31 State-mandated programs out of 54 eligible programs. Although the contract with DMG Maximus, the contractor responsible for assisting City departments in preparing and submitting SB 90 claims to the State for reimbursement, requires documentation of the reasons that City departments do not file SB 90 claims, the Controller's Office has not required the contractor to provide such documentation, nor does the Controller have such documentation.

Audits of SB 90 claims in two other California counties suggest that San Francisco could increase total SB 90 claims reimbursements by reviewing claims to ensure that all allowable costs are captured and that all possible claims are filed. A review of FY 1999-2000 Santa Clara County claims found that reimbursements could be increased by $1,610,256 and a review of FY 2000-2001 San Bernardino County claims found that claimed reimbursements could be increased by $621,000. The Controller should conduct a post claim audit of FY 2002-2003 SB 90 claims to ensure that all allowable costs are captured and that claims are filed for all applicable mandates.

Further, the Budget Analyst identified State-mandated services provided by San Francisco for which claims were not filed. The Budget Analyst estimates that, based on the claims filing experience of other California counties, San Francisco could receive at least an additional $95,000 in State reimbursement revenue annually by filing SB 90 claims for these services.

The Controller states in his response that "Finally, we do not agree with the Analyst's speculation that the City would save money by bringing the SB 90 filing in-house." The Budget Analyst does not speculate that the City would save money by bringing the SB 90 filing in-house. Rather, the Budget Analyst has recommended that the Controller develop a quality improvement program to assure the standardization and quality of cost claims. Alternatively, the Controller's Office could bring the work of claims processing in-house, and allocate a position in the Controller's Office to work with departments to track, process and submit claims. If the Controller's Office decides to terminate the contract with the contractor to prepare SB 90 claims and to bring the work in-house, the savings for terminating the contract will likely offset the increased personnel costs for performing the work in-house. It should be noted that all costs, whether contract or in-house, are fully reimbursed by the State.

The Controller's Office should:

12.1 Develop a quality improvement program to assure the standardization and quality of cost claims, including conducting audits of claims;

12.2 Alternatively, bring the work of the contractor in-house to exercise increased oversight over the SB 90 claims preparation and submission process;

12.3 Develop a reporting system for all City departments regarding which claims are filed and not filed. Document the reasons for not filing claims for all State-mandated programs applicable to San Francisco, and submit an annual written report to the Board of Supervisors regarding which claims are filed and the reasons for not filing claims and,

12.4 Conduct a post-claim audit for FY 2002-2003 and adjust future claims appropriately.

If the Controller's Office decides to terminate the contract with the contractor to prepare SB 90 claims and to bring the work in-house, the savings for terminating the contract would likely offset the increased personnel costs for performing the work in-house. In addition, these costs are reimbursed from the State. If the Controller's Office works with City departments to ensure that all applicable SB 90 claims are filed, the estimated increased annual revenue to the City would be at least $95,000.

13. Audits Division Productivity

The Administrative Code charges the Controller's Office with establishing an auditing function to monitor the economy and efficiency of departments and agencies of the City and County of San Francisco.

The Audits Division does not complete all planned audits and tasks included in its Audit Schedule. If unnecessary and obsolete mandates were eliminated from the Audit Plan, then the division could refocus on more valuable audits including Payroll audits.

The Audits Division is not meeting the same level of productivity as other county and city auditors responding to the National Association of Local Government Auditors' (NALGA) Benchmarking and Best Practices Survey, and management does not manage and limit training and time reporting as closely as it should. The Division's Time Distribution Reports show that for fiscal year 2002-2003, the Controller's audit staff spent on average 61.6 percent of the time reported on timesheets on audit and project work. Training and professional development accounted for 6.1 percent of the time reported, other general tasks and administration accounted for 14.7 percent of the time reported, and leave from work accounted for an additional 17.6 percent of time reported.

The Controller states in his response that "The Analyst has selectively used the second measure of productivity where the Division's usage time is 62% as compared to the average of 65%." The measure used in the Budget Analyst's report is consistent with the NALGA methodology, and was chosen because the Controller's Office timesheets do not segregate work hours in a manner that permits reliable comparison using the alternative measure reported by NALGA. Nonetheless, as shown in Table 13.1 of the report, the Controller's Office Internal Audit staff achieved a productivity of only 74.8 percent in FY 2002-03 compared to an average reported by the NALGA survey respondents of 76 percent, using the alternative methodology that the Controller cites in his response.

Further, Audits Division staff received an average credit of 62 hours of training for fiscal years 2001-02 and 2002-03. This is 55 percent more than the minimum requirements for training of audit staff. In addition, the Audits Division reported more training hours than required to meet continuing professional education hours. The inclusion of informal training hours increases the Audits Division reporting of training hours to 87 hours per auditor for FY 2002-2003, which is more than double the minimum standard of 40 hours per year for government auditors.

The Controller states in his response that "The Controller believes that well-trained staff are more efficient in their work and that additional training of staff is particularly warranted by the fact that 60% of the audit staff have been with the office for less than three years. He also believes the minimum training requirement should not be viewed as a standard or cap." The Budget Analyst agrees that the minimum training requirement should not be viewed as a "standard or cap." Nonetheless, it is an accepted industry benchmark which can be used to gauge acceptable levels of training in an audit organization. Although the Budget Analyst believes that training is essential for City employees, the fact that Controller's Office Internal Audit staff averaged double the number of hours included in the industry benchmark, with some individuals receiving as much as two and a half times the minimum number of training hours in a single year, is questionable. Combined with the statistics showing that productivity is below the average in other similar public sector audit organizations, we have recommended that the Controller increase productivity and strive toward the higher end of the productivity range reported by NALGA survey respondents.

At least one respondent to the National Association of Local Government Auditors' Benchmarking and Best Practices Survey reported productivity of 77 percent or more. The Audits Division's current level of productivity is 15.4 percent less than 77 percent. The 15.4 percent difference in productivity is equivalent to 2.65 FTEs for FY 2002-2003. The loss of 2.65 FTE in productivity is equivalent to salary costs of $220,895 based on the average salary for audit staff.

In response to this finding, the Controller stated that "Further, the Analyst concludes that the Internal (Audit) Division should be measured against a target of one standard deviation from the mean of responders and calculates a savings from a 77% productivity number on the second measure. This is a questionable methodology." The standard deviation is an accepted statistical test which can be used to determine where individual sample results fall in relation to the mean (or average). As stated in our report, like an average, the standard deviation provides a statistical indicator of relative performance within a sample population. Because detailed survey responses were not available to determine exactly how each jurisdiction reported performance, we used the standard deviation to estimate the degree to which high performers reported productivity above the average. We believe this measure is appropriately used in the context of the report recommendations.

The Controller should:

13.1 Evaluate the risk associated with the current mandates of the Audits Division;

13.2 Prioritize the mandates and request the Board of Supervisors to eliminate any unnecessary mandates;

13.3 Reduce training to required and/or necessary hours;

13.4 More closely monitor training hours in order to maintain appropriate and necessary training hours and prevent over use of training hours;

13.5 Improve productivity; and

13.6 Expand the number of audits for which it directly charges City departments to recover full costs for audits performed

There are no costs associated with increasing productivity or decreasing training hours to a more reasonable level. Increased efficiency in the Audits Division would result in more audits performed of City departments, funds, vendors and contractors.

We would like to thank the Controller, his staff and various representatives from City departments for their cooperation and assistance throughout this management audit.

Respectfully submitted,

Harvey M. Rose
Budget Analyst

Cc: President Gonzales
Supervisor Ammiano
Supervisor Daly
Supervisor Duffy
Supervisor Ma
Supervisor Maxwell
Supervisor McGoldrick
Supervisor Peskin
Supervisor Newsom
Supervisor Sandoval
Mayor Brown
Clerk of the Board
Edward Harrington, Controller
Ben Rosenfield
Ted Lakey

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Introduction

This *Management Audit Report of the San Francisco Controller's Office* was authorized by the Board of Supervisors of the City and County of San Francisco on May 13, 2003, pursuant to its powers of inquiry defined in Charter Section 16.114. Motion Number M03-81 directed the Budget Analyst to "conduct a management audit of the Controller's Office on a priority basis." The stated purpose of the management audit was "to ensure that the entity providing advice and counsel to other City departments about efficient management and performance (the Controller) is itself managed efficiently and performs efficiently . . ."

Based on the Board of Supervisor's discussion and the wording of motion number M03-81, the Board of Supervisors requested this management audit pending consideration by San Francisco voters of a Charter amendment to assign the Controller with the responsibilities of the "City Services Auditor." If approved by the voters, this Charter amendment will significantly expand the Controller's duties and responsibilities for monitoring the level and effectiveness of services rendered by the City and County of San Francisco to its residents. The measure also will require the Mayor and the Board of Supervisors to allocate 0.2 percent of the City's annual budget, apportioned by fund, for a Controller's audit fund. Based on the ballot measure analysis prepared by the Controller, this would equate to an allocation of $8,505,037 in FY 2003-2004, or $5,330,037 more than was appropriated for Controller audit related activities in the current year.

Because the motion to conduct the management audit was approved by the Board of Supervisors just prior to the beginning of the City's annual budget hearing cycle, the Controller indicated that he would not be prepared to participate in the management audit during May or June. Accordingly, he suggested that the project be postponed until July 2003. In deference to the Controller, the Budget Analyst delayed the entrance conference until July 1, 2003 and began field work immediately thereafter. The draft management audit report was completed and provided to the Controller for review, approximately eight weeks later, on August 27, 2003. A final report was submitted to the Board of Supervisors on September 9, 2003.

Purpose and Scope

The purpose of this management audit has been to examine the operations, management practices and finances of the Controller's Office, and to identify opportunities to increase the department's efficiency, effectiveness and economy. The scope of the management audit included a review of all of the divisions within the Department, including:

- Accounting Operations and Systems;
- Payroll and Personnel;
- Finance and Administration;
- Budget and Analysis;
- Internal Audit;
- Performance Management; and,
- City Projects.

Audit Methodology

As part of this management audit, the Budget Analyst interviewed the Controller, Deputy Controller and managers from each of the seven divisions in the Department; section managers; and, selected unit managers and staff. The Budget Analyst also interviewed representatives from other City and County Departments, responsible Controller officials from other jurisdictions, and representatives from the State Controller's Office who have certain regulatory responsibility over Controller activities.

In addition to interviews, the Budget Analyst reviewed the City Charter, various State statutes and local codes; examined various documents, reports and work products prepared by the Controller's Office; reviewed the audited financial statements for the City and County of San Francisco, including the management letters prepared by the outside auditors for each of the last three fiscal years; obtained and analyzed various data and financial reports from the City's FAMIS accounting system; and evaluated the effectiveness of the various tools used by the Controller, his managers and staff to oversee the activities of the organization.

The management audit was conducted in accordance with *Government Auditing Standards, 1994 Revision,* by the Comptroller General of the United States, U.S. General Accounting Office. In accordance with these requirements and standard management audit practices, we performed the following management audit procedures:

- Audit Planning – A preliminary management audit workplan was developed and provided to the Department, which generally defined the scope of review.

- Entrance Conference – An entrance conference was held with the Controller and his upper management personnel to introduce the management audit staff, describe the management audit program and scope of review, and respond to questions. A letter of introduction from the Budget Analyst, the management audit work plan, and a request for background information about the Department's operations were provided prior to the entrance conference meeting.

- Pre-Audit Survey – Interviews with key management personnel and a preliminary review of documentation provided by the Controller's Office were conducted to obtain an overview understanding of the Controller's Office, and to isolate areas of operations which warranted more detailed assessment. Based on the pre-audit survey, the work plan for the management audit was refined for internal use by the Budget Analyst.

- Field Work – Field work activities were conducted after completion of the pre-audit survey, and included: (a) interviews with managers, supervisors and staff; (b) a further review of documentation and other materials provided by the Controller's Office; (c) analyses of data collected manually and from the Controller's automated systems and records; and, (d) contacts with other jurisdictions and authorities outside of the City and County.

- Status Reporting – Periodic status meetings were held with the Controller, the Deputy Controller and the Controller's designated project liaison to describe the study progress and provide general information on our preliminary findings and conclusions.

- Draft Report – A draft management audit report was prepared and provided to the Controller for review and quality assurance purposes.

- Exit Conference – An exit conference was held with the Controller and his designated managers to collect additional information pertinent to the report, and to obtain the Controller's views on the report findings, conclusions and recommendations.

- Final Report – A final report was prepared after review and discussion of the report content with the Controller and his management staff. The Controller was requested to provide a written response to the report, which is attached.

Description of the Services Provided by the Controller's Office

The Controller is responsible for various duties and responsibilities defined in State law, the Charter of the City and County of San Francisco, and various local codes approved by the Board of Supervisors. The Controller's core powers and duties are defined in Charter sections 3.105, 9.101, 9.102, 9.105, 9.111, 9.113, 9.116 and 13.107, related to financial management, revenue certification, analysis and reporting to the Mayor and the Board of Supervisors. Other powers and duties are included elsewhere in the Charter.

The Controller's website states that, "The Controller is responsible for all financial management systems, procedures, internal control processes and reports that disclose the fiscal condition of the City to managers, policy makers and citizens. The Controller is also the auditor for the City and County, performing financial and performance audits of departments, agencies, concessions and contracts. In furtherance of these Charter-mandated functions, the Controller's Office provides a variety of support services. These include processing the City's budget, developing and maintaining a financial accounting information system for use by all departments, and preparing and distributing paychecks for all City employees." The Controller's stated mission is to "ensure the City's financial integrity and promote efficient, effective and accountable government."

In FY 2003-2004, the Board of Supervisors authorized total operating expenditures of $22.3 million for the Controller's Office. The Department is authorized 161 staff (142 budgeted staff), who were assigned to the seven major divisions of the department. The FY 2003-2004 budget reflects reductions in the staffing resources available to the Controller's Office in prior years. The Controller's Office was required to reduce the department's operating budget $954,660 below final budgeted levels in FY 2002-2003 (year-to-year comparison). These reductions reflected the net impact of (a) the transfer of the automated purchasing system from the Department of Administrative Services, which increased the Controller's budget by 4.0 FTE positions; and, the elimination of a total of 14 positions from Payroll and Personnel Services, Management, and Budget and Analysis. An additional four FTE positions were reduced from attrition savings.

Table 1

San Francisco Controller's Office Comparison Between FY 2002-03 FY 2003-04 Authorized Expenditures

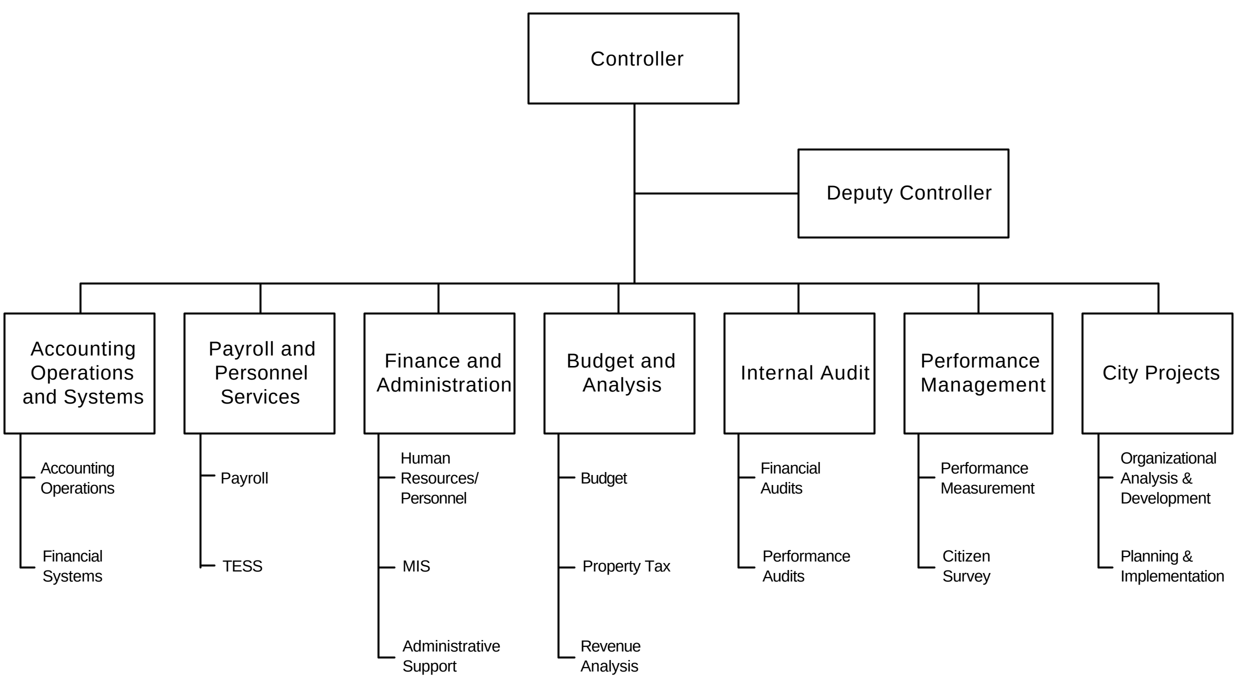
	FY 2002-03	FY 2003-04	Difference
Salaries	9,689,204	10,382,455	693,251
Mandatory Fringe Benefits	2,177,438	1,819,477	(357,961)
Non Personal Services	1,748,874	1,331,315	(417,559)
Materials and Supplies	300,688	245,674	(55,014)
Capital Outlay	-	60,000	60,000
Services of Other Departments	7,501,409	7,742,006	240,597
Citywide Special Projects	726,508	717,113	(9,395)
Citywide Performance Audit Project	632,115	-	(632,115)
Time Entry Project	476,464	-	(476,464)
Total Expenditure Appropriations	23,252,700	22,298,040	(954,660)

Source: Consolidated Budget and Appropriation Ordinance

The following organization chart illustrates the structure by division within the Department, during the period of the audit.

Exhibit 1

San Francisco Controller's Office Functional Organization as of June 2003



A brief description of each of each primary organizational division is provided below:

Finance and Administration

This division includes the Controller, the Deputy Controller and various administrative staff who provide a wide array of support services for the Department. Through the Controller, the division provides general fiscal oversight for the City. The division also responds to information requests from the Mayor, Board of Supervisors, concerned citizens and the press.

Accounting Operations and Systems

This division's responsibility is to control the financial activities of the City. The division is charged with certifying contracts; paying vendors; approving and reviewing personnel requisitions; and, monitoring, controlling and projecting departmental expenditures on a continuous basis to assess the City's overall financial condition. The division is also responsible for assisting departments with fiscal compliance, accuracy, timeliness and meaningfulness of financial information, and for producing the City's annual financial statements.

Payroll and Personnel Services

This division provides payroll and personnel services for 27,000 City employees, and ensures compliance with City, State and federal tax, wage and hours regulations. The division receives and processes large volumes of automated input and over 160,000 paper documents annually which result in the issuance of about 800,000 paychecks.

Budget and Analysis

The division provides general fiscal oversight and financial analysis for the City. Its staff prepares the City's budget, bond official statement information, and bond secondary disclosure data. In addition to expenditure reports and cost analyses, the division tracks, projects and reports on all the City's revenue items, and performs property tax allocations. The division also prepares six and nine month financial projection reports, and a joint three year financial projection with the Mayor and the Budget Analyst.

Internal Audit

The Internal Audit Division provides performance, financial, investigative and concession audits and reviews of City operations as a service to the City's boards, committees, commissions and departments. The division reports findings of its audits to the Mayor, Board of Supervisors, Civil Grand Jury, commissions, and department management.

Performance Management

The Performance Management Division works with departments to develop performance measures and tracking mechanisms. The division also coordinates the annual survey of citizen's opinions of City services, and trains managers to administer the Pay-for-Performance program.

City Projects

The City Projects Division is charged with developing and implementing initiatives to increase the City's effectiveness in a wide variety of functional areas. City Projects staff works with City departments on problem solving and implementing audit recommendations. The division also conducts financial analysis of ballot measures, as required by the City Charter.

Controller's Office Accomplishments

Management Audits typically focus on opportunities for improvements within an organization. Therefore, Section 7.43 and Section 7.44 of the *Government Auditing Standards, 1994 Revision*, published by the United States General Accounting office, require that the management audit report include "noteworthy management accomplishments" to provide a more balanced perspective on operations.

Accordingly, this section of the Introduction summarizes some of the current noteworthy accomplishments of the Controller's Office. In order to allow the Controller to highlight those accomplishments he feels are the most noteworthy, the Budget Analyst requested and received a list of accomplishments from the Controller. This list of accomplishments is included with this report as Attachment I.

Some of the more noteworthy accomplishments of the Controller's Office are described below:

Expansion of the Controller's Role

During recent years, the current Controller's Office has assumed a greater analytical, management reporting and consulting role in the City. While many of these added functions have stemmed from requests made by the Mayor and the Board of Supervisors, others have resulted from the Controller's professional goals to enhance financial management and the performance of departments within the City. Although these activities are largely non-mandated, the efforts made by the Controller and his staff are commendable.

Implementation of GASB 34

The Controller's Office successfully converted to a new financial reporting model, pursuant to Governmental Accounting Standards Board (GASB) 34 provisions affecting financial reporting, a year before the required deadline. The conversion significantly changed the ways in which financial data is reported within the City's Comprehensive Annual Financial Report (CAFR), given the unique requirements of GASB 34. Further, the Controller's Office successfully implemented alterations to its financial reporting processes to meet the new accounting standards of GASB and provided training to all departments on the GASB 34 model. The Controller's Office received a *Government Finance Officers Association Certificate of Achievement* for these efforts.

Accountant Intern Program

The 1649 Accountant Intern Program that was devised by the Controller's Office, has been recognized as a successful mechanism for improving the quality of accounting personnel throughout the City. Designed, operated and maintained by the Controller's Office, the program was created to improve accounting staff training and abilities. The program offers beginning accountants extensive training for 18 months, with two 9-month rotations in different departments. Since its inception in 1995, the Intern Program has graduated 59 of 67 participants. Approximately 40 percent of those participants were already City employees when they entered the program.

Payroll and Personnel Services Division

The Payroll and Personnel Services Division has been successful in attaining its goals and meeting performance measures. The division met their 98 percent accuracy target in the disbursement of approximately 29,000 paychecks for each of the 27 pay periods in FY 2002-03. The Payroll and Personnel Services Division also successfully issued all W-2 forms to City employees within 14 days of the calendar year, approximately two weeks ahead of the deadline.

Budget and Financial Analysis

The Controller continues to produce monthly, 6-month and 9-month Budget Status reports that provide useful tools for City policy makers and financial managers. These reports provide reasonable projections of revenue and expenditure trends, and in combination with the three-year budget projection report prepared jointly with the Mayor and the Budget Analyst, provide the basis for assessing the overall financial health of the City and financial planning.

Budget Analyst Comments

In accordance with *Government Auditing Standards* Sections 7.45 and 7.46, certain issues identified during an audit may be brought to the attention of the department being audited and the Board of Supervisors, even though specific findings are not included in the report.

This Management Audit Report, prepared by the Budget Analyst, includes 13 findings and associated recommendations that encompass major areas of the Controller's operations. Included are findings related to the department's organization, financial management, budgetary controls, fund management, indirect costs, mandated cost claiming and internal audit.

As detailed in the appendix to this introduction, the report identifies at least $1.1 million in potential savings, including reduced costs and increased revenues annually, and one-time available resources of approximately $2.4 million. Additional resources and revenues would be realized if the recommendations in this report to conduct a full analysis and reconciliation of funds and cost reimbursement opportunities are adopted. Further, the report focuses on methods for improving internal controls and accomplishing other systemic improvements to the operations of the Department.

Discussed below are other operational issues for which we did not develop specific findings, but which are of particular note to the organization, its effectiveness, and various factors impacting its ability to function in an efficient and economical manner.

Focusing on the Department's Core Mission

During the last decade, the Controller's Office has changed its financial management approach. Previously, the Office functioned in a more traditional manner by focusing its efforts on the processing of accounting transactions and budget control activities. With the advent of on-line FAMIS and other system enhancements, the Controller has moved its focus away from this more traditional role. Today, much of the responsibility for processing financial transactions has been decentralized and placed with the departments. While the Controller has established systems to monitor financial administration activities performed by the departments, using automated audit functions within FAMIS and performing post-audit testing, there are opportunities to strengthen the department's performance in this area.

In recent years, the Controller has expanded his administrative role in the City. The Performance Management and City Projects divisions have been created and expanded in an attempt to provide oversight of Citywide management initiatives, such as the development of an effective performance measurement system and technical consulting services to departments. While commendable, the Controller's Office needs to refocus its attention on strengthening the mechanisms that will ensure that the City continues to operate in a sound financial environment. As we discuss in several findings, the Controller needs to develop formalized standards, policies and procedures for departmental fiscal personnel, and develop effective systems for monitoring departmental compliance.

Controlling Expenditures

The Controller has specific responsibilities related to the monitoring and control over department spending. Charter Section 3.105 states, "Should the Controller determine at any time during the fiscal year that the revenues of the General Fund, or any special, sequestered or other fund are insufficient or appear to be insufficient to support the remaining anticipated expenditures from that fund for the fiscal year for any department, function or program, the Controller shall reduce or reserve all or a portion of the expenditure appropriation until such time as the Controller determines that the anticipated revenues for the remainder of that fiscal year are sufficient to support the level of expenditure anticipated for the remainder of the fiscal year."

As part of this management audit, we reviewed the procedures and processes used by the Controller to monitor and control departmental expenditures. The Controller's Office uses a hierarchy of actions to control the budget, beginning with the reservation of funds during the budget process for those departmental accounts where there may be some uncertainty regarding revenues. When the Board of Supervisors adopts the Annual Appropriation Ordinance, the Controller enters monthly and quarterly spending allotments for all City departments. During the year, fund accountants will monitor departmental expenditures and work with department fiscal staff when it appears that expenditures may exceed budget. If over expenditure patterns become more evident, the Controller will place departments on "watch lists," require the development of expenditure plans, and may meet with department management on a regular basis to encourage budget compliance. If the Controller believes the over expenditure patterns cannot be resolved, he will report his projections to the Mayor and the Board of Supervisors in a special report, or as part of the standard 6-month and 9-month budget reports that he submits in the Spring.

The Controller asserts that his ability to stop departmental over spending is limited. He is unable to deny payroll obligations, including overtime if determined appropriate by department officials such as the Sheriff, Police Chief or Fire Chief; but, he can stop personnel requisitions and expenditures for equipment and non-essential services and supplies. Usually, such actions have minimal impact on the departments, since many personnel requisitions are already stopped by action of the Mayor, and other non-personnel expenditures are less problematic for departments.

Our assessment indicates that the Controller's procedures in this area are appropriate, and that resolution of historical over expenditure patterns by departments must be addressed more strategically. The development of a strategic approach to expenditure control issues that are apparent in the City was outside of the scope of this review.

Analysis of Ballot Measures

The Controller is also mandated to conduct "impartial financial analysis of each City and County ballot measure which shall include the amount of any increase or decrease in the cost of government of the City and County and its effect upon the cost of government. Such analysis shall be issued in sufficient time to permit inclusion in the voters' pamphlet."

As part of this study, we reviewed the analysis conducted for the November 2002 elections, evaluating assumptions and work papers, and conducting limited testing of the Controller's computations. We also evaluated the timeliness of reporting to Elections. We found the Controller's analysis reasonable and timely.

City Services Auditor

In November 2003, the voters in San Francisco will consider a ballot measure to assign the Controller as the "City Services Auditor." If passed, this measure will significantly expand the Controller's authority, duties and responsibilities for monitoring the level and effectiveness of services rendered by the City to its residents. This management audit did not evaluate the Controller's organizational capacity or ability to assume these expanded duties.

Acknowledgements

We would like to thank the Controller, his staff and various representatives from City departments for their cooperation and assistance throughout this management audit.

1. Organization

- **Over time, the management structure of the Controller's Office has evolved, as new functions and responsibilities have been added and business lines have been redefined. During this evolution, sections have been created to perform non-traditional services and units have been established which provide questionable benefit to the organization. This has had the effect of expanding the number of management positions within the Controller's Office organization.**

- **The Board of Supervisors should reconsider whether it wishes to continue non-mandated functions performed by the City Projects and Performance Management divisions, which are more similar to services performed by city managers and county administrators in other jurisdictions. Further, the Controller should restructure the Department organization by disbanding the Performance Management Division and merging functions under the City Projects Division. Lastly, the Grants Unit in Accounting Operations should be eliminated and current functions merged with those performed by other staff within the organization.**

- **At a minimum, these organizational changes would result in $24,576 in annual savings by replacing one 0931 Performance Management Director with an 1805 Associate Performance Auditor. Potentially, an additional $98,032 in annual savings could be achieved by eliminating one 1824 Principal Administrative Analyst position, which is acting as a manager over the Grants Unit. Total savings related to these two changes would amount to $122,607 per year. Additional savings potentially could be achieved by discontinuing non-mandated functions currently performed by the City Projects and Performance Management Divisions.**

The San Francisco Controller's Office has four basic levels of management that have evolved over the years:

1. Executive Management includes the executive positions of the Controller and the Deputy Controller.

2. Division Director includes seven director level managers who are responsible for major business lines, including (a) Accounting Operations and Systems,[1] (b) Payroll and Personnel Services, (c) Finance and Administration, (d) Budget and Analysis, (e) Internal Audit, (f) City Projects, and (g) Performance Management.

[1] Position currently vacant.

3. Section or Project Manager includes 13 section level managers or project managers who are responsible for major sections or project activities.
   - Accounting Operations and Systems: (1) Accounting Operations Manager, (1) Financial Systems and Reporting Manager and (1) ADPICS System and Special Projects Manager.
   - Payroll: (1) Information Systems Project Director, and (2) Assistant Payroll Directors.
   - Budget and Analysis: (1) Budget and Fiscal Operations Manager, and (1) Property Tax Manager.
   - Internal Audits: (2) Performance Audit Managers, and (3) Financial Audit Managers.

4. Unit Manager includes 5 unit managers who are responsible for units that perform specific processing or technical functions, including:
   - Accounting Operations: (1) Compliance Manager and (1) Grants Manager;
   - Financial Systems and Reporting: (1) EIS Project Technical Director, (1) Financial Reporting Manager,[2] (1) Business Systems and Intelligence Manager, (1) FAMIS Systems and Training Support Manager, and (1) ADPICS System and Special Projects Manager.

In total, the Controller's Office has 27 staff acting in a management capacity in an organization that has 161 authorized positions. This equates to an average of 5.8 employees per manager. Exhibit 1 in the Introduction to this report illustrates the Controller's organization during the period of this management audit. Table 1.1 provides the average number of subordinate and reporting employees per management tier and manager in the organization, as of July 2003.

Several characteristics of the organization become apparent when reviewing Exhibit 1, Table 1.1 and the functional role of individuals in each management tier.

- Approximately 17.3% of the Controller's Office personnel perform management or director functions, equating to one manager for every 5.8 employees. These computations exclude four project manager positions in the City Projects Division, since these individuals do not directly manage the activities of other staff but instead may only act as leads on more complex analyses. The computations also exclude five supervisory personnel within the Payroll and Personnel Services Division, and the Finance and Administration Division.

- The number of subordinate personnel and number of direct reports to managers vary significantly. For example, the Compliance Manager (a fourth tier manager) directly manages the activities of 21 Fund Accountants who are responsible for ensuring that financial transactions are appropriately processed by the departments. At the other extreme, the Performance Management Director (a second tier manager) directly manages the activities of only one staff person. While the roles and responsibilities of these individuals differ significantly, the contrast is stark and will be discussed further in this report.

[2] Position currently vacant.

Table 1.1

Average Subordinates and Reporting Employees Per Management Tier San Francisco Controller's Office 2003

	Managers By Tier	Subordinate Personnel	Subordinates To Managers	Direct Reports
	TOTAL DEPARTMENT PERSONNEL	**161.0**		
I	***Executive Managers***	**159.0**	**79.5**	
1	Controller	9.0	9.0	9.0
2	Deputy Controller	1.0	1.0	1.0
II	***Division Managers***	**154.0**	**22.0**	
1	Accounting Operations and Systems	59.0	59.0	3.0
2	Payroll and Personnel Services	37.0	37.0	4.0
3	Finance and Administration	10.0	10.0	10.0
4	Budget and Analysis	11.0	11.0	9.0
5	Internal Audit	22.0	22.0	5.0
6	Performance Management	1.0	1.0	1.0
7	City Projects	6.0	6.0	6.0
III	***Section Managers and Directors***	**141.0**	**10.8**	
1	Accounting Operations Manager	28.0	28.0	2.0
2	Financial Systems and Reporting Manager	28.0	28.0	7.0
3	ADPICS System & Spec Projects Manager	3.0	3.0	3.0
4	Information Systems Project Manager	3.0	3.0	3.0
5	Assistant Payroll Director	7.0	7.0	3.0
6	Assistant Payroll Director	23.0	23.0	2.0
7	Budget and Fiscal Operations Manager	2.0	2.0	2.0
8	Property Tax Manager	2.0	2.0	2.0
9	Performance Audit Manager	2.5	2.5	2.5
10	Performance Audit Manager	2.5	2.5	2.5
11	Financial Audit Manager	3.7	3.7	3.7
12	Financial Audit Manager	3.7	3.7	3.7
13	Financial Audit Manager	3.7	3.7	3.7
IV	***Unit Managers***	**136.0**	**27.2**	
1	Compliance Manager	21.0	21.0	21.0
2	Grants Manager	5.0	5.0	5.0
3	Financial Reporting Manager	13.0	13.0	3.0
4	Business Systems and Intelligence Manager	4.0	4.0	4.0
5	FAMIS Systems and Training Support Manager	4.0	4.0	4.0
	MANAGEMENT PERCENTAGE/RATIO	**17.3%**	**5.8**	

Note: Excludes four Project Manager positions in the City Projects Division, since these individuals do not have staff reporting to them. The table also excludes a total of five supervisory positions in the Payroll and Personnel Services Division, and the Finance and Administration Division.

Note: The Controller's Office is funded for 142 positions.

Many managers have low manager to staff ratios, in part because of the functions that they perform. Using the third tier as an example, the Performance Audit Managers and Financial Audit Managers direct the activities of an average of 2.5 FTE and 3.7 FTE staff, respectively, since these managers are generally responsible for small analytical teams. In comparison, the managers in Accounting and Payroll direct the activities of large teams, which are responsible for more routine financial processing functions.

Accordingly, the functions performed by these managers vary by organizational level and function. Some managers, such as those assigned to the Accounting and Operations Division and Payroll, are responsible for larger groups of staff who are involved with administering, processing and monitoring financial activities for the City. Others, such as those assigned to Budget and Analysis, Internal Audit, City Projects and Performance Management, are responsible for smaller analytical teams or essentially perform staff analyst functions.

Mandated and Non-Mandated Functions

The Controller's mandates are outlined in the Charter of the City and County of San Francisco, and in the codes that have been adopted by the Board of Supervisors over the years. These various mandates present a formal hierarchy of services that must be performed by the department. Various non-mandated functions are also performed by the Controller, including those requested by the Mayor and the Board of Supervisors, and others that have been assumed by the Controller using his management prerogative.

Functions performed by the Accounting Operations and Systems Division, the Payroll and Personnel Services Division and the Budget and Analysis Division are significantly required to meet the various mandates of the Charter.[3] Other Divisions also perform key functions mandated by the Charter. For example, the City Projects Division is responsible for preparing impartial financial analyses of each City and County ballot measure, as mandated in Charter § 3.105. However, the Controller's authority and role in some activities are less well defined in the mandates of the City and County.

During initial interviews with the Controller, he stated that the direction of the Controller's Office has changed in recent years after the Chief Administrative Officer functions were placed under the Mayor. It is his assertion that many more requests to improve management performance have been directed to the Controller by the Mayor and the Board of Supervisors, and that many functions more traditionally performed by city managers and county administrators have been assumed by the Controller in an attempt to provide management continuity in the City and County. The following discussion examines the organizational divisions which have been most impacted by this change in role.

[3] The Controller's general financial management and budget management functions, as defined in Charter § 3.105, § 9.101, § 9.102, § 9.105, § 9.113 and others.

City Projects Division

The City Projects Division includes (1) 0931 City Projects Director, (4) 0922 Project Manager, and (2) 1805 Associate Performance Auditor positions. According to the City Projects Director, the primary mission of the division is to implement the "efficiency and effectiveness provisions of the Charter." There are no Charter provisions or code sections that specifically designate the Controller as being the City official who is responsible for implementing City-wide efficiency objectives.

In addition, the division implements portions of Charter Section 3.105, which states in part, "The Controller shall prepare an impartial financial analysis of each City and County ballot measure which shall include the amount of any increase or decrease in the cost of government of the City and County and its effect upon the cost of government. Such analysis shall be issued in sufficient time to permit inclusion in the voters' pamphlet." Other mandates fulfilled by the Controller are more general. For example, Article V of the Administrative Code, establishing the General Obligation Bond Oversight Committee, states in Section 5.32 (a) that, "The Board shall, without expending bond funds, provide the committee with any necessary technical assistance and shall provide administrative assistance in furtherance of its purpose and sufficient resources to publicize the conclusions of the committee." The Controller provides staff support to the Bond Committee, through the City Projects Division.

In describing the activities of the Division, the City Projects Director stated:

- The "primary function" of the division is to assist departments with the implementation of audit recommendations, and to provide other "short-term assistance to departments that need it." The division is the "consulting arm of the Controller's Office."
- The majority of the consulting assignments received by the Division are made directly by the Controller. Others originate as a result of requests from the Mayor, the Board of Supervisors and departments. Major examples of consulting work performed by the Division in FY 2002-03 included, (a) analyses of financial impacts from proposed changes to memoranda of understanding with employee bargaining groups and (b) assistance to General Fund departments on a request basis. The Director indicates that approximately 25 to 30 projects are performed each year, of which approximately four can be considered "major."
- The mandate to provide impartial analyses of ballot measures can be a significant responsibility, depending on the number of measures being presented to the voters. For the November 4, 2003 election, there was an approximate three month period between the last date Charter amendments could be introduced and the date when the Controller's analysis needed to be submitted to the Director of Elections.
- As mentioned previously, the Division provides staff support to the General Obligation Bond Committee. According to the Director, this is generally routine analytical support which does not draw significantly from other Division responsibilities.

Table 1.2 summarizes an estimate of the annual hours spent by the division by major activity category, based on data compiled for the period May 2002 through July 2003.

Table 1.2

Summary of Work Hours by Activity
Controller's Office City Projects Division

Hours Category	Annual Hour Estimate	Annual Hour Percent	Service Hour Percent
Generally Mandated			
Support to Other Controller Divisions	876	7.0%	10.0%
Charter Section 3.105 Ballot Measure Review	531	4.3%	6.1%
Bond Oversight Committee Staff Support	313	2.5%	3.6%
Controller and Board Requests for Information	249	2.0%	2.8%
Subtotal Generally Mandated	1,969	15.8%	22.5%
Generally Non-Mandated			
Departmental Consulting Projects	6,775	54.5%	77.5%
Subtotal Direct Service Hours	8,744	70.3%	100.0%
Administrative & Training Hours	1,433	11.5%	
Leave Hours (Sick, Vacation, Holiday)	2,258	18.2%	
Total Reported Hours	12,435	100.0%	

While clearly beneficial to the City organization, the major activities of the Division are not mandated. With the exception of the activities performed to accomplish the mandates included in Charter § 3.105, the activities of the Division are primarily discretionary. Of the 8,744 productive annual hours of service estimated from Division records, only 1,969, or 22.5% were spent providing services that are generally mandated. Approximately 77.5% of the Division's services are generally non-mandated. Approximately 30% of the Division's paid time is for leave, administration or training.

In a period of declining resources, the Board of Supervisors may wish to consider the elimination of positions that are used to support non-mandated activities, before reducing services in other areas of Controller's Office operations. In FY 2003-04, the Controller recommended, and the Board approved the elimination of 14 positions in the Payroll and Personnel Administration, Finance and Administration and Budget and Analysis divisions of the Controller's Office, which resulted in the layoff of 13 staff. As the Board continues to evaluate service reductions that may be necessary due to the lagging economy, State budget actions and other factors, it may wish to consider reductions in the City Projects Division.

As an example, the Board may wish to curtail consulting services the Controller provides to City departments, which are non-mandated. Instead, the Board may wish to rely on the considerable expertise that already exists in departments throughout the City organization, to ensure that audit recommendations and special projects are appropriately implemented. Based on the data included in Table 1.2, the savings to the City could be as much as 4.5 FTEs, amounting to over $400,000 per year in savings. The Board could once again fund these functions in the future, if determined to be an appropriate priority for the City.

Performance Management Division

The Performance Management Division is a two person unit that is staffed by (1) 0931 Performance Management Director and (1) 1805 Associate Performance Auditor. With the exception of a responsibility to perform a "citywide survey of parents and youth" every three years, none of the services provided by this unit are mandated.[4]

The Division provides a greater level of service than that which is defined in its single mandate. In documentation prepared for this management audit, entitled "Performance Management Group Core Functions," the Controller's Office described its activities in relation to the general City Survey that it conducts. Item 3 on this document stated, "Conduct City (citizen) Survey: Survey approximately 2,000 residents each year about the use of and satisfaction with City services, and other topics as needed . . ."

As part of this management audit, we reviewed the most recent City Survey prepared in 2003 and found it to provide general information regarding opinions of selected City services, as recorded by the citizen respondents. Information related to parents and youth was not a focused portion of the work. The Division supplements the results of the City Survey with a report on "indicators of community well-being," which is available on the Controller's website but, again, is not mandated.

According to the Controller's Office, the other primary activities of the Performance Management Division include:

- Establishing, maintaining, tracking and documenting performance information;
- Providing performance information to the Mayor, Board of Supervisors, public and other stakeholders; and,
- Assisting City departments in using surveys to measure performance.

[4] Charter Section 16.108, which establishes mandates related to the Children's Services Fund, states in subsection (i.2), ". . . The Community Needs Assessment shall include the results of a citywide survey of parents and youth to be conducted by the Controller every three years."

These functions are non-mandated, and are provided by the Division to assist departments with accomplishing mandates that are specified in Charter § 9.114. Charter Section 9.114 states, "Each departmental budget shall describe each proposed activity of that department and the cost of that activity. In addition, each department shall provide the Mayor and the Board of Supervisors with the following details regarding its budget . . .

5. **Productivity goals that measure progress toward strategic plans;**
6. The total cost of carrying out each program or activity; and,
7. **The extent to which each department achieved, exceeded or failed to meet its missions, goals, productivity objectives, service objectives, strategic plans** and spending constraints . . ." (Emphasis added).

While consistent with the City-wide objectives defined in Charter § 9.114, the Controller has not been mandated to be the City official responsible for ensuring that an effective performance measurement system is implemented. This function has been assumed by the Controller, by management prerogative. Further, the Internal Audit Division presently audits against performance measures to ensure compliance with the Charter mandate.

As with the City Projects Division, the Board of Supervisors should determine whether the non-mandated functions of the Performance Management Division should be continued during this period of economic downturn. Annual cost of the unit is approximately $201,732. Assuming that additional consultant resources would be required to perform the triennial survey of parents and youth, net savings to the City would amount to approximately $150,000 per year.[5]

The second question raised from our review of the Performance Management Division is whether the activities that are performed need to be placed at a division level in the organization. During interviews, the Controller stated that his decision to place the activity at the division level stemmed from his perceived need to have a manager available to directly interact with departments, in order to gain departmental cooperation. Accordingly, the Controller's Office established an 0931 Performance Management Director position, with only one subordinate position, to perform this function.

We do not agree with the Controller's opinion in this regard. Every employee in the Controller's Office carries the authority of the Controller, whether the employee is a fund accountant in the Accounting Operations Division or an analyst. That authority can be communicated in many ways, without establishing a two-person division. For example, the Controller could (a) directly communicate with department managers in writing, requesting cooperation; (b) place the two-person function under one of his other division managers, who has the same organizational stature as the incumbent manager of the Performance Management Division; or, (c) request the Board of Supervisors to grant authority to the Controller's Office in the Administrative Code.

[5] Assumes that the City would need to purchase consultant services to perform the triennial survey, at a cost of approximately $150,000 every three years. We believe this estimate is conservative, and that the actual cost would be less.

Even if the Board of Supervisors decides to fund all of the current activities of the Performance Management Division, the Budget Analyst believes the functions could be moved into the City Projects Division at a lower cost. Both the City Survey and the Performance Measurement responsibilities performed by the existing two-person division are appropriate for analytical personnel at the 1805 Associate Performance Auditor level.[6] If the functions were moved into the City Projects Division, and the two person staffing level was continued using employees at the 1805 Associate Performance Auditor level, the functions would be more appropriately staffed and the City and County would realize a savings of $24,746 per year. In addition, the number of division directors reporting to the Controller would be reduced from seven to six.

Grant Management Unit

Section 10.170-2 of the Administrative Code mandates that "the Controller shall keep accounts of all such grants adequate to record the status of any such grant during the life thereof. All officers and employees shall keep such records and render to the Controller such grant reports as the Controller may require to comply with the provisions of this Section." In fulfilling this mandate, the Controller has decentralized much of the responsibility of grant management to the departments. The Grant Management Unit's policies and procedures manual (*Financial Administration of Grants and Gifts*), which is currently being revised, lists the goals of departmental grant financial managers as:

- Smooth and fair delivery of grant-funded services,
- Full compliance with grant guidelines,
- Accurate accounting,
- Reconciliation of expenditures and revenues every fiscal year,
- Frequent billing of maximum eligible revenues,
- Pass audits successfully, and
- Continuous improvement.

With the exception of accurate accounting and grant reconciliation, the Grant Management Unit (Grant Unit) does not provide significant assistance or oversight with respect to the other departmental goals. The responsibility for accurate accounting, while monitored by the Grant Unit, is placed at the department level. Even the establishment of grant accounting codes in the financial system has been decentralized to certain departments. The Grant Unit has only recently started to systematically monitor department reconciliation efforts. The main functions of the Grant Unit, according to interviews with the Accounting Operations and Grants Managers, include:

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[6] The 1805 Associate Performance Auditor is the current classification of the non-manager staff person in the Performance Management Division, and the base analyst classification in the City Projects Division. The City Projects Division currently has four 0922 Project Manager employees, who act as project leads; and, two 1805 Associate Performance Auditor employees, who provide analytical support. A restructured City Projects Division, which would assume the current responsibilities of the Performance Management Division, would include four 0922 Project Manager positions and four 1805 Associate Performance Auditor positions.

- Coordinating the annual Single Audit of Federal Financial Assistance, which includes preparing the Single Audit financial reports and following up on audit findings and the related departmental corrective action plans;
- Providing guidance to departments on the establishment of grants and approving certain departmental grant accounting transactions;
- Conducting the periodic audit of grant accounting transactions; and
- Preparing the Countywide Cost Allocation Plan.

Additionally, the Unit performs the Controller's review and authorization for the acceptance and expenditure of grant funds, as mandated by Section 10.170-1 of the Administrative Code. This activity is discussed in further detail in Section 10 of this report.

The Controller's reasons for maintaining a separate Grant Unit stems from a previous single audit finding regarding a material weakness in the grants reporting function. In an effort to improve the Department's performance in this area, the Controller consolidated grant accounting and reporting functions in a single unit. According to the Controller, the material weaknesses previously identified have been significantly corrected as a result of this organizational consolidation. However, the current benefits that derive from this consolidation are unclear.

When asked about the Grant Unit's vision, the Grants Manager stated that they do not see themselves as a separate unit, and that it makes more sense for their goals to be the same as every other unit in the Accounting and Operations and Systems Division. In theory, grants require a certain degree of specialization to ensure that grants are accurately accounted for and reported. However, as already noted, much of this responsibility has been divested to the departments with the Controller's Office providing routine approval, audit, and reporting functions.

Additionally, a grants unit should ensure that grant revenues are maximized by verifying all allowable costs are claimed and reimbursed, and by compelling departments to file claims in a timely manner. However, the Grant Unit does not fulfill this role. While the Grant Unit has attempted to establish procedures for departments to complete a quarterly reconciliation of grant revenues and expenditures, which ensures that all grant costs have been appropriately accounted for, the first attempt in April 2003 has met with limited success, according to the Grants Manager and per internal tracking reports. This effort was instigated by a 2001 independent financial audit finding by KPMG that found significant errors in grant data and information reported by departments. In fact, KPMG actually conducted a training for departments in January 2003 on the reconciliation process. With respect to ensuring all allowable costs are claimed and pursuant to Section 10.170-1 (d) of the Administrative Code, the Grant Unit should be reviewing and certifying whether the appropriate indirect cost reimbursement has been included in the grant budget. As noted in Section 10 of this audit report, the Grant Unit is not providing this level of review. Finally, according to the Grants Manager, the Grant Unit does not monitor department claims to verify they are being completed in a timely manner and therefore obtaining reimbursement as quickly as possible.

The degree of specialization required by grants does not necessitate a separate Grants Management Unit as it is currently managed. Most of the activities conducted by the Grants

Unit do not differ in great respect to the duties of the Compliance Unit with regard to ensuring accurate accounting or the Financial Reporting Unit with regard to financial reporting and reconciliation. Specialization based on activity rather than by grant will consolidate Controller functions, assist in ensuring Controller policies and procedures are consistent, and simplify the relationship between departments and Controller staff.

Additionally, preparation of the Cost Allocation Plan in the Grants Unit appears to be illogical, as the Grants Manager provides no supervisory or management review of its preparation. The Cost Allocation Plan as well as the review and authorization for the acceptance and expenditure of grant funds, which is primarily a review of grant indirect costs and grant budgets, should be placed in the Budget and Analysis Division where other cost functions are performed and where the Division Manager can provide management review and oversight. The Controller should reassign the three Grant Unit staff to the Compliance Unit, the Financial Reporting Unit, and the Budget and Analysis Division and transfer duties and tasks accordingly.

During interviews for this management audit, we were advised that the Grants Manager has spent a portion of her time coordinating the process of the single audit, preparing the single audit schedule and following-up on audit findings and the corrective action plans of departments. In recent months, she has spent a considerable amount of her time conducting a post-audit of grant transactions that had been processed by the departments. Many of these individual activities could be assumed by the managers in other divisions of the department. As an example, the coordination, scheduling and follow-up activities related to the Single Audit could be assumed by management personnel within the Financial Reporting Unit. Oversight duties related to the post-audit could be consolidated under the Compliance Unit.

We recognize that the incumbent of the unit adds value to the organization in her current role. However, in the course of this expedited management audit, we were not provided with sufficient justification for retaining this management position when the functions currently performed by the specialized unit could be successfully dispersed within the organization. Accordingly, we believe the Grants Manager position should be eliminated at an annual savings of $98,032 per year.

Conclusions

Over time, the management structure of the Controller's Office has evolved, as new functions and responsibilities have been added and business lines have been redefined. During this evolution, sections have been created to perform non-traditional services and units have been established which provide questionable benefit to the organization. This has had the effect of expanding the number of management positions within the Controller's Office organization.

The Board of Supervisors should reconsider whether it wishes to continue non-mandated functions performed by the City Projects and Performance Management divisions, which are more similar to services performed by city managers and county administrators in other jurisdictions. Further, the Controller should restructure the Department organization, by disbanding the Performance Management Division and merging functions under the City

Projects Division. Lastly, the Grants Unit in Accounting Operations should be eliminated and current functions merged with those performed by other staff within the organization.

At a minimum, these organizational changes would result in $24,576 in annual savings by replacing one 0931 Performance Management Director with an 1805 Associate Performance Auditor. Potentially, an additional $98,032 in annual savings could be achieved by eliminating one 1824 Principal Administrative Analyst position, which is acting as a manager over the Grants Unit. Total savings related to these two changes would amount to $122,607 per year. Additional savings potentially could be achieved by discontinuing non-mandated functions currently performed by the City Projects and Performance Management Divisions.

Recommendations

The Controller should:

1.1 Disband the Performance Management Division;

1.2 Reassign responsibilities for producing the Citizen's Survey to the City Projects Division;

1.3 Reassign responsibilities for assisting departments with the development of performance measures to the City Projects Division;

1.4 Disband the Grants Unit; and,

1.5 Reassign Grants Unit duties and responsibilities to the staff within the Compliance Unit, the Financial Reporting Unit, and the Budget and Analysis Division.

The Board of Supervisors should:

1.6 Eliminate one 0931 Performance Management Director position;

1.7 Add one 1805 Associate Performance Auditor position;

1.8 Eliminate one 1824 Principal Administrative Analyst position; and

1.9 Consider funding alternatives which would narrow the mission of the City Projects Division to include only mandated functions.

Costs and Benefits

There would be no cost to implement these recommendations. The management structure of the Controller's Office would be streamlined, functions would be more suitably aligned, and the City and County would achieve annual savings of approximately $122,607 per year. Additional savings of $400,000 could potentially be achieved by discontinuing non-mandated functions currently performed by the City Projects and Performance Management Divisions.

2. Financial Administration

- **As Chief Financial Officer for the City and County of San Francisco, the Controller is responsible for establishing the necessary framework to facilitate sound financial management and accounting practices. Sound financial and accounting practices are contingent upon authoritative and comprehensive policies and procedures that guide financial processes, and a financial accounting system and structure that can produce useful financial reports for the monitoring and control over the City's finances and operations.**

- **A review of the Controller's findings with respect to routine audits of financial transactions found a decrease in the adherence to the City's policies and procedures from calendar year 2001 to the first three months of 2003. With respect to reporting issues, departments have created parallel applications, spreadsheets and other duplicative procedures to obtain financial data and information in a format that is useful. Further, the lack of centralized monitoring of the accounting structure has led to the existence of unnecessary funds, unreconciled financial activity, the accumulation of resources, and accounting structures that do not necessarily meet the needs of departments. Incomplete and untimely reviews of user security allows for unauthorized access to financial systems and weakens the integrity of financial activity.**

- **The Controller should strengthen the financial management framework by developing authoritative and comprehensive policies and procedures, addressing departmental financial reporting needs, ensuring consistent and stable departmental accounting structures, and verifying that only appropriate personnel have user access to the financial systems.**

Role of the Controller as Chief Financial Officer

As the Chief Financial Officer for the City and County of San Francisco (the City), it is the Controller's responsibility to establish authoritative and comprehensive accounting policies and procedures, as well as to establish the financial accounting systems and reporting necessary for departments to effectively manage City finances and operations. Further, it is the Controller's responsibility to establish the appropriate internal controls over accounting processes and the financial accounting systems to ensure sound financial management and accounting practices.

Authoritative and Comprehensive Policies and Procedures

Historically, the Controller has relied upon various resources to communicate financial and accounting policies and procedures to departments. Such resources included training classes and user manuals for the financial accounting system, FAMIS, as well as departmental instructions, memoranda and email "flashes" that communicate to departments policies and procedures on a topical basis.

According to Controller staff, the Controller's Office has made significant strides toward providing departments guidance through financial system on-line access to screen inquiries, help menus, real-time edits and other technological improvements. The Controller also asserts that policies and procedures that guide departments and promote sound financial practices are contained in the City's Administrative Code and the *Governmental Accounting, Auditing, and Financial Reporting* text published by the Government Finance Officers Association and otherwise known as the "Blue Book." Individually, however, these resources do not provide a comprehensive overview of the City's financial and accounting policies and procedures to ensure departments are utilizing sound and consistent financial management practices. Written policies and procedures do not exist for several accounting and finance processes, such as the preparation of indirect cost rates and the reconciliation and monitoring of funds and sub-funds. Accordingly, the Controller's Office does not have a document that brings all of the various resources together and expands on areas that may not be addressed anywhere else.

In Fall 2002, the Compliance Unit of the Accounting Operations and Systems Division (AOSD) conducted an annual "Post-Audit" of accounting transactions for the previous calendar year. In total, the Compliance Unit tested $19.5 billion of transactions and found processing exceptions on accounting transactions that totaled $742.3 million. 1,178 exceptions were found on a test population of 5,470 documents for an exception ratio of one exception for every 4.64 documents. The Controller's Office has noted that several of the exception categories do not, in their judgment, impact financial integrity. These exceptions include non-compliance with 12B/HRC requirements, incorrect or incomplete data input, insufficient supporting documentation, and non-current business tax certificate. When these exceptions are excluded, the ratio increases to one exception for every 10.06 documents. According to the Compliance Unit Manager, due to the high exception rate, the Controller's Office conducted a training in January and February 2003 in an attempt to improve departmental performance.

The Compliance Unit is currently completing a small Post-Audit of accounting transactions for the first three months of 2003 and has recently compiled summary statistics. A review of these statistics shows that overall the Compliance Unit found an exception for every 4.00 documents, an overall decrease in adherence to City policies and procedures of 13.9 percent from the Post-Audit conducted the previous fall. Excluding the exception categories that the Controller believes do not impact financial integrity, the exception ratio for this period is one exception for every 8.47 documents, a decrease in adherence to policies and procedures of 15.7 percent from the Post-Audit conducted the previous fall. A summary table of these findings is attached to the end of this section as Appendix 2.1. Departmental detail on these summary statistics shows significant variation among departments. Some departments have greatly decreased processing exceptions while other departments showed significant increases in processing exceptions. It should be acknowledged that because the training occurred early in the period being audited, the training would have had only limited impact on the audit results for the period. Nonetheless, not only has there not been improvement, an actual overall decrease in the adherence to the City's established policies and procedures has been found. This is an important finding, because the Post-Audits are reviewing the practices of departments and any exception, whether for $10 or $1.0 million, represents a lapse in internal controls. The extent of these lapses and the inconsistencies among departments found during our review indicates a need for authoritative, standardized and comprehensive policies and procedures.

Select departments were interviewed about accounting policies and procedures and their use of the Controller's financial accounting systems. One department fiscal manager stated that there was a need for comprehensive training to understand how accounting and finance were structured in the City. This manager further stated that FAMIS training was not sufficient to learn the City's accounting and finance policies and procedures. Another fiscal staff stated that he had not received training in FAMIS although he started nearly 10 months previously. This departmental fiscal staff stated that the best training for him came from his supervisor, who had previously worked at the Controller's Office. None of the departments that were interviewed had a readily accessible accounting and finance policies and procedures manual.

The Controller's Office has recognized a need for highly skilled and trained fiscal staff that understand the accounting and finance practices of the City. To address this need, the Controller developed an accountant internship program in the mid-1990s, which rotates interns through two departments over 18 months. Due to Controller identified gaps in the training, the program has been restructured and strengthened during the last year. According to the Deputy Controller, interns currently take 10 to 12 formal training courses, prepare a training binder, and are instructed in the full cycle of accounting transactions. While the internship and training program is specific to new accountants in the 1649 and 1652 classifications, the policies and procedures that they gather throughout their internship are relevant to all City finance and budget staff. Yet, these staff or departments in general are not provided similar binders of policies and procedures.

The Controller's Office should develop and distribute or make available a written comprehensive and authoritative policies and procedures manual for all aspects of accounting and financial management in the City. A written manual would ensure that policies and procedures support accurate, consistent, and quality accounting and finance practices throughout the City and would enhance the Controller's oversight of the accounting and financial practices throughout the City. It would bring together the various resources that the Controller now relies upon, including online system edits and controls, Controller instructions, memoranda, and email flashes, industry guidelines such as those presented in the Blue Book, and Administrative Code requirements. Additionally, a written manual would ensure that policies and procedures are available and communicated to departments. These written policies and procedures should be reviewed and updated annually. Several counties, including Los Angeles and Orange counties, have comprehensive policies and procedures manuals that can provide guidance to the Controller's Office on format and content. Both of these manuals are available electronically.

Financial Reporting

In addition to the need for comprehensive policies and procedures to guide departments in financial management and accounting activities, the current financial accounting and reporting systems do not meet departmental needs. The City's core financial accounting system, FAMIS, was last upgraded in FY 1995-1996, when the system migrated from batch processing to an on-line, real-time system. Issues surrounding FAMIS and the Controller's financial accounting systems are discussed in more detail in Section 3 of this report. Because FAMIS only provides mainframe reports that are not flexible, the Controller installed the Executive Information System (EIS) in 2000 to develop financial reports. The focus of that program to date has been to develop EIS support for the Comprehensive Annual Financial Report, which is at such a high level that the data and information is not useful for the day to day financial and operational needs of the City. However, the Controller intends to allow departments access to and training on EIS, although no formal program has been developed. The Controller reports 13 departments are working with EIS at this time.

However, to meet departmental financial reporting needs, departments continue to request special reports from one of two Systems Units or from the Budget and Analysis Division in the Controller's Office. While the Controller may be able to provide these reports relatively quickly, within a day or two, there is little flexibility and the process remains an obstacle to obtaining meaningful and timely financial reporting. By way of example, for this audit, a request was made to obtain cash and fund balances by fund. It took over three weeks to obtain this basic financial information.

Understandably, departments undertake varying degrees of effort to create data and information they need on a timely basis, as noted in a survey of select departments. For example, the Department of Human Resources (DHR) creates excel spreadsheets to monitor expenditures by index code and sub-objects. Additionally, DHR creates excel spreadsheets for monitoring the Health Service System, for analysis during the budget development process, and for position control. The Department of Children, Youth and Their Families re-enters transaction data into excel spreadsheets to track expenditures by index code and by lower levels of detail, such as purchase order. The Recreation and Park Department has developed their own monthly report by index code to track revenues and expenditures. These efforts by departments require considerable resources to essentially recreate financial data and information in a useable format. The Recreation and Park Department reports that it takes 50 percent of one accountant's time just to produce the monthly financial reports that the Department needs for the Recreation and Park Commission.

In addition to the inefficiencies created by the need to recreate financial data and information, the inability to obtain useful financial reporting impairs the ability to effectively monitor and control departmental finances and operations. To the extent that departments do not develop the reports they need to monitor activity, they risk making uninformed decisions that can ultimately impair departmental finances and operations.

The Controller should conduct an assessment of departmental and City reporting needs and should develop a formal strategic plan for meeting those needs. The Controller should utilize existing analytical resources, such as City Projects Division or Financial Systems and Reporting Division staff which should be available now that GASB 34 conversion project has been completed.

Financial Accounting Structure

The Financial Systems and Reporting Units of the AOSD are responsible for the financial accounting systems and the reporting structure. The responsibility for the accounting structure and the chart of accounts, such as funds, departments, index codes, and so on, is fragmented between and amongst various units in the Controller's Office. For example, according to Controller documents, funds can be created by the Business Systems and Intelligence Unit, the Cash and CAFR Support Unit, and the Reconciliation and Analysis Unit. Additionally, index codes and other departmental accounting coding can be created by the Compliance Unit, the Grant Management Unit, and selected departments. Accordingly, there is no single area or unit to provides guidance on or control over the entire accounting structure.

As noted in Section 6 of this report, our review found there are no formal policies and procedures that define the Controller role or assigns responsibility in the area of fund and sub-fund creation, monitoring and reconciliation. Subsequently, the lack of centralized monitoring has led to the existence of unnecessary funds, unreconciled financial activity, and the accumulation of resources.

Additionally, departmental "recasts" are customary, where a department's accounting structure is significantly revised and prior year financial data must be "recast" to conform with the revised structure. Recasts are an intensive process that requires considerable Controller and departmental resources. Additionally, recasts are generally problematic. Historical information is restated and reported in a way that was never intended, impairing the quality and comparability of financial data and departmental activities over time. There are legitimate reasons why a recast may be necessary, such as fundamental changes in the operating environment. However, departmental structures should remain relatively stable and not be subject to shifting policies or personalities, such as when changes in department heads and fiscal officers occur. Departmental accounting structures should be based on a thorough analysis of a variety of factors, including the department's mission, its operational structure, service delivery, expenditure patterns, and so on. If the accounting structure is sound, there should be no reason to change it for political or other human influences.

There are existing departmental accounting structures currently that are not effective. The Controller's Office reports two or three departments significantly recast the departmental accounting structure each year. During interviews with the Recreation and Park Department and the Sheriff's Department, which both recast their accounting structures within the last few years, the fiscal staff stated that the old accounting structure was meaningless and did not serve the needs of the departments. Additionally, a Controller summary of recasts completed in 2002 states that the Department of Human Services created new index codes "to help with their internal reporting." Clearly, if the structure is not meeting a department's needs or if there is a fundamental change in the operating environment, an accounting structure should be recast. As the Controller's Office reviews departmental requests for and provides assistance to departments during the recast process, it should perform its assessment with the intent of establishing a structure for long-term stability. Ultimately, the Controller, as the Chief Financial Officer and as the expert on and control over the financial accounting structure, is responsible not only to ensure that the technical needs of the departments are being met, but also that operationally the accounting structure makes sense.

The Controller should formally designate the responsibility for controlling the financial accounting structure to one of the Financial Systems and Reporting Units of the AOSD or to a consistent working group of Controller staff. This group should be responsible for the creation of all new accounting codes that define a department's main financial framework, including funds, sub-funds, organization, and index codes. Excluded from this level of control would be grants, projects, user codes and department activity. The group should be responsible for ensuring that any changes to the accounting structure are appropriate and in accordance with sound financial management and accounting practices. Additionally, the group should be responsible for periodic review of unused and obsolete codes and the monitoring of funds and sub-funds to ensure that departments are appropriately accounting for financial activity and resources.

User Security Reviews

The Controller's Office has a policy to conduct a user security review for FAMIS, the purchasing system (ADPICS) and the fixed asset database (FAACS) on an annual basis and coinciding with the end of the fiscal year. The Controller's Office reports that the last user security review was completed in January of 2003, which was six months behind schedule for FY 2001-2002, and that the FY 2002-2003 user security review is currently being conducted. According to the Controller's Office, the goal of the survey is "to preserve security by requiring that each department verify their users are active and are assigned to the appropriate and active Department."

As part of the security review for FY 2002-2003, the Controller's Office distributed a list of staff with FAMIS, ADPICS or FAACS access and instructed department heads or chief financial Officers to respond by July 31, 2003 with updated information on which staff are authorized to access the financial systems to: (a) initiate transactions, (b) approve transactions, or (c) inquiry on transactions. The Controller's Office stated that "users whose status is not confirmed or updated by July 31, 2003 may then be denied system access." However, of six department user security surveys selected for review, one department's survey was never submitted and a second department's survey was incomplete. There was no indication that any users were denied system access as a result of non-compliance with the security policy. Because unauthorized access to financial systems weakens the integrity of financial activity, user security reviews should be thorough and conducted in a timely manner. Access should be automatically denied for users whose status is not confirmed.

Conclusions

The Controller could strengthen the financial management framework. The need for comprehensive and authoritative policies and procedures, useful financial reporting, and controls over the accounting structure and controlled access to the accounting systems impair the departments' ability to effectively manage departmental finances and operations and impair the Controller's ability to provide effective oversight.

Recommendations

The Controller should:

2.1 Develop and make available to departments, physically or electronically, written, authoritative and comprehensive policies and procedures for all aspects of the financial and accounting processes;

2.2 Perform an assessment of departmental financial reporting needs, and develop a strategic plan for meeting those needs, by June 30, 2004;

2.3 Consider the long-term structural stability of departmental accounting structures when developing departmental accounting structures and conducting recasts;

2.4 Designate the following responsibility to oversee the accounting structure to a specific unit in the Financial Systems and Reporting Units or to a consistent working group, including:

   i. Being the sole authority for the creation of funds, sub-funds, organization and index codes;

   ii. Being the sole authority for the recast of a department's accounting structure; and

   iii. Ensuring that the accounting structure is appropriate and is in accordance with sound financial management and accounting practices; and

   iv. Being accountable for the monitoring of funds and sub-funds.

2.5 Ensure that annual user security reviews are conducted in a timely manner; and

2.6 Deny system access for users whose status is not confirmed or updated by the deadline in order to enforce compliance with the security policy.

Costs and Benefits

The development of a policies and procedures manual should be achieved through the assignment of existing resources. Oversight of the accounting structure can be achieved through the reallocation and consolidation of the current assignments. An assessment of reporting needs and strategic planning will require additional resources which should be obtained through a reallocation of existing staff as current projects, such as GASB 34 implementation, are completed, rather than with new staff. The benefits of these recommendations include operational efficiencies and enhanced controls at the departments and at the Controller's Office which will exceed the costs of implementation.

3. System Planning

- **The City Charter charges the Controller with the responsibility for establishing accounting records, procedures and internal controls necessary to facilitate sound financial management and accounting practices. In order to perform these basic duties, the Controller is responsible for establishing and maintaining a financial accounting system that can produce accurate, timely and useful financial reports, and provide for the monitoring and control over the City's finances and operations.**

- **The City's current financial accounting system, FAMIS, and supporting financial and reporting systems are inadequate to meet the financial reporting and fiscal management needs of City and County of San Francisco departments. In an effort to compensate for the shortcomings in the financial system, the Controller and departments have implemented an ad hoc system of databases and reporting software. However, many departmental reporting and financial management needs are still left unmet. The current system is inflexible, resulting in delays in meeting basic reporting needs and the duplication of work.**

- **The estimated cost of updating FAMIS is $500,000 to $1.7 million. At least one jurisdiction replaced a system similar to FAMIS for $13 million. The significant cost of updating FAMIS, or acquiring a new system, has resulted in a decision by the Controller to continue operating the current system and develop enhancements to the system in the immediate future.**

- **The Controller should perform an assessment of the short-term financial reporting and accounting needs of the departments, and the City and should develop a strategic plan for meeting those needs. In addition, the Controller should assess the impact to the City and County's financial management resulting from the continued long-term use of the FAMIS financial accounting system and develop a strategic plan for replacing the current system.**

As stated previously in this report, it is the Controller's responsibility to establish the financial accounting systems and reporting necessary for departments to effectively manage City finances and operations.

Financial Systems

The City's primary financial systems consist of:

- FAMIS, which is the general ledger accounting system;
- BPREP, which is the budget preparation system that uploads budget data to FAMIS;
- Executive Information System (EIS), which is a reporting and analytical tool for FAMIS and includes the Oracle database, which is a data repository: and, Powerplay and Impromptu, which are reporting tools linked to FAMIS and EIS;
- ADPICS, which is the purchasing system; and,
- FAACS, which is a centralized fixed-asset database.

Current System Limitations

The current financial accounting and reporting systems do not meet departmental needs. In an effort to compensate for the weaknesses in the financial system, the Controller and departments have implemented an ad hoc system of databases and reporting software.

The City's core financial accounting system, FAMIS, was last upgraded in FY 1995-1996, when the system migrated from batch processing to an on-line, real-time system in which users enter data and the system updates immediately. Because FAMIS is a transaction based mainframe system, it is inflexible and developing reports is costly and time consuming. FAMIS does not efficiently track appropriations and expenditures in the manner that departments would like to manage expenditures. For example, it is difficult to produce reports which track expenditures by vendor. In addition, the inflexibility of the system hinders the monitoring of compliance with City policies, such as the Minority/Woman/Local Business Enterprise (M/W/LBE) Ordinance.

To address the aforementioned reporting limitations, the Controller installed EIS in 2000, as a reporting and analytical tool with Powerplay and Impromptu, which are reporting tools linked to FAMIS and EIS. The focus of EIS to date has been to develop support for the Comprehensive Annual Financial Report (CAFR). However, the CAFR format is at such a high level that the data and information is not useful for the day to day financial and operational needs of the City. Therefore, the acquisition of EIS has not resolved all of the departments' reporting needs. For example, it is still difficult to report by vendor using EIS, through either Powerplay or Impromptu. To meet this basic departmental financial reporting need, departments currently must request a special report from the Controller's Office. In addition, EIS is not currently available to all departments. A total of 13 departments are working with EIS at this time and there is no timetable for making Powerplay and Impromptu available to all departments. However, the Controller's Office states that it intends to allow departments access to and training on EIS, although no formal program has been developed.

Many departments do not have access to other applications implemented by the Controller's Office. In addition to EIS, many departments do not have online access to FAACS, which was established for the early implementation of GASB 34. While some departments can access

FAACS online and provide data for capital transactions, the Controller inputs asset data centrally on behalf of the other departments.

The budget system, or BPREP, is an antiquated system with little enhancement capability. For instance, BPREP is currently incapable of recording department performance measurements to compare with budgeted amounts. The current budget system's lack of adaptability hinders policy based budgeting. In addition, departments do not have an online review capability because BPREP is still a batch processing system. Departments cannot look at specific expenditures across divisions in BPREP without creating a special report.

As discussed previously, the limitations of the current systems result in departments setting up duplicative systems requiring manual data input. These efforts by departments require considerable resources to essentially recreate financial data and information in a useable format. These duplicative systems allow departments to track appropriations and expenditures in the manner that departments manage expenditures and to create data and information they need on a timely basis. In addition to the operational inefficiencies created by the need to recreate financial data and information, the inability to obtain useful financial reporting impairs the ability to appropriately monitor and control departmental finances and operations. The limited and inflexible reporting tools make it difficult for departments to manage their financial data. The Controller's Office maintains that the system is currently stable and reliable. However the Controller's Office acknowledges that the system is inflexible and limited. In addition, the Controller's Office has begun planning for short-term solutions, as will be discussed in the following section.

Strategic Planning for the Short Term

The Controller's Office reports that it has begun a cycle of strategic planning for short-term solutions to the limitations of the current systems. For example, the Controller's Office is moving towards web-based applications for many of the systems. In addition, the Controller's Office has begun archiving files older than three years in FAMIS in order to speed-up the system for current transactions. However, the information available regarding the strategic planning process lacks specific detail and is not documented in writing.

The Controller's Office has relied on customizations of the existing software packages as short-term patches to the limitations of the City's financial systems. Such customizations can be incrementally costly without significantly enhancing the functionality of the system and without eliminating the necessity for a replacement system. Therefore, the Controller should conduct an assessment of departmental and City needs and should develop a strategic plan for meeting those needs. As previously stated, the Controller should utilize existing analytical resources, such as City Projects Division or Financial Systems and Reporting Division staff.

Long Term Planning

The Controller is responsible for establishing and maintaining a financial accounting system that can produce accurate, timely and useful financial reports, and provide for the monitoring and control over the City's finances and operations. The estimated cost of updating FAMIS is

$500,000 to $1.7 million. Discussions with the Controller's Office indicated that replacing FAMIS with a new general ledger, budget and purchasing system could cost $30 million, excluding hardware and in-house implementation costs. However, the Controller's Office has not received a bid on the cost. The Budget Analyst notes that Santa Clara County has recently purchased a new general ledger system for $13 million. The significant cost of acquiring a new system has resulted in a decision by the Controller to continue operating the current system in the immediate future. However, many departmental reporting and financial management needs are still left unmet and short-term patches do not compensate for a cohesive financial accounting and reporting system.

Although the current economic outlook has delayed the decision to upgrade FAMIS, it is critical that the Controller's Office be prepared to move forward with improvements to the City's financial systems. As the general supervisor of the City's accounts, the Controller's Office has the responsibility to prepare for future City needs. A new improved system would facilitate monitoring and control over the City's finances and operations. In addition, a modernized system would be compatible with other jurisdictions and would facilitate information sharing and cooperation among municipalities and counties.

The short-term solutions being developed and implemented currently have not eliminated the need for a replacement system in the long-term. In addition to performing an assessment of the budgeting, financial accounting and reporting needs of departments and the City in the short-term, the Controller should assess the impact to the City's financial health resulting from the continued use of the FAMIS financial accounting system and BPREP budget system, over the long-term and develop a strategic plan for replacing the current system. A strategic plan should formalize the Controller's short-term and longer-term strategies for modernizing the financial systems and allow for budgeting for the cost of the replacement system.

Conclusions

The City Charter charges the Controller with the responsibility for establishing accounting records, procedures and internal controls necessary to facilitate sound financial management and accounting practices. In order to perform these basic duties, the Controller is responsible for establishing and maintaining a financial accounting system that can produce accurate, timely and useful financial reports, and provide for the monitoring and control over the City's finances and operations.

The City's current financial accounting system, FAMIS, and supporting financial and reporting systems are inadequate to meet the financial reporting and fiscal management needs of City and County of San Francisco departments. In an effort to compensate for the weaknesses in the financial system, the Controller and departments have implemented an ad hoc system of databases and reporting software. However, many departmental reporting and financial management needs are still left unmet. The current system is inflexible, resulting in delays in meeting basic reporting needs and the duplication of work.

The estimated cost of updating FAMIS is $500,000 to $1.7 million. At least one jurisdiction replaced its general ledger system for $13 million. The significant cost of updating FAMIS, or acquiring a new system, has resulted in a decision by the Controller to continue operating the current system and develop enhancements to the system in the immediate future.

The Controller should perform an assessment of the short-term financial reporting and accounting needs of the departments, and the City and should develop a strategic plan for meeting those needs. In addition, the Controller should assess the impact to the City's financial management resulting from the continued long-term use of the FAMIS financial accounting system and develop a strategic plan for replacing the current system.

Recommendations

The Controller should:

3.1 Perform an assessment of the City's financial systems needs and report back to the Board of Supervisors by June 30, 2004;

3.2 Develop a strategic plan for meeting identified departmental and City needs; and,

3.3 Be prepared to move forward with a replacement system when it becomes either necessary or financially feasible.

Costs and Benefits

The estimated cost of updating FAMIS is $500,000 to $1.7 million. The Controller has estimated that the cost to replace the City's general ledger, budget and purchasing systems would be approximately $30 million, not including hardware or in-house implementation costs. At least one jurisdiction recently replaced its general ledger system for $13 million. A new accounting system would provide long term operational efficiencies in the Controller's Office and departments.

4. Internal Control Reporting and Financial Auditor Independence

- **Although the federal Sarbanes-Oxley Act is intended to increase oversight over the financial reporting of publicly-held private companies, two key provisions of the Act apply to local governments: (1) increased authority of the audit committee and enhanced independence of the financial auditor, and (2) the effectiveness of financial internal controls over financial reporting.**

- **The Sarbanes-Oxley Act strengthens audit committee oversight and auditor independence. Under the Charter, the Board of Supervisors selects the City's financial auditor. The financial auditor has a direct reporting relationship with the Board of Supervisors Audit Committee. By adopting policies consistent with the Sarbanes-Oxley Act, the Audit Committee would increase the financial auditor's direct reporting requirements to the Audit Committee. The Audit Committee would also have authority over the approval of any non-audit services provided by the financial auditor.**

- **The Board of Supervisors should approve policies to maintain financial auditor independence. These policies include rotating the audit partner every five years and standards for conflict of interest.**

- **The Board of Supervisors should also assess the feasibility of conducting a Citywide evaluation of internal controls and requiring the financial auditors to report on the effectiveness of these internal controls. The increased costs of internal control evaluation and reporting could be offset by a reduction in loss from fraud or inefficiency.**

Applying Sarbanes-Oxley to the Public Sector

In 2002, Congress enacted the Sarbanes-Oxley Act, increasing oversight of financial reporting of publicly-held private companies. Although the Sarbanes-Oxley Act does not apply to audits of government organizations,[1] the underlying principles do apply. Two key concepts of Sarbanes-Oxley are:

- Increased audit committee oversight and enhanced auditor independence; and

- Ensuring effective internal controls and financial reporting on the effectiveness of internal controls.

[1] Government financial auditors are governed by separate regulations that are set by the federal Office of the Inspector General (OIG).

Auditor Independence and Audit Committee Oversight

The Securities and Exchange Commission has adopted new rules, which amend existing requirements regarding auditor independence and enhance the independence of accountants that audit and review financial statements. Under these final rules, the Security and Exchange Commission has recognized the importance of the audit committee in assuring auditor independence. The Sarbanes-Oxley Act required the Securities and Exchange Commission to develop new rules on auditor independence, defining:

- Allowable and non-allowable non-audit services;
- Relationship between the independent auditor and the audit committee;
- Conflict of interest standards; and
- Auditor partner rotation and second partner review requirements.

<u>Non-audit services</u>

Under the new rules established by the Security and Exchange Commission, certain non-audit services provided by the financial auditor are prohibited, and other non-audit services require pre-approval by the audit committee. The Security and Exchange Commission's rules regarding non-audit services are based on three basic principles:

1. An auditor cannot function in the role of management.
2. An auditor cannot audit his or her own work.
3. An auditor cannot serve in an advocacy role for his or her client.

The new rules prohibit the financial auditor from performing such non-audit services as:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- Financial information systems design and implementation;
- Appraisal or valuation services;
- Actuarial services;
- Internal audit outsourcing services;
- Management functions or human resources;

- Broker or dealer, investment adviser, or investment banking services; and
- Legal services and expert services unrelated to the audit.

Non-audit Services Performed by the Financial Auditor in San Francisco

Over the past few years, San Francisco's financial auditor, KPMG LLP, has performed several non-audit projects for the City. These projects include (a) a FY 2001-2002 report on the Municipal Transportation Authority's payroll process and internal controls, (b) a policies and procedures manual on accounting for capital assets under the new government accounting standards, GASB 34, (c) assistance to the Controller's Office in implementing GASB 34, and (d) assistance to the Public Utility Commission in integrating their accounting information technology system.

During the same period, KPMG Consulting (now known as Bearing Point), which separated from KPMG LLP in 2000, provided consulting services to the Controller's Office on the City's automated purchasing system (ADPICS) and the financial reporting system (EIS). Bearing Point now has a contract with the City to provide support to the financial accounting management information system (FAMIS).

Role of the Audit Committee

Charter § 9.117 establishes the Board of Supervisors' Audit Committee. Under the Charter, the financial auditor reports directly to the Audit Committee. The Charter also gives the Board of Supervisors the authority to select the independent auditor to report on the annual financial statements. Consistent with the Security and Exchange Commission's new rules, the Board of Supervisors should consider adoption of Administrative Code provisions that would implement the intent of the Sarbanes-Oxley Act.

<u>Financial Auditor Reports to the Audit Committee</u>

The financial auditor already has a reporting responsibility to the Audit Committee. The Sarbanes-Oxley Act requires that the reporting by the financial auditor to the Audit Committee be more timely. The Security and Exchange Commission rules require that the financial auditor report to the Audit Committee, prior to issuing the final audit report on the financial statement:

- All critical accounting policies and practices used by the company management;
- All alternative accounting treatments of financial information that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm;
- Other material written communications between the accounting firm and company management.

According to the Security and Exchange Commission, requiring the accountants to communicate information directly to the Audit Committee will aid the Audit Committee in fulfilling its responsibilities. As part of the proposed Charter Amendment discussed above, the Board of Supervisors should include requirements consistent with the Security and Exchange Commission's rule on financial auditor reporting to the audit committee.

<u>Standards for Conflict of Interest</u>

Consistent with the Sarbanes-Oxley Act, the Securities and Exchange Commission established a rule restricting employment of financial audit firm employees by the audited company. The Securities and Exchange Commission rule requires a one-year "cooling off" period before a member of the financial audit firm's audit team can be employed by the audited company in certain key positions, such as chief executive officer, controller, chief financial officer or chief accounting officer.

<u>Financial Auditor Partner Rotation</u>

The Security and Exchange Commission's rules establish a mandatory rotation of the financial auditor's lead partner every five years. Under the rules, the "audit partner" refers to the partner who is a member of the audit engagement team and who has responsibility for decision-making on significant auditing, accounting, and reporting matters that affect the financial statements or who maintains regular contact with management and the audit committee. According to the Commission, in establishing the partner rotation requirement, the Commission attempted to strike a balance between the need to have an audit team, which can take a fresh look at the financial report, and the need to have competent accountants on the audit team. The Controller's Office should develop a policy for adoption by the Board of Supervisors that is consistent with the Security and Exchange Commission rules on conflict of interest standards and financial auditor partner rotation.

Internal Control Assessments

Section 404 of the Sarbanes-Oxley Act directs the Security and Exchange Commission to adopt rules requiring annual reports of publicly-held private companies to include an assessment of the effectiveness of internal controls and procedures for financial reporting. Section 404 also requires the company's independent auditors to attest and report on management's assessment of internal controls. The Act did not specify a deadline by which the Security and Exchange Commission is to adopt rules regarding the assessment of the effectiveness of internal controls.

Process of Assessing and Reporting on Internal Controls

The Committee of Sponsoring Organizations of the Treadway Commission (COSO)[2] issued a report in 1992, *Internal Control-Integrated Framework*, which defined internal controls and provided guidelines to assessing and improving internal control systems. The report defined internal controls as "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:"

- Effectiveness and efficiency of operations;
- Reliability of financial reporting; and
- Compliance with applicable laws and regulations.

The COSO report also identified five interrelated components of effective internal control, including:

- Control environment;
- Risk assessment;
- Control activities;
- Information and communications; and
- Monitoring.

Although the Security and Exchange Commission has not yet completed proposed rules for internal control assessment and reporting in compliance with the Sarbanes-Oxley Act, the completed rules are expected to be consistent with the definitions in the COSO report. Under existing practice, the financial auditor gives an opinion on the annual financial statement but does not report on the system of internal controls. According to the KPMG auditors in the March 1, 2002, Management Letter, the auditors "considered internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the basic financial statements. An audit does not include examining the effectiveness of internal control and does not provide assurance on internal control." Under the Sarbanes-Oxley Act, the financial auditors would evaluate and report on management's assessment of the effectiveness of internal controls.

[2] The Committee of Sponsoring Organizations of the Treadway Commission was formed in 1985 as an alliance of five professional organizations, including Financial Executives International, the American Accounting Association, the American Institute of Certified Public Accountants, the Institute of Internal Auditors, and the Institute of Management Accountants.

Implementing Policies to Assess and Report on Internal Controls

It could be costly for the City to conduct an assessment of internal controls and require financial reporting on internal controls. An internal control assessment would require identifying and evaluating the effectiveness of existing controls for City departments and functions, and developing internal controls to strengthen departments' practices. If the City implemented a policy to include an audit of internal controls as part of the annual financial statement audit, consistent with the intent of the Sarbanes-Oxley Act, then the cost of the annual financial statement audit would increase.

The Controller should study the feasibility of implementing policies to assess and report on the City's internal controls, including potential risk reduction and costs to the City. The feasibility study should be presented to the Board of Supervisors prior to June 30, 2004, with the possibility of implementing the policy for the fiscal year ending June 30, 2005. The Controller should present to the Board of Supervisors the expected cost, including expenditure details, of such a study within 60 days to the Board of Supervisors.

Conclusion

Although the Sarbanes-Oxley Act, which increases oversight over publicly-held private companies, does not apply to government agencies, the principles underlying the Act do apply. The Sarbanes-Oxley Act strengthens the role of the Audit Committee in the financial reporting process and increases the level of auditor independence. The Board of Supervisors Audit Committee already has a direct reporting relationship with the City's financial auditors. By adopting policies consistent with the Securities and Exchange Commission's rules under the Sarbanes-Oxley Act, the Board of Supervisors would increase its oversight over financial statement audits and non-audit services provided by the financial auditor.

The provisions of the Sarbanes-Oxley Act to evaluate and report on internal controls could be costly for the City to implement. However, if the City reduced its risk of loss from inefficient or fraudulent activities through strengthening internal controls, the reduced loss could offset the increased costs of implementing a comprehensive policy to evaluate and report on internal controls.

Recommendations

The Board of Supervisors should:

4.1 Propose an amendment to the Administrative Code, adopting the policies of the Sarbanes-Oxley Act and giving the Audit Committee authority to:

i pre-approve all non-audit services performed by the City's financial auditor, and ü require financial auditor reports to the Audit Committee prior to issuing the final audit report on the financial statement, which include (i) all critical accounting policies and practices used by City management; (ii) all alternative accounting treatments of financial information that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm; and (iii) other material written communications between the accounting firm and City management.

The Controller should:

4.2 Develop and present a policy within 60 days for Board of Supervisors adoption on auditor independence, including (a) standards on conflict of interest, and (b) financial auditor partner rotation;

4.3 Develop and present a cost estimate, including expenditure details, within 60 days for Board of Supervisors' consideration, of a feasibility study to assess and report on the City's internal controls; and,

4.4 If the Board of Supervisors approves the feasibility study, conduct and report on the feasibility of a policy to evaluate and report on the City's internal controls, prior to June 30, 2004, to be implemented for the fiscal year ending June 30, 2005.

Costs and Benefits

The City's costs to implement policies consistent with the Sarbanes-Oxley Act provisions on audit committees and auditor independence would be negligible. The provisions of the Sarbanes-Oxley Act to evaluate and report on internal controls could be costly for the City to implement, but could result in risk of loss from inefficient or fraudulent activities, offsetting the increased costs.

5. Budgetary Controls

- **The Controller's Office does not always enter appropriation reserves into FAMIS in a manner that achieves the Board of Supervisors' policy objectives. In FY 2002-2003, departments expended reserved funds without prior Board of Supervisors approval in two instances, because the FAMIS entry did not capture the work order or subproject level expenditure.**

- **The Controller's Office procedures for entering Mayor's Office reserves or contingencies into FAMIS to achieve savings targets are redundant. Both the Budget and Analysis Division and the Accounting Operations and Systems Division enter reserves or contingencies into FAMIS to control departments' expenditures, resulting in a process that is inefficient and could lead to errors in FAMIS entries.**

- **The Controller's Office does not closely monitor General Fund appropriation reserves for continuing projects. Our review of the listing of appropriation reserves, produced by the Controller's Office at the request of the management audit, found that several appropriation reserves on continuing projects had already been released and expended. Two out of the 16 projects reviewed, however, should be closed, and available revenues returned to the General Fund. By reviewing and closing these three projects, one of which was appropriated in FY 1993-1994, at least $177,000 could be returned to the General Fund.**

- **The Controller's Office approves most City department requests to carry forward unexpended appropriations from one fiscal year to the next. The Controller's Officer generally only denies departments' carry forward requests if the department does not have sufficient funds or if the department has funding for the purpose in the next fiscal year. The Controller's Office approves departments' requests to carry forward funds although some of these requests exceed the Controller's Office written policy for carry forward approval. In FY 2001-2002, the Controller's Office recommended approval of 76 percent of all departments' requests to carry unexpended General Fund monies forward into FY 2002-2003, thus recommending approval of the carry forward of $21,468,665 in unexpended annual appropriations out of $28,423,087 requested. Six percent of appropriations that are carried forward into the next fiscal year are based on policy decisions, rather than stricter guidelines accounting for sufficiency of funds or the prior commitment of funds.**

Monitoring Appropriation Reserves

The Board of Supervisors, the Controller, and the Mayor establish appropriation reserves to monitor and control department expenditures.

- The Board of Supervisors, or a committee of the Board of Supervisors, may establish appropriation reserves during the annual budget review, upon adoption of a supplemental appropriation ordinance, or upon approval of a resolution to accept and expend grant funds. Generally, the Board of Supervisors establishes appropriation reserves as a policy tool to monitor departments' expenditures or to require additional information about departments' programs.

- The Controller, under Charter Section 3.105, establishes appropriation reserves during the annual budget review to control departments' expenditures if revenues are not available. The Controller places these reserves when bonds have not yet been issued or if sources of revenues, such as fee revenues or specific tax revenues, may be less than anticipated in the budget.

Reserves established by the Board of Supervisors or by the Controller during the annual budget review are included in the Annual Appropriation Ordinance.

- The Mayor may establish appropriation reserves to set spending targets that are less than the annual appropriation. In FY 2002-2003, the Mayor established reserves throughout the year to meet reduced spending targets (or savings) to offset expected reductions in revenues.

The Budget and Analysis Division of the Controller's Office is responsible for entering appropriation reserves into the automated general ledger system, FAMIS. Appropriation reserves authorized by the Board of Supervisors during the budget review are entered into the automated budget preparation system, BPREP, and then downloaded into FAMIS. Following the budget process, appropriation reserves authorized by the Mayor's Office are entered directly into FAMIS by Budget and Analysis Division staff. Release of reserves requires written documentation. Reserves established by the Board of Supervisors committees require committee action to release. The Budget and Analysis Division requires written requests from the Mayor's Office to release reserves established by the Mayor.

Board of Supervisors Reserves

Often, the Board of Supervisors or its committees establish appropriation reserves to achieve a policy objective. Departments must submit a request to the Board of Supervisors or the committee that established the reserve to release the funds. The request is generally considered in a public hearing before the Board of Supervisors or appropriate committee.

In the past year there have been two instances when Board-authorized appropriation reserves were spent without prior Board of Supervisors approval. In March of 2003, the Department of Administrative Services requested retroactive release of $3,088,926 reserved by the Board of

Supervisors in the FY 2002-2003 budget for the maintenance and repair of City-owned vehicles. Because the Department of Administrative Services provides vehicle maintenance services on a work order basis to City departments, the Controller's Office placed the appropriation reserve on the requesting departments. Between July of 2002 and March of 2003, when the Finance and Audits Committee authorized the retroactive release of reserves, the Controller's Office City Projects staff worked with the Department of Administrative Services to address the Board of Supervisor's policy issues. Also, a March 19, 2003 memorandum to the Budget Analyst from the Department of Administrative Services states that the Department had been in regular contact with the office of the sponsoring supervisor "for the last three months in regard to the timing and substance of the release of reserve request".

Although the monies were on reserve, the Administrative Services Central Shops performed the work and charged $836,484 against the $3,088,926 reserve prior to authorization by the Finance and Audits Committee to release the funds. According to the Budget and Fiscal Operations Manager, requesting departments should notify performing departments if insufficient funds are available to pay for the work. According to the Accounting Operations Manager, the reserve was entered into FAMIS at the high work order level for the requesting department and not on the specific work order between the requesting and performing department. Therefore, the Accounting Operations and Systems Division fund accountants could only identify if monies were spent against all the requesting departments' work orders, up to the level of the reserve, and could not identify if monies were spent against the specific work order for which the reserve had been placed.

In April of 2003, the Department of Public Works requested retroactive release of reserves for completed Fire Department capital projects. In 1996, the Board of Supervisors appropriated $14,233,588 in Fire Bonds for 20 Fire Department capital projects and had reserved $7,864,100 of the $14,233,588 appropriation. From 1996 until 2003, the Board of Supervisors released $4,340,872 of the $7,864,100 reserve, with a remaining balance of $3,523,228. The remaining reserves were designated for capital projects at three fire stations. However, the Department of Public Works spent unreserved funds in the Fire Bond program for the three fire station projects, for which funds had been reserved. According to the Deputy Controller, the capital project appropriation was entered into FAMIS at the higher project level, and the Controller's Office could not monitor reserves placed on sub-projects.

The Controller's Office should work with the Board of Supervisors to ensure that the Board's policy objectives are met. In the example of reserves placed on work orders, the Controller's Office should place the reserve on the specific work order rather than on the higher level work order and on the corresponding expenditures in the performing department to ensure that both the performing and requesting departments are meeting the policy objective. In the example of the capital project, the Controller's Office should enter the sub-project appropriation reserve into FAMIS at a lower project level to ensure that the sub-project details are captured.

Mayor's Reserves

In FY 2002-2003, the Mayor's Office placed reserves on City departments' expenditures to reduce spending below the appropriation level. The Budget and Analysis Division entered these reserves into FAMIS. Additionally, in FY 2002-2003 the Accounting Operations and Systems Division began entering "contingencies" into FAMIS, when the Mayor requested a reduction in specific department expenditures. A contingency is a separate line, which pulls out expenditures from the department's budget in order to control spending or to account for revenue shortfalls. Contingencies can be entered into FAMIS for on-going operating expenditures but project expenditures must be entered into FAMIS as reserves.

The Budget and Analysis Division's role in placing "reserves" on expenditures due to projected revenue shortfalls or to achieve savings below the level of appropriation, and the Accounting Operations and Systems Division's role in placing "contingencies" on over-expenditures resulting from decreased revenues are redundant. The Budget and Analysis Division is responsible for monitoring appropriation reserves that are placed by the Board of Supervisors or Controller during the budget process or by the Board of Supervisors during the fiscal year through the legislative process. However, the Accounting Operations and Systems Division is responsible for entering contingencies to control over-expenditures resulting from revenue shortfalls.

During FY 2002-2003, the Budget and Analysis Division and the Accounting Operations and Systems Division both entered the Mayor's appropriation reductions into FAMIS, either as a reserve or a contingency. In one instance, the Budget and Analysis Division entered a $1.5 million reserve for the Department of Administrative Services into FAMIS on September 16, 2002, as part of the Mayor's "Capital Reserve List". The Accounting Operations and Systems Division entered a $340,943 reserve into FAMIS for the Department of Administrative Services on April 11, 2003 as part of the Mayor's savings initiative. According to a May 11, 2003 FAMIS journal entry, the $340,943 "was part of $1,500,000 reserve placed on JECO03000268-03 on 9/16/02 and recorded again on JECO03018086 on 4/11/03". The Accounting Operations and Systems Division released the $340,943 reserves, and entered into the FAMIS notepad that the transaction was to "release portion of reserve that was duplicated". Subsequently, the Controller's Office has stated that the entry was not a duplicated entry and that the monies were released after discussion with the Mayor's Office.

The Controller's Office should define the policies and procedures for establishing reserves and contingencies and the respective responsibilities of both the Budget and Analysis Division and the Accounting Operations and Systems Division for placing and monitoring reserves and contingencies. The Budget and Analysis Division should retain its oversight over reserves placed by the Board of Supervisors and Controller during the budget process and by the Board of Supervisors during the fiscal year through the legislative process. However, the Accounting Operations and Systems Division should assume responsibility for placing reserves on projects and contingencies on operating expenditures that are intended to reduce expenditures to offset projected revenue shortfalls. By defining the purpose of reserves and contingencies and identifying the roles and responsibilities of the respective divisions, the Controller's Office would increase the efficiency of the process and reduce opportunities for duplicated entries or other errors.

Prior Years' Appropriation Reserves

Charter Section 9.113 states that the Controller shall transfer unused or unencumbered balances to the Cash Reserve Fund at the end of the fiscal year. Unexpended annual appropriations for department operations and for annual projects are closed out to the fund balance at the year-end close. The Charter provision does not require the Controller to close out to the fund balance unexpended appropriation balances designated for continuing projects at the year-end. The Controller's Office closes out to the fund balance unexpended General Fund appropriation reserves for department operations (1G AGF AAA) and for annual projects (1G AGF AAP) at the year-end. The Controller's Office does not monitor appropriation reserves for continuing projects separately from continuing project appropriations overall. This management audit requested a listing of appropriation reserves for all funds, which is not a standard report produced by the Controller's Office. The Controller's Office provided a listing of all outstanding appropriation reserve documents in FAMIS through June 30, 2003. According to the listing, all outstanding General Fund appropriation reserves for annual department operating expenditures (1G AGF AAA) and annual projects (1G AGF AAP) are from FY 2002-2003, and according to the Controller's Office, these appropriation reserves will be closed out and returned to the General Fund balance during the year-end close.

According to the listing, as of June 30, 2003, there were $18,144,792 in appropriation reserves for continuing projects (1G AGF ACP). The majority of these projects were multi-year capital or information system projects, although a few of the projects were for other types of programs. More than half of these monies, or $9,728,296, were listed as appropriation reserves for continuing projects established in FY 1999-2000 or earlier. We reviewed the details for the 16 projects that were established in FY 1999-2000 or earlier, and based on our interviews with the respective departments, found that many of these appropriation reserves had been released and expended. For example, of the five Department of Public Works projects, three of the appropriation reserves had been released and expended and the projects closed, one project had been closed and the monies returned to the fund balance, and one project from FY 1993-1994 was still open. Both Recreation and Park Department appropriation reserves had been released and expended.

At least two of the appropriation reserves that we reviewed should be reviewed for appropriateness by the Controller, and the Controller should recommend return of these monies to the fund balance.

- The listing showed a $22,063 appropriation reserve, established in FY 1996-1997, for which the Medical Examiner's Office was able to identify the entry into FAMIS in April 1997 and the enabling Ordinance 101-97, but was not able to identify the associated project. Because the revenue source was Jail Overcrowding Fine Revenue, which is not a revenue source for the Medical Examiner's Office, the Medical Examiner's Office thought that this could be an incorrect journal entry.

- The listing showed a $61,210 appropriation reserve, established in FY 1993-1994, for the Department of Public Works Civic Center Steam System Improvement Project. According to the Department of Public Works, the balance in this account, including the $61,210 reserve, is $177,995. Although the Department of Public Works owns the steam system loop in Civic Center, a private contractor provides the actual steam heat. The Department of Public Works is reviewing the feasibility of transferring the steam system to the private contractor, and therefore, the appropriateness of the $177,995 account, including the $61,210 reserve, needs to be reviewed.

<u>The Controller's Procedures in Reviewing General Fund Continuing Projects</u>

According to the Controller's Office, the Budget and Analysis Division is responsible for working with the Mayor's Office to review and determine which continuing projects and associated reserves should be closed out at the year end. Annual operating and project funds close out automatically at the year-end but continuing projects are carried forward into the next year. The Accounting Operations and Systems Division is responsible for reviewing and closing out continuing projects that do not have appropriation reserves.

As noted above, the Controller's Office does not produce systematic reports on appropriation reserves for continuing projects. Because the appropriation reserves are entered into FAMIS at the project level, if a department attempts to spend against the appropriation reserve, FAMIS will deny the transaction. The Budget and Analysis Division will then look at the history of the appropriation reserve and if necessary request the department to provide justification for the reserve.

Currently, the Mayor's Office plays the lead role in reviewing continuing projects and identifying which projects should be closed. The Mayor's Office requests EIS reports from the Controller's Office on prior year and current year continuing project balances, which include encumbered and unencumbered funds. The Controller's Office also produces a year-end report on inactive projects, which is reviewed by the Deputy Controller. According to the Deputy Controller, in recent times, City departments have identified projects within their budgets that can be closed to meet spending targets. Other projects are not closed because, although the project is nearly complete, the department continues to need some monies for completion or the project. Projects are also not closed if the funded source is project-specific. Although the Mayor's Office takes the lead in working with departments to close continuing projects, the Controller's Office can close projects with the department's agreement.

Carry Forward of Annual Appropriations into the Next Fiscal Year

Although the Charter requires the Controller to return unencumbered balances to the Cash Reserve Fund, the Controller's practice has been to allow departments to carry forward unexpended appropriations from one fiscal year to the next, after review by the Controller's Office and the Mayor's Office. Each year, the Controller's Office sends a memorandum to departmental fiscal officers regarding the Controller's policy for carrying forward unexpended annual appropriations into the next fiscal year, stating that unencumbered balances of all annual appropriations are automatically closed to the fund balance at year end. The memorandum provides the criteria used by the Controller's Office to determine if City departments can carry forward unspent monies into the next year, as follows:

- These monies must be for specific non-recurring items or services.
- The department can not have funds budgeted in the next fiscal year for the specific purpose.
- The department must spend the money in the next fiscal year for the same purposes for which it had been appropriated in the prior fiscal year.

The fund accountants review the departments' requests to carry forward monies and the Accounting Operations Manager reviews the fund accountants' actions. The Accounting Operations and Systems Division staff review departments' carry forward requests in August with further review by the Mayor's Office in September. The fund accountants, Accounting Operations Manager and Deputy Controller meet with Mayor's Office staff as part of the review. In FY 2001-2002, in which final information is available, the Controller's Office approved 76 percent of all departments' requests to carry unexpended General Fund monies forward into FY 2002-2003. The Controller approved carry forward of $21,468,665 out of $28,423,087 requested. The Mayor's Office approved $17,771,396, or 82.8 percent of the Controller's approved amount of $21,468,665.

We reviewed FY 2001-2002 carry forward requests for six General Fund departments. Of the requested carry forward of funds by these six departments, the Controller's Office approved 83 percent, of which one-half were approved because the funds had already been committed and one-half were approved for other reasons, as noted in Table 5.1.

Table 5.1

Controller's Approval or Denial of Requests by Six General Fund Departments to Carry Forward FY 2001-2002 Funds

Status of Request to Carry Forward Funds	Police	Human Services	Fire	Adult and Aging Services	County Clerk	Public Health	Total[1]
Denied for insufficient funds	2	1	1	3	0	0	7
Denied due to FY 2002-2003 funding	0	0	1	0	0	8	9
Denied for other reasons	0	0	0	0	0	2	2
Total Denials	2	1	2	3	0	10	18
Approved for encumbrances or other commitments	0	4	4	0	1	35	44
Approved as one-time funds (no FY 2002-2003 appropriation)	0	4	3	0	0	9	16
Approved due to delay in project or uncompleted work	0	0	2	0	0	20	22
Approved for other reasons	0	0	0	0	0	6	6
Total Approvals	0	8	9	0	1	70	88
Percent Denied	100%	11%	18%	100%	0%	13%	17%
Percent Approved	0%	89%	82%	0%	100%	87%	83%

[1] The total percentages are based on total denials and approvals for all six departments.

Source: Controllers Office

The Controller's Office generally only denied projects for insufficiency of funds or because additional monies had been appropriated in FY 2002-2003. Sixteen of the 18 denied requests for the carry forward of appropriated funds from FY 2001-2002 to FY 2002-2003 were denied by the Controller's Office for these reasons. In two out of the 18 denied requests to carry forward appropriations, the Controller's Office denied the request for other reasons. The Controller denied one request because the project had already been paid and denied another request because the monies had previously been carried forward from FY 2000-2001. The Controller's Office approved all other requests to carry forward FY 2001-2002 unexpended appropriations into FY 2002-2003.

As noted above, one-half of the Controller's Office recommended approvals to carry forward unexpended funds were for reasons other than that the funds were already committed. The majority of approved projects, other than projects for which funds were already committed, were due to delays in capital and information systems projects, or for one-time projects for which no additional monies were available in the next fiscal year.

The Controller's Office approved six Department of Public Health requests to carry forward unexpended funds for varying reasons, other than those in the stated Controller's Office policies, or six percent of the approved requests in our sample.

- The Controller's Office approved three requests to transfer funds for information systems or telecommunications projects. In one instance, the funds were transferred between Department of Public Health cost centers and in another instance the funds were transferred from a professional services contract to a work order with the Department of Telecommunication and Information Services. Another request was to fund an increase in a work order with the Department of Telecommunication and Information Services. According to the notation, the Controller's Office had approved the FY 2001-2002 budget transfer but was unable to increase the work order encumbrance because the deadline had passed.

- The Controller's Office approved one request to carry forward funds to pay for an anticipated workers compensation settlement.

- The Controller's Office approved a request by the Community Mental Health Services Pharmacy to purchase bulk medications due to missing the end of the year purchasing deadline.

- The Controller's Office also approved a request by the Department of Public Health Substance Abuse division to fund a purpose in FY 2002-2003 that differed from the appropriation in FY 2001-2002. The Board of Supervisors had approved monies for contractual services to provide transitional housing for women and children in FY 2001-2002. However, the Department of Public Health requested that these monies, with a remaining balance of $254,000, be used instead to pay off the mortgage of the contractor, who was going out of business in the next fiscal year, and to transfer title of the property to the Department of Public Health.

In the above example, the Department of Public Health used $254,000, appropriated for professional services in FY 2001-2002 and carried forward into FY 2002-2003, to pay off the mortgage balance of the Women's and Children's Family Services facility at 15 Bishop Street. Although the funds were used to pay off the mortgage balance for the non-profit organization, these monies continued to be identified in FAMIS as monies for a professional services contract. According to the City Attorney's Office, the title to the building will be transferred to another non-profit organization, the Mission Neighborhood Development Corporation. Because the transaction involves the transfer of property between two non-profit organizations rather than the purchase or transfer of the property to the City, the proposed transaction has not been submitted to the Board of Supervisors for approval.

According to the Deputy Controller, the Controller's Office approves all requests by City departments to carry forward unexpended funds if the departments provide sufficient justification for expending the funds and if the monies are not needed for other purposes. In one example, the Controller's Office approved the Community Mental Health Service request to carry forward funds for bulk medicines, which is not consistent with the criteria that carry forward requests must be for one-time purposes. The annual appropriation is authorized for the level of spending that is justified. When carry forward requests for ongoing expenditures are approved by the Controller's Office, the annual appropriation level approved by the Board of Supervisors is modified. Appropriation authority is the Board of Supervisors' primary tool to implement policy and account for resources. When City departments shift monies between fiscal years, they circumvent the appropriation process. The City needs a clearly stated policy on the carry forward of appropriations from one fiscal year to the next. Currently, the Administrative Code is silent on the process. Although the Controller's Office has a documented policy to carry forward one-time monies if there is no new appropriation in the next fiscal year and if the purpose is unchanged, the Controller's Office approves the carry forward of funds for many reasons. Our review of the six City department's requests shows that the Controller's Office recommends approval of carry forward requests in most instances, unless the department has insufficient funds or has an appropriation for the purpose in FY 2002-2003.

The Controller's Office should work with the Board of Supervisors to define the policy objectives and scope of carrying forward annual appropriations from one year to the next, and propose Administrative Code amendments as needed. The Controller's Office also should clearly define the policies and procedures for reviewing and approving the carry forward of unexpended annual appropriations into the next fiscal year.

Conclusions

The Controller's Office does not always enter appropriation reserves into FAMIS in a manner that will achieve the Board of Supervisors' policy objectives. Departments have been able to spend against reserves because the Controller's Office did not enter the reserve against the work order or subproject for which it was established. The Controller's Office procedures for entering Mayor's Office reserves or contingencies into FAMIS to achieve savings targets is redundant. Both the Budget and Analysis Division and the Accounting Operations and Systems Division enter reserves or contingencies into FAMIS to control departments' expenditures, resulting in a process that is inefficient and could lead to errors in FAMIS entries.

The Controller's Office does not closely monitor General Fund appropriation reserves for ongoing projects. Our review of the listing of appropriation reserves produced by the Controller's Office at the request of the management audit found that several appropriation reserves on continuing projects had already been released and expended. We identified at least two out of the 16 projects, however, which should be closed, and available revenues returned to the General Fund.

The Controller's Office approves most City department requests to carry forward unexpended appropriations from one fiscal year to the next. Carry forward requests are generally only denied if the department does not have sufficient funds or if the department has funding for the purpose in the next fiscal year. The Controller's Office approves departments' requests to carry forward funds although some of these requests exceed the Controller's Office written policy for carry forward approval.

Recommendations

The Controller's Office should:

5.1 Work with the Board of Supervisors to ensure that the Board's policy objectives are met in authorizing appropriation reserves, including defining such procedures as (a) placing work order reserves on both the performing and requesting departments, and (b) establishing separate project accounts to account for reserves placed on sub projects;

5.2 Define the policies and procedures for establishing reserves and contingencies and the responsibilities of the Budget and Analysis Division and the Accounting Operations and Systems Division for placing and monitoring reserves and contingencies, including the responsibility for the Budget and Analysis Division in overseeing Board of Supervisors and Controller's reserves, and the responsibility of the Accounting Operations and Systems Division in overseeing the Mayor's reserves to achieve savings targets; and,

5.3 Work with the Board of Supervisors to (a) define the policy objectives and scope of carrying forward annual appropriations from one year to the next, and propose Administrative Code changes as needed; and (b) define the policies and procedures for reviewing and approving the carry forward of unexpended annual appropriations into the next fiscal year.

Costs and Benefits

Our recommendation to redefine the responsibilities of the Budget and Analysis and Accounting Operations and Systems Divisions in monitoring reserves and contingencies would increase efficiency by reducing duplicative efforts in establishing and monitoring appropriation reserves.

Our recommendation to increase the Controller's role in monitoring and recommending closure of continuing General Fund projects, including projects with appropriation reserves, would release additional revenues to the General Fund for alternative uses. Closing out the $22,000 Medical Examiner appropriation reserve would clear the books but may not result in additional revenues if no revenues were received from the Jail Overcrowding Fines. However, by working with the Department of Public Works to close out prior year continuing projects, approximately $177,000 could be available for other uses.

Our recommendation to increase oversight over the approval of departments' requests to carry forward unexpended appropriations would ensure that departments' appropriations in the next fiscal year do not exceed the appropriation levels intended by the Board of Supervisors.

6. Fund Maintenance

- **Funds are the accounting instruments by which governmental entities record financial activities and resources. A governmental entity may have many funds to separate disparate activities and restricted resources. Sound financial management and governmental accounting practices prescribe that funds be kept to the minimum number necessary to prevent unwarranted complexity and inflexibility. Accordingly, the Controller's Office has structured the financial accounting framework so funds are comprised of numerous sub-funds, which are the level at which the Controller records financial activities and resources that are segregated for specific uses.**

- **Historical records on the creation of sub-funds have not been maintained by the Controller's Office. Accordingly, for any given sub-fund, there is limited documentation on the purpose, source of revenue, authorization, and department(s) responsible for the sub-fund. A review of selected special funds maintained by the Controller's Office has identified sub-funds that are not necessary. Some funds are not legally required. Other funds are required by the City and County of San Francisco Code, but do not appear to otherwise meet the criteria for a separate fund. These activities may be accounted for and separately tracked in the General Fund or other primary operating fund. Further, financial activities are not necessarily monitored at the sub-fund level. For example, a number of sub-funds had inappropriate deficit or residual fund balances. Other sub-funds should be closed due to lack of activity as required by Administrative Code Section 10.100-1 and the Annual Appropriation Ordinance.**

- **The Controller's Office should review all sub-funds, closing those that have not had activity or those for which activity is not required to be recorded separately. The Controller's Office should also establish comprehensive written policies and procedures for the establishment, maintenance, and monitoring of sub-funds. Internal and external policies and procedures should be developed, clearly defining the roles and responsibilities of the departments as well as of the Controller's Office.**

- **This review identified approximately $2,193,114 in funds that can potentially be transferred to the primary operating funds of the City, including the General Fund. Some, but not all of these funds may continue to be restricted for certain activities. The remaining special and fiduciary sub-funds that have not been reviewed would almost certainly have additional monies that could be transferred to the primary operating funds of the City, including the General Fund. A thorough analysis is required to address the issues discussed in this review and would identify additional fund balances available to support General Fund or other primary operating fund activities. In addition to identifying available resources, operational and financial management efficiencies would be realized.**

Fund Accounting

Generally Accepted Accounting Principles (GAAP) dictate that governmental entities use fund accounting. GAAP defines funds and fund accounting as follows:

> "A fund is defined as a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations."[1]

While there is no limit on the number of funds that a governmental entity may use, GAAP stipulates that governmental entities should maintain the fewest number possible:

> "Governmental units should establish and maintain those funds required by law and sound financial administration. Only the minimum number of funds consistent with legal and operating requirements should be established, however, since unnecessary funds result in inflexibility, undue complexity, and inefficient financial administration."[2]

GAAP has separated funds into eleven fund types and categorized them into three groups as noted in Table 6.1.

Table 6.1
Fund Types and Fund Groups

Governmental Funds	Proprietary Funds	Fiduciary Funds
General fund	Enterprise	Pension trust
Special revenue	Internal service	Investment trust
Debt service		Private-purpose trust
Capital projects		Agency
Permanent		

[1] National Council on Governmental Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 2.

[2] NCGA Statement 1, paragraph 4.

All of the eleven fund types, except for the General Fund, can be comprised of multiple funds. The Controller has taken the reporting of fund activity one step further by recording disparate financial activity and resources at the sub-fund level.

The Controller's Office simplified and consolidated the City's special funds in FY 2000-2001 by creating a standardized categorization system. The categorization system details how the funds are to be administered, including whether 1) interest accrues to the fund, 2) funds are automatically appropriated, and 3) the fund balance carries forward. The Controller reports closing funds and sub-funds at that time and conducting a major revision of the Administrative Code to reflect the consolidation and categorization of special funds.

The Controller's Office reports that the review of funds and sub-funds is an ongoing process. For external financial reporting purposes, funds are reconciled annually. According to the Controller's Office, the extent to which sub-funds are reviewed and reconciled is based on priority and available staff resources. Further, the Controller reports that there are working groups of high level Controller staff that review and approve the creation of funds and sub-funds. However, the Controller does not have comprehensive written or formal policies and procedures guiding the creation, maintenance and monitoring of funds and sub-funds.

Review of Existing Sub-Funds

Because discretion is used more frequently in the establishment of special revenue funds and fiduciary funds, detail was requested on these funds and their respective sub-funds. The Controller reported 25 special revenue funds and 16 fiduciary funds. These funds are comprised of 185 special revenue sub-funds and 78 fiduciary sub-funds. The following table provides cash and fund balances for these funds:

Table 6.2
Special Revenue Funds and Trust Funds
Cash and Fund Balances

As of 6/30/02	Special Revenue Funds	Fiduciary Funds (1)
Fund Count	25	15
Sub-Fund Count	185	77
Cash Balance	$364.4 million	$490.9 million
Fund Balance	$356.2 million	$243.3 million

(1) Fiduciary Funds reported in the table exclude the Employees' Retirement System which has a total cash balance of $11.0 billion and a fund balance of $10.4 billion.

The Controller maintains limited historical documentation on these funds. Of a sample of 65 special revenue sub-funds, no central file existed for 22 sub-funds, excluding 12 grant sub-funds, which are not managed at the sub-fund level, but at the grant level. Of the remaining 31 sub-funds for which files were located, the extent of documentation varied substantially, with many of the files only containing financial reports from the reconciliation that occurred in FY 2000-2001. No historical files are maintained for fiduciary funds. The Controller's Office reports that it intends to place the type of information typically contained in historical files, such as legal authorization, purpose and source of funds, in FAMIS and available for on-line review.

Departments were then contacted to gather data and information on the use of 18 special revenue sub-funds. Of the 18 special revenue sub-funds, several did not appear to be administratively necessary or legally required outside of the Administrative Code. Other funds were identified that should be closed. Several funds had unreconciled activity, including residual or negative fund balances.

Funds Not Required by GAAP

As noted earlier, GAAP stipulates that a minimum number of funds be maintained. While GAAP indicates that "sound financial administration" may be cause for establishing a separate fund, oftentimes, financial accounting systems are sophisticated enough to monitor and track financial activity in a multitude of ways, rendering the need for a separate fund obsolete.

The Board of Supervisors may request funds that do not specifically meet the definition of a fund, as defined by GAAP. In order to stem the proliferation of funds and sub-funds, the Controller reports that he has worked with the City Attorney's Office and individual Supervisors to develop language in any proposed legislation requiring a separate accounting for activity to be segregated into either a special fund **or account**. Therefore, the activity can be effectively tracked and monitored in the General Fund or other primary operating fund.

Our review identified the following sub-funds that are not administratively necessary or legally required outside of the Administrative Code, and where the financial activity and resources can be accounted for in the primary operating fund, which is most often the General Fund.

<u>General Services Special Revenue Fund – Civil Service Special Revenue Sub-Fund</u>

According to Controller files, this sub-fund is to record revenues received from the lease of examination material and the provision of consulting services for the purpose of examination research and development. Additionally, according to the Controller's files, the Administrative Code requires amounts in excess of $10,000 to be transferred to the General Fund. Further, Controller staff asserted that this fund is used to reimburse Civil Service Commission expenditures in the General Fund. As of June 30, 2003, the fund balance was $1,441.

The Civil Service Commission was unaware of this fund and believed that fund management might be the responsibility of the Department of Human Resources (DHR). However, DHR stated that the fund is not in their purview, and noted that the only activity in the sub-fund was posted by the Controller's Office. However, according to Controller staff, this sub-fund is the responsibility of the Civil Service Commission. The activity purported to be recorded in this fund does not necessitate a separate fund and should be recorded in the General Fund.

<u>General Services Special Revenue Fund – Tenants Overtime Sub-Fund</u>

This sub-fund is used by the Fine Arts Museum to record overtime incurred for guards and other Museum personnel when the Museum is rented for special events. These expenses are reimbursed by the parties renting the facilities. According to Controller files, the Recreation and Parks Department and County Agriculture used this sub-fund for the same purpose, but both departments ceased using this sub-fund in 1999. At June 30, 2003, this sub-fund recorded a fund balance of $150,129. Given that these funds are to reimburse already incurred overtime expenditures, these funds are due to the General Fund where the expenditures were initially recorded. Given the ability to record and monitor these expenditures in the General Fund, as other departments do, and given the lack of any legal requirement, there is no clear reason why this sub-fund is required for financial administration purposes.

<u>Off-Street Parking Fund – Annual Projects Sub-Fund and Continuing Projects Sub-Fund</u>

When the Department of Parking and Traffic was merged with the Municipal Transit Agency (MTA), most of the Department's financial activity was transferred to the MTA enterprise fund. These two sub-funds, however, were not merged. According to the Department, these funds will remain open until the projects or activities have been completed. However, if the Department has been merged with MTA creating one reporting entity, all of its financial activity, even if it relates to prior year appropriations, should be merged and these sub-funds should be closed.

<u>Public Works, Transportation and Commerce Special Revenue Fund – DPW Personnel Sub-Fund</u>

According to the Department of Public Works (DPW), this sub-fund is DPW's "homebase errors fund." As such, this sub-fund records the salaries and fringe benefits expenditures of employees who inaccurately bill their time to a job that does not match an appropriate project account. Accordingly, this sub-fund works like a suspense account, where errors or unidentified activity is recorded until the appropriate accounting is determined. By isolating these expenditures in another fund, actual salaries and fringe benefits expenditures are understated in the initiating fund and are not monitored against appropriations until a reconciliation occurs and errors are corrected.

<u>Public Works, Transportation and Commerce Special Revenue Fund – Citywide Waste Disposal Sub-Fund</u>

This sub-fund has been recently created to account for DPW's payment of City departments' garbage bills. According to the DPW, the Mayor's Office recommended this fund during the budget process and the Controller created the sub-fund in the financial accounting system. It should be noted that it is Controller's responsibility to authorize and control the chart of accounts and funds in accordance with GAAP requirements and sound financial management practices and not the Mayor's Office responsibility.

According to DPW, this activity could be accounted for in the General Fund. For administrative ease, DPW prefers a separate fund. Given the ability to record and monitor these types of expenditures in the General Fund as other departments do and given the lack of any legal requirement, there is no clear reason why a sub-fund is required for financial administration purposes.

<u>Public Works, Transportation and Commerce Special Revenue Fund – Service to Outside Agencies Sub-Fund</u>

DPW accounts for services performed for non-City agencies, such as Caltrans, by establishing projects in this sub-fund. However, DPW is unaware of any reason as to why these activities have been accounted for in this sub-fund and suggested that it is because it has always been done that way. Given there is no legal requirement that this type of activity be recorded in a separate fund, there is no reason why projects for these purposes cannot be established or monitored in DPW's other operating funds.

Inactive Funds and Sub-Funds

Pursuant to Administrative Code Section 10.100-1(d) and the Annual Appropriation Ordinance:

> "…if there has been no expenditure activity for the past two fiscal years, a special fund should be closed and repealed. The Controller is hereby authorized and **directed** to close such funds, consistent with the budgetary and fiscal provisions of the Charter."[3] (Emphasis added)

The following sub-funds were identified during our review as having no activity for at least a two year period.

<u>General Services Special Revenue Fund – Wages - Voting Tabulation Sub-Fund</u>

According to a memorandum in the Controller's files, the Registrar of Voters requested this sub-fund be closed in May, 1999. At that time, the Registrar reported that the fund had not been active for over 10 years. The sub-fund has recorded the same fund balance of $7,453 for at least the last three years. Subsequent communication with the Registrar indicated that the Department continues to want the sub-fund closed.

<u>Public Protection Special Revenue Fund – Sheriff Management Assistance Sub-Fund</u>

According to the Sheriff's Department, the sub-fund was closed when the Controller completed its reconciliation in FY 2000-2001. While there has been no fund balance for at least the last three years, FAMIS reports balances in budgetary accounts in FY 2002-2003. So, while the sub-

[3] City and County of San Francisco, *Consolidated Budget and Annual Appropriation Ordinance*, Fiscal Year Ending June 30, 2004.

fund may have been closed, the appropriate accounting entries were not recorded to close out all sub-fund activity and balances.

Off-Street Parking Fund – Continuing Projects Sub-Fund

This sub-fund has shown the same fund balance of $1,544,422 for the last three fiscal years ending June 30, 2000, 2001, and 2002. While the sub-fund has no fund balance and has been closed as of June 30, 2003, more than two years elapsed before the fund was reconciled and closed.

The Controller reports that this sub-fund can only be reviewed in conjunction with other sub-funds within the Off-Street Parking Fund because the department was not managing its activities at the sub-fund level. However, if this sub-fund did not have activity for over two years, it was incumbent upon the Controller's Office to identify that there had been no activity and at that time a reconciliation should have occurred and the sub-fund either closed or corrected to reflect accurate departmental activity and balances.

Fund Reconciliation and Other Financial Management Issues

Sound financial management practices require that funds and sub-funds be regularly reconciled to identify any irregular or erroneous fund activity. Reconciliation includes analysis of whether fund balances are appropriate and all activity has been appropriately recorded. For example, if the special revenue fund records activity that is reimbursed, there should not be a positive fund balance because any revenues would be paying for expenditures already incurred.

General Services Special Revenue Fund – Tenants Overtime Sub-Fund

As noted previously, this sub-fund is used by the Fine Arts Museum to record overtime incurred for guards and other Museum personnel when the Museum is rented for special events. These expenses are reimbursed by the parties renting the facilities. For the last three fiscal years from June 30, 2000 through June 30, 2002, the fund has recorded a fund balance at year end of $156,024, $235,898, and $222,720. Given that these funds are to reimburse already incurred overtime expenditures, at year end, these funds should either be transferred to the fund where the expenditures and liabilities are initially recorded or a liability should be recorded in the sub-fund at year end.

General Services Special Revenue Fund – Dispute Resolution Program Sub-Fund

Pursuant to Administrative Code Section 10.100-295: "The Board of Supervisors hereby authorizes payment to the General Fund of the City from the Dispute Resolution Program Fund of an amount not to exceed 10 percent of the total amount of said fund for any necessary and reasonable administrative costs incurred…" According to the Mayor's Office of Criminal Justice (MOCJ) and Superior Court, which administered the sub-fund from 1997 to 2002, this transfer has not occurred. In fact, Superior Court was not even aware of such a stipulation in the Administrative Code. Prior to Superior Court, the Mayor's Office of Community Development administered the fund.

According to MOCJ, 10 percent of funding in FY 2002-2003 is $37,505. However, according to MOCJ, there is no requirement that administrative costs be reimbursed by the program. Given the inclusion of such a clause in the Administrative Code, it appears that the intent of the Board of Supervisors was to recover administrative costs incurred by the General Fund. If $37,505 is representative of historical administrative costs, the General Fund has absorbed approximately $262,535 in costs since 1997. While the Controller cannot ensure that every appropriate transaction is completed, the Controller has the responsibility to ensure that funds are adequately managed, including compliance with Administrative Code, especially when funds are transferred between departments and general City accounts.

<u>Public Works, Transportation and Commerce Special Revenue Fund – DPW Personnel Fund</u>

As noted above, this fund is used to account for errors made by DPW employees when billing projects. The year end fund balance for FYs 1999-2000, 2000-2001, and 2001-2002 of this sub-fund was a negative $569,480. According to DPW, this negative balance was created in the conversion to on-line FAMIS in FY 1995-1996. Otherwise, DPW does not know the source of the negative balance. According to DPW, the Controller asked DPW to recover these funds through charging for these costs through DPW's overhead account. However, according to DPW, the Department has forgotten to do this and the negative fund balance remains. In accordance with the Controller's direction, DPW should resolve this negative fund balance in FY 2003-2004.

Fiduciary Funds

According to Controller staff, individual departments or outside agencies, such as the Community College District, are responsible for the maintenance and reconciliation of fiduciary funds. Accordingly, inquiries were made to several departments regarding fiduciary funds. In several instances, departments did not have any information on the fiduciary funds that seemed to correlate with the department. For example, Administrative Services was unaware of the Administrative Services – Department of Consumer Assurance Fund (with a negative fund balance of $564), the Department of Public Health was unaware of the Public Health Miscellaneous Trust Fund (with a fund balance of $37,332), and DPW's Deposits Fund is being used by the Department of Building Inspection.

To the extent that the City is responsible for the administration of the assets held in a fiduciary capacity, such as funds held on deposit, any subsidiary accounting or tracking system should be reconciled to the City's financial accounting system, FAMIS. One fiduciary sub-fund that was reviewed during the course of the audit, the Sheriff Deposits Fund, is not reconciled back to FAMIS. In fact, according to the Sheriff's Department, the subsidiary system cannot even provide a fund balance for the accounts that it is tracking. Another fiduciary sub-fund, the Social Services Assistance Program Fund, is not reconciled by the Department of Human Services (DHS). In fact, DHS could only identify approximately $340,000 of a total fund balance of $1,047,000. DHS could not associate the remaining $707,000 with any specific program or activity. According to the Controller's Office, the residual fund balance in this sub-fund was also created in the conversion to on-line FAMIS in FY 1995-1996.

Another fiduciary fund managed by DHS, the Social Service Building Trust Fund, accounted for excess revenues derived from the bond issuance for the construction of a DHS building at 170 Otis. Per the bond covenants, these funds are restricted for project costs, which DHS has interpreted as including building maintenance and rental costs. According to DHS, while these funds could have been used in prior years to subvent General Fund costs for these purposes, they were not always used. DHS anticipates and has appropriated to use in FY 2003-2004 the remaining $291,859 fund balance as of August 27, 2003, along with anticipated final project revenues of approximately $470,000.

Gift and Bequest Funds

The Controller has established a gift fund and a bequest fund to track donations to the City. For these funds, the Controller has not established separate sub-funds for each gift or bequest. Instead, gifts and bequests are tracked in the financial accounting system by grant numbers. As of August 8, 2003, the gift fund had 241 grants for a total of $6,048,718. The bequest fund had 9 grants as of August 8 and totaled $5,573,946.

Of the 241 grants in the gift fund, 21 had balances less than $1.00 and 15 had balances less than $100.00. Therefore, 36 funds, or 14.9 percent of funds, had balances less that $100.00, indicating that a significant number of gift funds are inactive and should be closed. 28 gift funds had a negative fund balance totaling $1,243,759. Given the nature of gifts and bequests, a negative fund balance typically indicates that either departments have not appropriately accounted for gift activity or have over-expended gift funds.

Additionally, there are two grants in the gift fund titled “Unallocated Grant,” for which there is no clear responsible department and which total $698,526. In the bequest fund, one unallocated grant totaled $15,623. In total, unallocated grants amount to $714,149. According to the Controller’s Office, these grants were created in 1996 when FAMIS was upgraded to consolidate small inactive grants. According to the Controller, these monies might be used to “offset” negative balances, essentially covering gift expenditures when departments have overspent.

Correspondence with select departments identified the following examples of inappropriate use of or balances in the gift fund:

- DPH has a number of gifts from the mid-1980s that the Department is currently working with the Controller to close out.

- The Police Department reports that most of the existing gift funds are from prior to 1998 and are inactive. Police gift funds total approximately $46,486.

- The gift fund includes $776,065 from unknown sources in an account entitled OES Command Center Project – Earthquake Relief.

- The gift fund includes 2 grants that total approximately $87,685 in fines and forfeitures that DPW uses for the Adopt a Tree Program.

- The gift fund includes approximately $191,075 in insurance settlements for earthquake damaged art. According to the Fine Arts Museum, the repair and replacement of art to be paid for with the funds has already occurred.

- Although the project is complete, gift funds totaling $6,838 remain for the Doggie Diner Head Repair.

Conclusions

The Controller does not provide adequate oversight or control over the establishment or maintenance of sub-funds. Accordingly, existing sub-funds are not necessarily required by legal provisions or for financial administration purposes as stipulated by GAAP. These activities can be recorded in the General Fund or other primary operating funds. The lack of monitoring and oversight has also resulted in unexplained and unreconciled financial activity, which has produced among other issues, negative or residual fund balances. Our review of 35 sub-funds identified $2,193,114 that can likely be transferred to the primary operating funds of the City, including the General Fund. While some of these funds may be restricted for certain activities, many of these funds are not restricted or can be used to subvent General Fund subsidies of the specified activity. Certainly, the remaining 227 special and fiduciary sub-funds would have additional monies that could be transferred to the primary operating funds of the City, including the General Fund.

Recommendations

The Controller should:

6.1 Establish formal policies, procedures and criteria for the establishment of special revenue and fiduciary funds and sub-funds, in accordance with Generally Accepted Accounting Principles, and develop specific criteria for funds that are necessary to meet "sound financial administration" principles;

6.2 Conduct a thorough review and reconciliation of special revenue and fiduciary funds and sub-funds by June 30, 2004, including an analysis of departments' subsidiary financial accounting systems that record detail on special revenue or fiduciary fund activities;

6.3 Conduct a review and reconciliation by June 30, 2004 of all gift and bequest funds, identifying monies where:

(a) Recording in the gift or bequest fund is not warranted and the resources/activity can be recorded in the primary operating fund; and

(b) Gift purpose has been achieved and residual gift balances must be disposed.

6.4 Close and transfer any residual fund balances for those funds and sub-funds that do not meet the criteria established by Recommendation 6.1, above, and for which the activity can be sufficiently tracked and monitored in the primary operating fund;

6.5 Resolve or dispose of any inappropriate residual or deficit fund balances identified by the reviews performed pursuant to Recommendation 6.2 and 6.3 above; and

6.6 Establish periodic and year-end procedures for the reconciliation and review of all special revenue and fiduciary funds and sub-funds.

The Board of Supervisors should:

6.7 Consider the use of special accounts rather than special funds as an acceptable and preferable mechanism by which activities can be segregated, tracked and monitored.

Costs and Benefits

While the recommendations above will require both one-time and limited on-going resources, the costs will be significantly exceeded by the identification of available recourses resulting from 1) residual balances identified by the Controller's review which can be returned or escheated to the General Fund and 2) operational and financial management efficiencies. A minimum of approximately $2,193,114 in funds can likely be transferred to the primary operating funds of the City, including the General Fund. Review of the remaining 227 special and fiduciary sub-funds almost certainly will identify additional funds. While some of these funds may be restricted for certain activities, many of these funds are not restricted or can be used to subvent General Fund subsidies of the specified activity.

7. Cash Revolving Funds

- **According to the San Francisco Administrative Code Sections 10.100 and 10.125, the Controller is charged with the responsibility to administer, monitor use, and authorize exceptions to Cash Revolving Funds. As part of its responsibility to monitor the use of Cash Revolving Funds, the Controller's Office is responsible for periodically auditing Cash Revolving Funds, assessing the appropriateness of authorized amounts and recommending changes to authorized amounts of such funds.**

- **Currently, there are a total of 58 Cash Revolving Funds with a total authorized amount of $765,950. In FY 2002-03, the Controller's Office approved a total of $3,499,150 in transactions through Cash Revolving Funds. Because the Controller's Office does not have clear policies and procedures regarding the appropriate number and authorized amount for Cash Revolving Funds some Cash Revolving Funds are replenished as infrequently as once a year (or not at all) and some are replenished multiple times in one day, based entirely on the frequency of requests by departments. The Controller's Office Audits Division periodically audits Cash Revolving Funds. However the Controller's Office considers such audits a lower priority. The Audits Division performed a total of three audits of Cash Revolving Funds in FY 2001-2002.**

- **The City's risk for loss is unnecessarily high due to the proliferation of unnecessary Cash Revolving Funds and Cash Revolving Funds with authorized amounts set higher than necessary. In addition, in the absence of a clear policy regarding frequency and amount of replenishments for Cash Revolving Funds, the workload associated with replenishing the funds is not being minimized by the Controller's Office.**

- **The Controller's Office should implement standards for the replenishment of Cash Revolving Funds, which would reduce and standardize the Controller's Office workload associated with maintaining such funds. In addition, the Controller's Office should annually assess the necessity for Cash Revolving Funds and recommend the elimination of those with zero transactions occurring during a fiscal year and the reduction of the authorized amounts for underutilized Cash Revolving Funds. Cash Revolving Funds should be set at the minimum amount necessary for departments. Implementation of our recommendations would reduce Cash Revolving Funds by $487,100 and would reduce the risk associated with cash disbursements in the affected departments.**

The City Charter provides that the Board of Supervisors may establish Cash Revolving Funds "to be used as petty cash funds for specific purposes" and provides that the Cash Revolving Funds are "subject to settlement and audit by the Controller's Office at least monthly." The

Administrative Code provides for 58 Cash Revolving Funds, with a total authorized amount of $765,950 disbursed among 41 departments. In FY 2002-2003, the Controller's Office authorized a total of $3,499,150 in replenishments for expenditures made from Cash Revolving Funds. The Administrative Code further provides that "petty cash purchases and disbursements shall be for purposes and within funds available in the appropriations from which said revolving funds claims are to be reimbursed; and shall be in conformity with applicable rules prescribed by the Purchaser of Supplies and the Controller."

Policies and Procedures

With appropriate policies and controls in place the risk associated with Cash Revolving Funds is moderate for small funds. The Controller's Office considers the controls in place for Cash Revolving Funds to be adequate and considers the funds to be low risk. However, Cash Revolving Funds are inherently risky for loss because they involve cash. Clearly, it is preferable to have only the necessary amount of cash disbursed in departments. The Controller's policies and procedures regarding Cash Revolving Funds for departments are contained in Departmental Instructions Numbers 1051 and 1052 issued by the Controller's Office in August 1996. The memorandum accompanying those instructions stated:

> <u>Purpose and Phase-out of Revolving Funds</u>
> Departmental Revolving funds were established as petty cash funds for very small expenditures. Over the years, due to the extremely cumbersome purchasing and payment procedures of the Purchaser and Controller these funds grew to allow departments to expeditiously purchase various goods and services. Now that On-line ADPICS (Purchasing) and On-line FAMIS (Accounting) systems are in place, the purchase of goods and payments for them is much simpler and quicker. Therefore, we plan to minimize the use of revolving funds for the routine purchase of goods and services…Over the next several months we expect to work with departments to lower the authorized amount of revolving funds to reflect this reduced usage.

The Administrative Code provides that a "department head, board or commission, with concurrence of the Controller, may authorize such subdivisions in any revolving funds as will effect the most efficient operation thereof." Many departments have disbursed the cash in revolving funds to multiple locations. The Sheriffs Department reports that it has divided its total authorization amount of $13,000 (Administrative Code Sections 10.164. and 10.164-1) among 30 substations. This subdivision of Cash Revolving Funds can result in multiple replenishments of funds on a single day multiple times each month. For example, in April of 2003, the Sheriff's Department requested a total of 19 replenishments of its funds on five separate days for a total amount of $5,112.60. While the Controller's Office has not established any limit to the number of replenishments permitted for Cash Revolving Funds, the Controller's Office reports that "separate documents for multiple replenishments within the same day may require more time and effort" by the Controller's Office. The Sheriff's Department's Cash Revolving Funds authorization amounts were modified based on recommendations of the Controller's Office in 2000 in order to minimize the number of necessary replenishments (Files 00-1851, 00-1852 and 00-1853). However, it appears that in the absence of a clear policy regarding frequency and amount of replenishments for Cash Revolving Funds, the work load associated with replenishing is not being minimized by the Controller's Office.

Authorization Amounts

Some departments require Cash Revolving Funds to serve clients or be prepared for immediate operational needs. However, for most departments, minimal planning for operational needs and the accounting and purchasing systems make a Cash Revolving Fund unnecessary. If Cash Revolving Funds are not clearly justified, they should be closed out.

Although it appears that some Cash Revolving Funds were closed out or reduced following the issuance of Departmental Instructions Numbers 1051 and 1052 and the Controller's review of usage in 1996, the Budget Analyst has identified a total of 19 Cash Revolving Funds that showed no activity for FY 2002-2003 and an additional 37 Cash Revolving Funds that showed transaction activity that did not appear to justify level of the authorized amount. The following table shows those Cash Revolving Funds with current authorization in the Administrative Code that had no activity for FY 2002-2003.

Table 7.1

Cash Revolving Funds With Zero Activity in Fiscal Year 2002-2003

Department	Administrative Code Authorization	Authorized Amount
Administrative Services – Convention Facilities	Sec. 10.137.	$50
Administrative Services – Public Administrator	Sec. 10.152.	$500
Administrative Services – Purchasing	Sec. 10.158-1.	$5,000
Administrative Services – Purchasing	Sec. 10.169-19.	$7,000
Administrative Services – Real Estate	Sec. 10.169-13.	$100
Commission on Aging	Sec. 10.169-15.	$200
City Attorney	Sec. 10.136.	$8,000
Civil Service Commission	Sec. 10.138.	$50
Commission on the Environment	Sec. 10.169-12.	$100
Commission on Status of Women	Sec. 10.169-11.	$100
County Clerk	Sec. 10.159.	$500
Department of Building Inspection	Sec. 10.135.	$200
Human Resources – Workers Compensation Program	Sec. 10.145-1.	$750
Human Resources	Sec. 10.145-2.	$500
Human Rights Commission	Sec. 10.169-17.	$200
Juvenile Probation	Sec. 10.146.	$500
Mayor's Office of Emergency Services	Sec. 10.142.	$100
Recreation and Park Department – Camp Mather	Sec. 10.161.	$750
Recreation and Park Department – SF County Fair	Sec. 10.160-1.	$5,000
Total of Unused Authorization		**$29,600**

The Controller's Office reports that the San Francisco County Fair Cash Revolving Fund included in the preceding table was closed in 1998. However, the fund is still authorized at $5,000 in the Administrative Code. The Controller's Office should have previously requested that the San Francisco County Fair Cash Revolving Fund authorization be removed from the Administrative Code in order to eliminate unnecessary Cash Revolving Fund authorization. While the Controller's Office maintains that it is the responsibility of departments to suggest Administrative Code changes, the Budget Analyst believes that the Controller should take the initiative to advise the Board of Supervisors on the authorization for funds it is responsible for administering and monitoring.

In addition to the $29,600 in excess Cash Revolving Fund authorization for funds with zero activity in FY 2002-2003, the Budget Analyst has identified $457,500 in underutilized authorization for Cash Revolving Funds, with at least some activity in FY 2002-2003. Appendix 7.1 to this report shows those 37 Cash Revolving Funds that were underutilized in FY 2002-2003 with recommended reductions to authorization amounts.

Expenditure Exemptions

The Controller's Office has a policy that states "no single purchase of goods and services through the revolving fund can exceed $200." Certain departments and funds have exemptions from the $200 limit on purchases, including the Municipal Transportation Authority, the Department of Public Works, the Airport Commission and the Elections Department. For example, the Administrative Code provides for a $500 Cash Revolving Fund for the Elections Department and states that the Elections fund "may also be used, with the approval of the Controller, to reimburse election judges, inspectors and other poll workers" (Sec. 10.162). In FY 2002-03, the Elections Department's Cash Revolving Fund was replenished for $465,000 with individual replenishments of $450,000, $5,000 and $10,000. The Controller's Office has stated that "due to the volume of details, expenditures are not verified at the time reimbursements are made. The revolving fund is subject to periodic audit by the Controller's Internal Audit." The Elections Department Cash Revolving Fund is an example of the risk associated with such funds.

Appropriate Level of Risk

The Controller's Office considers Cash Revolving Funds to be a low risk because procedures and controls are in place and because departments know that the funds may be subject to an audit. However, the Audits Division has significantly reduced the number of audits it performs on Cash Revolving Funds based on the assessment that these funds are of low risk. The Controller's Office has also discontinued conducting risk assessments for funds and departments based on the assumption that the level of risk associated with City assets and departments are low risk. However, the infrequency of audits and the discontinuation of an annual risk assessment have resulted in excessive authorization for Cash Revolving Funds. Therefore the Budget Analyst recommends that the Controller's Office conduct an annual risk assessment of Cash Revolving Funds. Such a risk assessment should include a review of replenishments to Cash Revolving Funds and a more in-depth analysis of transactions when deemed necessary.

The Controller's Office should also conduct an annual analysis of Cash Revolving Fund utilization in an effort to reduce the Cash Revolving Funds authorizations, in accordance with the Controller's Office policy, to phase out unnecessary Cash Revolving Funds as stated in the memorandum issued to departments in August 1996. The phase out of unnecessary Cash Revolving Funds would result in reduced cash disbursed in City departments and therefore a reduced risk for loss.

Conclusions

According to the San Francisco Administrative Code Sections 10.100 and 10.125, the Controller is charged with the responsibility to administer, monitor use, and authorize exceptions to Cash Revolving Funds. As part of its responsibility to monitor the use of Cash Revolving Funds, the Controller's Office is responsible for periodically auditing Cash Revolving Funds, assessing the appropriateness of authorized amounts and recommending changes to authorized amounts of such funds.

Currently, there are a total of 58 Cash Revolving Funds with a total authorized amount of $765,950. In FY 2002-03, the Controller's Office approved a total of $3,499,150 in transactions through Cash Revolving Funds. Because the Controller's Office does not have clear policies and procedures regarding the appropriate number and authorized amount for Cash Revolving Funds some Cash Revolving Funds are replenished as infrequently as once a year (or not at all) and some are replenished multiple times in one day, based entirely on the frequency of requests by departments. The Controller's Office Audits Division periodically audits Cash Revolving Funds. However the Controller's Office considers such audits a lower priority. The Audits Division performed a total of three audits of Cash Revolving Funds in FY 2001-2002.

The City's risk for loss is unnecessarily high due to the proliferation of unnecessary Cash Revolving Funds and Cash Revolving Funds with authorized amounts set higher than necessary. In addition, in the absence of a clear policy regarding frequency and amount of replenishments for Cash Revolving Funds, the workload associated with replenishing the funds is not being minimized by the Controller's Office.

The Controller's Office should implement standards for the replenishment of Cash Revolving Funds, which would reduce and standardize the Controller's Office workload associated with maintaining such funds. In addition, the Controller's Office should annually assess the necessity for Cash Revolving Funds and recommend the elimination of those with zero transactions occurring during a fiscal year and the reduction of the authorized amounts for underutilized Cash Revolving Funds. Cash Revolving Funds should be set at the minimum amount necessary for departments. Implementation of our recommendations would reduce Cash Revolving Funds by $487,100 and would reduce the risk associated with cash disbursements in the affected departments.

Recommendations

The Controller should:

7.1 Conduct an annual risk assessment of Cash Revolving Funds;

7.2 Conduct an annual analysis of Cash Revolving Fund utilization;

7.3 Develop and implement clear policies on frequency of replenishments to Cash Revolving Funds;

7.4 Develop and implement clear policies on disbursement of cash among locations within departments;

7.5 Request that the Board of Supervisors repeal the Administrative Code authorization for the 19 Cash Revolving Funds listed in Table 7.1, resulting in reduced authorization of $29,600; and

7.6 Request that the Board of Supervisors reduce the authorized amount for the 38 Cash Revolving Funds listed in Appendix 7.1, resulting in reduced authorization of $457,500.

Costs and Benefits

These recommendations can be accomplished within the normal management responsibilities within the organization. Our recommendations would result in tighter controls over Cash Revolving Funds and reduce cash authorizations by a total of $487,100.

8. Cost Allocation Plan

- **The Controller's Office is responsible for preparing the Countywide Cost Allocation Plan which allocates the costs of support and administrative services to benefiting programs, departments and agencies. These allocated costs are then able to be appropriately reimbursed either through direct billing or by including the costs in claims for reimbursement, typically through federal or State programs, and in fees charged to the public. In today's environment of decreasing budgets, it is increasingly important for the City, in general, and the Controller, specifically, to accurately identify the true costs of services being provided and to aggressively maximize revenues.**

- **The Controller has not approached the cost plan and cost recovery in a systematic and comprehensive manner. Accordingly, the current cost plan, as it is prepared, is incomplete and does not represent the actual cost of City support services and administration. Allowable costs have not been included in the cost plan's preparation and additional entities may be able to be billed for their costs. These deficiencies have resulted in lost revenues every year and potentially could result in non-compliance with A-87 guidelines and other legal issues with regards to billing cost plan allocations.**

- **Potentially, an additional $29,271,533 in allowable costs could be included and allocated through the cost plan, which represents an increase of 36.6 percent in allocated costs. These costs would be allocated among City activities including those reported in the General Fund, special revenue funds and enterprise funds. To the extent that the Controller can identify additional entities and programs that receive support and administrative services which can be billed, costs will be reimbursed and revenues will be increased.**

According to Administrative Code Section 10.195, "The Controller shall prepare those budgetary procedures, regulations, reporting requirements and guidelines sufficient…to determine for each service rendering agency the costs of its operation to the extent services are rendered or facilities provided to recipient agencies and, if not funded directly by recipient agencies, to allocate the cost of that operation on and amongst recipient agencies…" In that capacity, the Controller's Office is responsible for preparing the Countywide Cost Allocation Plan (cost plan) which allocates the costs of support and administrative services to benefiting programs, departments and agencies. These allocated costs are then able to be appropriately reimbursed either through direct billing or by including the costs in claims for reimbursement, typically through federal or State programs, and in fees charged to the public.

Pursuant to federal regulations authorized by the Budget and Accounting Act of 1921 and several other related acts, the federal Office of Management and Budget (OMB) has prepared OMB Circular A-87 entitled *Cost Principles for State, Local and Indian Tribal Governments*. The purpose of this circular is to standardize claims for the reimbursement of costs related to federal programs and grants, according to uniform principles of cost accounting and definitions of allowable indirect costs. The federal agency responsible for implementing OMB Circular A-87 (A-87) is the Department of Health and Human Services (HHS). In that capacity, HHS designated the State Controller's Office as the cognizant agency to oversee implementation of A-87 cost plan procedures in California. Accordingly, the State Controller has developed and issued a handbook of procedures and requirements to be followed by counties.

The cost plan is compiled using actual costs from two years prior to the year the cost plan is used for billing and claiming purposes. Accordingly, the cost plan includes an adjustment every year to correct for the difference between what was allocated in any given year, the base allocation (using two year old data), and the actual costs for that year. This adjustment is called the roll forward.

The City's cost plan used in the fiscal year ending June 30, 2003 reported $560,989,520 in support and administrative services, with unallocated or unallowed costs totaling $366,682,644. Additionally, $113,709,541 of support and administrative services are directly billed and are therefore not allocated to benefiting departments through the cost plan. However, these costs may be included in departmental indirect cost rates. Support and administrative services allocated to benefiting departments and agencies though the cost plan total $80,597,335.

Inclusion of All Allowable Costs

While the State Controller's Office reviews and approves the City's cost plan annually, the State Controller's Office is primarily concerned with whether any unallowable support or administrative costs have been included in the cost plan. It is not the focus of the State Controller's Office to attest to completeness of the plan. The following areas have been identified as support or administrative costs that may be allowable costs pursuant to A-87, but have not been included in the City's annual cost plan. These costs would be allocated among City activities including those reported in the General Fund, special revenue funds, and enterprise funds.

Self-Insurance and General Liability Costs

According to the State Controller's handbook, insurance costs for tort liability losses, property losses, and employee-related losses are allowable costs. It is common practice among California counties to have a self-insurance program rather than purchase insurance from private insurance companies or join public insurance pooling arrangements. The State Controller's handbook describes a self-insurance program as follows:

> "A statement of purpose, program administration, including safety, claims, and legal services coordination, and cost savings analysis are all integral parts of both risk management and self-insurance administration. Other elements that enter into the administration of self-insurance programs are methods of funding and cost distribution to benefiting departments."[1]

Self-insurance programs include the estimation of risk and the establishment of reserves to cover future costs.

According to Section 4180 of the State Controller's handbook, a county is considered non-insured if it has not established a self-insurance program but rather finances any losses through current appropriations, issuance of debt, or other "spur-of-the-moment" financing. According to the State Controller's Office, the City is considered non-insured for general liability costs pursuant to OMB Circular A-87 guidelines, because it has not established a self-insurance program. Accordingly, the City cannot be reimbursed by federal or State programs for the actual costs of liability claims. The State Controller's Office reported that the City along with the County of Los Angeles are the only two counties in the State that are considered non-insured. However, both entities were "grandfathered-in" under A-87 cost allocation guidelines with respect to workers' compensation costs and can receive reimbursement under their "pay-as-you-go" systems.

However, for general liability, the State Controller's Office asserts that it has repeatedly advised the City of the millions of dollars that it has forgone in reimbursements by not establishing a self-insurance program and liability reserves, but the City has chosen to continue in a non-insured status since the late 1970's. Because the issue is over twenty years old, neither the State Controller's Office nor the City Controller's Office has maintained any information or documentation of the issue or the State Controller's recommendations.

The County of Los Angeles has obtained a waiver for these insurance costs from the federal and State governments because that County has established an analytical model which uses ten years of loss experience to estimate the amount of their annual budget appropriation for liability claims settlement needs. Further, Los Angeles allocates these costs to departments based on historical experience as well as current employee count in order to account for the assumption of future risk.

This review noted that while Workers Compensation is included in the Cost Allocation Plan, general liability costs are not. In order to provide an estimate of the general liability costs that could be claimed if the City either established a self-insurance program or obtained a waiver similar to the County of Los Angeles, claims and litigation payments as reported by the City Attorney's Office have been reviewed. Although the City Attorney's Office's Office has identified limitations on their data, such as the fact that activity is not reconciled to the Controller's reporting of these costs in FAMIS, our review indicates that the data still provides a

[1] California State Controller's Office, *Handbook of Cost Plan Procedures for California Counties*, Section 4130, March 2001.

reasonable estimate of general liability costs and may in fact be conservative in that the Controller's amounts are significantly larger on average over the last five years[2] and these costs do not include any administrative costs that may be incurred in the administration of a general liability program.

Table 8.1
General Liability Claims Costs (1)

FY 2002-2003	$18,120,457
FY 2001-2002	16,780,641
FY 2000-2001	16,815,702
FY 1999-2000	10,115,262
FY 1998-1999	26,439,193
Total	$88,271,255
5-Year Average	$17,654,251

(1) Amounts exclude payments made on behalf of the Tax Collector because the payments appear to be related to tax disputes and not related to general liability costs.

Using the City Attorney's data to estimate general liability costs, over the last five years, the Controller has not allocated to benefiting programs, departments and agencies approximately $88,271,255 in allowable costs. While these costs can fluctuate significantly from year to year, it is clear that the Controller is not including and allocating approximately $17,654,251 in general liability costs annually.

The Controller notes that a significant portion of these costs would be allocated to the Municipal Transit Agency (MTA) and accordingly would not benefit the General Fund. However, it should be noted that the MTA does obtain significant funding from federal and State revenue sources. According to the Comprehensive Annual Financial Report for FY 2001-2002, federal and State operating grants were approximately $211.3 million dollars or 64.4 percent of operating and non-operating revenues. Additionally, MTA receives substantial federal and State monies in the form of capital grants. To the extent that general liability costs can be claimed by MTA for federal and State reimbursement, MTA's revenues would increase.

[2] According to a special report prepared by the Controller's Office, Judgements and Claims expenditures over the last five years averaged $40,906,803 annually and ranged from $26,975,946 to $89,290,649.

Treasurer-Tax Collector Functions

The Treasurer-Tax Collector provides administrative support to all City functions. While some Treasurer-Tax Collector activities are not considered allowable, such as the tax collection function, others are allowable. According to the Controller's Office, bank charges used to be included in the cost plan, but were removed in FY 1999-2000 because, at that time, the Treasurer-Tax Collector ceased cashing checks for cash assistance recipients. However, cashing checks by the Treasurer-Tax Collector is not the only direct administrative support provided by bank charges and according to the State Controller's Office, bank charges are typically allowable. According to the Office of the Treasurer-Tax Collector, bank charges in FY 2002-2003 totaled $1,784,694.

Other Treasurer-Tax Collector costs, such as those for the treasury and the collections function may also be allowable. According to the State Controller's Office, costs related to the treasury and the collections functions are not explicitly unallowable per A-87 guidelines. Cost plans should be constructed to the benefit of the claiming agency and to the extent that costs are not explicitly unallowed and they can be supported by the claiming agency, they should be included in the cost plan. If at a later time a cost is disallowed, the claiming agency is no worse off than had the cost not been included.

According to the Annual Appropriation Ordinance, appropriations for these two functional areas in FY 2003-2004 are $2,472,852 for Treasury and $4,676,659 for Delinquent Revenue. If the Treasurer-Tax Collector applies all interdepartmental recoveries of $1,463,212 and an additional $700,000 in off-setting revenues for Delinquent Revenue to these areas, potential costs including banking charges that can be included and allocated through the cost plan total approximately $6,770,993 annually.

The Controller reports that Treasury costs, including banking charges, are recovered by being offset by interest earnings. Accordingly, such costs cannot be allocated through the cost plan and recovered for a second time from other sources. While this is accurate, it seems the Controller has not considered that the City is the prime recipient of interest revenue and as such continues to absorb Treasury costs. To recover the City's component, the Controller can either identify those costs and allocate them directly through the cost plan or the Controller can allocate all Treasury costs through the cost plan, with a direct bill or allocation to those agencies that would have otherwise experienced a reduction in their interest earnings. The second methodology is preferable as it clearly identifies and segregates the accounting transactions, makes the costs transparent, and is simple to administer.

Equipment Use Allowance

Equipment use allowance is a typical and commonly included cost allocated through the cost plan. According to the State Controller's Office handbook, "a standard percentage of the total cost of each fixed asset…may be claimed each year that the asset is in use. Six and two-thirds percent of the total acquisition cost of each piece of equipment…may be claimed." According to the Controller staff, these costs were included in the City's cost plan until FY 1993-1994, when the State Controller's audit of the cost plan found that the City's fixed asset inventory was inadequate and unable to provide accurate historical cost information on the City's equipment inventory. Instead of addressing the State Controller's concerns, the costs were simply dropped from the cost allocation plan.

In FY 2000-2001, the Controller implemented a new fixed assets tracking system, FAACS, in order to comply with GASB 34 reporting requirements. Therefore, the Controller has had in place an adequate and accurate accounting of the City's equipment for the last two fiscal years. According to the reports prepared by the Controller for the production of the Comprehensive Annual Financial Report, as of June 30, 2002, historical cost of the City's General Fund equipment (net of accumulated depreciation) was approximately $72,658,000. Equipment usage allowance of 6.67 percent results in approximately $4,846,289 in allowable costs that should be included and allocated through the cost plan annually. An alternative method for recovering costs related to equipment use is to allocate depreciation expense. The Controller should analyze both methodologies, equipment use allowance and depreciation expense, and select the method that would yield the largest amount.

According to the Controller, most of equipment use costs would be allocated to non-"paying" departments, such as the Sheriff's department, and therefore there is no discernable benefit to the City from allocating these costs. However, to the extent that departments charge fees or have federal and State grants, these costs can be recovered. By way of example, according to the Annual Appropriations Ordinance for FY 2003-2004, the Sheriff has budgeted 38.4 percent of its revenues from federal and State funding sources and 8.0 percent from fee revenues.

In addition to the issues identified above, the format and content of the cost allocation plan does not adequately capture and report Citywide support services. The cost plan should compile all Citywide administrative costs and then distribute those costs into either allowable costs or unallowable costs pursuant to A-87 guidelines. The current cost plan places all unallowable costs in an "unallocated" column and there are no costs identified as unallowable in the cost plan. Further, the unallocated costs contain such activity as the General Fund contributions to the enterprise funds, which are clearly not administrative costs. The Controller should perform an overall assessment of Citywide support services and administrative costs and should develop a cost plan that comprehensively and accurately represents the true cost of City functions and activities.

Billing of Allocable Costs

The Budget and Analysis Division calculates the allocable costs to be charged to non-General Fund City agencies and programs as well as independent entities that receive general City support. In FY 2002-2003, the calculation included a cost of living adjustment applied to base allocable costs.

Billing All Agencies and Programs that Incur Support Services and Administrative Costs

According to the Controller's Office, it is Controller policy to bill allocable costs unless there is a reason that billing would be inappropriate. The Controller's Office asserts that the billing is reviewed and adjusted every year. The following agencies and programs may be able to be charged for support services and administrative costs incurred on their behalf:

<u>Retirement</u>

The cost plan allocates indirect costs to the San Francisco City and County Employees' Retirement System (Retirement System). According to the Retirement System, many administrative costs are already directly billed to the Retirement System. However, as Table 8.2 demonstrates, considerable costs are not directly billed and are, therefore, not reimbursed.

Table 8.2
Allocated Retirement System Indirect Costs

Fiscal Year	Allocated Indirect Costs (1)
2002-2003	$(49,993)
2001-2002	687,149
2000-2001	769,634
1999-2000	307,309
1998-1999	(102,147)
1997-1998	(53,205)
1996-1997	552,226
Seven-Year Total	$2,110,973

(1) Negative charges result from the roll forward adjustment.

The City, as employer, has not had to make a contribution to the Retirement System since FY 1995-1996, indicating that Retirement resources have been sufficient to cover at least a portion of its indirect costs. Over the last seven years, the City has failed to charge the Retirement System approximately $2,110,973 in allowable costs. To the extent that the City continues to not have to make employer contributions to the Retirement System, indirect costs allocated through the cost plan should be billed to the Retirement System.

County Office of Education

The County Office of Education (COE) receives a substantial allocation from the cost plan every year. However, these costs are not charged to the COE. Table 8.3 provides allocated costs for the past six years:

Table 8.3
Allocated County Office of Education Indirect Costs

Fiscal Year	Allocated Indirect Costs
2002-2003	$3,270,498
2001-2002	3,517,932
2000-2001	2,412,000
1999-2000	2,339,742
1998-1999	180,689
1997-1998	2,145,417
Six-Year Total	$13,866,278

Provided that charging the County Office of Education is not legally prohibited, it is a policy decision for the Board of Supervisors as to whether to bill indirect costs incurred by the agency.

Other Special Revenue Funds

Select special revenue funds are billed for countywide indirect costs. However, out of a total of 185 special revenue sub-funds, only 7 were billed in FY 2002-2003. Additionally, as noted in Section 6 of this report, the Dispute Resolution Program sub-fund has not been billed for indirect costs, although the Administrative Code explicitly permits the charging of administrative costs of up to 10 percent of program funds. The Controller should do a thorough review of the City's special revenue funds and identify those sub-funds that programmatically receive support from the central service agencies and conduct an analysis of what those costs are. It is a policy decision for the Board of Supervisors as to whether or not these sub-funds should be billed for indirect costs, thereby reducing available funding for direct program costs and services.

Application of the Cost of Living Adjustment

In prior years, the Controller billed specific entities and programs the base allocation in the annual cost allocation plan and applied a cost-of-living-adjustment (COLA). In FY 2002-2003, the Controller revised its billing procedures and now bills specific entities and programs the base allocation, the COLA (applied to the base allocation only), and the roll forward. The application of a COLA is not traditionally applied by counties when billing cost plans. Because of the recent change in billing procedures, we were unable to discern exactly how the roll forward and COLA are being applied and, given the scope of our audit and the its time constraints, we did not conduct a full assessment. The State Controller's Office expressed concern over the application of a COLA and roll forward when asked about it specifically. Given these factors and the concern that there may be an issue of double counting, we recommend the independent financial auditors review this issue.

It was also noted that the Controller applied a COLA to Child Support Services. Because Child Support Services is 100 percent funded by federal and State sources, the COLA which totaled $7,907 in FY 2002-2003 is not allowable pursuant to A-87 guidelines.

Quality Control and the Big Picture

Cost plan activities are split between two Divisions in the Controller's Office. The cost plan is prepared in the Grant Management Unit of the Accounting Operations and Systems Division, while calculation of billing amounts occurs in the Budget and Analysis Division. In the Grant Management Unit, there is no management review of the cost plan or supervision over its preparation. The staff responsible for the preparation of the cost plan, when asked about a supervisory review, stated that the State Controller's Office is really the authority that he answers to. As noted above, there are several examples of areas where management and supervisory oversight should have addressed and resolved the underlying issues. As an additional example, the FY 2002-2003 cost plan includes a reference to tuition reimbursement that has not been allocated through the cost plan because "The City has not implemented an appropriate allocation basis."[3] The staff responsible for the cost plan preparation stated that this phrase should have been removed and it was no longer applicable as the program was direct billed to benefiting departments by the Department of Human Resources. This example brings up two issues: 1) an allocation method should have been developed for application in prior years and 2) there should have been a supervisory review to identify the error in the FY 2002-2003 cost plan.

The Controller asserts that the cost plan has had comprehensive and supervisory reviews over time. He reports that the former managers of the Grant Management Unit used to review the cost

[3] Cost Allocation Plan, City and County of San Francisco, For the Plan Year Ending June 30, 2003, Schedule 3.001, page 19.

plan in detail and that he, too, has reviewed it at some length in the past. Further, he advises that the new Grant Manager will review the next cost plan.

The Controller has noted that for cost plan purposes, support and administrative services must be allowable, distributed to benefiting departments and agencies using a justifiable allocation methods, and must result in the recovery of costs. According to the Controller, the previously identified examples do not necessarily meet these three criteria and, therefore, the perceived benefits do not exceed the costs of allocating the identified support and administrative costs. However, in today's environment of decreasing budgets, it is increasingly important for the City, in general, and for the Controller, specifically, to accurately identify the true cost of services being provided and to aggressively maximize revenues. Until an analysis is completed that compiles all support and administrative costs, determines methods of allocation, and identifies external funding sources, the cost and benefits of these issues as well as any others identified in a comprehensive review are unknown and not estimable.

We recommend that the preparation of the cost plan be transferred to the Budget and Analysis Division for several reasons. First, the cost plan is a complex document that requires strong analytical skills in its preparation and its review. Second, the Budget and Analysis Division is the Division where other cost functions are performed, including the review and preparation of indirect cost rates, and it is the Division that determines the cost plan billings. Finally, the Budget and Analysis Division has the understanding of and exposure to the broader contextual issues that effect the City and its support and administrative services, and the impacts that these issues have on the cost plan.

Conclusions

The Controller has not approached the cost plan and cost recovery in a systematic and comprehensive manner. Accordingly, the current cost plan, as it is prepared, is incomplete and does not represent the actual cost of City support services and administration. These deficiencies have resulted in lost revenues every year and potentially could result in non-compliance with A-87 guidelines and other legal issues with regards to billing cost plan allocations.

Recommendations

The Controller should:

8.1 Perform a comprehensive assessment of Citywide support services and administration and treatment in the cost plan and report back to the Board of Supervisors by June 30, 2004;

8.2 Assess and address the issues noted in this report and report back to the Board of Supervisors by June 30, 2004, on the following areas:

i. Self-insurance and general liability costs;

ii. Treasurer-Tax Collector functions;

iii. Equipment use allowance;

iv. Retirement billing;

v. County Office of Education billing;

vi. Other Special Revenue Fund billing; and

vii. Cost of Living Adjustment.

8.3 Request that the independent financial auditors review the application of the COLA and roll forward methodology for computing cost plan billings, and report back to the Board of Supervisors on their findings;

8.4 Establish written internal policies and procedures for the preparation and billing of the cost plan;

8.5 Consolidate the preparation and billing of the cost plan in the Budget and Analysis Division; and

8.6 Require the Budget and Analysis Director to supervise the preparation of the cost plan, annually review the cost plan document, and be actively involved in the State Controller's annual review of the City's cost plan, including participating in discussions with the State Controller's Office on any identified issues and findings.

Costs and Benefits

While there are costs associated with the comprehensive assessment of the cost plan and its application, there will be increased revenues by addressing the issues outlined in this report. The Controller should utilize existing Controller analytical resources other than the current staff responsible for cost plan preparation.

9. Multi-Tiered Cost Plans

- **The Controller's Office annually prepares a County-wide cost allocation plan pursuant to federal Office of Management and Budget regulations that are contained in Circular A-87 and State guidelines. Local governments must comply with these regulations when charging indirect costs to grants or other programs that are funded by the federal and State governments.**

- **Pursuant to Circular A-87, certain costs cannot be charged to grants or programs funded by federal and State governments. Appropriately, the Controller's Office has identified certain costs as unallowable in the County-wide cost allocation plan. However, the City also applies Circular A-87 regulations when allocating indirect costs to programs that are not funded by federal or State governments. This is not required. In at least one other California jurisdiction, multi-tiered full cost plans have been developed and are used to ensure that the maximum amount of legitimate indirect costs are allocated to programs other than those governed by federal or State cost allocation regulations. This practice serves to maximize indirect cost reimbursement to the General Fund from user fees, enterprise fund and special fund activities, and is endorsed by the State Controller.**

- **As a result, the Controller's Office may have missed opportunities to maximize reimbursement for the legitimate cost of providing support services to programs that are not funded by the federal or State governments. If such costs are allocated to these programs, additional revenues could be recovered by the General Fund.**

Pursuant to federal regulations authorized by the Budget and Accounting Act of 1921 and several other related acts, the federal Office of Management and Budget (OMB) has prepared OMB Circular A-87, entitled *Cost Principles for State, Local and Indian Tribal Governments*. The purpose of this circular is to standardize claims for the reimbursement of costs related to federal programs and grants, according to uniform principles of cost accounting and definitions of allowable indirect costs. The federal agency responsible for implementing OMB Circular A-87 is the Department of Health and Human Services (HHS). In that capacity, HHS designated the State Controller's Office as the cognizant agency to oversee implementation of A-87 cost plan procedures in California. Accordingly, the State Controller has developed and issued a handbook of procedures and requirements to be followed by counties.

In Section 8 of this report, the Budget Analyst discusses OMB Circular A-87 cost plan requirements and allowable costs. This Section discusses opportunities for maximizing General Fund reimbursements from programs that are not funded by the federal or State governments.

Unallowable Costs in an A-87 Conforming Plan

OMB Circular A-87 defines the tests to be used by local governments when determining those costs that can be charged to federal and State funded grants and programs. Four tests provide guidance regarding those costs that cannot be charged in an A-87 conforming plan:

- Costs must be necessary and reasonable for the proper and efficient performance and administration of the program.
- Costs must be permissible under A-87 guidelines (not a specific unallowable cost).
- Costs must not be prohibited by state or local laws or regulations.
- Costs must be consistent with policies, regulations and procedures that apply uniformly to both federal programs and grants, and other activities of the governmental unit.

Other tests related to the treatment of costs and program revenues guide preparers on other technical aspects of the plan.

OMB Circular A-87, Attachment B, identifies various specific items of cost that are unallowable. These include:

1. Advertising and public relations (certain exceptions apply);
2. Alcoholic beverages;
3. Bad debt losses;
4. Value of donated services;
5. Contingency appropriations and reserves;
6. Contributions and donations;
7. Defense and prosecution of civil and criminal proceedings and claims;
8. Entertainment, including tickets, travel, meals, lodging and gratuities;
9. Fines and penalties related to violations of federal, state or local laws;
10. Fund raising and investment management costs, except for pension fund investment management;
11. General government costs, including salaries and other costs of the legislative body and the executive office, all judicial branch costs and other general government services provided to the general public, such as fire and police protection;
12. Idle facilities and capacity, meaning unused buildings and equipment and the related costs of such idle facilities;
13. Interest related to the financing of operations;
14. Lobbying and membership costs in lobbying organizations; and,
15. Upgraded commercial air travel in excess of coach class.

Pursuant to A-87 restrictions regarding unallowable costs, the FY 2002-03 cost plan prepared by the Controller's Office accounted for $561 million of net indirect costs to be allocated to all of the programs and functions of the City and County. The Controller's Office identified $26.4 million of costs that it considered unallowable.

Multi-Tiered Full Cost Plans

The Controller's Office has identified certain costs as unallowable in the cost plan because such costs meet the A-87 test which excludes "general government costs, including salaries and other costs of the legislative body and the executive office, all judicial branch costs and other general government services provided to the general public, such as fire and police protection." Accordingly, many legitimate costs – such as those related to budget, audit and legal services – could be charged under a full cost plan. The Controller's Office has not identified which of these costs could be allocated under a full cost plan nor the revenue gain to the City by allocating costs under a full cost plan.

The distinction between an A-87 cost plan and a full cost plan is based on the differences in the programs and functions to which indirect costs can be allocated. A-87 cost plans are required for all federal and State grants and programs, and must comply with the cost criteria and limitations of the A-87 regulations. Full cost plans are based on the policies and criteria of a governmental unit's governing board. Therefore, a board of supervisors can establish the criteria to be followed when deciding which costs should be included in a full cost plan, even if such costs are not allowable or allocable under A-87 cost allocation regulations. Unlike A-87 cost plans, full cost plans can only be used to allocate costs to programs and functions that do not receive federal or State funding, and for purposes of developing user fees and charges for services.

The practice of developing multiple cost plans for differing applications is recommended by the State Controller in the *Handbook of Cost Plan Procedures for California Counties.* Section 1430 of the handbook states, in relation to federal and State grants, that:

> " . . . counties should monitor the reimbursement process to ensure that maximum reimbursements have been received for all program costs, including indirect overhead. Additionally, any departments that charge outside agencies for their services should be monitored to ensure that the billing structures used recover all applicable costs, including indirect overhead."

Further, Section 1460 of the State Controller's cost plan handbook states that county departments that do not receive federal and State funds and who are:

> ". . . charging for their services can utilize the cost plan in determining their billing rate structures. If a department charges the public a fee for the service it provides, the board of supervisors should be aware of the total cost of providing that service, including all applicable indirect costs. This will allow the supervisors to establish fees at the appropriate level to recover the true costs associated with the services provided. Even if the department is not charging a fee for the service,

> this concept can be employed as a management tool in identifying countywide overhead costs to all applicable departments."

Section 1470 states in part:

> "A county could prepare a 'fullcosting plan' to identify all county overhead costs to the appropriate departments, including those costs that are currently considered unallowable (e.g., general government costs)."

The practice of preparing multiple cost plans is used by other counties in order to maximize the appropriate allocation of all indirect costs among funds within the County and governmental units that receive services from the County. As an example, Los Angeles County reports that it annually prepares four cost plans, including (1) an A-87 plan for State and federal programs and grants; (2) an enterprise fund plan; (3) a plan for internal use with other County funds; and, (4) a plan for use when charging non-County government entities.

The City and County of San Francisco currently prepares a single plan which generally conforms with the regulations contained in OMB Circular A-87. According to the Controller, the preparation of a full cost plan would yield very little benefit to the County, since much of the A-87 unallocated cost is either recovered through direct charges to departments or would be charged to General Fund departments or other funds which are incapable of reimbursing the General Fund. While there is some merit to the Controller's comments, these assertions were not convincingly demonstrated during the course of this management audit. For example, if the full cost allocation were to yield an average increase of only one percent on the $81.2 million in fees collected by the City each year, over $800,000 in additional income would be realized.

Accordingly, the Controller should identify unallocated costs that could be allocated through a full cost plan. Once such costs have been identified, a test allocation should be conducted to clearly establish the net General Fund benefit that would be derived from implementing such a plan in the City. Until such testing is comprehensively completed, the revenue benefits to the City will not be known. If a multi-tiered cost plan approach could be employed, as suggested by the State Controller and as is done by other jurisdictions such as the County of Los Angeles, the General Fund of the City and County of San Francisco potentially could recover additional annual revenues.

Conclusions

The Controller's Office annually prepares a County-wide cost allocation plan pursuant to federal Office of Management and Budget regulations that are contained in Circular A-87 and State guidelines. Local governments must comply with these regulations when charging indirect costs to grants or other programs that are funded by the federal and State governments.

Pursuant to Circular A-87, certain costs cannot be claimed on grants or programs funded by the federal and State governments. Appropriately, the Controller's Office has appropriately identified certain costs as unallowable in the County-wide cost allocation plan.

However, the City also applies Circular A-87 regulations when allocating indirect costs to programs that are not funded by federal or State governments. This is not required. In other California jurisdictions, full cost plans have been developed and are used to ensure that the maximum amount of legitimate indirect costs are allocated to programs other than those governed by federal or State cost allocation regulations. This practice serves to maximize indirect cost reimbursement to the General Fund from user fee, enterprise and special fund activities, and is endorsed by the State Controller.

As a result, the Controller's Office may have missed opportunities to maximize reimbursement for the legitimate cost of providing support services to programs that are not funded by the federal or State governments. If such costs are allocated to these programs in FY 2002-2003, additional revenues could be recovered by the General Fund.

Recommendations

The San Francisco Controller should:

9.1 Direct staff to conduct a test allocation of A-87 unallocated costs to determine potential General Fund revenues that could be realized from implementing a multi-tiered cost plan;

9.2 If appropriate based on the results of the test plan, direct staff to prepare multi-tiered full cost plans, in accordance with State Controller guidelines and modeled after similar plans in other jurisdictions; and,

9.3 Allocate full costs to departments and non-General Fund activities in order to maximize reimbursement to the General Fund.

The Board of Supervisors should:

9.4 Based on the results of the Controller's test plan, consider adoption of legislation that would require the Controller to annually prepare multi-tiered full cost plans, which appropriately allocates costs to departments and non-General Fund activities. The full cost plans would include allocations of costs that are not allocable for federal or State claiming purposes under Circular A-87 regulations.

Costs and Benefits

The Controller will incur some additional staff time during the development of the full cost plan models. Staff from the Internal Audit Division or City Projects Division can be temporarily diverted to assist the Cost Plan Accountant during the development phase. Accordingly, there will be no incremental costs associated with the implementation of these recommendations.

The General Fund will recover additional revenue annually in reimbursements from user fees and charges to other funds, although the actual amount of revenue can not be know until the Controller's Office identifies and distributes unallocated costs.

10. Departmental Indirect Cost Rates

- **The San Francisco Administrative Code charges the Controller with the responsibility to direct and approve indirect cost rates for each City department. Such rates are applied to user fees and grants in order to reimburse the City for administrative and support costs associated with fee and grant activities.**

- **The Controller's Office has not established consistent methodology for calculating departmental indirect cost rates and their application to City fees. In some cases, the departments calculate their own indirect cost rates and the Controller merely checks for reasonableness. For the remaining departments, the Controller has three different methods for calculating departmental indirect costs. These methods are either calculated at the program level or by department. In addition, some are based on budgeted costs and some are based on actual costs.**

- **The Controller's Office has no involvement with the analysis or application of indirect cost rates for grants. The Grants Management Unit only checks to ensure the completeness of grant documentation before grants are forwarded to the Board of Supervisors for approval. The Controller's Office does not certify that provisions for appropriate indirect cost reimbursement are included in grant budgets, pursuant to Section 10.170-1 of the Administrative Code.**

- **The Controller's Office should develop consistent policies and procedures for calculating departmental indirect cost rates. The Controller's Office should also perform analyses of grant budgets to determine whether indirect cost amounts are accurate; and, if not included in the grant budget, that such costs are accurately disclosed. While it is a policy matter for the Board of Supervisors to decide whether grant applications should include indirect costs (if allowable), the Controller's Office should ensure that the Board has complete information prior to grant approval.**

In the *A-87 Cost Principles for State, Local and Indian Tribal Governments*, the federal Office of Management and Budget defines indirect costs as "costs incurred for a common or joint purpose benefiting more than one cost objective, and not readily assignable to the cost objectives specifically benefited, without effort disproportionate to the results achieved." Section 10.170.1d of the Administrative Code states that "every department, board or commission shall establish a rate for such indirect costs that is approved by the Controller and fixed in accordance with a directive issued by the Controller."

The Controller's Office prepares a County-Wide Cost Allocation Plan (COWCAP), which is used to establish indirect cost rates that can be charged to federal and State grants in accordance with A-87 regulations [e.g., an allocation of the administrative and support costs associated with services provided by one City department (such as the City Attorney) to another]. Additionally, City departments may charge for internal administrative and support activities that support services that are funded by fees and grants [e.g., an allocation of the administrative and support costs associated with services provided by one department division (such as a fiscal division) to another].

By applying departmental indirect costs to fees and grants, the City's General Fund can be reimbursed for the cost of administrative and support activities that are generally provided for multiple programs. However, the Controller has not established a consistent or effective process for managing the development of indirect cost rates, also referred to as departmental overhead rates, when determining the cost of fee or grant activities in the City.

Development of Departmental Overhead Rates

When calculating departmental overhead rates for fee and permit administration, the Controller's Office divides total departmental administrative costs by total salaries and benefits (excluding administration salaries and benefits). In some departments, several rates are determined for separate programs or divisions within one department. However, in other departments, only one rate is determined for the entire department. These Departmental Overhead Rates are then applied to departmental fees and charges. However, the Controller's Office employs at least four different methods for determining departmental overhead rates. These are described below.

1. Departments calculate an overhead rate without any direction or guidance from the Controller's Office. The departments then send these rates to the Controller's Office, which checks for reasonableness. For example, the Department of Public Works calculates an overhead rate for seven of its divisions, without formal guidelines or advice from the Controller's Office. The Controller's Office states that all departments use actual costs. However, our research found that there are departments that used budgeted costs rather than actual costs in their overhead calculations.

2. The Controller calculates overhead rates solely from budget information compiled in the Annual Appropriation Ordinance.

3. The Controller calculates overhead rates from budgeted administration costs out of the Annual Appropriation Ordinance and obtains salary costs from FAMIS reports. The Controller's Office utilizes both budget and actual costs in this method.

4. The Controller calculates overhead rates by obtaining budgeted salary information out of the Annual Appropriation Ordinance, and obtains administrative costs directly from the Department. The Controller utilizes both budget and actual costs in this method.

Out of 70 departments (and divisions) for which the Controller records an overhead rate, the Controller's Office calculated only 18 rates for FY 2002-03. The remaining 52 departments or divisions either calculated their own rates, or rates have not yet been determined. For departments that calculated their own rates, the Controller's Office does not offer formal policies or training to departments regarding indirect cost allocation principles or methodologies. According to an analyst in the Controller's Budget and Analysis Division who works with fee administration, the check for reasonableness consists of reviewing individual cost computations to ensure that the rate prepared by the department is "reasonably accurate".[1]

In an analysis of the 11 highest revenue producing user fees in the City, indirect cost methodologies varied. Two of these eleven fees, assessed by the County Clerk's Office, applied an indirect cost rate that was calculated by the department based on budgeted costs. Five fees assessed by the Department of Public Health's Food program applied an indirect cost rate that was calculated by the department based on actual costs. The remaining four fees, assessed by County Medical Examiner and the Fire Department, applied indirect cost rates that were calculated by the Controller using budgeted costs. These 11 fees represented $6.5 million in fee revenues in FY 2002-2003.

As is illustrated in this small sample of high revenue generating fees, the indirect cost rate methodology managed by the Controller's Office is highly inconsistent and allows potential for inaccuracies. The Controller's Office methods of calculating indirect cost rates are inefficient, as some departments calculate their own rates using actual numbers and some departments use budget numbers. Similarly, the Controller's Office, when calculating rates in-house, use both budgeted and actual numbers, depending on what is available. Such discrepancies could yield entirely different indirect cost rates. Such differences could result in over-charging for fees, which could result in legal liability, and some could under-charge for fees, which results in lost revenue to the City.

For example, the Controller's Office calculates a departmental overhead rate for the Police Department from budgeted costs (not actual costs) included in the Annual Appropriation Ordinance. The Police Department's rate is calculated at 22.55 percent for FY 2002-03. The rate was obtained by dividing their total Operations and Administrative budget of $49,667,012 by total salaries and benefits (less administration salaries and benefits) of $220,293,945. However, budget costs differ from actual costs. In the Police Department's Operations and Administrative budget, costs were $1.36 million dollars less than actual costs in FY 2001-02, and $4.49 million dollars less in FY 2002-03. If actual costs had been used in the indirect cost rate calculation, a significantly lower rate would have been produced. Thus, if the Controller sets the indirect cost rate too high, as is evident in this example, the Police Department might be overcharging for its fees, a potential legal liability for the Department.

The Controller's Office should establish clear and consistent guidelines for calculating departmental indirect cost rates, rather than using four different methods. Standards need to be established to determine when individual programs or divisions require their own indirect cost

[1] The Controller's Office was unable to provide examples or information regarding any Departments whose rates were deemed "unreasonable".

rates, or when a department-wide rate is sufficient. The Controller should have standardized guidelines for what is required if a department calculates its own rates, instead of a simple check for reasonableness. Further, the Controller's Office should use actual costs rather than budget costs when calculating rates, as these will be more accurate.

Indirect Costs Applied to Grants

Section 10.170-1 of the Administrative Code states that "the receipt and expenditure of grant funds shall not be approved by the Board of Supervisors unless the Controller has certified that provisions for appropriate indirect cost reimbursement is included in the grant budget." However, as with fees, the Controller's Office is not currently involved in calculating or reviewing indirect cost rates associated with grants for City departments.

The Grants Management Unit performs the Controller's review and authorization for the acceptance and expenditure of grant funds. However, the Grants Management Unit only verifies that the indirect costs have been appropriately disclosed in the 'accept and expend' resolution that is forwarded to the Board of Supervisors for approval. There is no review of indirect costs for accuracy or appropriateness.

Departments must submit to the Controller's Office a completed Grant Information Form (GIF) to complete their grant 'accept and expend resolution' requirements. The GIF requires departments to state if indirect costs are included in the budget of the grant. If indirect costs are included, departments must state the amount and the calculation methodology. If indirect costs are not included, the department must indicate why they are not included. If indirect costs are not included in the grant budget, the GIF does not require departments to estimate or state how much those indirect costs will be. Therefore, the indirect costs, which are effectively being subsidized by the City, are not detailed in the GIF for informational purposes and are not reviewed or certified by the Controller, as mandated by the Administrative Code.

According to the Grants Unit, approximately 101 grants were reviewed by the Controller's Office between July 1, 2002 and June 30, 2003 for a total of $192,209,176. For these 101 grants, GIFs were located in the Controller's files and analyzed. In 39 cases, or 39 percent of the grants in that year, indirect costs were budgeted within the grant award. The average indirect cost rate for these 39 grants was 7.71 percent, ranging from 0.34 percent to 39.61 percent.

The remaining 62 grants, or 61 percent of the grants reviewed by the Controller's Office between July 1, 2002 and June 30, 2003, did not include indirect costs in the grant budget. In 35 cases, or 35 percent, indirect costs were not included because they were unallowable by the grantor. However, in 27 cases, or 27 percent of the grants, indirect costs were not included "*to maximize use of grant funds on direct services*." In other words, whatever indirect costs the department might have while expending these grant awards will be absorbed by the City. During the period between July 1, 2002 and June 30, 2003, such grant awards totaled $27,455,818. However, no such analysis is or was performed by the Controller's Office. While it is a policy matter to decide between maximizing direct or program services and using program monies for indirect costs, the Controller should regularly determine whether the grant budget has been appropriately developed in accordance with Administrative Code § 10.170-1.

The Controller's Office should perform a thorough review of indirect cost claiming in terms of grants administration to ensure that indirect costs are being appropriately and accurately reported by the departments. Further, the Controller's Office should revise the GIF to include a budget of indirect costs, even if they are not paid by the grant to provide more accurate information to the Board of Supervisors.

Conclusions

The San Francisco Administrative Code charges the Controller with the responsibility to direct and approve indirect cost rates for each City department. Such rates are applied to user fees and grants in order to reimburse the City for administrative and support costs associated with fee and grant activities.

The Controller's Office has not established a consistent methodology for calculating departmental indirect cost rates. In some cases, the departments calculate their own indirect cost rates and the Controller merely checks for reasonableness. For the remaining departments where rates have been determined, the Controller has three different methods for calculating departmental indirect costs. These methods are either calculated at the program level or by department. In addition, some are based on budgeted costs and some are based on actual costs.

The Controller's Office has no involvement with the analysis or application of indirect cost rates for grants, which ignores a direct mandate in the Administrative Code § 10.170-1. The Grants Management Unit only checks to ensure the completeness of grant documentation before grants are forwarded to the Board of Supervisors for approval. The Controller's Office does not certify that provisions for appropriate indirect cost reimbursement are included in the grant budget, as pursuant to Section 10.170-1 of the Administrative Code.

The Controller's Office should develop consistent policies and procedures for calculating departmental indirect cost rates. The Controller's Office should also perform analyses of grant budgets to determine whether indirect cost amounts are accurate; and, if not included in the grant budget, that such costs are accurately disclosed. While it is a policy matter for the Board of Supervisors to decide whether grant applications should include indirect costs (if allowable), the Controller's Office should ensure that the Board has complete information prior to grant approval.

Recommendations

The Controller should:

10.1 Develop clear and consistent policies and procedures for the calculation of departmental overhead rates, using actual costs rather than budgeted costs;

10.2 Develop standards to determine when individual programs or divisions require individual indirect cost rates, or whether department-wide rates are sufficient;

10.3 Develop and disseminate procedures for departments to follow when calculating indirect cost rates. Such procedures should mirror Controller's procedures for calculating indirect cost rates;

10.4 Develop procedures for the Controller's Office to certify that provisions for appropriate indirect cost reimbursement are included in the grant budget, as pursuant to Section 10.170-1 of the Administrative Code; and,

10.5 Require that all indirect costs be disclosed on the Grant Information Form, even if costs will not be paid by the grantor. This will enable the Board of Supervisors to make a more informed decision regarding how grant money should be allocated and whether administrative costs should be absorbed.

Costs and Benefits

There would be no new cost to implement these recommendations.

The recommendations would increase the Controller's ability to manage indirect cost rate development. Additionally, the recommendations would ensure that the Controller's Office provides full disclosure of indirect costs associated with grant administration to the Board of Supervisors.

11. Cost-Based Fees for Service

- **In FY 2002-03, the City and County of San Francisco generated approximately $77.4 million in fee revenue, and departments estimate fee revenues will generate $81.2 million in FY 2003-04. Some of these fees are set by statute while others are set based on market rates. A significant number of these fees are cost-based.**

- **San Francisco City Charter Section 3.105 charges the Controller with the responsibility to provide "general supervision over the accounts of all officers, commissions, boards and employees of the City and County charged in any manner with the receipt, collection or disbursement of City and County funds." As an extension of this general mandate, the Controller has established some procedures for tracking, controlling and annually evaluating cost-based fees charged by the departments.**

- **Despite these efforts, the Controller's Office has not yet compiled a comprehensive fee schedule for information or control purposes, nor has the Office provided City departments with written standards or procedures to ensure that fees are annually reviewed or consistently analyzed based on generally accepted cost accounting principles. Further, no criteria have been established to guide departmental fee-setting, so that costs are accurately computed and maximum revenue is recovered.**

- **The Controller's Office should annually produce and maintain a comprehensive fee schedule, which can be used as a control document to ensure that fees are appropriately evaluated and submitted for consideration by the Board of Supervisors each year. In addition, the Controller should establish and disseminate written criteria, standards and procedures for cost-based fee analysis to all City Departments. Such procedures should provide methods for compiling direct costs, analyzing and applying indirect costs, and analyzing cost recovery information.**

- **By (a) establishing formalized control mechanisms; (b) creating formal fee development criteria, standards and procedures; and, (c) monitoring compliance and reporting to the Board of Supervisors, the City and County would be provided greater assurance that fees recover full costs, when appropriate. If a sample of only six Departments raised a total of 34 fees to full cost recovery levels, the City could generate at least $880,000 in additional fee revenues annually.**

San Francisco City Charter § 3.105 charges the Controller with the responsibility to provide "general supervision over the accounts of all officers, commissions, boards and employees of the City and County charged in any manner with the receipt, collection or disbursement of City and County funds." As an extension of this general mandate, the Controller has attempted to establish procedures for tracking, controlling and annually evaluating the appropriateness of cost-based fees charged by the departments.

User fees are a significant source of City revenues. In FY 2002-03, the City generated approximately $77.4 million in fee revenue, and departments estimate fee revenues will generate $81.2 million in FY 2003-04. Because charges and fees are imposed on the public, they are regulated by State law, which requires sufficient cost analysis to ensure fees do not exceed costs, Board of Supervisors authorization, and public disclosure. The Controller, in accordance with the Charter and as chief financial officer for the City, should oversee the processes used by the department to develop, adjust, impose and charge fees.

The Controller should manage the general processes of fee development throughout the City. The Controller's Office should establish criteria and subsequent standards for the departments and maintain the administration in a formalized manner. Departments should cooperate and respond to requests and initiatives from the Controller's Office so that fees are analyzed and assessed for appropriateness on a regular basis. Managing the maintenance and administration of all City fees is an imperative function of the Controller's Office. The Controller should create and maintain a comprehensive fee schedule to regulate the process of fee development.

Master Fee Schedule

To better control and manage fee development and analysis throughout City departments, the Controller should create, publish, and actively maintain a master fee schedule of all fees assessed in the City. A comprehensive fee schedule will act as a tool to record and analyze extensive fee information. Such a control document would therefore allow administrators and policy makers to manage the fee development process with more accurate and timely information. Additionally, a master fee schedule would provide the public with quick information about fees. It is imperative the Controller establish a master fee schedule as a basis for the necessary fee analysis and review mandated by the City Charter.

Section 3.7 of the Administrative Code requires departments to submit a comprehensive schedule of fees and estimates of fee revenue with each year's budget submission, except for fees regulated by federal or State law. In the Controller's Technical Instructions for Budget Year 2003-2004, the Controller requested all departments that budget revenue from licenses, permits, fines and or service charges to complete and submit to the Controller's Office a "Form 2b." Form 2b contains a brief description of the fee, authorizing Code citation, whether the authorizing code provides for an automatic CPI adjustment, sub-object number, index code, fee per unit in previous year, estimated quantity in units for the previous year, estimated percentage of the overall cost of the service recovered in the previous year, proposed fee per unit of service, estimated quantity in units for the budget year, estimated percentage of the projected cost of the service in the budget year that will be covered by the proposed fee, the date of the last increase, and the fee prior to last increase. In the Budget Technical Instructions, the Controller stated that all departments were required to submit a completed Form 2b to the Controller's Office by Friday, January 10, 2003.

The Controller's Office was unable to provide exact receipt dates of submitted Form 2b's. However, by March 13th, 2003, only 21 of 35 applicable departments had submitted a Form 2b to the Controller's Office. Two other departments submitted general fee information to the Controller by March 13th, but not on the Form 2b. Instead, these two departments submitted less formal analysis and fee proposals. Out of the 21 Form 2b's submitted by March 13th, only 14 departments included cost recovery analysis, as specifically requested on Form 2b. Cost recovery and other fee analysis was obtained from 10 departments directly by the Budget Analyst's Office, after the Controller's Office was unsuccessful in obtaining documents directly from departments.

Although all General Fund departments submit some type of schedule of their fees, whether the Form 2b or otherwise, there is no comprehensive fee schedule within the City showing the amount for all fees charged by City departments or the authority for charging each fee. Further, City departments have not evaluated fee levels on an annual or other regular basis to determine the potential for recovering costs or to compare fee levels with those charged by other jurisdictions.

Since no comprehensive fee analysis or schedule has been presented to the Board of Supervisors on an annual basis, the Board of Supervisors has not been provided a regular opportunity to consider the question of full cost recovery for many City departments. As a consequence, the Board of Supervisors' fee policies for City department activities are inconsistent. Further, policy decisions by the Board of Supervisors to determine which fees should fully recover cost and which fees should be subsidized by the General Fund or other funding sources, have not been made on a City-wide basis.

To address these issues, each year, the Controller, with the cooperation of City departments, should provide a master fee schedule with a report indicating (a) the cost of each fee service and whether fee increases are appropriate, and (b) the level of cost recovery for all fees that may be charged. Departments should then work with the Controller's Office to develop recommendations for fee changes.

Management of the Citywide Database

To maintain the Master Fee Schedule, the Controller's Office should work with Departments on an annual basis to ensure that the Master Fee Schedule is accurate and up to date. Moreover, the Controller's Office should continue to work with Departments to ensure that analysis of cost recovery is conducted for each individual fee. In addition to the Controller's general responsibilities related to San Francisco Charter § 3.105, this responsibility is consistent with City Charter § 9.102 of the, *Certification of Revenue Estimates,* which charges the Controller with the responsibility to review estimated revenues during the annual budget process and advise the Board of Supervisors on the "accuracy of economic assumptions … and the reasonableness of such estimates and revenues." Keeping the Master Fee Schedule updated will ensure its continued usefulness as a centralized resource for the Board of Supervisors, the Controller's Office, the Mayor's Office, the Budget Analyst's Office, and other decision-makers.

Included in 2003-2004 Mayor's Proposed Budget, a portion of the Controller's narrative (p.130) reads "The Controller's Budget and Analysis Division is improving projection and tracking of revenues citywide, and in 2003-2004 plans to focus its analysis on fees and service charges. Templates were developed and provided in the 2003-2004 budget instructions to help city departments capture and analyze the actual cost of charges to be reviewed and updated by departments consistently and will assist the Controller in maintaining complete and consolidated information on these and all other city revenue sources." While the Controller states that analysis of fees will be a priority, it is still too early in the fiscal year to determine the degree to which the department is attaining this goal.

Cost Analysis

Included within the Controller's responsibilities of overseeing fee administration is cost analysis. As the chief financial officer of the City, the Controller's Office should be the authoritative agency in determining costs of departmental fees. However, the Controller's Office does not determine or develop the cost of fees, such determinations are left to departments. Further, the Controller's Office does not provide procedures or guidelines to City departments in terms of determining the cost of fees. Departments independently determine the cost of providing services with no training or guidance from the Controller's Office. Some departments find determining the cost of fees to be difficult.

For example, legislation to require a license for fortunetellers was proposed by the Board of Supervisors in November of 2002. The Police Department's Permits Division was charged with determining direct costs of the fortuneteller license fee. The cost of the license was calculated and submitted to the Controller by the department at least three times over the course of several months. Each time, the Controller's Office checked for the "reasonableness" and then certified the fee. However, the cost of the fortuneteller license ranged from $240 to $295 and the direct costs associated with providing a fortuneteller license ranged from $188 to $33,957 amidst the three cost submissions. Each submission was subsequently certified by the Controller's Office and forwarded to the Budget Analyst's Office for a budget analyst report. The Controller's Office was not involved with the calculation of the direct costs, they only checked it for reasonableness. Clearly, the calculation of direct costs was unreliable, if not inaccurate.

The Police Department acknowledges their staff has little experience in calculating direct costs, and often uses time and motion studies that have not been reviewed since the mid-1980s as their basis for current fee costs. With no training or expertise provided by the Controller's Office, departments must estimate costs to the best of their ability. But as in the case of the Police Department, such estimates can be highly inaccurate. Such inaccuracies can lead to over or under charging of fees.

Likewise, the Controller's Office has not established a consistent methodology for calculating indirect cost rates to be applied towards departmental fees. In some cases, the departments calculate their own indirect cost, or overhead rate and the Controller checks for the reasonableness of their rates. For the remaining departments, the Controller has three different methods for calculating departmental overhead, some of which are calculated by program, some by department. Some are calculated using budget numbers, some are calculated using actual numbers. These inconsistent methods are discussed in more detail in Section 10 of this report.

Direct and indirect cost calculations as applied to fees are currently left up to each department to determine. Some departments do not have the expertise and training required to produce sound cost methodology for their fees. The Controller should provide training, guidance and written procedures on cost analysis for departments so that all methodologies are consistent and accurate.

Cost Recovery Fee Issues

Within the Controller's general mandate of certifying revenues, management of fees must include a thorough analysis of cost recovery. However, the Controller does not conduct cost recovery analysis of fees on a regular basis, and has not established procedures for departments to conduct cost recovery analysis. Many City departments do not have their own written procedures in place to ensure that fees and charges are periodically reviewed for cost recovery, based on established cost accounting principles. Even though the Controller's Office requests all applicable departments to submit fee analysis annually, many departments do not submit the information in the correct form, or do not submit complete information. The Controller has not exercised his authority to demand the departments comply with their requirements, and therefore sufficient fee analysis is rarely completed. Further, the Controller's Office has not developed City-wide standards and has not exercised sufficient oversight over this important financial function. As a result, City fees and charges are not based on standardized criteria, are not reviewed or updated in a timely or consistent manner, and are not regularly approved by the Board of Supervisors.

Under the California Constitution and State law, City Departments may impose fees for services, but generally cannot receive more than the full cost of providing those services. Exceptions include those fees that are voluntary and not regulatory, such as golf course fees. Voluntary fees can be set at market rates and may exceed the cost of providing services. However, even for non-regulatory fees, there may be policy or programmatic reasons to establish fees at less than 100 percent of cost, which will be discussed later in this section.

As part of its annual budget review and this management audit, the Budget Analyst's Office conducted a citywide analysis of fees to determine those which are cost-based. The Budget Analyst found:

- A majority of City departments had a difficult time conducting the cost recovery fee analyses. The Budget Analyst's Office worked with the staff of City departments' to conduct the cost recovery analysis and explain appropriate methodologies. More appropriately, this should have been a Controller role. Nonetheless, during this exercise, the Budget Analyst found that departments did not have a consistent understanding of methodologies for analyzing costs.

- Several City departments that performed cost recovery fee analyses had a difficult time determining appropriate fees. A number of City departments aggregate their fees into one index code for budget purposes that include revenues for numerous fees, and may include various other revenue sources, thus making the assessment of cost recovery for any individual fee arduous.

- Several departments were unable to provide cost recovery fee analyses at all.

Many City departments were unable to provide or compute a cost recovery analysis for individual fees. Therefore, it is not clear whether departments currently possess the tools or expertise to determine those fees which fully recover costs. The departments' general difficulties conducting full cost recovery fee analyses results in an inability to fully advise the Board of Supervisors with information regarding the need for General Fund discretionary program support. The Controller should provide procedures and guidance for these departments. In the absence of such guidance, several issues can arise.

The potential exists for some City departments to be overcharging for their services. For example, in a memo dated April 15, 2003 written to the Budget Analyst from the Assessor/Recorder, department staff indicated that a cost recovery analysis of services has not been conducted. Yet, based on documentation provided by the Assessor/Recorder's Office, the FY 2002-2003 projected revenue from fees is nearly double the budgeted amount, even though the Assessor/Recorder's Office budgeted fee revenue equal to the full recovery of fees. Therefore, it appears very possible that the Assessor/Recorder's Office is in excess of full cost recovery for services. In the absence of detailed cost recovery analyses, City departments could not defend themselves against litigation that may claim that fees are generating more than the cost of providing services. Therefore, the development of a full cost recovery plan should be required and reviewed by the Controller's Office for all City departments.

There is also a significant cost to the City that results from undercharging, or not fully recovering the costs of providing services. In a small sample of nine City departments, our research indicates that City departments could collect an additional $4.2 million in revenue, assuming the selected fees were set at full cost, or 100 percent recovery. The analysis was adjusted to consider a more conservative list of 34 fees in six departments, where increases were not considerable, thus a more realistic analysis. The additional revenue in this narrowed sample of fees would still be approximately $880,000 annually for the City[1]. The Controller's Office should ensure that complete cost recovery analysis is presented to the Board of Supervisors and all City Commissions that have fee-setting authority. Full cost recovery analysis is essential to understand the degree to which discretionary resources are being used to subsidize services.

However, because of limited information provided by City departments, even analysis on such a small scale is incomplete. As previously noted, many City departments have not conducted cost recovery analyses or have been unable to separate out the revenues derived from individual fees. Comparatively, in some instances where the Budget Analyst was able to conduct full cost

[1] The Budget Analyst notes that one of the departmental fees included in this analysis is proposed for an increase, and is scheduled to be brought before the Board of Supervisors on September 17, 2003. However, this proposed fee increase is does not fully recover costs.

recovery analyses, it was clear there may be legitimate policy reasons for not increasing fees to full cost recovery levels. For instance, the Board of Appeals attempted to implement a fee increase of approximately 105 percent per fee for FY 2003-2004. Such proposed fee increases would only recover approximately 29.4 percent of these costs, based on total FY 2003-2004 costs of $433,534 and fee revenue projections of $127,459. According to Board of Appeals managers, the Board of Appeals did not propose to increase their FY 2003-2004 fees to be 100 percent cost recovery because such fees would be prohibitively high. According to Board of Appeals managers, significantly higher Board of Appeals fees would discourage ordinary residents, neighborhood associations, business operators and other individuals, other than the most wealthy, from having access to the administrative review process that the Board of Appeals offers for appealing City permits and other department actions.[2]

Animal Care and Control fees are another example where raising fees to full cost recovery might be legal in terms of user fees, but might be against policies of the City. Currently the fee to adopt an animal is set at $10.00, which recovers only 2 percent of costs associated with assessing that fee. In order to raise this fee to 100 percent recovery, the fee would need to be increased to $519.50. Such an increase would lead to far less pet adoptions in the City, which undoubtedly would be counter to the policy objectives established by the Board of Supervisors.

In addition to the need to develop systems for full cost recovery, the City needs to safeguard against the possibility that some fees may exceed cost. State laws specifically prohibit some City departments from establishing fee schedules that are more than cost. State law mandates that the Planning Department fees for a development project application can only be set at an "estimated reasonable cost of providing the service for which the fee is charged."[3] Moreover, California Government Code §66014 states "(a) Notwithstanding any other provision of law, when a local agency charges fees for zoning variances; zoning changes; use permits; building inspections; building permits…those fees may not exceed the estimated reasonable cost of providing the service for which the fee is charged." Another relevant State law provision is that:

> "…no local agency shall levy a new fee or service charge or increase an existing fee or service charge to an amount which exceeds the estimated amount required to provide the service for which the fee or service charge is levied. If, however, the fees or service charges create revenues in excess of actual cost, those revenues shall be used to reduce the fee or service charge creating the excess."[4]

Therefore, State law explicitly states the Planning Department may not exceed the cost of providing the service provided for the fee.

2 The proposed Board of Appeals fee increases were not approved by the Budget Committee on May 5, 2003.

3 California Government Code §66014

4 California Government Code §66016

However, as part of this analysis, the Planning Department indicated that fee cost recovery analysis has been accomplished and the Planning Department is in the process of fully implementing recommendations based on the Management Audit of the San Francisco Planning Department completed in June 2002, which recommended the Planning Commission direct staff to "develop a method … for establishing all fees and to propose fee adjustments that are based on actual historic staff costs for each type of development project application and all allowable and appropriate indirect costs attributable to processing application including administrative and support costs … and all allowable indirect costs." However, the Planning Department has yet to develop such methods and did not submit a Form 2b to the Controller's Office as requested. Included in their submittal for the FY 2003-2004 budget, the Planing Department proposed fee increases that resulted in cost recovery ranging up to 493 percent, clearly violating state law. The Controller's Office repeatedly stated that they were not involved with the Planning Department's FY 2003-04 fee proposals. Because the Planning Department's FY 2003-04 budget was balanced on illegal fee proposals, the Budget Committee placed $1.38 million of the Planning Department budget on reserve, pending receipt of proper fee analysis.

Based on discussions with several City departments and the Controller's Office, it is clear that the budgeting and the tracking of fee revenue makes the analysis of cost recovery exceedingly difficult. In many City departments, fee revenue is aggregated into one index code or several fees are aggregated into an index code. If revenue is aggregated, unless a detailed analysis of the individual fee is conducted, the amount of subsidy provided by the General Fund is not known.

While the Controller's Office verifies the reasonableness of revenue estimates by departments based on the departmental submissions of fee information, in some instances the Controller is to report to the Board of Supervisors and certify the revenue projections. Section 8.33.1 of the San Francisco Administrative Code, regarding County Clerk's Fees, states[5]:

> No later than May 15th of each year, the Controller shall file a report with the Board of Supervisors reporting the new fee schedule and certifying that: (a) the fees produce sufficient revenue to support the costs of providing the services for which each fee is assessed, and (b) the fees do not produce revenue which is significantly more than the costs of providing the services for which each fee is assessed.[6]

Therefore, the Controller's Office should develop written procedures for fee methodology and cost recovery analysis for all City departments, including the County Clerk's Office. Such policies and procedures would ensure a consistent methodology for establishing fee schedules for departments. Moreover, providing training to City departments would ensure the methodology is

5 The Administrative Code contains similar provisions for the Medical Examiner's Fees (Section 8.14(b)).

6 According to the Controller's Office, they fulfill these reporting requirements in the annual Revenue Letter (mandated in San Francisco Charter 9.102), which provides an opinion regarding economic assumptions underlying the revenue estimates and the reasonableness of such estimates and revisions.

accurate for fee development and all appropriate components of cost recovery are included in the analysis. Such training would also ensure that similar methodology is used throughout the City.

A full cost analysis should be completed annually according to standards and procedures established by the Controller's Office, to provide the basis for setting all charges and fees and to establish program or activity cost. Second, all charges and fees should be systematically and regularly reviewed by the Controller for consistency with the standards that he establishes. City departments are already required to submit fee information, including cost recovery analysis, with the annual budget. The Controller requires such information in a specified format, although many departments ignore the requirements and deadlines, as explained earlier in this Section of the report. It is the Controller's responsibility to obtain this fee material, and if departments are not willing to cooperate, the Controller has the responsibility to exercise his authority on city fiscal matters, either by refusing to certify departmental revenues or by going before the Board of Supervisors to obtain more authority over departmental submissions of financial data.

Based on the limited information presented by City Departments regarding full cost recovery of fees, the Budget Analyst recommends the Controller's Office assume an increased role in fee development and analysis. Full recovery of costs is a policy matter for the Board of Supervisors. As such, the Controller's Office should continue to work with City departments and provide a comprehensive fee schedule including cost recovery analysis on an annual basis to the Board of Supervisors.

Conclusion

Although City departments maintain some type of schedule of their fees, the Controller has not yet compiled a comprehensive fee schedule detailing the amount for all fees charged by City departments or analyzing cost recovery information for each fee.[7] While City departments do not fully cooperate with the Controller's Office in submitting complete fee information on time, the Controller currently provides limited guidance or training to departments on the determination of costs for fees. Further, the Controller has not guided City departments to evaluate fee levels on an annual or other regular basis to determine the potential for recovering costs. The Controller has not provided City Departments with a consistent methodology for cost recovery analysis, rendering some City Departments potentially in violation of the California Constitution, Article 13A and State law[8]. Full recovery of costs is a policy matter for the Board of Supervisors. Without analysis conducted on each individual fee charged by the City, the Board of Supervisors is making fiscal decisions based on a partial picture.

7 While the Budget Analyst contacted all City Departments, the response varied between City Departments.

8 Such as California Government Code §54985, §54986, and §66016.

Recommendations

The Controller's Office should:

11.1 Develop and maintain a Master Fee Schedule for all City Departments to be reviewed on an annual basis;

11.2 Develop and disseminate written procedures to City departments detailing methodologies for direct costs, indirect costs, and cost recovery analysis for fees;

11.3 Provide training to City departments on fee cost analysis methodology and cost recovery analysis;

11.4 Continue to work with Departments to ensure that analysis of cost recovery is conducted for each individual fee; and

11.5 Provide quality control by reviewing fees submitted to the Board of Supervisors for conformity with State law, City policy, and cost accounting guidelines.

City Departments should:

11.6 Work cooperatively with the Controller's Office to analyze fees, analyze cost recovery, and develop recommendations for fee changes.

Costs and Benefits

These recommendations can be accomplished within the normal management responsibilities of the organization. Our recommendations would increase the Controller's ability to analyze fee revenues and therefore, forecast more accurate revenues for the City. In a small sample of total cost recovery of fees in nine departments, we estimate that the City could generate at least an additional $880,000 annually.

12. Monitoring Claims for State-Mandated Costs Reimbursements

- **The Controller's Office does not exercise sufficient oversight over the City departments, which file claims for reimbursements for State-mandated programs, known colloquially as the SB 90 program. The Controller's Office does not monitor the quality of the SB 90 claims prepared and submitted by the contractor. A review of four SB 90 claims filed in FY 2001-2002 revealed inconsistent methodology and errors in the claims. For example, the contractor used a methodology for calculating the Election Department's indirect cost rate that was inconsistent with the methodology used for other departments' indirect cost rates. The Budget Analyst estimates that the City would have received an additional $21,000 in departmental indirect cost reimbursements for the Absentee Ballot program if consistent methodology had been used.**

- **The management audit also found errors in the calculation of hourly staff rates. Out of 26 positions reviewed, we found nine positions with errors, or an error rate of 35 percent. These errors resulted in inaccurate amounts being claimed for reimbursement and could result in the disallowance of claim costs by the State Controller's Office during a desk audit.**

- **In FY 2001-2002, the City filed reimbursement claims for 31 State-mandated programs out of 54 eligible programs. Although the contract with DMG Maximus, the contractor responsible for assisting City departments in preparing and submitting SB 90 claims to the State for reimbursement, requires documentation of the reasons that City departments do not file SB 90 claims, the Controller's Office does not have such documentation. The Budget Analyst estimates that, based on the claims filing experience of other California counties, San Francisco could receive an additional $95,000 in State reimbursement revenue annually by filing SB 90 claims for all State-mandated services provided by San Francisco.**

The State's Reimbursements to Cities and Counties for State-mandated Programs

The California Constitution and California Government Code require the State to reimburse the cities and counties for State-mandated services and programs. The local governments generally receive these reimbursements based on claims they file with the State, calculating the specific costs attributable to a specific State-mandated program. The mandate-reimbursement program is known colloquially as the SB 90 program, after the legislation establishing it.

As a combined city and county, San Francisco is eligible to file claims for reimbursement under 54 State-mandated programs, as defined by the State Controller's Office. In FY 2001-2002, San Francisco filed $10.3 million in claims for reimbursement for 31 of the 54 State-mandated programs and received $5.2 million in actual reimbursements. The Controller's Office is in the process of preparing FY 2002-2003 SB 90 claims.

In FY 2003-2004, the State appropriated no or limited funds for payment of SB 90 claims. Although FY 2003-2004 funding is not currently available to pay FY 2002-2003 SB 90 claims, the State's responsibility to pay such claims will continue for all programs that were mandated during the year of the claim.

The Controller's Office Oversight of SB 90 Cost Claims

In San Francisco, the Controller is responsible for coordinating the SB 90 claims prepared by the City departments. The Controller's Office has assigned one staff person in the Budget and Analysis Division to coordinate SB 90 claims. Departments are responsible for tracking staff hours and other costs which are eligible for reimbursement under SB 90. The Controller's Office has a long standing contract with an outside contractor to work with departments to prepare and submit SB 90 cost claims to the State Controller for reimbursements. Since 1997, the Controller's Office has had a contract with DMG Maximus to prepare and submit claims. The Controller's Office recently submitted a Request for Proposal and selected the Public Resource Management Group for SB 90 claims preparation and submission. Although the contractor has changed, the actual contractor performing the work, who moved from DMG Maximus to the Public Resource Management Group, will remain the same. During the course of this audit, the new contract with the Public Resource Management Group was under review and had not been formally awarded.

The City departments' finance officers are responsible for collecting and reviewing data for SB 90 claims and the contractor reviews and summarizes the claims data to comply with the State Controller's Office requirements. The SB 90 contractor meets with City departments' finance staff to discuss source document requirements for filing claims. The individual departments are responsible for developing and maintaining the source documents, including tracking staff hours and other costs allocated to eligible programs. The Controller's Office does not oversee the work of the departments in tracking eligible program costs and maintaining source documents, although, according to the SB 90 Coordinator, the Controller's Office does tell departments that the Controller's Office is a resource in establishing claims data tracking methods. The SB 90 Coordinator also encourages departments' finance staff to attend State-sponsored training on the filing of SB 90 claims.

State Controller's Office Audits of SB 90 Claims

The Controller's Office SB 90 Coordinator tracks the filing of claims and records actual receipts. The SB 90 Coordinator also assists the State Controller's Office when representatives from that Office conduct desk audits of San Francisco's SB 90 claims. In FY 2001-2002 and FY 2002-2003, the State Controller audited four San Francisco SB 90 claims, including the Domestic Violence Arrest Policies and Standards program, the Absentee Ballots program, the Services to

Handicapped Students program, and the Child Abduction and Recovery program. In these four audits, the State Controller's Office determined that a portion of the costs claimed by the City of San Francisco were not eligible costs, reducing the amount of the claims reimbursement. In one instance, because the City was able to produce documentation to support the cost claim, the State Controller's Office allowed additional costs.

The Management Audit Review of SB 90 Claims

The management audit selected four FY 2001-2002 SB 90 claims files to assess the methodology used by the contractor to calculate departments' indirect costs and departments' staff productive hours. The management audit reviewed FY 2001-2002 files for the Peace Officers Procedural Bill of Rights program, the Domestic Violence Arrest Policies and Standards program, the Absentee Ballots program, and the Mandate Reimbursement Process. Under the Mandate Reimbursement Process, the City is able to claim cost reimbursement for the actual costs associated with preparing and submitting SB 90 claims.

<u>Calculation of departments' indirect cost rates</u>

According to the State Controller's Office, indirect costs include (a) the overhead costs for the unit performing the mandate, and (b) the costs of central government services distributed through the central service cost allocation plan and not otherwise treated as a direct cost. If the city or county claims departmental indirect costs, then the city or county may use one of two different indirect cost methodologies.

(1) The city or county may claim 10 percent of the department's direct labor costs, excluding fringe benefits. The State Controller's Office states that this 10 percent rate may benefit small agencies, which provide few supportive services.

(2) If the department's indirect costs exceed 10 percent of the department's direct labor costs, the city or county may prepare an indirect cost rate proposal (or ICRP) which complies with the Federal Office of Management and Budget circular No. A-87, *Cost Principles for Grants to State and Local Governments.*

In the four FY 2001-2002 SB 90 claims, the contractor calculated the department's indirect cost rates as 10 percent of direct labor costs in one claim, the Peace Officers Procedural Bill of Rights program, and calculated indirect costs based on an indirect cost rate proposal in the other three claims. According to the Office of Citizen Complaints, which provides services under the Peace Officers Procedural Bill of Rights mandate, the contractor determined that the 10 percent of direct labor cost methodology for indirect cost calculations would yield a better result for the Office of Citizen Complaints, due to the small size of the program.

Indirect cost calculation methodologies in three selected claims

In the other three programs, which include the Domestic Violence Arrest Policies and Standards program, the Absentee Ballots program, and the Mandate Reimbursement Process, the contractor calculated an indirect cost rate proposal for each department. The indirect cost rate proposal was based on:

- The department's actual expenditures for the year,
- Identified unallowable, allowable direct, and allowable indirect costs, and
- The department's portion of countywide overhead costs, which are developed by the Controller's Office as part of the countywide cost allocation plan (or COWCAP).

The indirect cost rate proposal was the ratio of total allowable indirect costs to total allowable direct salaries and benefits. The contractor calculated an indirect cost rate proposal for five departments, which filed claims under the three mandated programs reviewed by the management audit. All the indirect cost rate proposals exceeded 10 percent of direct labor costs, as shown in the table below.

Table 12.1

FY 2001-2002 Indirect Cost Rate Proposals for Five City Departments

City Department	Indirect Cost Rate Proposal
Police Department	18.6 percent
Sheriff Department	26.8 percent
District Attorney's Office	22.4 percent
Elections Department	104.4 percent
Controller's Office	32.5 percent

Source: San Francisco Controller's Office SB 90 Claims Forms

The management audit noted that the contractor was inconsistent in calculating the Elections Department indirect cost rate proposal. For the other four departments, the contractor based the indirect cost rate proposal on the ratio of total allowable indirect costs, including indirect salaries and benefits, and total direct salaries and benefits. Once the contractor established the ratio, the indirect cost rate proposal (or percentage) was multiplied by the total salaries and benefits allocated to the mandated program. For example, for the Domestic Violence Arrest Policies and Standards program, the contractor multiplied the indirect cost rate proposal by the total salaries and benefits allocated to the program to obtain the amount of indirect costs of $22,203, as follows:

Salaries	$102,290	
Benefits	17,082	
Subtotal		$119,372
Indirect Cost Rate		x 18.6%
Total		$22,203

In calculating the Election Department's indirect cost rate proposal and actual indirect costs for the Absentee Ballot program and Mandate Reimbursement Process, the contractor used inconsistent methodology. The contractor calculated the indirect cost rate proposal, based on salaries only, whereas the other departments' indirect cost rate proposals were calculated, based on salaries and benefits. The contractor calculated an Election Department indirect cost rate of 104.4 percent, and then applied the 104.4 percent indirect cost rate inconsistently to two different claims to obtain the actual amount of indirect costs.

- In the Mandate Reimbursement Process claim, the contractor applied the 104.4 percent indirect cost rate incorrectly to both Election Department Mandate Reimbursement Process salaries and benefits.

- In the Absentee Ballot claim the contractor applied the 104.4 percent indirect cost rate correctly to Election Department Absentee Ballot salaries only.

The Budget Analyst estimates that, if the Elections Department indirect cost rate had been calculated in the same manner as the other City departments, the indirect costs claimed for the Absentee Ballot program would have been approximately $21,000 more than the indirect costs actually claimed.

Calculation of Departments' hourly rates for staff time

When the State reimburses local jurisdictions for costs incurred for providing State-mandated services, the local jurisdictions are able to receive reimbursement for actual staff hours allocated to the State-mandated programs and for a corresponding number of hours for paid time off, such as vacation time or paid sick time. According to the State Controller's Office, the productive hourly rate for actual staff time allocated to State-mandated programs can be calculated by dividing the actual salary rate by 1,800 hours. This method allows the local jurisdiction to include the cost of paid time off in the reimbursement claim. For example, if the City calculates reimbursement based on 2,080 hours per full time equivalent position (FTE) for an employee in the classification of Police Officer I with annual salary of $62,026, the hourly rate is $29.92. However, as noted below, if the City calculates the productive hourly rate based on 1,800 per FTE, the salary rate is $34.46.

Salary	$62,026
Divided by productive 1,800 productive hours	1,800
Productive salary cost per hour	$34.46

The management audit identified different methods for calculating productive hourly rates in the SB 90 cost claims.

- When staff time are exclusively allocated to a State-mandated program, such as the Child Abduction and Recovery Unit of the District Attorney's Office, the department claims total annual salaries and benefits.
- Other programs, such as the Office of Citizen Complaint, track the hourly pay rate for staff allocated to a State-mandated program over the course of the year, multiply by 2,080 hours and then divide by 1,800 hours.
- The contractor calculated the Police Department staff hourly rate for the Mandate Reimbursement Process by dividing annual salary expenditures for each classification by the number of full time equivalent (FTE) positions in the classification and then dividing by 1,800 hours to obtain the hourly productive rate.

All of these methods are consistent with State Controller's Office guidelines for calculating hourly productive rates for staff hours allocated to State-mandated programs.

The management audit found multiple errors in the actual calculation of productive hourly rates for the Mandate Reimbursement Process, the Domestic Violence Arrest Policies and Standards program, and the Peace Officers Procedural Bill of Rights program. We reviewed the average hourly productive rates for Election Department positions, which were mostly temporary positions, and found them to be generally accurate. However, we reviewed 26 positions, for which claims were filed under the Peace Officers Procedural Bill of Rights program, the Mandate Reimbursement program, and the Domestic Violence Arrest Policies and Standards program and found errors in the calculation of productive hourly rates for nine of the 26 positions reviewed, or an error rate of 35 percent.

- One principal administrative analyst pay rate was entered into the claim as $31.22 per hour when the actual rate was $46.99;
- One police officer III position was entered into the claim as a police officer II; and
- Seven positions had hourly pay rates entered into the claim form which differed from the hourly rate reported by the Department, although the reason for the difference was not identifiable.

Quality Control of SB 90 Claims

The Controller's Office does not closely supervise the process of preparing or submitting claims nor ensure that SB 90 claims are accurately filed. According to the SB 90 Coordinator, the Controller's Office tracks the filing of claims and actual receipts over the fiscal year and assists with desk audits conducted by the State Controller's Office. The Controller's Office does not audit the departments' development of source documents to support claims. The contractor works with departments to develop and maintain source documents, but the Controller's Office serves only as a resource if departments choose.

The Controller's Office does not monitor SB 90 claims to ensure the quality and accuracy of the claims. Our review of four SB 90 claims found that the contractor used inconsistent methodology in calculating indirect costs and made errors in calculating productive hours. These errors and inconsistencies in some instances resulted in cost claims that were less than the actual costs. Additionally, errors in the claims could result in the disallowance of claim costs by the State Controller's Office during a desk audit. The Controller's Office needs to establish a program to audit SB 90 claims to ensure the quality of the claims, including source documentation developed by the departments and review of the contractor's claim submissions.

Alternatively, the Controller's Office could bring the work of claims processing in-house, and allocate a position in the Controller's Office to work with departments to track, process and submit claims. In either case, the Controller's Office needs to increase its oversight over the SB 90 cost claims process.

Determining Which Claims to File

San Francisco files SB 90 cost claims for 31 of the 54 State-mandated programs. Under the contract with DMG Maximus, the City may instruct the contractor to not file a specific claim or the contractor may notify the City in writing of its intent to not pursue a specific claim and the reasons for not pursuing the claim. However, the Controller's Office has no documentation of the reasons for not pursuing claims for 23 State-mandated programs. In some instances, the City may not pursue claims because the City does not provide the State-mandated program or the reimbursements may fall below the minimum reimbursement level of $200. According to the SB 90 Coordinator, some departments do not file claims because they do not have sufficient staff resources to track claims, and other departments, such as Adult Probation, simply do not respond to requests for information about the filing of claims.

As the City's chief financial officer, the Controller has a responsibility to ensure that the City is receiving reimbursements for mandated services. Therefore, the Controller's Office should identify reasons for not filing claims in State-mandated programs, and if the Controller determines that the department's or contractor's justification for not filing claims is insufficient, the Controller's Office should ensure that such claims are filed.

The City could file claims in at least three additional programs, resulting in an estimated $95,000 annually in revenues. The City could receive an estimated $90,000 annually for the Domestic Violence Treatment Services program services, which are currently provided by the Adult Probation Department, and $5,000 annually for the SIDS Training for Firefighters program, currently provided by the Fire Department. The City already incurs costs for such program services and would be eligible for cost reimbursement for claim filing costs as well as program service costs.

Other Counties' SB 90 Experience

Audits of SB 90 claims in two other California counties suggest that San Francisco could increase total SB 90 claims reimbursements by reviewing claims to ensure that all allowable costs are captured and that all possible claims are filed. A review of FY 1999-2000 Santa Clara County claims reimbursements could be increased by $1,610,256 and a review of FY 2000-2001 San Bernardino County claims estimated that reimbursements could be increased by $621,000. The Controller should conduct a post claim audit of FY 2002-2003 SB 90 claims to ensure that all allowable costs are captured and that claims are filed for all applicable mandates.

Conclusions

Although the Controller's Office is responsible for coordinating the SB 90 program, the Controller's Office does not exercise sufficient oversight over the filing of claims. The Controller's Office does not ensure the quality of the claims filed nor ensure that all claims for which the City could receive reimbursement are filed. The Controller's Office should establish a quality review of the SB 90 claiming process, which would include developing a policies and procedures manual for the City departments, conducting audits of the contractor's work, and documenting reasons for not filing claims. Alternatively, the Controller's Office could bring in-house responsibility for working with City departments to file SB 90 claims annually.

Recommendations

The Controller's Office should:

12.1 Develop a quality improvement program to assure the standardization and quality of cost claims, including conducting audits of claims;

12.2 Alternatively, bring the work of the contractor in house to exercise increased oversight over the SB 90 claims preparation and submission process;

12.3 Develop a reporting system for all City departments regarding which claims are filed and not filed. Document the reasons for not filing claims for all State-mandated programs applicable to San Francisco, and submit an annual written report to the Board of Supervisors regarding which claims are filed and the reasons for not filing claims; and,

12.4 Conduct a post-claim audit for FY 2002-2003 and adjust future claims appropriately.

Costs and Benefits

If the Controller's Office decides to terminate the contract with the contractor to prepare SB 90 claims and to bring the work in-house, the savings for terminating the contract should offset the increased personnel costs for performing the work in-house.

If the Controller's Office works with City departments to ensure that all applicable SB 90 claims are filed, the increased annual revenue to the City would be approximately $95,000.

13. Audits Division

- **The Administrative Code charges the Controller's Office with establishing an auditing function to monitor the economy and efficiency of departments and agencies of the City and County of San Francisco.**

- **The Audits Division is not meeting the same level of productivity as other county and city auditors responding to the National Association of Local Government Auditors' Benchmarking and Best Practices Survey, and management does not manage and limit training and time reporting as closely as it should. The Division's Time Distribution Reports show that for fiscal year 2002-2003, Audit staff spent on average 61.6 percent of the time reported on timesheets on audit and project work. Training and professional development accounted for 6.1 percent of the time reported, other general tasks and administration accounted for 14.7 percent of the time reported, and leave from work accounted for an additional 17.6 percent of time reported.**

- **Further, Audits Division staff received an average credit of 62 hours of training for fiscal years 2001-2002 and 2002-2003. This is 55 percent more than the minimum requirements for training of audit staff. In addition, the Audits Division reported more training hours than required to meet continuing professional education hours. The inclusion of informal training hours increases the Audits Division reporting of training hours to 87 hours per auditor for FY 2002-2003, which is more than double the minimum standard of 40 hours per year for government auditors.**

- **The Audits Division does not complete all planned audits and tasks included in its Audit Schedule. If unnecessary and obsolete mandates were eliminated from the Audit Plan, then the division could refocus on more valuable audits including Payroll audits.**

- **At least one respondent to the National Association of Local Government Auditors' Benchmarking and Best Practices Survey reported productivity of 77 percent or more. The Audits Division's current level of productivity is 15.4 percent less than 77 percent. The 15.4 percent difference in productivity is equivalent to 2.65 FTEs for FY 2002-2003. The loss of 2.65 FTE in productivity is equivalent to salary costs of $220,895 based on the average salary for audit staff.**

The Audits Division is made up of two groups. The Performance Audits group consists of one 1801 Audit Manager and four 1684 Associate Performance Auditors. Two of the four 1684 auditors are part time, equating to a full time equivalent workforce of approximately 4.2 FTE for the Performance group. The Financial Audits group is made up of three 1686 Audit Managers and nine 1684 Associate Auditors, or 12.0 FTE. The Audits Division has one 1842 Management Assistant and is managed by one 1690 Audits Director. The mandated work of the Controller's Office Audits Division is discussed in the following section.

Mandates

The Audits Division of the Controller's Office is charged with performing quarterly audits of the City's cash and investments, auditing concessions under which tenants pay the City more than $100,000 in rent per year; franchise fees; 10 percent of contractors on a random sample basis for compliance with the MBE/WBE requirements; City loans, contracts, grants to verify funds have not been used for political activity; Cultural Centers; and charities licensed to solicit donations on the street. In addition, the Controller's Office has contracted with the PUC to conduct contract compliance reviews every six months. The mandated functions of the Controller's Office Audits Division also include evaluating the economy and efficiency of departments and agencies of the City and County of San Francisco and auditing the accounts of any department head or custodian of an account. Appendix 13.1 to this report is a list of all mandates for the Controller's Office Audits Division compiled from the Administrative Code, the Business & Tax Code, the Police Code and contractual agreements. The Audits Division prepares an Audit Schedule each year and subsequently releases an Annual Report describing the accomplishments of the division.

The Controller's Office acknowledges that the Audits Division does not complete all audits and tasks planned for in the Audit Schedule. The Controller's Office has stated that the Audits Division does not have the resources necessary to perform all planned audits. One of the main constraints on the resources of the Audits Division is that the division must perform unnecessary or obsolete functions. For example, the audits of charitable organizations mandated by the Police Code may not provide significant benefit to the City or its citizens. The Controller's Office has reported that these audits are of very little value to the City as the amounts of money audited are very small. However, such audits remain mandated by the Police Code.

The Controller should evaluate the risks and benefits associated with all of the current mandates and develop a prioritization of those mandates. Such an evaluation should have been performed previously and the Controller should have presented to the Board of Supervisors the risks associated with current mandates and requested the elimination of unnecessary and obsolete audit requirements in order to allow the dedication of staff to higher risk audit work.

For example, the Audits Division has included Payroll audits in the audit plan every year, but they have not actually conducted a complete Payroll audit. Payroll audits are not mandated by the current Administrative Code. In addition, Payroll is subject to annual audit by the outside auditors. However, if the Controller's Office was to evaluate the current mandates and find that Payroll audits are of higher value, the Controller could then present it to the Board of Supervisors as a priority function of the Audits Division and request that the codes be updated. If unnecessary and obsolete mandates were eliminated from the Audit Plan, then the division could refocus on more valuable audits including Payroll audits. While the Controller's Office maintains that it is the responsibility of departments to suggest Administrative Code changes, the

Budget Analyst believes that the Controller should take the initiative to advise the Board of Supervisors on the relevance of these subject mandates.

Productivity

One standard for productivity is the percentage of total paid hours of an organization that are expended on direct outputs of that organization. Because productive hours are those hours actually expended in the production of the outputs of the office, namely audits, for the measurement of productivity of the Audits Division, we included those hours expended directly on audits, audit planning and follow-up, and those hours expended on Special Projects. We did not include hours expended on general tasks, administration, professional development and leave from work. The hours expended on general tasks were not included because the category does not meet the criteria for productive hours. The Audits Director described it as follows:

> This is used to account for time not attributable to audits, authorized projects, or leave. For example, staff are allowed two 15-minute breaks by the MOU with Local 21 and they may charge this time as general time. Staff also use this category to charge downtime when they are unable to perform audit work and spend time on activities such as resolving computer problems, reading and responding to e-mail and mail, emergency office procedures (evacuation drills from City Hall, and any other activities not chargeable as audit or project time).

Hours expended on Special Projects were included in the count for productive hours although it is not entirely clear that all hours counted under Special Projects are expended on direct outputs of the division. In fact, it appears that some of the Special Projects functions may be more appropriately performed by the Controller's Office City Projects Division, or other divisions rather than the Audits Division. The following table shows the percentage of expended hours spent on the direct outputs of the Audits Division and also the percentage of available hours expended on direct time. Table 13.1 includes totals for all work of the division and also for the Audit staff only. Audit staff includes the Audits Director, Audit Manager and Associate Auditor positions, but not the Management Assistant position.

As shown in the following table, Audit staff spent 61.71 percent of total time expended on audit work or other special projects in fiscal year 2001-2002 and 61.61 percent of total time expended on audit work or other special projects in fiscal year 2002-2003. The National Association of Local Government Auditors' (NALGA) Benchmarking and Best Practices Survey for Fiscal Year 2002 stated that the average percentage of total time spent on direct outputs for auditing divisions with 13 to 35 auditors was 65 percent. The NALGA survey average has a standard deviation of 12 percent, which means that some respondents to the survey reported spending at least 77 percent of total time on audit work. Like an average, the standard deviation provides a statistical indicator of relative performance within a sample population. Because detailed survey responses were not available to determine exactly how each jurisdiction reported performance, we used the standard deviation to estimate the degree to which high performers reported productivity above the average.

Table 13.1
Audits Division Productive Hours for All Division Staff and Audit Staff Only FY 2001-2002 and 2002-2003

	FY 01-02		FY 02-03	
	Division	Audit Staff	Division	Audit Staff
Direct Time	27,321	26,720	22,157	22,039
Indirect Time	11,416	10,425	8,970	7,439
Available Time	38,737	37,145	31,127	29,478
Benefit Time	6,384	6,152	6,450	6,293
Total Time	45,121	43,297	37,577	35,771
Percent of Direct Time to Available Time	70.53%	71.93%	71.18%	74.76%
Percent of Direct Time to Total Time	60.55%	61.71%	58.97%	61.61%

The Audits Division should endeavor to exceed the NALGA standard for productivity and achieve the same level of productivity as the most productive audit divisions in other counties and cities. The Audits Division expended 74.76 percent of Available Time on division direct output, while the average in the NALGA survey was 76 percent with a standard deviation of 14 percent. When measuring Direct Time to Total Time, the Audits Division's current level of productivity is at least 15.4 percent less than the level of productivity of at least one respondent to the NALGA survey for hours expended on direct outputs. That 15.4 percent difference in productivity is equivalent to 2.65 FTEs for FY 2002-2003. The loss of 2.65 FTE in productivity is equivalent to salary costs of $220,895 based on the average salary for audit staff. It appears that one contributing factor to the division's measures of productive is the division's current level of training, as will be discussed in the following section.

Training Hours

Training is critical for government sector auditors. It is important to maintain skills and to remain familiar with current standards in auditing. Training also allows for the expansion of skill sets to enable an organization to take advantage of new technology that becomes available as tools for auditors. Generally Accepted Government Auditing Standards for training require government sector auditors to complete 80 hours of training every two years with at least 20 hours of training occurring each year. As shown in the following, table auditors completed an average of 62 continuing professional education (CPE) hours per year over the two-year period, which is 55 percent more than the minimum standards for government auditors.

Table 13.2
Continuing Professional Education Hours for Audit Staff

	FY 2001-2002	FY 2002-2003	Mean Hours per year
CPE Training hours	1,036	1,079	1,058
Mean Training hours per auditor	60.9	63.5	62
Median Training hours	64	63	

In the preceding table, the mean training hours per auditor are total CPE training hours completed by the audit staff of the Audits Division divided by the number of audit staff reporting hours in that year. The training records included instances of auditors receiving 106, 96, and 89 hours in training in a single year. This means that the auditors were completing more than twice the amount of training than the minimum amount necessary to meet standards. The reported hours for training are conservative, since the division also includes hours for informal training and other professional development activities in their time sheets that are not counted as CPE hours. The division defines Informal Training as:

> Informal training generally refers to time spent on activities related to training but does not result in CPE credit. It includes such activities as informal self-study (reading reference materials such as the PPC Guide to Audits of Nonprofits, Sawyer's Internal Auditing, and more recently the AICPA, IIA, and NALGA Peer Review Manuals), review of the division's audit manual, professional reading (bulletins and journals from such professional organizations as the IIA, AICPA, AGA, NALGA) and researching, registering or preparing for professional training.

There are also inconsistencies between the number of CPE hours completed by division staff and the number of hours reported as training in time records. In some instances, the number of hours recorded in time reports far exceeded the number of CPE training hours reported. Some of the difference can be explained by staffing changes. However, the difference is quite large for FY 2001-2002. The following table shows the number of CPE training hours, the number of training hours included in time records and the number of informal training and development/training hours included in time records.

Table 13.3
Training Records for Division Staff

	FY 01-02	FY 02-03
Training hours reported in time sheets	1,944.5	1,141.5
CPE training hours current staff	1,103.0	1,087.0
Difference between credited hours and reported hours	841.5	54.5
Additional Informal Training hours and Training Develop/Records hours	72.8	434.5

The inclusion of informal training hours increases the Audits Division reporting of training hours to an average of 87 hours per auditor for FY 2002-2003, which is more than double the minimum requirement of 40 hours per year for government auditors. The Controller's Office Audits Division should implement management controls to more closely monitor training hours in order to maintain appropriate and necessary training hours and prevent over use of training hours. In addition, the division should assess the value of Informal Training and determine if it is an appropriate use of division time. The hours recorded for training and informal training that are above the minimum requirements for training are equivalent to an average of 0.44 FTE for fiscal years 2001-2002 and 2002-2003, or an equivalent salary cost of $36,677 per year based on the average salary for audit staff. If training hours in excess of required training and informal training hours for fiscal years 2001-2002 and 2002-2003 were instead devoted to the direct work of the division, the productivity of audit staff would improve by an average of 2.47 percent.

Direct Charging

Much of the work of the Audits Division is performed for other departments and agencies of the City and County of San Francisco. Of the 65 audit reports issued in FY 2001-2002, the division completed 22 audits for the Airport, two for the Department of Parking and Traffic, seven for the Port and three for the Recreation and Parks Department. Currently, City departments pay for Audits Division concession audits through workorders. For FY 2003-2004, the Controller's Office has budgeted $530,950 for work order recoveries for the Audits Division. The Audits Division should expand the number of audits for which it directly charges City departments in an effort to recover full costs for audits performed.

Peer Review

The California Counties Audit Chiefs Committee sponsors a Peer Review Program in order to provide quality assurance reviews of county audit functions. The general standard is that a Peer Review takes place every three years. The last peer review of the Audits Division was conducted by the County of Santa Barbara Office of the Auditor-Controller in 1998 and issued in 1999.

Since that time, the Controller's Office Audits Division has not had a Peer Review completed, although a Peer Review has recently begun.

The Peer Review issued in 1999 stated that the "Division generally conforms with the Standards for the Professional Practice of Internal Auditing."[1] However, the peer auditors did present several findings and recommendations. The peer auditors found that:

> Budgetary constraints, their effect on Divisional staff size, and the primacy given to concession audits adversely affect the Division's ability to perform the required scope of audits to be conducted under the City and County' Charter, as well as that suggested by IIA Standards. This issue was also noted in the Quality Assurance Review dated December 31, 1994.

In addition, the peer auditors found that that the Controller's Office had not conducted a risk assessment since FY 1995-1996 and recommended that the Audits Division "perform an annual risk assessment in order to help in setting divisional priorities and work schedules." As noted previously in this report, the Controller's Office reports that it has discontinued performing risk assessments.

Conclusions

The Administrative Code charges the Controller's Office with establishing an auditing function to monitor the economy and efficiency of departments and agencies of the City and County of San Francisco. The Audits Division is not meeting the same level of productivity as other county and city auditors responding to the National Association of Local Government Auditors' Benchmarking and Best Practices Survey and management does not manage and limit training and time reporting as closely as it should. The Division's Time Distribution Reports show that for fiscal year 2002-2003, Audit staff spent on average 61.6 percent of the time reported on timesheets on audit and project work. Training and professional development accounted for 6.1 percent of the time reported, other general tasks and administration accounted for 14.7 percent of the time reported and leave from work accounted for an additional 17.6 percent of time reported.

Further, Audits Division staff received credit for an average of 62 hours of training for fiscal years 2001-2002 and 2002-2003. This is 55 percent more than minimum requirements for training of audit staff. In addition, the Audits Division reported training hours in addition to continuing professional education hours. The inclusion of informal training hours increases the Audits Division reporting of training hours to 87 hours per auditor for FY 2002-2003, which is more than double the general minimum standard of 40 hours per year for government auditors.

[1] Standards for the Professional Practice of Internal Auditing are developed by the Institute of Internal Auditors.

The Audits Division does not complete all audits and tasks planned for in the Audit Schedule. If unnecessary and obsolete mandates were eliminated from the Audit Plan, then the division could refocus on more valuable audits including Payroll audits.

At least one respondent to the National Association of Local Government Auditors' Benchmarking and Best Practices Survey reported productivity of 77 percent or more. The Audits Division's current level of productivity is 15.4 percent less than 77 percent. The 15.4 percent difference in productivity is equivalent to 2.65 FTEs for FY 2002-2003. The loss of 2.65 FTE in productivity is equivalent to salary costs of $220,895, based on the average salary for audit staff.

Recommendations

The Controller should:

13.1 Evaluate the risk associated with the current mandates of the Audits Division;

13.2 Prioritize the mandates and request the Board of Supervisors to eliminate any unnecessary mandates;

13.3 Reduce training to required and/or necessary hours;

13.4 More closely monitor training hours in order to maintain appropriate and necessary training hours and prevent over use of training hours;

13.5 Improve productivity; and,

13.6 Should expand the number of audits for which it directly charges City departments to recover full costs for audits performed.

Costs and Benefits

There are no costs associated with increasing productivity or decreasing training hours to a more reasonable level. Increased efficiency in the Audits Division would result in more audits performed of City Departments, Funds, Vendors and Contractors.

Appendix I.1
Estimated Annual Savings to the City and County of San Francisco from Implementation of Audit Recommendations

Report Section		One-Time Resources	Annual Savings
1	Organization		$122,607
2	Financial Administration		
3	System Planning		
4	Internal Control Reporting and Financial Auditor Independence		
5	Budgetary Controls	$177,000	
6	Fund Maintenance (1)	2,193,114	
7	Cash Revolving Funds	(2)	
8	Cost Allocation Plan		Undetermined (3)
9	Multi-Tiered Cost Plans		Undetermined (3)
10	Departmental Indirect Cost Rates		
11	Cost-Based Fees for Service		880,000
12	Monitoring Claims for State-Mandated Cost Reimbursements		95,000
13	Audits Division		
Total Savings		$2,370,114	$1,097,607

(1) Some, but not all, of these funds may be restricted for certain activities.

(2) Recommendations include a $487,100 reduction in cash revolving funds, but do not result in increased funds available for appropriation.

(3) Increased revenues resulting from increasing costs claimed for federal and State grants, or recovered through fees or billing to outside agencies and special funds were not determined due to the limited scope of our review.

Appendix 2.1
Post-Audit Exception Comparison

	Findings	ALL EXCEPTION CATEGORIES						EXCEPTIONS RELATED TO FINANCIAL INTEGRITY (1)					
		CY 2001 TOTAL		CY 2003 TOTAL			%	CY 2001 TOTAL		CY 2003 TOTAL			%
		Count	Documents to Exceptions	Count	Documents to Exceptions			Count	Documents to Exceptions	Count	Documents to Exceptions		
1	Non-12B/HRC compliant vendors or HRC forms not on file	182	30.05	146	22.75	D	-24.3%						
2	Same initiator/receiver and approver	145	37.72	18	184.56	I	389.2%	145	37.72	18	184.56	I	389.2%
3	Incorrect keying or lack of invoice/deposit/vendor info/dates	148	36.96	110	30.20	D	-18.3%						
4	Incorrect input (doc. type/subobject/comm. Code/remit add)	101	54.16	53	62.68	I	15.7%						
5	Missing/misfiled/insufficient supporting/original documentation	91	60.11	19	174.84	I	190.9%						
6	Untimely/inappropriate deposit and recording of cash deposits	77	71.04	34	97.71	I	37.5%	77	71.04	34	97.71	I	37.5%
7	Paid from copy invoices without certification	61	89.67	41	81.02	D	-9.6%	61	89.67	41	81.02	D	-9.6%
8	Non-current business tax certificate or not on file	61	89.67	70	47.46	D	-47.1%						
9	Late posting/payment of expenses	60	91.17	44	75.50	D	-17.2%	60	91.17	44	75.50	D	-17.2%
10	Payment or authorization prior to certification or contract	53	103.21	87	38.18	D	-63.0%	53	103.21	87	38.18	D	-63.0%
11	No packing slip/receiving report/documentation/authorization	41	133.41	39	85.18	D	-36.2%	41	133.41	39	85.18	D	-36.2%
12	Inappropriate use of one-time vendors	33	165.76	16	207.63	I	25.3%	33	165.76	16	207.63	I	25.3%
13	No purchase order/contract/encumbrance/invoice	24	227.92	32	103.81	D	-54.5%	24	227.92	32	103.81	D	-54.5%
14	Copy of departmental blanket/PO missing, blanket-related issues	23	237.83	1	3322.00	I	1296.8%						
15	Notepad & document ref field not used appropriately	15	364.67	19	174.84	D	-52.1%						
16	Discount not taken	14	390.71	14	237.29	D	-39.3%	14	390.71	14	237.29	D	-39.3%
17	Vendor's insurance not verified/valid for contract payment	13	420.77	21	158.19	D	-62.4%						
18	Unbudgeted or made by unauthorized personnel	12	455.83	-	#DIV/0!	I		12	455.83	-	#DIV/0!	I	
19	Authorization missing/incomplete	10	547.00	38	87.42	D	-84.0%	10	547.00	38	87.42	D	-84.0%
20	Inappropriate use of or non-compliant to Prop Q/3 bids/quotation	8	683.75	27	123.04	D	-82.0%	8	683.75	27	123.04	D	-82.0%
21	Paid $ not match purchase order/contract/encumb/invoice	6	911.67	2	1661.00	I	82.2%	6	911.67	2	1661.00	I	82.2%
	Total Exceptions	1,178	4.64	831	4.00	D	-13.9%	544	10.06	392	8.47	D	-15.7%
	Test Population	5,470	1.00	3,322	1.00			5,470	1.00	3,322	1.00		

(1) Exceptions related to Financial Integrity were identified by the Controller's Office.

Legend:
I - Increased documents per exception reflecting an increased adherence to policies and procedures
D - Decreased documents per exception reflecting a decreased adherence to policies and procedures

Appendix 7.1
Underutilized Cash Revolving Funds in Fiscal Year 2002-2003

Department	Total Activity	Average Transaction Amount	Average Monthly Amount	Current Authorized Amount	Recommended Authorization	Recommended Reduction
Airport	15,045	327	1,254	10,000	1,500	8,500
Animal Care and Control	1,105	1,105	92	2,000	100	1,900
Adult Probation	173	58	14	300	50	250
Arts Commission	245	245	20	500	50	450
Assessor	8,620	718	718	1,000	750	250
Consumer Assurance	775	258	65	800	100	700
Board of Supervisors	203	203	17	500	50	450
Medical Examiner	1,038	130	87	500	150	350
Controller	1,164	83	97	200	100	100
Planning	383	128	32	200	50	150
District Attorney	200	200	17	200	50	150
Ethics Commission	279	70	23	100	50	50
Fire Department	1,999	1,999	167	3,000	200	2,800
Community Health	40,517	614	3,376	43,000	5,000	38,000
SFGH	9,952	905	829	10,000	5,000	5,000
Laguna Honda	518	518	43	5,000	200	4,800
Library	1,731	247	144	5,000	250	4,750
Permit Appeals	241	80	20	150	50	100
Public Defender	519	130	43	200	50	150
Port	6,321	253	527	5,000	500	4,500
MTA (2 funds)	13,426	177	1,119	102,000	3,000	99,000
DPW	6,724	280	560	10,000	1,000	9,000
Rent Board	441	73	37	100	50	50
Elections	465,000	155,000	38,750	500	50	450
Recreation and Parks	886	886	74	5,000	100	4,900
Retirement	2,399	200	200	500	200	300
Sheriff (2 funds)	41,458	222	3,455	13,000	5,500	7,500
Superior Court	212	106	18	5,000	50	4,950
Human Services	2,818,283	6,791	234,857	450,000	250,000	200,000
DTIS	6,046	1,008	504	6,000	500	5,500
Treasurer/Tax Collector	1,232	411	103	4,500	150	4,350
PUC	13,633	505	1,136	20,000	1,500	18,500
Hetch Hetchy	454	113	38	10,000	50	9,950
Water	5,507	306	459	20,000	1,000	19,000
War Memorial	3,150	787	262	1,000	350	650
	Totals			**735,250**	**277,750**	**457,500**

Appendix 13.1
Controller's Office Audits Division Mandates

Mandated Audits	Frequency	Code	Section
Civil Grand Jury Implementation Status: Report to BOS on implementation of recommendations that pertain to fiscal matters considered at a public hearing	Annual	Administrative	2.10
Performance Audits of Boards, commissions, officers, and departments: audit operations to evaluate effectiveness and efficiency as needed.	As needed	Administrative	2A.20
Financial Audits: Audit accounts of any officer or department as requested by Mayor, BOS, or any board or commission for its own department	As needed	Administrative	2A.20
Fund Disbursement: Audit accounts of all boards, officers, and employees of SF who are charged with custody, collection, or disbursement of funds. Audit all accounts of money that go to Treasurer; frequency determined by CA state law. (This mandate is performed in conjunction with post-audits by the Accounting Division.)	As needed	Administrative	2A.20, 10.6, 3.03 Charter
Establish a Performance and Efficiency Audit Office within the Controller's Office to identify inefficient operations and functions of departments, agencies, boards, and commissions of the City and County of SF that should be eliminated. Plan should include an evaluation of cost-effectiveness of expenditures, utilization of employees and contractual services, consolidation of overlapping activities and functions, promotion of interdepartmental information sharing, cost-cutting recommendations, etc. Controller establishes schedule for recommendations and reports plan execution to BOS.	As needed	Administrative	2.92
Fee Refunds: Audit and approve or disapprove claims for refunds of fees/erroneously collected money. (This mandate is performed by the Claims Division.)	As needed	Administrative	10.43
Concessions/Leases under which City is Lessor: audit departments to ensure that they are adequately managing their leases for city-owned property where rent is $100K or more.	As needed	Administrative	10.6-2
Treasurer: Audit Treasurer.	Quarterly	Administrative	10.6-3
Revolving Funds: administer, monitor use and authorize exceptions to Cash Revolving Funds.	As needed	Administrative	10.100, 10.125
Franchise Compliance: file report with Board analyzing those owing Franchise fees comply with audit, establish payment requirements	Biannual	Administrative	11.44

Appendix 13.1
Controller's Office Audits Division Mandates

Mandated Audits	Frequency	Code	Section
MBE/WBE Utilization: In cooperation with Director, conduct random audits of prime contracts (10% of joint ventures granted bid discounts) in order to insure compliance with MBE/WBE ordinance.	Annual	Administrative	12.D.A.6
Political Activity: Audit annually at least 10 persons/entities that enter into contracts or agreements with city to ensure that public funds are not used for political activity; promulgate rules and regulations for implementation of ordinance, including penalties for breaching agreements.	Annual	Administrative	12G.2-4
Retirement System: Audit Retirement System. (Retirement contracts with an independent auditing firm for Retirement System audits.)	Annual	Administrative	16.41
Services: Evaluate provision of in-kind aid for general assistance, personal assisted employment services, cash assistance (Medi-Cal), SIPP, aid to homeless to determine program effectiveness and cost efficiency	Every 3 years	Administrative	20.60.13, 20.95, 20.126, 20.227, Appendix 63
Supervisorial Election Campaigns: Assist Ethics Commission and audit supervisorial election campaigns; disburse public financing accordingly. (The Ethics Commission performs supervisorial election campaign audits.)	As needed	Administrative	Appendix 52
Cultural Centers: Perform a financial review of all cultural centers every four years supported through the Arts Commission.	Every 4 years	Business & Tax	515.01
Public Utilities Commission Consulting Contract: Conduct a review/audit of Consultant's cost and performance.	Every 6 months	Contract	Contract
Charitable Organizations: audit for accuracy and completeness 3 randomly selected financial statements submitted by charitable organizations each calendar year.	Annual	Police	660.4

Controller's Office
Statement of Accomplishments

Mission and Vision:

The mission of the Controller's Office is to ensure the city's financial integrity and to promote efficient, effective, and accountable government. The office strives to be a model for good government and to make the City a better place.

Overall Organization and Staffing:

Ed Harrington has served as Controller since 1991, and was appointed and confirmed in 2000 to a second ten-year term. Over time, the Controller's Office has worked to automate, decentralize, and streamline the City's financial and payroll operations. The City has been transitioned from systems that were largely based on paper document processing, to systems that are on-line and rules-based. The nature of the work done by Controller's staff has similarly changed—where formerly we reviewed a large volume of documents and entered data to the financial systems, we now review and approve transactions on-line, provide guidelines and training for financial staff citywide, conduct post-audits of the city's financial activity, and do reporting and analysis. Accounting and payroll staff and capacity are spread citywide, and the City uses the effort and expertise of the departments to run more of San Francisco's day-to-day financial operations. Reflecting these trends, the Controller's staff has decreased the number of its staff 35% overall in the 12-year period, from 219 to 142 people, representing a savings to the City of approximately $5.6 million annually. Today, the Controller's Office is continuing to increase its post-auditing capability, implement improvements to financial reporting, improve the efficiency and accuracy of payroll operations, and develop the office's ability to provide high-level reporting, reconciliation, performance measurement, and problem-solving services.

Accounting Operations and Systems

- San Francisco was among the first large cities to implement the new reporting model of Government Accounting Standards Board Statement 34 (GASB 34)—a full year before the required deadline. The Controller's Office provided training to all city departments on the GASB 34 model, developed database reports supporting the City's analytical needs, and received a Government Finance Officers Association Certificate of Achievement for Excellence for San Francisco's presentation of the Comprehensive Annual Financial Report (CAFR) in the GASB 34 format.
- The City's financial and budget information is housed on mainframe computer systems. While inquiry and transaction screens answer most questions regarding balances and accounting activity, most high-level reporting and analysis, and some low-level, (payroll-based) reporting and analysis formerly required a programmer to write or access report specifications. The Controller's Office has addressed these issues over time by building PC-based databases and by

developing, for citywide use, the Executive Information System (EIS). EIS is a user-friendly, point-and-click style interface to the financial information stored on the mainframe. EIS has both standard reports and ad-hoc reporting capability and City departments use the system to meet a wide variety of their needs for reporting and analysis. The Controller's Office is engaged in an ongoing process of expanding and developing EIS capabilities in response to the City's needs and customer requests.

- The Controller's fund-accounting staff carry out an annual process, the post-audit review, which samples and tests accounting transactions from 80% to 100% of City departments, provides detailed reports of the types and amounts of exceptions found, and follows up with training tailored to the needs of the departments. The post-audit process has both increased its scope and has helped effectively reducethe rate of errors and exceptions found in the last two fiscal years.
- In FY 2000-2001, the Controller's Office initiated a process to simplify and consolidate the City's special funds by creating a standardized categorization system specifying how the fund's finances are to be managed. Outmoded and inconsistent fund references in the City's codes were repealed as part of the effort. The new code language developed, Administrative Code Section 10.100, also reduces the analyst time and discretion to manage special funds and simplifies reporting.

Payroll and Personnel

- Beginning in FY 1998-1999, the Controller's Office developed a new, rules-based time entry system, replacing archaic and labor-intensive data entry processes. In simple terms, the Time Entry and Scheduling System (TESS) insures that City employees only receive pay for which they are eligible. Payroll clerks no longer manually confirm the eligibility of individual employees for hundreds of special pay codes—rather, the exact terms of the City's Memoranda of Understanding with more than 40 labor unions are built into TESS. The system replaces manual processing of timesheets with on-line time recording and on-screen system edits. It has substantially reduced the error rate, processing time, and effort needed to record employee hours and pay. The system has been successfully rolled out to 85% of all departments, with the Payroll Division providing training and problem-solving on-site.
- At the calendar year end, the Payroll and Personnel Services Division conducts the reconciliation, reporting and problem-solving tasks necessary to issue W-2 statements to the City's approximately 29,000 employees. In each of the last three years, W-2s have been issued within 14 days of the end of the calendar year, well in advance of the January 31 deadline.
- Payroll and Personnel Services has steadily worked to increase the percentage of employees receiving direct deposit of their paychecks. Of the approximately 29,000 employees currently receiving checks each pay period, approximately 80% now have electronic fund transfer from the City to their bank account. In addition to the convenience to employees, direct deposit increases biweekly

payroll processing efficiency and greatly reduces the City's risk for fraud and theft.

- The Payroll and Personnel Services Division has recently initiated a process to automate and web-enable payroll information. Currently, city employees with direct deposit receive a paper pay stub listing the necessary deductions and the net amount of the deposit. In FY 2003-2004, the department will eliminate these "advice of deposit" records and transition to a paperless system. Employees will be able to access their payroll information through a secure, web-based information system. The Controller's Office is currently working on solutions for employees without day-to-day access to computers by providing telephone, fax and other access points. This initiative will reduce printing, production and paper costs and eliminate biweekly distribution costs in the Controller's Office and citywide.

Audits, Performance Measurement, City Projects

- Over the most recent five-year period, the Controller's Office has significantly increased and improved its capability to provide auditing, performance measurement, and management and technical services to departments. These divisions represent the Controller's efforts under Charter and Administrative Code mandates to increase the effectiveness and efficiency of city government.
- The total number of audits completed increased from 43 in 2001 to 65 in 2002, while the cost per audit dropped for all major categories of audits—concession, financial and performance. At the same time, the Audits Division has also provided special reporting and other needed services, such as a program to train non-profit service providers on compliance with City contracting requirements.
- Departmental management audits and special reports issued by the Performance Audits group have grown in scope and complexity, providing services and information not available from any other source. An audit of the City's provision of homeless services, and a forthcoming audit of the City's efforts to affect job training and the labor market contain analyses of policy issues that cross the City's organizational lines, giving policymakers critical tools and information for the budget and legislative processes.
- The Controller's Performance Measurement unit, created in FY 1997-1998, has built citywide participation in the Code-mandated effort to track public service delivery in terms of quality, quantity and effectiveness. Beginning in FY 2000-2001, performance information has been brought into a database designed by in-house staff that allows the Controller's Office and departments to develop the quality and reliability of the data used for measurement. The database is also designed to allow the City to track year-to-year change consistently, populate the Mayor's budget book directly with performance information, and provide reports for policymakers. The data is also used to inform the City's participation in national comparative performance and best practice surveys such as that administered by the International City/County Management Association (ICMA).
- The Performance Measurement unit annually directs and publishes the City's major scientific sampling of citizen opinion—the Citizen Survey. Since the

advent of district elections, the Controller's Office has also provided district-level analysis of the survey data—giving each Supervisor a look at how citizen opinion in their district differs from the citywide statistics. In June of 2003, the Controller's Office published, for the first time, a web-based Community Indicators Report compiling, linking and graphically displaying information on San Francisco's economy, education, health care, housing, transportation and other critical measures. These indicators of the City's success and progress as a place to live, work, and visit will be added to and updated throughout FY 2003-2004 to inform citizens, policymakers, and government agencies as they plan and provide service to the public.

- The City Projects group, created by the Controller with the assistance of the Mayor in FY 2000-2001, provides critical short-term analytical, technical and managerial services to City departments. The group also allows the Controller's Office to maximize the benefit of its audit function by providing assistance to departments who need help to implement audit recommendations. The group has implemented service improvements in health, safety, and in public information provided by the City, among other areas.
- In each of the last two labor negotiation cycles, in FY 2000-2001 and 2002-2003, the City Projects group provided analytical support and cost estimates of the proposals exchanged by the City and the unions in the collective bargaining process. This service has meant both a significant improvement in the City's ability to manage and understand the costs and implications of its labor agreements, and an improved process, helping the parties to avoid arbitration and reach agreement within Charter deadlines.

Budget and Analysis Division

- The Budget and Analysis Division initiates budget process and systems improvements on an ongoing basis. All departments with mainframe access have been trained to use the Budget Preparation System on-line, replacing manual submission of reports. The Controller's Office created an MS Access database that is used daily to provide the information required by the departments, Mayor's Office, and Budget Analyst for their various analytical and reporting needs. The Controller's Budget Unit itself has reduced the time it requires to balance and clear errors from the budget data, allowing more time for the departments, Mayor and Board to work on the budget. Overall, the Controller's Office provides more analytical support to the Mayor and Board annually, and has facilitated changes to the budget process requested by the Board—balancing and publishing budget data earlier in each of the last two years.
- The Controller's Budget and Analysis Division is improving the City's projection and tracking of revenues citywide. Templates were developed and provided in the FY 2003-2004 Budget Instructions to help city departments better capture and analyze their actual cost of services and the revenues recovered. This information will allow fees and service charges to be more rigorously justified and annually updated by the departments on a consistent basis, and will assist the Controller's Office effort in FY 2003-2004 to maintain complete and consolidated information

on these and all other city revenue sources. In the last two years, Controller's staff have instituted improvements to the City's documentation and analysis of major revenue sources, and have published a compilation of statistics, trends, sensitivities, and relevant law on the Controller's website for public use.

- The Six and Nine Month Budget Status Reports prepared by the Controller's Office have been increased in scope in the last two fiscal years—giving economic trends, factors affecting the City general fund, and reporting more information of interest to policymakers and the public, such as comprehensive mid-year projections of revenue, and the City's compliance with Charter-mandated baselines.
- In response to requests from the Board, Mayor, and the public, the Budget and Analysis Division now provides a high volume of special reports and general economic and market analysis, in addition to the city financial analyses which comprise its core function. In recent years, the Division has provided labor market and economic analysis for union negotiations, special analyses of the taxi industry for rate-setting processes, analysis of city insurance functions (with the City Projects group), and the analytical work for the Rainy Day Reserve Charter amendment proposal, among other products.

Administration

- In response to a growing need for accounting skills citywide, the Controller's Office initiated the 1649 Accountant Internship program in the 1990s. The program includes a curriculum on San Francisco and general governmental accounting procedures and municipal administration taught by City staff, training on accounting, budgeting, and purchasing systems, and rotating placements in City departments for practical experience. Enrollees in the program include both current employees upgrading their skills and new recruits to the City workforce. The highly effective program has graduated 59 fully trained governmental accountants since its inception.
- The Controller's Office carried out two moves—into City Hall, and, for the Payroll Division, into 875 Stevenson Street, in recent years. Public service was been improved in each case—counter facilities in payroll, claims processing, and the property tax offices were improved and increased security provided. Public assistance is available at the main office in Room 316 from 8am to 6pm daily, where front desk staff respond to a wide array of requests for financial and general city government information, and provide referrals.
- The Controller's website, redesigned by staff in FY 2002-2003, is now improved and more accessible to the public. Standard reports such as the CAFR, AAO, Six and Nine Month Budget Status Reports, Citizen Survey, and Audit Reports are available for multiple fiscal years and are clearly labeled and grouped. A prominent News and Events link gives the most recent information published by the Controller's Office, and links are provided for employment, budget reports and instructions, and other frequently requested information.

The Controller's Office will continue to plan for and implement improvements and upgrades in the City's financial, payroll, audit and related functions on an ongoing basis. The Office seeks to achieve excellence, to understand and meet the needs of its customers, and to make San Francisco's public management responsive to the changing environment and to the needs of the City and its citizens.

CITY AND COUNTY OF SAN FRANCISCO
OFFICE OF THE CONTROLLER

Ed Harrington
Controller

Monique Zmuda
Deputy Controller

September 8, 2003

Mr. Harvey Rose
Board of Supervisors Budget Analyst Office
1390 Market Street Suite 1025
San Francisco, CA 94102

Dear Mr. Rose,

This is the Controller's Office (Controller) response to your management audit of our office conducted in July and August of 2003.

The Controller is pleased that there are few or no findings or recommendations regarding most of the core functions of the office, such as budget preparation and monitoring, property tax operations, payroll, vendor payments, and bond and financial statement reporting activities. As auditors, we understand and welcome comments that point out areas for improvement in our activities.

We have reviewed the Budget Analyst's (Analyst) recommendations and summarize our response here and provide more detailed responses on the pages that follow. We apologize in advance if the comments do not exactly match the text of the Analyst's final report due to the rushed nature of this audit and the limited time available for both the Analyst to prepare and the Controller to respond to this audit.

We believe the great majority of the Analyst's comments fall into three areas:

1. **Policies and Procedures**

In general, the Analyst believes the Controller should put more emphasis on compiling, creating, documenting, and promulgating policies and procedures in various areas. Eighteen, or 26% of the 69 recommendations in the report fall in this area. In general, we agree that this would be beneficial to the City and will prioritize this, taking into consideration limited budget resources and a cost benefit approach to working on the most important areas first.

2. **Enhanced revenues through various cost allocation processes**

The Analyst spent a considerable amount of time looking at how we could increase the ability of the City to increase reimbursement for costs from other agencies or within the city structure. The Controller has focused in the past on those items that we believe had the greatest expectation of actually producing funds for the City and particularly for the General Fund. The Analyst's report, while not finding any significant items that have been missed, encourages us to focus on this area. We agree to do so, again taking into consideration a cost benefit approach and limited staffing.

3. **Need for new information technology systems**

The Analyst correctly points out that we have aging budget, accounting and purchasing technology systems that require upgrade and eventual replacement. The basic systems are not flexible enough to easily meet changing, but reasonable, departmental expectations. They do, however, enable the City to prepare a budget, pay its employees and vendors, and meet all bond and financial reporting requirements. The Controller is currently working on a number of upgrades to these systems. The eventual replacement is expected to cost $25 to $30 million for outside software and assistance plus the efforts of a considerable number of City staff. The Controller welcomes an opportunity to discuss with the Board the possibility and timing of funding such an endeavor.

On the pages that follow, we have summarized what we believe to be the Analyst's key findings for the reader's convenience. This summary should not be viewed as a substitute for reading the Analyst's report. We look forward to seeing your final, complete report and following up on its recommendations.

Sincerely,

Ed Harrington
Controller

Encl.

1. Organization

The Analyst has recommended that the Board of Supervisors consider whether it wishes to continue non-mandated functions performed by the Controller's City Projects and Performance Management Divisions. The Analyst also recommends that the Controller disband the Performance Management and Grant Units, redistribute the work among other divisions, eliminate the Grants Manager position and downgrade the Performance Management Director position.

The Controller does not agree with the recommendations to disband the Performance Management Division and the Grants Units and redistribute its work to employees of other divisions. We also do not agree with the recommendation to downgrade the Performance Management Director and to delete the Grants Manager position. Although we do not agree with these specific recommendations, the Controller will review and, if necessary, revise its organizational structure based on the outcome of the proposed Charter amendment (Proposition C) at the November election to increase the performance measurement and auditing functions of the Controller.

The Controller has added performance management and special projects functions to improve the performance of the City and believes these functions have added value. The City Projects Division was created by the Controller in consultation with and approval of the Mayor and the Board of Supervisors to improve the efficiency and effectiveness of City operations. The City Projects staff provide analysis and assistance to departments in the implementation of management and operational changes. The Performance Management Division staff consult with and coordinate departmental efforts to develop and track their performance measures and mandated efficiency plans, and manages the citywide annual citizen survey. The work that has been performed by staff in both divisions has led to improvements in the operations of City services. The Analyst found no fault or inefficiency in the operation of these units. The Controller believes they add considerable value to the City.

The Grants Management Unit was added in the mid 1990's as a response to a material weakness in the City's operations identified by the City's independent auditor. The addition of this unit has corrected the material weakness from the independent auditor's perspective. The grants unit oversees budget transactions for grants, establishes account structures for new grants, performs reconciliations of grant funds, provides training and technical assistance to City departments, conducts periodic audits of grant accounting transactions, and prepares the Countywide Cost Allocation Plan. The recommendation to delete the manager position, which manages and performs these functions, would jeopardize the gains that have been made. The Analyst criticizes the grants unit for not doing more to manage the City's grant activities, but instead of recommending efforts be increased, recommends the Controller disband the unit and reduce the staffing. The Analyst's assertion that these duties should be performed in other divisions would not streamline the functions, but rather would increase the workload among fewer employees. The Controller believes the savings being claimed by the Analyst would be small compared to the risk of the loss of grant funds.

2. Financial Administration

The Analyst recommends compilation of existing policies and instructions regarding financial activities, and development of new policies. He also recommends an assessment of City departmental reporting needs, consolidating responsibility for the accounting structure into one work unit, and increased enforcement in the Controller's review of user access to the financial system.

The Controller agrees that more emphasis can be placed on creating, documenting and promulgating policies and procedures in various areas, but notes that new technology allows more options for doing this than a traditional procedures manual. The Controller believes the Analyst misunderstands the reporting needs of the various departments and how they are being met. Finally the Controller believes security measures currently in place provide adequate system security, but could be enhanced.

The Controller agrees that more emphasis can be placed on creating, documenting and promulgating policies and procedures in various areas. However some of the Analyst's comments come from a lack of familiarity with how the City's financial systems and their inherent controls are designed to work. In general the City's financial systems have been changed, over the last ten years, from relying on written procedures attempting to enforce adherence to hundreds of financial practices, to rules-based systems with on-line edits and system controls. The City's financial systems require that staff set up structures, and initiate and process transactions, within parameters that include accounting, classification, and organizational codes and several types of expenditure and budget allocation and control. In most cases, inappropriate or incorrect entries are either automatically rejected by the system or disapproved by Controller staff reviewing the material or transaction on-line.

The post-audit process conducted by the Controller analyzes the errors that do occur and uses the results to develop new coding, system controls, and training to address weaknesses. The Analyst's statement that the number of exceptions identified in the Controller's last post audit indicates a decrease in adherence to policies and procedures does not give a complete picture. The Analyst does not consider that the dollar value of the errors dropped significantly, nor recognizes that the Controller focused its last review solely on those departments with the most exceptions in the prior year. In the last post-audit, we found appreciable improvement in the financial areas that the Controller targeted as representing the most risk to the City and therefore provided additional procedures, training, and oversight. For example, transactions initiated and approved by the same person dropped by 87%. This indicates that the training and follow-up corrective action plans developed concurrently by the Controller and user departments have led to improvements in the financial transactions posted over the past year.

The Analyst correctly states that the City budget and accounting systems are aging and that that they do not meet all of the City's reporting needs. The Controller notes here that the systems provide the functions that mainframe computers are designed for—among them allowing for the City to process thousands of daily transactions, prepare a budget, pay vendors and meet all bond and financial reporting requirements. The Controller's office has addressed the real need for more flexible use of financial data at the department and other levels on multiple fronts. We have added on-line inquiries, created and maintain a Microsoft Access database with the reports requested most often, distribute written monthly revenue, expenditure, and spending rate report, provide downloads into Excel file format, provide staff assistance to departments who have specialized reporting needs and have developed the Executive Information System (EIS), which is a flexible, menu-driven reporting and analysis software. EIS is now used for the Controller's citywide reporting including the Comprehensive Annual Financial Report (CAFR), and by 13 departments representing 77% of the City's budget. The Controller will be happy to work with any City departments who have not yet taken advantage of these tools, or of Controller's training, for their reporting and management needs. (The systems area is the focus of Chapter 3 of this report; the reader may want to refer to comments in that section for a complete understanding of the issue.)

The Controller maintains central control where it is critical—over the chart of accounts, the major classification structures of the system, and the fund architecture that supports comprehensive auditing and reporting. The Analyst is incorrect is stating that the Controller does not provide centralized monitoring of the City's accounting structure. Only a limited number of Controller staff can create or change all but the lowest level of accounting codes. In this area, it is very odd that the Analyst cites as evidence of weakness the fact that departments restructure their accounting frameworks with consultation, problem-solving and approval provided by the Controller's Office. The Analyst states "there should be no reason to change it [accounting structure] for political or other human influences." The Controller believes reorganizations occur in response to real world change—for example the advent of district elections in part caused the Recreation and Park department to want to analyze their spending geographically, and a charter amendment mandated the consolidation of MUNI and Parking and Traffic into one department, requiring changes to their accounting and reporting structure. We anticipate that regardless of any Controller policy or procedure, the City's business requirements and elected and appointed leadership will continue to change, and the accounting structure may need to change accordingly. A "consistent working group" to respond to this need in the Controller's Office as recommended by the Analyst is exactly what exists now.

The City has multiple controls and security reviews which protect access to the financial system. The Analyst recommends that the Controller ensure that its annual security reviews be conducted in a timely manner and that the Controller deny system access for users whose status is not confirmed. This is the process that is in place under the existing security review, but this area can be emphasized more in the future. In addition, the Department of Telecommunications and Information Services has controls not reviewed by the Analyst which add further security in this area. It should be noted that in reviewing the Controller's process, the Analyst did not find any cases of inappropriate user access to the system.

3. System Planning

The Analyst states that the City's current financial information systems are inadequate to meet the financial reporting and fiscal management needs of the departments and that the Controller should assess departmental financial reporting and accounting needs and be prepared to move forward with a replacement system when it becomes necessary or financially feasible.

The Controller concurs that the City's systems are aging and need to be upgraded and eventually replaced. However the current systems perform all required functions, and the cost to replace them exceeds $25 to $30 million. Departmental needs are currently being met to a large degree by separate reporting mechanisms.

The Controller recognizes that the existing systems are over ten years old, and that we need to plan for eventual replacement of the systems. Major advances have been made in information technology since the City's systems were installed in the mid-1990's. Newer systems would offer departments and the City as a whole more flexibility in responding to today's needs.

However, with the current systems the City is able to perform all of its mandated financial functions, including paying our employees and vendors, meeting our accounting and budgeting requirements, and developing financial statements and producing the City's Annual Financial Report. These required functions are not in danger of failure with the current systems.

Santa Clara County has recently spent $13 million simply to upgrade its financial system. Outside experts have estimated it would cost the City $25 to $30 million in external software and assistance to upgrade its financial, budgeting and purchasing systems. There would be additional costs to dedicate City staff to this effort. This need must be considered in relation to all other City priorities. The Controller would welcome discussing this need with the Mayor and the Board.

The Controller's staff has initiated several short-term enhancements to improve the City's financial reporting capabilities that will be in place until we can invest in a new system. For example, the Controller is continuing to roll out the Executive Information System (EIS), a flexible, user-friendly financial reporting system that is being used in 13 City Departments representing 77% of the City's current budget. In addition, the Controller is developing web-based tools to enable departments to access additional budget reports. These short-term improvements will provide added functionality to the financial reporting capabilities that department users have requested.

(The Analyst also includes a discussion of system needs in Chapter 2. The reader may also want to refer to that discussion).

4. Financial Auditor Independence

The Analyst recommends changes to maintain financial auditor independence to comply with changing federal regulations enacted in the past few years. He also recommends considering a Citywide internal control review and a financial auditor report on the internal control review.

The Controller wants to make it clear that at no time has the City's external independent auditor been out of compliance with any legal or industry rule or regulation in any work conducted on behalf of the City. The Controller is quite comfortable that the City's independent auditor is selected by the Board and the Board is free to make whatever rules they would like in this area.

The Controller believes that the City's external auditors have always complied with all legal and industry rules and practices related to their independence. The Analyst lists several projects that the City's current auditor has done for the City. We want to make it completely clear that this work was not and is not out of compliance with any regulation.

The Charter gives the Board authority over the selection of the City's external auditor and the Board should feel free to make whatever changes it deems fit in this area. It has been the City's policy to do a complete selection process every five years for external audit services related to the audit of the Controller's records. This winter we intend to start that process because we are coming to the end of our five-year cycle. Last time this was done, the Board President sat on the selection panel and the Board formally adopted the resulting contract. The City's auditor regularly meets with the Board Audit Committee. The Board should feel free to make changes in this area in the Administrative Code, in the new audit contract, or by giving the auditor specific direction.

One of the recommendations being made by the Analyst is that the City have a policy that the Audit partner on this engagement be changed every five years. As noted above, the Board has the opportunity every five years to change not just the audit partner, but the entire audit firm. The current partner on the City's engagement has been in that capacity for three years.

The City needs to decide the costs and potential benefits of doing a comprehensive internal control review and purchasing an external audit of the review. Internal controls are important to the City. Our external auditors test internal controls to the extent they need to rely on them to give an opinion on the City's financial statements. But there are multiple levels of internal control throughout the City. At least a portion of these controls are presumably not documented or tested for a variety of reasons—chief among them is that area being controlled is financially immaterial or the reasonableness of the resulting expense or balance can be ascertained without a detailed review of the controls. To document all of these controls would be expensive and time consuming. There would be an additional cost to have auditors test and report on the controls. Since this is not a requirement in any legislation or an industry practice, the City needs to consider the relative priority and additional cost of City staff and outside contractors.

5. Budgetary Control

The Analyst recommends changes in the area of Board reserves and carry-forward of appropriations.

The Controller concurs with the Analyst's recommendation that the technical parameters for establishing appropriation reserves be enhanced in order to assure that funds are controlled at the same level as they are appropriated and are closed out when no longer needed**.** The Controller believes that current procedures regarding the carry-forward of unspent appropriations are adequate, but would be happy to work with the Mayor and Board to amend or codify any policies they deem appropriate.

The Controller will continue to enhance reserve controls to meet the needs of policymakers. The Controller has established and rescinded hundreds of reserves worth millions of dollars over the years. The Analyst notes two reserves where funds were spent before Board approval and two old reserves that can be removed. The Controller believes these are anomalies but will implement procedures to prevent these occurrences in the future. For example, the Controller will adjust the reserve procedures for work orders and for ongoing projects to ensure that the reserves are properly segregated from other funds to facilitate the monitoring and closing of these funds.

The Controller believes current practices related to the carry-forward of unspent appropriations from one year to the next are appropriate, but would be willing to work to amend or codify any changes desired by the Mayor or Board. The Analyst reports that the Controller approves most of the Departments' requests to carry forward unexpended funds from one year to the next when they meet the Controller's guidelines implying this indicates inadequate review. However, the Analyst has not substantiated his opinion that in some instances, approvals granted to carry-forward funds have exceeded the Controller's policies.

The Analyst also implies but has not shown any instance that the carry-forward process circumvented the Board's appropriation authority. In no instance has the Controller allowed Departments to carry-forward funds that were not already approved by the Board of Supervisor, or circumvented the appropriation process of the Mayor and the Board of Supervisors.

6. Fund Maintenance

The Analyst recommends formal City policies and procedures for the creation of certain types of funds, a review of balances in some City funds and sub-funds, and that the Board of Supervisors specify "accounts" rather than "funds" as a preferable accounting mechanism.

The Controller believes the City's funds are properly set up and maintained according to Generally Accepted Accounting Principles (GAAP), with full oversight exercised by the

Controller. We also believe the dollar amounts that will be available to the General Fund from the process of reconciling and closing the funds listed are likely to be much less than that claimed by the Analyst. Finally we agree with the recommendation that the Board specify "accounts" rather than "funds" and have worked with the City Attorney on this for the past several years.

The City's funds are set up and maintained according to Generally Accepted Accounting Principles (GAAP), with full oversight exercised by the Controller. We do not agree with the assertion that inadequate oversight is provided and that the City has funds which do not meet GAAP standards. Only the Controller's staff has the authority to set up new funds in the financial system, and they do so according to GAAP requirements, including the criteria of sound financial administration. For example, among the six funds that are listed as unnecessary in the Analyst's opinion are one that is specified in the recent update to the Administrative Code, and three that account for activities that are multi-year in nature and are not paid for by operating funds. These funds serve the legitimate operating purpose of keeping General Fund budget authority available for true General Fund activity. In addition, the City's external auditors have concurred that the City's funds are appropriately within GAAP guidelines in their annual financial review.

The dollar amounts available to the General Fund from the process of reconciling and closing the funds listed are likely to be much less than that claimed by the Analyst. The Controller's Office agrees that there are existing funds that can be closed out, and indeed some of the specific funds listed by the Analyst are already included the Controller's year-end close process for FY 2002-2003.

However, the Analyst spent most of their time reviewing selected sub-funds and accounts. The City controls its budget at the fund level. So while the Analyst identified positive balances in some accounts, he did not have time to fully research all of the related accounts that might have offsetting negative balances. For example a department might account for revenues in one sub-fund and expenses in another, or process revenue transfers between funds and sub-funds. As long as we control at a fund level these variances can be reconciled. It is by no means "certain" the process of reconciling all special and fiduciary funds will produce surplus monies—both because there are negative as well as positive balances to be analyzed, and because restrictions attached to fiduciary funds must be honored before the criteria of closing inactive funds is applied.

We are pleased to add that among the types of funds reviewed for the Analyst's report, there are literally billions of dollars that are managed consistently. In addition, analysis done by the Controller's Office has helped close out and make available millions of dollars to balance the budget in the most recent fiscal years. For example, the agency fund where property tax revenue is managed has over $1 billion in transactions annually, including allocations to the Unified School District, Redevelopment Agency, and other taxing entities. Over $49 million from various sources was analyzed, closed out and made available to the General Fund to help balance the budget in FY 2002-2003. As noted, the Controller's Office does reconciliation and analysis on a priority and staff availability basis and focuses its limited time on managing larger dollar value activity.

Significant progress has been made by the Controller on the issue of fund maintenance in recent years. As noted in the report, the Controller's Office has worked to ensure that new financial structures called for in legislation be worded such that the Controller can establish the appropriate form in which the activity will be recorded, and we are pleased that the Budget Analyst further recommends this approach to the Board. This has and will effectively reduce the numbers of new funds created. In FY 2000-2001, the Controller's Office initiated a process to simplify and consolidate the City's special funds by creating a standardized categorization system specifying how the fund's finances are to be managed. Outmoded and inconsistent fund references throughout the municipal codes were also repealed as part of the effort. The next phase of this project, already underway, will close outmoded funds and simplify reporting. The function of the files called for by the Analyst will be served instead by on-line tools including a new screen with data fields supplementing the fund information which is printed annually in the CAFR.

7. Revolving Funds

The Analyst recommends an annual risk assessment and audit of cash revolving funds, changes to policies and procedures for these funds, and closing out or reducing authorization for a number of revolving funds.

The Controller's Office agrees that the assessment of authorization amounts and elimination of unnecessary cash revolving funds is desirable. We also concur that policies and procedures in this area could be enhanced.

The Controller's Office agrees that the assessment of authorization amounts and elimination of unnecessary cash revolving funds is desirable. Over the last seven years, the City has reviewed all of its revolving funds. Based on recommendations by the Controller's Office the number of funds was reduced from 107 to 64 and the total authorization from approximately $1.8 million to under $800,000. It is appropriate to do this same type of analysis on a periodic basis. However, given the existing controls, audit schedule, and the relatively small dollar amounts remaining in cash revolving funds, the Controller's Office believes that periodic reviews are appropriate and that an annual risk and utilization analysis is not indicated. We should note that the amounts currently authorized in revolving funds were the result of considerable negotiation between the Controller and departmental operating staff and we would want to consult with department staff before making changes.

It is the Controller's policy is to audit revolving funds on a periodic basis, not every year. The Analyst notes that only three audits of cash revolving funds were conducted in FY 2001-2002. This is true, however over the period of the five fiscal years ending with that year (FY 2001-2002), the Internal Audits Division had audited <u>all</u> of the revolving funds in which there were activities.

The Controller's current policies and procedures for cash revolving funds could be enhanced. The Controller has general guidelines for estimating the appropriate size of revolving funds and how often they should be replenished. However, these guidelines could be strengthened and promulgated more widely.

8. Compliance with A-87 Cost Plan Requirements

The Analyst believes the Controller has not aggressively sought to maximize the charging of allowable indirect costs. The Analyst concludes that an additional $29 million of costs could be included in the City's cost allocation plan and further implies that once costs are allocated, they should be collected from all agencies. Finally, the Analyst suggests that the City is at risk for non-compliance with State and Federal guidelines under OMB Circular A-87 *Cost Principles for State, Local and Indian Tribal Governments* (OMB Circular A-87).

The Controller concurs with a recommendation to perform further work in this area to determine if additional costs may be allocated. However, the Controller believes the Analyst overstates the potential benefit of this work. The Controller also believes that once the costs are determined it is a decision of the Mayor and the Board to charge departments and agencies for the full cost. The Controller notes that the City is in full compliance with all legal requirements and guidelines in this area, and that annually the City's cost plan is certified by the State Controller.

The Analyst's discussion of additional costs that could be included in the cost allocation plan is inaccurate and largely overstates the potential benefits. To be of benefit and justify making detailed calculations in the cost plan, a cost must be eligible, allocable and ultimately collectible. The two largest components of the Analyst's additional costs are for general liability claims and Treasury costs—they represent $25 of the $29 million dollars noted in the report. It has not been shown that these items meet the three criteria.

Approximately $18 million of the additional costs listed by the Analyst relate to general liability payments. We pointed out to the Analyst that a substantial majority of liability claim amount listed in their table relates to enterprise activities such as the MUNI Railway, are already directly billed to them and therefore would not be processed through our cost allocation plan. In addition, major MUNI funding sources like the Transportation Authority have a finite amount of funding available and any increase to overhead costs would simply reduce the amount available for direct service or project spending. Approximately $7 million of the additional costs relate to activities of the Treasurer. All of these charges are currently being spread in other ways and additional analysis would be needed to show whether inclusion in a cost allocation plan would bring any revenues to the City. In addition to these issues, an insurance plan of the type described by the Analyst involves up-front costs such as completing an actuarial analysis and establishing loss reserves. A cost-benefit review of these cost recovery methodologies is necessary.

The Analyst incorrectly implies it is the Controller's decision regarding which agencies are billed for allocated costs when in fact this decision is made by the Mayor and the Board of Supervisors in the budget process. The only significant non-billing pointed out by the Analyst is that City policymakers have chosen not to bill the School District for charges properly calculated in the Controller-prepared plan. Should the Board wish to bill the School District for the approximately $3.3 million due the City in FY 2002-2003, we would be happy to attempt to collect.

9. Multi-Tiered Cost Plans

The Analyst recommends that the Controller test the effect of allocating costs that are excluded, under Federal and State guidelines, from the City's current indirect cost plan to determine if a "multi-tiered" methodology would increase reimbursements to the General Fund from enterprise funds and fee-supported functions within the City structure.

The Controller believes that all significant costs that can be reimbursed are being captured at this time. The Controller agrees that a test could provide more information to determine if the City should consider the preparation of a multi-tiered cost plan

The Controller's Office has focused its efforts on those approaches to cost recovery that we believe have the greatest expectation of producing funds for the City and particularly the General Fund. To that purpose, we prepare a Cost Allocation Plan in compliance with OMB Circular A-87, and increasingly are working with departments on their indirect cost rates and on full cost recovery fee analysis (also see Sections 8, 10 and 11). Over the last three budget cycles, we have also worked in coordination with the Mayor's Office on identifying and moving staff and costs that benefit enterprise and fee-based City functions directly into those functions. These approaches have produced an immediate benefit to the General Fund, with less effort than would likely be required to produce a multi-tiered cost plan.

Development of a multi-tiered cost plan would not be free. The Analyst suggests that there would be no incremental cost to develop a multi-tiered cost plan. The Controller does not agree that it would be a matter of temporarily diverting staff to produce a multi-tiered cost plan, and notes that the State Controller similarly cautions governments considering this approach that it is "not a simple task" and that "each individual grant or contract should be analyzed to determine to what extent indirect costs are reimbursable." We also note that the State Controller does not "endorse" this method, but merely suggests it as an option for counties. We also note that a multi-tiered cost plan is particularly beneficial to governments that do not have other indirect cost recovery tools, but that this is not the case in San Francisco. Nevertheless, the Controller's Office will review this approach, taking into consideration the cost benefit and limited staff availability.

10. Departmental Indirect Cost Rates

The Analyst states that the Controller has not established consistent methodology for calculating department indirect costs and their application to City fees. He further states that the Controllers' Office has no involvement with the analysis of indirect rates for grants, and that we should develop policies and procedures for calculating department indirect cost rates.

The Controller believes the City uses appropriate policies and procedures to calculate departmental indirect costs rates, but there is always room for continuous improvement. The Controller believes that the approach of decentralizing the calculation of indirect cost rates with limited central direction and review is appropriate, and notes that should the Board desire additional Controller oversight, additional staff will be needed.

The Controller believes the City uses appropriate methodologies for calculating departmental indirect costs rates. It would not be reasonable to require MUNI Railway, the Public Utilities Commission, the Airport, the Department of Public Works and others with very different "businesses" to use one consistent methodology when various ones are legally available and maximize revenue.

The Controller does not need to establish a 'City only' methodology for establishing indirect costs because we already use existing State methodologies. We use the California State Controller's Handbook of Cost Plan Procedures for California Counties as a guide in developing and implementing cost plans. Additionally, for fee setting the Controller uses the Municipal Revenue Sources Handbook (published by the California League of Cities) and the California Constitutional provisions and Code sections that govern taxation and fee setting. Further, the requirements for taxation are clearly outlined in Article XIII of the California Constitution, and recovery of funds in excess of the cost of providing service is deemed to be taxation.

The Controller assists departments in the preparation and approval of indirect costs and reviews the results for reasonableness. The Controller issues technical instructions to guide departments in proposing fee increases and fee revenues in their budget. This provides the necessary tools for departments to be able to perform fee cost recovery analysis, including both direct and indirect costs. Additionally, departments are encouraged to meet with the Controller's Office Revenue Unit in advance of any proposed fee change to ensure that an appropriate and full-cost analysis is made.

Further, the *Mayor's Policy Instructions & Controller's Technical Instructions For Budget Year 2003-2004* provided detailed instructions to Departments for submitting information on Licenses, Permits, Fees and Service Charges. As part of this process, departments are provided a basis for estimating reasonable indirect costs for both citywide central service and departmental overhead rates. Central service overhead rates are calculated using the Countywide Cost Allocation Plan (COWCAP), which is developed in accordance with the California Controller's Handbook on Cost Plan Procedures and the Federal government's OMB Circular A-87.

The Controller calculates Departmental Overhead Rates based on the adopted budget. Additionally, departmental overhead rates are based on department-specific adopted budget pertaining to centralized department administrative costs.

As part of our centralized, high-level direction and review, in the FY 2004-05 budget process the Controller will continue to work with departments to increase the fluency of department fiscal staff in fee setting and overhead rate calculation methods. Additionally, we will be working with Departments to increase consistency where desirable for capturing centralized departmental costs.

The Analyst also suggests that the Board of Supervisors require that indirect cost calculations be shown for every grant application, even if the grantor does not pay indirect costs. This is a decision for the Board.

11. Cost-Based Fees for Service

The Analyst believes the Controller has not developed policies and procedures to systematically calculate cost-based fees. He recommends the Controller produce a comprehensive fee schedule. He also indicates that additional work in this area would produce at least $880,000 annually.

The Controller communicated to the Board as part of the FY 2003-2004 budget deliberations our intent to provide additional work in this area, but also believes that appropriate procedures are in place to make correct fee calculations. Adoption of fees at a level that would result in full cost recovery is a policy decision for the Mayor, Board of Supervisors or, in some cases, the Municipal Transportation Authority (MTA).

The Board has had full information about the major fees the Analyst recommends be raised to full cost recovery and made the decision not to do so. Of the $880,000 listed in the Analyst's report $826,000 is under three departments as follows:

- $525,289 pertains to Parking and Traffic's Tow Administration fee, which was just increased from $30 to $50 in June 2003. Parking and Traffic is already authorized to impose a fee for this activity based on full-cost recovery. The Department and the MTA instead made a policy decision to implement a $20 increase. The Department used the fee recovery template created by the Controller to analyze the cost of this function.

- $199,814 pertains to the Art Commission's Street Artist fee. The Street Artist Fund has an accumulated fund balance currently. If a fee increase based on full-cost recovery is implemented, the Street Artist program would be intentionally over-recovering the actual cost of running the program, which is not permitted under State constitutional requirements for fees and taxation.

- $101,250 pertains to the Medical Examiner's Removal of Remains fees ($84,583) and Storage of Remains fees ($16,667). Both fees were substantially increased in 2002. San

Francisco already charges more for this service than almost any other jurisdiction in the state. Additionally, many of the families served by the department are low-income and therefore the Board opted not to further increase these fees.

The Controller has provided substantial direction to departments related to fee calculation. In the annual Budget Instructions and on the City's intranet, we provide templates and instructions for completing fee calculations. Where departments have used this information, the Mayor and Board have been able to make fee decisions based on complete information. But some departments have not followed our instructions or responded to our requests.

The Analyst points out that proposed fees related to a particular project—licensing of fortunetellers—changed dramatically over the course of several months. The report implies that these changes mean that the numbers were incorrect in the earlier versions and not caught by the Controller. As we pointed out to the Analyst, the program's parameters changed considerably over the course of the Board's deliberations so it is not surprising the costs also changed.

The Controller developed a comprehensive fee schedule already for departments who provided the information and made this data available to the Budget Analyst and the Mayor's Budget Office during the FY 2003-2004 budget process. Administrative Code Section 3.7 requires all departments to provide a comprehensive fee schedule as part of their budget submission. We have repeatedly reminded departments of this requirement; however, some have not complied. We will continue to work with departments to achieve full compliance with the Code requirements.

Finally, the Analyst has stated that the Budget Committee placed $1.38 million of Planning department fees on reserve since they were "illegal." The Controller is not aware of any determination that these fees were illegal, though was aware that as of the time of the Board's review the department had not provided to our office the necessary fee materials to review. And, in fact, the Controller recommended reserving of appropriation authority until adequate fee documentation was provided by the department.

12. SB 90 Program Effectiveness

The Analyst recommends a quality improvement program for the City's claims to the State under the SB90 Program (reimbursement of the cost of state mandated programs) or, alternatively, bringing the task of filing the claims (currently done by a consultant) in-house, a report detailing which claims are filed, and a post-audit of claims for FY 2002-2003.

The Controller agrees that a written report on the City's SB 90 claims with more detailed information would be informative and will make such a report available to the Board of Supervisors. However, the Controller disagrees with the Analyst's assertion that the City has lost significant revenue and may be subject to auditing and disallowance of costs. Further, the Controller does not believe that bringing this program in-house would be cost-effective. Finally, we note that the State has not budgeted funds to reimburse counties under SB 90 over the last two budget cycles and that the City does not have any expectation of getting actual revenue from this source in the foreseeable future.

The City's consultant can apply different indirect cost rate approaches to maximize the City's claims. We concur with the Analyst that some errors have occurred in salary reporting and will take corrective action in this area. In the case of the OCC, a default indirect cost rate of 10 percent was appropriately used to maximize the claimed amount because the program already claims virtually all of its costs as direct costs. In the case of the Elections Department, the City's consultant used a higher rate assuming it would maximize revenue, but in this case the Analyst appears to be correct that it did not.

There is a need for departments to provide information for SB 90 claims to both the Controller's Office and the consultant in a timely fashion. City departments are responsible for their own processes related to SB 90 claims and the Controller's Office works with the consultant to monitor the process, provide assistance, make site visits, and facilitate participation by departments. Most departments are doing a good job of providing their SB 90 data, tracking their costs and building solid source documentation. However, it does happen that even after several contacts departments put off providing their claim data. What is shown by the Analyst's review is a need for departments to be diligent in providing the information for SB 90 claims. The Adult Probation Department, which administers the one major program for which the City is eligible but has not filed, should work with the Controller's Office and the consultant to file a claim for the domestic violence treatment program (annual value under $100,000).

Finally, we do not agree with the Analyst's speculation that the City would save money by bringing the SB 90 filing work in-house. San Francisco's consultant provides this service for most of the counties in the State, and stays current on the law and regulations related to the program. We have reviewed this issue recently, and concluded that duplicating the technical expertise of the consultant would not be an efficient use of the Controller's limited staff time.

13. Internal Audit

The Analyst's report states that the Internal Audits Division is not meeting the same level of productivity as other county and city auditors, that auditors in the Controller's Office exceed minimum requirements for training, and that the Internal Audits Division should eliminate unnecessary mandates in order to free up additional audit time.

The Controller believes that there is always room for improvement, but that we are operating at the average of other audit units of our size. We agree that we provide more training opportunities than the minimum required for licensure, but we believe the training is justified. We agree with the Analyst that continuous risk assessment and prioritization of audits is important.

The Controller's Internal Audits Division productive audit time is 75% to 80% depending on how break time required under the City's labor contracts is reported, as compared to the productive audit time of survey respondents of 76%, where it is unknown how similar break time is reported. The Analyst compares the Controller's productivity to the responses of 17 similar government audit units who answered the National Association of Local Government Auditors (NALGA) survey (only four percent of membership). The NALGA survey measures time usage two ways: the first compares audit time to total available time (excludes paid time off). The second measure compares audit time to total time (includes paid time off). The first measure is the reasonable one to use for comparative purposes, as it measures how time is spent when auditors are at work. And it excludes factors beyond the Internal Audits Division's control such as negotiated paid time off where the City offers higher than average benefits. The Analyst has selectively used the second measure of productivity where the Division's usage time is 62% as compared to the average of 65%.

Further, the Analyst concludes that the Internal Division should be measured against a target of one standard deviation from the mean of responders and calculates a savings from a 77% productivity number on the second measure. This is a questionable methodology.

The Controller believes that well-trained staff are more efficient in their work and that additional training of staff is particularly warranted by the fact that 60% of the audit staff have been with the office for less than three years. He also believes the minimum training requirement should not be viewed as a standard or cap. Professional training provided to Internal Audits Division auditors includes fraud detection, government auditing standards, government financial auditing, assessing risk in the public sector, sexual harassment prevention, diversity training, auditing not-for-profit organizations, among others. These training sessions are important to maintain the high standards among the Controller's auditing staff.

The Controller believes that most mandated audit work that is justified. In recent years, we have worked with the Board to raise the threshold of revenue for required concession audits, thereby reducing some low value audits. Although the Controller agrees that outdated mandates be eliminated, the one example identified by the Analyst would free up only 100 hours each year.