

Washington State Auditor's Office
Accountability Audit Report

City of Seattle
King County

Report Date
May 17, 2011

Report No. 1005905

Issue Date
June 20, 2011



WASHINGTON
BRIAN SONNTAG
STATE AUDITOR



**Washington State Auditor
Brian Sonntag**

June 20, 2011

Mayor and City Council
City of Seattle
Seattle, Washington

Report on Accountability

We appreciate the opportunity to work in cooperation with your City to promote accountability, integrity and openness in government. The State Auditor's Office takes seriously our role to advocate for government accountability and transparency and to promote positive change.

Please find attached our report on the City of Seattle's accountability and compliance with state laws and regulations and its own policies and procedures. Thank you for working with us to ensure the efficient and effective use of public resources.

Sincerely,

BRIAN SONNTAG, CGFM
STATE AUDITOR

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King County
May 17, 2011

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Audit Summary

City of Seattle
King County
May 17, 2011

ABOUT THE AUDIT

This report contains the results of our independent accountability audit of the City of Seattle from July 1, 2009 through June 30, 2010.

We evaluated internal controls and performed audit procedures on the activities of the City. We also determined whether the City complied with state laws and regulations and its own policies and procedures.

In keeping with general auditing practices, we do not examine every transaction, activity or area. Instead, the areas examined were those representing the highest risk of noncompliance, misappropriation or misuse. The following areas were examined during this audit period:

- Allocation of central costs – DIT, Facilities
- Determination of utility rates
- Procurement/public works requirements – selection of contractors
- Citizen reported issues and loss investigations
- Determination of eligibility for utility assistance rates
- General expenditure testing – multiple City departments
- Budget compliance
- Payments to noncompetitively selected contractors
- Adjustments to utility customer accounts
- Performing public works with public employees – LED Streetlight Conversion
- Change orders – SPU, Parks
- Physical inventory processes
- Monitoring of public defense contract and school based social programs
- Fire Department permitting

RESULTS

In most areas, the City complied with state laws and regulations and its own policies and procedures.

However, we identified conditions significant enough to report as findings:

- The City of Seattle lacks adequate internal controls over utility discounts resulting in benefits to individuals whose eligibility has expired and in increased utility rates to ratepayers.

- The City of Seattle lacks adequate processes to monitor adjustments to accounts that reduce amounts owed by utility customers, which may cause other customers to pay more.
- The City of Seattle does not have adequate processes to ensure its internal service funds charge all City department customers in an equitable way.

We commend City managers for their commitment to resolve other audit issues before they become significant as we encouraged in the prior audit report.

Related Reports

**City of Seattle
King County
May 17, 2011**

FINANCIAL

Our opinion on the City's 2009 financial statements and compliance with federal grant program requirements was provided in a separate report, which includes the City's financial statements. In that report, we identified significant deficiencies in internal controls over annual financial reporting at the City, the Seattle City Employees Retirement System and Seattle Public Utilities. Corrective action will be evaluated during the 2010 audit.

The 2010 financial statement audit is expected to be completed around June 2011.

FEDERAL GRANT PROGRAMS

We evaluated internal controls and tested compliance with the federal program requirements, as applicable, for the City's major federal programs, which are listed in the Federal Summary section of the 2009 financial statement and single audit report. That report includes a federal finding regarding controls over and compliance with rules related to spending of federal money. We questioned \$160,822 charged to the Federal Transit Formula Grant. The City's resolution of the reported condition will be verified during the 2010 audit.

The 2010 federal compliance audit is expected to be completed by the end of September 2011.

Description of the City

City of Seattle
King County
May 17, 2011

ABOUT THE CITY

The City of Seattle is the largest city in King County and the state, with a population of approximately 602,000 citizens. The City has a mayor-council form of government with nine elected Council Members, an elected Mayor and an elected City Attorney. The City's budget for 2010 was about \$4.2 billion, including \$905 million for the General Fund. It has approximately 11,000 employees and provides a full range of services including water, drainage and wastewater, solid waste, electric power, police, municipal court, fire, emergency medical, parks and recreation (including four golf courses), planning and economic development, and municipal libraries.

ELECTED OFFICIALS

These officials served during the audit period:

Mayor:

Greg Nickels (2009)
Mike McGinn (2010)

City Council:

Richard Conlin
Tim Burgess
Sally J. Clark
Jan Drago (2009)
Jean Godden
Bruce Harrell
Nick Licata
Richard J. McIver (2009)
Tom Rasmussen
Sally Bagshaw
Mike O'Brien
Thomas A. Carr (2009)
Peter S. Holmes (2010)

City Attorney:

APPOINTED OFFICIALS

Director of Finance

Glen Lee

CITY CONTACT INFORMATION

Address: City of Seattle
700 5th Avenue, Suite 4300
Department of Executive Administration
P.O. Box 94669
Seattle, WA 98124-4669

Phone: (206) 684-CITY (2489)

Website: www.seattle.gov

AUDIT HISTORY

We annually audit the City's compliance with state laws and regulations and its own policies. We also annually audit the City's financial statements and compliance with federal grant requirements. The past five audits reported four accountability, 10 financial statement and eight federal grant compliance findings. The current audit report also includes three findings as described in the Audit Summary section of this report. The City management is responsive and respectful of our recommendations.

Schedule of Audit Findings and Responses

City of Seattle
King County
May 17, 2011

1. **The City of Seattle lacks adequate internal controls over utility discounts resulting in benefits to individuals whose eligibility has expired and in increased utility rates to ratepayers.**

Background

The City operates Seattle Public Utilities, which provides water, sewage, garbage and drainage services and Seattle City Light, which provides electricity.

The City's Utility Discount Program allows eligible customers to receive utility bill reductions of approximately 50 percent. City ordinance and Municipal Code spell out program benefits and eligibility requirements. Eligibility is based in part on income. Applicants living in subsidized housing are not eligible for discounts.

The Mayor's Office of Senior Citizens processes applications and determines eligibility for the discounted rates. The Office states approximately 14,800 accounts receive discounts. At an average annual savings to participants of \$850 the program provides almost \$13 million of utility discounts annually.

The Office operates on about \$2.1 million in 2010. The utilities pay it approximately \$800,000 annually to do eligibility determinations for this program.

The Office gives the utilities a list of newly eligible customers each week and the utilities apply the discounts to their bills. Seattle Public Utilities and Seattle City Light estimate it costs them each about \$100,000 to administer the program in addition to the amount paid to the Office.

Description of Condition

We noted several weaknesses in internal controls over utility discounts at the Mayor's Office for Senior Citizens and at the utilities.

For the Mayor's Office of Senior Citizens, we found:

- Program eligibility requirements are the same for all applicants regardless of their age. However, the application process is different for applicants who identify themselves as "senior". Non-senior applicants are required to provide documentation, such as income verification and housing status, to prove eligibility. The Office does not require this from individuals who state they are senior and does not take any steps to verify any information provided.

- No one does secondary reviews of initial and subsequent eligibility determinations.
- Eligibility for the program expires after 18 months. When it does, the Office does not recertify or terminate eligibility in a timely manner. Without this action, accounts whose eligibility has expired will continue to receive discounted rates.

We also found the utilities do not verify that discounts are applied only to accounts the Office determines are eligible and do not have controls to ensure that beneficiaries whose eligibility expires are removed from the program.

Cause of Condition

The City's priority has been to increase the number of new participants receiving a discount. Therefore, the City has placed a lower priority on eligibility renewal.

Effect of Condition

Because all utility customers have to pay their prorated share of the \$15 million subsidized through the discounted utility rates, utility ratepayers may face increased rates if ineligible households participate in the discounted rate program.

Participants whose eligibility expired continued to receive discounted rates. At the time of our audit, approximately 2,800 accounts (19 percent) participating in the Utility Assistance Program were past eligibility expiration. At an average discount of \$850 per year, the utilities may have given \$2.4 million in utility discounts to ineligible individuals.

Further, because state law allows governments to provide assistance only to low-income persons, the City may be out of compliance with state law if it does not adequately document participant eligibility.

Recommendation

We recommend the Mayor's Office for Senior Citizens ensure it documents eligibility for all utility assistance program participants. Amendments to the Seattle Municipal Code may be needed to streamline different sections that describe the program and related requirements. Program administrators should revise guidance to reflect changes in code or state law.

We further recommend the Office:

- Use one application form and require verification of identification, income, and housing status for all applicants and re-certifications for the program regardless of their age. This will help ensure all applicants are eligible.
- Require a secondary review of all eligibility determinations. Such a process is standard for programs that involve eligibility decisions.
- Assign a supervisor to review, on at least a spot basis, approved applications to ensure the secondary review process is working.

- Ensure eligibility re-determination and certifications are done in a timely manner and only individuals with current eligibility certification continue to receive the discounted rates.
- Include participant eligibility expiration dates in weekly reports to the utilities.
- Cooperate with other City departments, state agencies and social service providers to streamline the eligibility determination process. For example, reliance on third parties' eligibility determination can result in more efficient use of City resources.

We recommend Seattle Public Utilities and Seattle City Light identify areas in which the risk of misuse of public resources is high and establish internal controls, including monitoring, in those areas. Specifically we recommend the utilities:

- Effectively review adjustments to utility accounts. The review should compare newly added discount credits to original weekly reports to ensure only those who are eligible receive discounted rates.
- Establish an automated system to verify continued eligibility for the program. For example, the utilities could activate a utility billing system function that discontinues discounts when eligibility expires.

City's Response

We appreciate the auditor's review of the Utility Discount Program as well as their recommendations. The City has implemented or plans to implement the following measures to enhance internal controls over eligibility requirements:

By SCL:

Seattle City Light is performing comparative analysis of the approved applicant list provided by MOSC and data from the utilities billing system to identify, research, and resolve discrepancies.

By SPU:

Seattle Public Utilities has initiated a comprehensive effort to improve its internal controls or transactions made to utility customer accounts, where these efforts overlap with the Human Services Department and Seattle City Light, SPU will coordinate the development of new processes and procedures so that they are in alignment. In addition, a new policy outlining expectations for access to utility customer accounts was adopted on March 28, 2011.

By HSD:

- *Since July 2007, each quarter, a 5% sample of enrolled seniors have been required to provide documentation of their income and housing status for the 18-month eligibility renewal.*
- *Beginning in December 2010, senior customers have been required to provide proof of identification. As of May 15, 2011 all senior customers will be required to show proof of all eligibility requirements.*

- *In January 2011, new procedures were implemented requiring a supervisor to review all newly approved applications before the Batch report is sent to the utilities.*
- *Beginning April 6, 2011, Batch reports include recertification due dates.*
- *By March 2011, all customers with past-due eligibility reviews on the Delete List of January 2011 have been contacted. Based on the review, customers were either recertified or terminated. By early April, approximately 200 customers are still in pending status, awaiting submittal of additional documentation for review.*
- *Under the UDP re-design (see details below), recertification statuses will be closely tracked using the new data base, to trigger timely follow up with customers, in order to significantly reduce recertification backlog on an on-going basis.*
- *The City is also addressing operational efficiency. A consultant has completed recommendations for redesigning program operations. Phase I implementation is projected to occur in July 2011, and Phase II later in the year. Key features of the redesign include: 1) a Contact Center model; 2) a "functionalized" job model where work will be processed in a specialized manner versus the current end to end approach; 3) a fillable electronic PDF application which the program intake representatives will complete while conducting in-depth interview with the customers at initial contact for new and renewal applications (use of a paper application will be reduced); 4) a new database connected to the state benefit portal for efficient tracking and internal controls; and 5) a quality management program with metrics for individual and group productivity.*
- *In addition, in June 2011 HSD will begin to develop collaborative partnerships with housing groups and other entities for third party eligibility determination protocol, and seek appropriate authorization for such protocol if necessary.*

Auditor's Remarks

We appreciate the City's commitment to resolve this finding and thank the City for its cooperation and assistance during the audit. We will review the City's corrective action during our future audits.

Applicable Laws and Regulations

RCW 35.92.020(5) allows the City to provide sewerage and solid waste utility assistance to low-income persons. It states:

(5) A city or town may provide assistance to aid low-income persons in connection with services provided under this chapter.

RCW 74.38.070 allows the City to provide utility assistance to low-income senior citizens. It states, in part:

Notwithstanding any other provision of law, any . . . city . . . providing utility services may provide such services at reduced rates for low-income senior citizens or other low-income citizens: PROVIDED, That, for the purposes of this section, "low-income senior citizen" or "other low-income citizen" shall be defined by appropriate ordinance or resolution adopted by the governing body of the . . . city

RCW 43.09.200 requires all financial transactions to be fully supported with documentation so verification of eligibility factors is also required; it states in part:

The accounts shall show the receipt, use, and disposition of all public property, and the income, if any, derived therefrom; all sources of public income, and the amounts due and received from each source; all receipts, vouchers, and other documents kept, or required to be kept, necessary to isolate and prove the validity of every transaction

Seattle Municipal Code (SMC), Chapter 21.49 establishes Seattle City Light reduced rates to “qualified low-income residential customers.” It also requires that applicants for reduced rates verify the information required to determine eligibility. The rates are not available for home-owner applicants who do not participate in Comprehensive Residential Weatherization Program. Even details such as water heater type and electrical usage are elements of eligibility.

Seattle Municipal Code, Chapter 21.76 establishes and provides rules for the Low Income Rate Credit Program. The program requires minimum consecutive residence of 90 days, income eligibility, and requires verification of such information.

Each SMC chapter above assigns the Human Services Department with responsibility to carry out the program in accordance with the SMC.

Budget Accounting and Reporting System (BARS) Manual, Part 3, Accounting, Chapter 1, Accounting Principles and General Procedures, Section C, Internal Control, states in part:

Internal control is a process – affected by those charged with governance, management and other personnel designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

Management and the governing body are responsible for the government’s performance, compliance and financial reporting. Therefore, the adequacy of internal control to provide reasonable assurance of achieving these objectives is also the responsibility of management and the governing body. The governing body has *ultimate* responsibility for ensuring adequate controls to achieve objectives, even though *primary* responsibility has been delegated to management. Since management and the governing body are assumed to work in harmony, both parties are collectively referred to as “management” throughout the rest of this section.

Internal control should be viewed as an integral or inherent part of the policies, systems and procedures management uses to operate and oversee the organization. This is not to say effective control will never require additional or incremental effort. Rather, controls exist to provide reasonable assurance about the achievement of objectives and so should be integrated into all the organization’s fundamental business processes. Controls are normally most effective when built into the government’s infrastructure rather than being treated as supplemental or separate processes. In the same way, implementation and monitoring of internal

controls should not be viewed as a singular event, but rather a continuous or iterative process.

Controls and processes should generate adequate documentation to demonstrate achievement of objectives. This is not only important for audit, oversight and public records purposes, but also to enable effective monitoring of controls over compliance by management.

Schedule of Audit Findings and Responses

City of Seattle
King County
May 17, 2011

2. **The City of Seattle lacks adequate processes to monitor account adjustments that reduce amounts owed by utility customers which may cause other customers to pay more.**

Background

The City of Seattle operates Seattle Public Utilities, which provides water, sewage, garbage and drainage services, and Seattle City Light, which provides electricity. Together, the utilities have approximately two million customer accounts and annually bill approximately \$1.2 billion.

The City's Consolidated Customer Service System brings all of Seattle's municipally owned utilities into a single customer database.

The utilities' customers frequently request modifications to their bills when they believe a billing error has occurred or to request waiver of late payment charges.

From July 2009 to November 2010, utilities' employees made approximately 2.4 million adjustments to over 264,000 accounts, reducing bills by \$24.7 million.

Description of Condition

The utilities do not adequately monitor adjustments to customer accounts to ensure they are legitimate. The utilities do not have any way to know if employees are adjusting their own accounts.

We noted approximately 300 employees have the system access needed to make adjustments to utility accounts.

Cause of Condition

While the utilities appear to understand the need for improved monitoring, utilities management has not yet developed sufficient measures to adequately monitor adjustments. One City Light manager stated that monitoring was in place, but the processes apparently had not been adequately communicated to staff. While SPU intended to revise its reporting and monitoring of adjustments based on prior auditor recommendations, the primary individual responsible for this work retired and so the changes have not yet been implemented.

We also found:

- Utilities' policies and employee training do not clearly define the process for adjustments.
- Management believed that proposed new monitoring processes would be adequate. However, those processes have not yet been implemented at the time of the audit. We believe that unless further refinement of monitoring processes is done, they likely will not identify inappropriate adjustments.

Effect of Condition

When utility customers do not pay for services they receive because their accounts are reduced, other customers may pay more.

Because the utilities do not conduct sufficient monitoring, employee reduction of their own utility bills could go undetected.

Recommendation

We recommend the utilities adopt formal policies and establish processes for determining when account adjustments are necessary.

We also recommend utilities management:

- Require employees who can make account adjustments disclose all accounts in which they have an interest.
- Closely monitor all adjustments, time pay agreements and other arrangements involving employees' accounts.
- Establish a computerized monitoring process to help identify account adjustments that represent the highest risk.
- Periodically evaluate the effectiveness of the monitoring process to ensure it is working.

City's Response

The City thanks the auditors for their observations and recommendations.

Before the audit, Seattle City Light had implemented the following measures to improve monitoring of customer account adjustments:

- *Customer Service Director receives and reviews the account adjustment report weekly.*
- *Account adjustment procedures were documented.*
- *All employees who have access to CCSS must sign a confidentiality agreement that includes an Ethics statement.*

Since the beginning of 2011, City Light has taken further steps as follows:

- Other reports are generated to monitor compliance with processes and approvals.
- Closely monitor all adjustments, time pay agreements and other arrangements involving employee accounts.
- IT has completed a massive clean-up of employees that had access to CCSS. This included help from various business units in order to eliminate duplicates, etc.
- Customer Care did a complete audit with the help of IT of records going back to the beginning of the CCSS implementation and found no evidence of any City Light employees making adjustments on their accounts.

In addition, City Light will improve communication with staff to reinforce their training on adjustment policies and procedures.

The City's Code of Ethics SMC 4.16.070 prohibits employees from acting on City business where they have a financial interest. Seattle Public Utilities (SPU) adopted a new policy effective March 28, 2011 to make it clear that the Ethics prohibition applies to making transactions on utility accounts. To further its internal controls on utility adjustments and enforce this policy, SPU will develop a set of companion procedures that will include rigorous monitoring of all forms of transactions posted to utility customer accounts; these are in the process of being developed and are anticipated to be completed before the end of 2011.

The City agrees that better controls are necessary to manage the processes which adjust account balances, and will continue working to implement changes in policies, procedures, and monitoring practices. However, the City believes that financial risks from our current monitoring processes have not been appropriately described in the Audit and we would like to take this opportunity to do so.

First is a correction. The data evaluated in the Audit reflected a 17-month period, not a 12-month period. The comparable billed revenue for this time period is roughly \$1.42 billion for water, sewer, electrical, and solid waste services rendered by the City.

As the audit report notes, in that time period, there were approximately \$24.7 million in adjustments made to those bills. This amount comprises less than two percent of the total revenue billed.

The audit did not delve into which aspects of the \$24.7 million warranted improvements in internal controls. The City's review of the data indicates that almost half was part of a re-billing process and a large portion of the remainder is the result of rate changes. Additionally, both utilities had exceptionally high quantities of transactions as a result of two unrelated bad-debt fixes which resulted in a no net differential. Under normal circumstances there would have been significantly fewer adjustments.

Once you take into account the cancel and re-bills, bad-debt fixes, and rate-driven system adjustment, there remains only a small portion where customer service representatives have the discretion to determine if a customer's charges may be adjusted. These types of situations predominately include late fees and excess solid waste charges.

The City is committed to improve its controls systems for these processes and is working diligently to put these in place. While we understand that these controls have been lacking, we note that the audit report did not contain any assertion of revenue loss or illegitimate billing adjustments or the potential loss of "millions" of dollars due to bad billing adjustment practices.

Auditor's Remarks

We appreciate the City's commitment to resolve this finding and thank the City for its cooperation and assistance during the audit. We will review the corrective action taken during future audits.

Applicable Laws and Regulations

Budget Accounting and Reporting System (BARS) Manual, Part 3: Accounting, Chapter 1: Accounting Principles and General Procedures, Section C: Internal Control, states in part:

Internal control is a process – affected by those charged with governance, management and other personnel designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

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

Management and the governing body are responsible for the government's performance, compliance and financial reporting. Therefore, the adequacy of internal control to provide reasonable assurance of achieving these objectives is also the responsibility of management and the governing body. The governing body has ultimate responsibility for ensuring adequate controls to achieve objectives, even though primary responsibility has been delegated to management. Since management and the governing body are assumed to work in harmony, both parties are collectively referred to as "management" throughout the rest of this section.

Internal control should be viewed as an integral or inherent part of the policies, systems and procedures management uses to operate and oversee the organization. This is not to say effective control will never require additional or incremental effort. Rather, controls exist to provide reasonable assurance about the achievement of objectives and so should be integrated into all the organization's fundamental business processes. Controls are normally most effective when built into the government's infrastructure rather than being treated as supplemental or separate processes. In the same way, implementation and monitoring of internal controls should not be viewed as a singular event, but rather a continuous or iterative process.

Ultimately, providing reasonable assurance of achieving compliance and financial reporting objectives is within the government's control and

depends primarily on how well controls are designed and operated. Achievement of operational performance objectives also depends in large part on effective internal controls. By implementing effective controls a government can have reasonable assurance that it is doing all it can to meet its objectives.

Controls and processes should generate adequate documentation to demonstrate achievement of objectives. This is not only important for audit, oversight and public records purposes, but also to enable effective monitoring of controls over compliance by management.

Schedule of Audit Findings and Responses

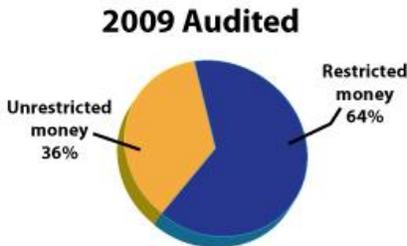
City of Seattle
King County
May 17, 2011

3. **The City of Seattle does not have adequate processes to ensure its internal service funds charge all its customers in an equitable way.**

Background

Money collected by the City is categorized as either restricted or unrestricted. Restricted money is generated from fees charged to utility customers; from tax levies or other tax sources set aside for specific purposes, such as the gas tax; and grants. Unrestricted money is generated primarily by property, sales and business tax collections. The City can use this money to pay for any City activity. The City can use restricted money only for specific activities.

As shown below, the City collected \$2.9 billion in 2009. Of that, \$1.8 billion was restricted and \$1 billion was unrestricted.



Two City departments, Information Technology and Fleets and Facilities, charge other departments for the services they provide. These charges and payments are accounted for in internal service funds. Internal service funds should account for the full cost of capital assets used in providing services to internal customers, including the depreciation expense and building debt. Internal service funds should be setup to “break-even” and should not make or lose money.

Accounting principles give the City flexibility in how to allocate costs to its departments, but state the allocation should be based on relevant, sufficient, and reliable data. Federal grant rules contained in federal Office of Management and Budget Circular A-87 require allocations to be fair, accurate and equitable to all activities that benefit from the shared costs, including to activities paid with non-federal funds. Finally, the Budget Accounting and Reporting System (BARS) manual requires the City to retain documents to support all charges.

Description of Condition

Information Technology

The Department charged its users approximately \$49 million in 2009. We examined support for rates for Citywide WebTeam Support, Data Center Facilities and Management, and Network Access services covering about 10 percent of Department revenue. We found the Department does not have adequate documentation such as time studies to support the rates charged for the two latter services. In addition, we found it does not consistently compare budgeted costs to actual expenses in order to ensure rates charged to users are based on costs of service, and does not consistently distinguish the working capital assets from those that are accumulated and held for future acquisition or replacement of capital assets.

Fleets and Facilities

The Fleets and Facilities internal service fund charged City departments approximately \$112 million in 2009 for the use of City-owned buildings and vehicles. The City appropriately accounts for vehicles and equipment in the fund but not for the buildings rented to other departments. The City also does not account for the building-related debt, depreciation and interest expenses, or debt principal payments in the Fleets and Facilities fund.

Cause of Condition

Information Technology

The Department's rate-setting process is complex and involves the City Budget Office and many of the City Departments that use its services. Because keeping some supporting documentation such as time studies may be expensive, the Department sometimes bases rates on incompletely documented estimates.

Fleets and Facilities

The City decided to exclude facility assets and related debt from the internal service fund. It does not have documentation on past management decisions that established the current processes. However, the City does account for the building acquisition, costs necessary to prepare the building for use, building-related debt, depreciation and interest expenses, and debt principal payments in other general government funds and reports those accounts in citywide financial statements.

Effect of Condition

Information Technology

The Department of Information Technology cannot provide documentation to show that it charges accurate rates to its customers. In total, the Department charged more than \$5.7 million to the Seattle City Light and more than \$6.6 million to Seattle Public Utilities in 2009. Other departments that are also largely funded by restricted money paid over \$3 million (Seattle Department of Transportation) and \$513,200 (Human Services Department). Because we cannot be sure all service charges are based on actual costs

of providing the related services, we deem the Data Center Facilities Management and Network Access charges to departments to be unsupported and may be questionable.

Fleets and Facilities

Because the City does not account for the full cost of buildings as well as related depreciation, liabilities and interest and principal payments in the internal service fund, the fund does not capture the full cost of providing space to other City operations, which is potentially important information for users of financial reports.

Recommendation

The City's internal service fund managers should:

- Document the detailed costs of providing each service. These details should include point-in-time physical inventories, time studies, comparison of budget to actual, etc.; supporting records should be maintained centrally and available for audit; the logic for pooling costs should be supported by narrative and accounting records. Management should retain records supporting the decisions to use estimates and should periodically re-evaluate the decisions to determine whether estimated amounts are still comparable to detailed amounts.
- Maintain departmental cost allocation plans for all internal service funds. The City should model its plan after federal Office of Management and Budget Circular A-87 that establishes commonly accepted rules for allocating and billing indirect costs.
- Document decisions related to the sharing of costs between City departments to retain institutional knowledge during personnel changes to serve as support for charges to restricted funds, and to demonstrate accountability to citizens and those charged with governance.

City's Response

The City thanks the auditors for their review of our internal service operations and recommendations. The City is committed to demonstrating accountability and transparency in the conduct of its operations, continually developing cost-effective ways to track and match detail costs with related revenues, and improving documentation to support pricing decisions and practices.

We will review our cost plans and study options to improve processes, documentation or support for rates charged by our internal service funds.

The City agrees with the auditor observation that the internal service fund that manages and maintains the buildings, provides space to City departments, and collects revenues to recover all related costs does not include records of the buildings and related debt and depreciation. Instead, those items are recorded in other general government accounts, and ultimately included in citywide financial reports. The City also agrees with the auditor observation that the internal service fund that collects space rent revenues contributes monies for payment of principal and interest on debts issued to acquire the buildings, and that those contributions are recorded in the fund, not as direct payments of principal and interest, but as "operating transfers" to the Debt Service Fund, the fund

designated to collect contributions from all affected funds, and to centrally pay for principal and interest on all general long-term debt. It is important to point out that the above-cited accounts are all included in citywide financial reports.

We understand that the City's accounting and reporting practices described above are also followed by other entities in the State. However, we acknowledge that the auditor recommendation to have all related cost elements accounted for within the internal service fund could facilitate costs tracking and analysis. The City will consider the auditor's recommendations along with other governmental accounting best practices as it continues to review and improve its accounting and reporting practices.

Auditor's Remarks

We appreciate the City's commitment to resolve this finding and thank the City for its cooperation and assistance during the audit. We will review the corrective action taken during our future regular audits.

Applicable Laws and Regulations

2011 Budget Accounting and Reporting System (BARS) Manual issued by the State Auditor pursuant to RCW 43.09 states in part:

Part 3, Chapter 1, Section C:

Internal control is a process – affected by those charged with governance, management and other personnel designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

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

Management and the governing body are responsible for the government's performance, compliance and financial reporting. Therefore, the adequacy of internal control to provide reasonable assurance of achieving these objectives is also the responsibility of management and the governing body. The governing body has *ultimate* responsibility for ensuring adequate controls to achieve objectives, even though *primary* responsibility has been delegated to management. Since management and the governing body are assumed to work in harmony, both parties are collectively referred to as "management" throughout the rest of this section.

Internal control should be viewed as an integral or inherent part of the policies, systems and procedures management uses to operate and oversee the organization. This is not to say effective control will never require additional or incremental effort. Rather, controls exist to provide reasonable assurance about the achievement of objectives and so should be integrated into all the organization's fundamental business processes. Controls are normally most effective when built into the government's infrastructure rather than being treated as supplemental or separate processes. In the same way, implementation and monitoring of internal

controls should not be viewed as a singular event, but rather a continuous or iterative process.

Controls and processes should generate adequate documentation to demonstrate achievement of objectives. This is not only important for audit, oversight and public records purposes, but also to enable effective monitoring of controls over compliance by management.

2011 BARS Part 3, Chapter 7, Section G prescribes accounting and documentation requirements for internal service funds. It states, in part (page 405):

Depreciation

Internal service funds are proprietary funds so depreciation of capital assets must be recorded.

Rates

Rates can be developed for individual assets or similar groups of assets. Composite rates - single rates developed to apply to dissimilar asset groups - should be avoided. Rates developed in this manner tend to overcharge or undercharge depending on the type of asset used. Rates may be billed as a single rate or each rate component can be billed separately. Rates should be reviewed at regular intervals.

Management Information

Management must maintain records which will identify all revenues and costs associated with an asset or asset group.

The following is provided for reference and should be considered in the design and implementation of internal controls.

The King County Superior Court decision in *Okeson v. City of Seattle*, No. 02-2-05774-8SEA (2004) held that Seattle City Light utility rate revenue may not support the City's general government functions. Central cost services charged to the utilities should have sufficiently closed relationship (nexus) to the utilities primary purposes and all such services should result in benefits to the utility ratepayers.

State law (RCW 43.09.210) requires separate accounting for distinct units of government and prohibits a department from benefiting financially at the expense of another department within the same agency. It states in part:

Separate accounts shall be kept for every appropriation or fund of a taxing or legislative body showing date and manner of each payment made therefrom, the name, address, and vocation of each person, organization, corporation, or association to whom paid, and for what purpose paid.

Separate accounts shall be kept for each department, public improvement, undertaking, institution, and public service industry under the jurisdiction of every taxing body.

All service rendered by, or property transferred from, one department, public improvement, undertaking, institution, or public service industry to another, shall be paid for at its true and full value by the department, public improvement, undertaking, institution, or public service industry receiving the same, and no department, public improvement, undertaking, institution, or public service industry shall benefit in any financial manner whatever by an appropriation or fund made for the support of another.

The City receives federal grants and directly or indirectly charges shared costs to those grants. All grant money must be spent in accordance with federal guidelines outlined in the Office of Management and Budget's (OMB) *Circular A-87* which is authoritative guidance and leading practice for cost allocations.

Attachment A, states in part:

Section F1 - Indirect cost pools should be distributed to benefited cost objectives on bases that will produce an equitable result in consideration of relative benefits derived.

Section C3 - Allocable costs.

- a) A cost is allocable to a particular cost objective if the goods or services involved are chargeable or assignable to such cost objective in accordance with relative benefits received.
- b) All activities which benefit from the governmental unit's indirect cost, including unallowable activities and services donated to the governmental unit by third parties, will receive an appropriate allocation of indirect costs.
- c) Any cost allocable to a particular Federal award or cost objective under the principles provided for in this Circular may not be charged to other Federal awards to overcome fund deficiencies, to avoid restrictions imposed by law or terms of the Federal awards, or for other reasons.
- d) Where an accumulation of indirect costs will ultimately result in charges to a Federal award, a cost allocation plan will be required as described in Attachments C, D, and E.

Attachment C, states in part:

. . . Since federally supported awards are performed within the individual operating agencies, there needs to be a process whereby these central service costs can be identified and assigned to benefitted activities on a reasonable and consistent basis. The central service cost allocation plan provides that process. All costs and other data used to distribute the costs included in the plan should be supported by formal accounting and other records that will support the propriety of the costs assigned to Federal awards

Attachment C - section A1, also states in part:

. . . All costs and other data used to distribute the costs included in the plan should be supported by formal accounting and other records that will support the propriety of the costs assigned to Federal awards.

Attachment C – section G.2, also states:

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

Attachment C - section G4, also states:

A comparison of the revenue generated by each billed service (including total revenues whether or not billed or collected) to the actual allowable costs of the service will be made at least annually, and an adjustment will be made for the difference between the revenue and the allowable costs.

Status of Prior Audit Findings

City of Seattle
King County
May 17, 2011

The status of findings contained in the prior years' audit reports of the City is provided below:

1. **The City's internal controls are insufficient to ensure users pay for the space that they use, resulting in a shift of general government costs to restricted funds.**

Report No. 1003732, dated May 10, 2010

Background

City did not have adequate processes to ensure all users of City-owned building space pay only for their fair share of building costs.

Status

To allow the City adequate time to take corrective action, we did not perform specific audit procedures to follow-up on this issue during this audit period and plan to include it in the 2011 audit.

2. **The City of Seattle's internal controls over appropriate usage of existing contracts were inadequate.**

Report No. 1003732, dated May 10, 2010

Background

The City did not have adequate processes to ensure its contracts are only used for the original contract purpose.

Status

To allow the City adequate time to take corrective action, we did not perform specific audit procedures to follow-up on this issue during this audit period and plan to include it in the 2011 audit.



ABOUT THE STATE AUDITOR'S OFFICE

The State Auditor's Office is established in the state's Constitution and is part of the executive branch of state government. The State Auditor is elected by the citizens of Washington and serves four-year terms.

Our mission is to work in cooperation with our audit clients and citizens as an advocate for government accountability. As an elected agency, the State Auditor's Office has the independence necessary to objectively perform audits and investigations. Our audits are designed to comply with professional standards as well as to satisfy the requirements of federal, state, and local laws.

The State Auditor's Office employees are located around the state to deliver our services effectively and efficiently.

Our audits look at financial information and compliance with state, federal and local laws on the part of all local governments, including schools, and all state agencies, including institutions of higher education. In addition, we conduct performance audits of state agencies and local governments and fraud, whistleblower and citizen hotline investigations.

The results of our work are widely distributed through a variety of reports, which are available on our Web site and through our free, electronic subscription service. We continue to refine our reporting efforts to ensure the results of our audits are useful and understandable.

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