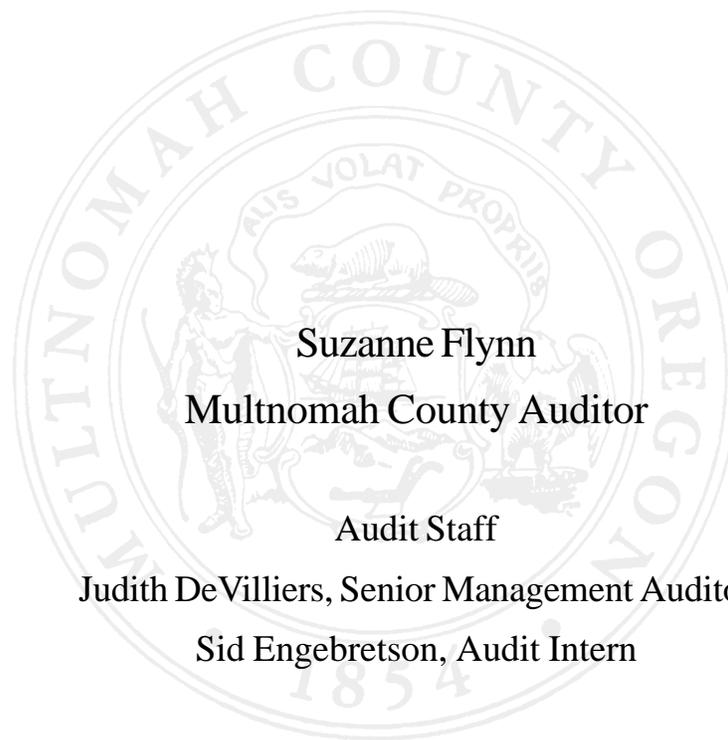


Internal Services

Clearly define business operations

December 2000



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MEMORANDUM

Date: 12/04/2000

To: Beverly Stein, Multnomah County Chair
Diane Linn, Commissioner, District 1
Serena Cruz, Commissioner, District 2
Lisa Naito, Commissioner, District 3
Sharron Kelley, Commissioner, District 4

From: Suzanne Flynn, Multnomah County Auditor

Subject: Audit of Internal Services Billing

The attached report covers our audit of Internal Services Billing and includes the billing systems for Data Processing and Telecommunications; Facilities and Property Management; and Fleet, Electronics and Mail Distribution. This audit was in our FY99-00 Audit Schedule.

Currently, Internal Service Reimbursements are used to recover costs of business services that the County provides internally and other costs that must be allocated Countywide but are not directly related to a service. In the initial stages our assumption was that the systems in place did not provide adequate information to determine the cost of services. We did not find this to be true. As a result, this audit makes several recommendations that we believe are a first step towards increasing the County's ability to control the costs and quality of internal services.

We have discussed our findings and recommendations with the Internal service, Finance and Budget managers, and the County Chair. Included in the audit are responses from the County Chair and the Finance and Budget Managers. Because of the shift in audit direction, our Office will direct audit follow-up to the Chair's Office. Pursuant to our new practice we will follow-up in 6 – 12 months and issue a report at that time.

We appreciate the cooperation extended to us by the management and staff of the internal service programs.

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Summary

Internal services are businesses that a government or corporation have chosen to operate rather than purchase from outside the organization. A service that is delivered by the organization itself can be more responsive to user needs and more efficient. In FY 2000-2001 Multnomah County's internal services that we examined were budgeted for \$56 million.

The purpose of our audit was to assess the effectiveness of the internal service billing systems for Data Processing and Telecommunications; Facilities and Property Management; and Fleet, Electronics and Mail Distribution.

All of the internal service divisions we reviewed have costing systems that produce adequate information to allow them to define and determine the cost of services. However we found users were generally dissatisfied and confused with the current billing systems. Users believe that some services are not comparable to outside services and question the costs.

We believe the problem is the design of the internal service billing systems. Currently billings are primarily to recover costs, and therefore provide few incentives or mechanisms to control costs or quality. Services are not clearly defined and some billed costs may not be directly related to the services provided. As a result, many services cannot be compared to industry standards and executive decisions made for the good of the County cannot be tracked.

The County needs to adopt a business model for internal service billings and to develop policies that can be applied consistently to all internal services. This policy needs to acknowledge the two objectives of internal services, to meet user needs and to meet countywide needs. The policies need to make clear who has authority over the particular asset involved, require internal services to set performance standards and be held accountable, separate accounting for decisions made at an executive level from those made at an operational level, and to set standards for contingency reserves.

Internal services should clearly define their services using commercial equivalent or industry standards. Services should be separated into clearly identifiable components and the internal service managers should clarify expectations and responsibilities. Once this is completed the County should routinely measure the services on quality and cost based on the standards and agreements with customers.

Background

Internal services are an integral part of doing business for large organizations in both the private and public sectors. In large corporations internal service units generate about 45% of employment, and about 11% for Multnomah County. All internal services represent 27%, \$557 million, of the County's 2000-2001 budget not including state and federal funds to contractors and capital. Not only do internal services represent a significant usage of public resources, but they also impact direct services provided to the citizens.

Generally internal services include any activity not delivered directly to a company's customers. Such services might include legal, accounting, human resources, data processing, facilities, fleet, and training. These services are usually centralized to provide cost savings, create uniformity, and provide technical expertise.

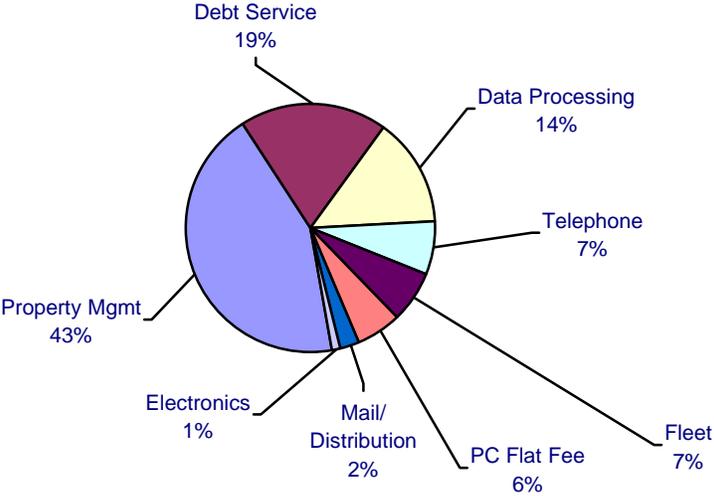
In the corporate world, centralized internal service costs may or may not become part of the direct cost of products and services. For a government entity, the internal service costs also may or may not be included as an expense in the department or program level budgets. When internal services are included with the operating expenses of a program or business unit these internal service costs are billed to the users of those services using a specific rationale. Billing methods used by a government or a business are similar.

When internal services costs increase, the effect is different for government. For a business, the profits will decrease; for a government with funding constraints, rising internal service costs may result in a reduction of other program resources. Despite the difference in effect, solutions for rising costs or inefficiencies are the same.

Internal services in
Multnomah County

Internal services examined in this audit were budgeted for \$56 million for FY2000-2001. Included in this amount are data processing, PC Flat fee (replacement fund), telephone, facility management, fleet management, electronics, mail distribution, and debt service. The budget by service type is shown below.

Internal service billings
FY2000-2001



Internal service billings have grown 33% from FY94-95 to FY98-99 nearly the same rate as most other cost categories. The increase in internal service billings varied from a high for Facilities and Property Management of 47% growth to a decrease of 7% for Data Processing. Some of the Facilities and Property increases are due to increased square footage, implementation of the asset preservation program and increased construction in the County.

Scope and methodology

The purpose of this audit was to determine if internal service billings were fair and reasonable. The scope included Data Processing and Telephones; Facilities and Property Management; and Fleet, Electronics and Mail Distribution. We did not look at risk management or indirect cost billings.

We interviewed finance or budget managers in most County departments. We talked with the internal service division managers, their finance managers and other staff. We also utilized information from the Fleet Audit that was in process at the same time. We looked at best practices for internal services and for cost accounting.

As part of the audit we did a cost study for Data Processing, Fleet, and Facilities and Property Management. The cost study included a review of the costing methodology used for accumulating costs for the purpose of billing departments. For Facilities and Property Management we also accessed data from their labor input and their accounting systems to analyze costs for the nine-month period from July 1, 1999 through March 31, 2000.

This audit was included in our FY99-00 audit schedule and was conducted in accordance with the General Standards Section of *Government Auditing Standards*. A follow-up review will be completed in 6-12 months.

Audit Results

Policy for internal services needs to be established

The County needs to improve policies for internal services. Each internal service was created at different times without establishing consistent criteria. Most internal services are accounted for in separate funds, except electronic services which is in the Fleet Management Fund. The names of the organizational location and accounting fund are often not the same. Organizationally, some are identified as a separate division, while others are part of a larger division. In the case of Facilities & Property Management Division, several distinct internal services are operating as one.

Exhibit 3

County internal services

Service Type	Organizational Location	Accounting Fund
Data processing	Information Services Division	Data Processing Fund
PC Replacement & software "Flat Fee"	Information Services Division	Capital Asset Acquisition Fund
Telecommunications	Information Services Division	Telephone Fund
Property management & capital improvements	Facilities & Property Management Division	Facilities Management Fund
Fleet "Motor Pool"	Fleet, Records, Electronics, and Distribution Services Division (F.R.E.D.S)	Fleet Management Fund
Mail distribution	F.R.E.D.S	Mail Distribution Fund
Electronics	F.R.E.D.S	Fleet Management Fund

Source: Auditor's Office Analysis

Current practices do not encourage good decisions

The County has not developed criteria for deciding when an internal service business unit or fund is needed. Commonly, internal services are developed to meet the objectives of efficiency, uniformity and to allow internal expertise. The current philosophy in the County appears to be cost recovery rather than buying and selling services. This direction has led to conflict and mistrust, resulting in inefficiencies for the County as a whole. Although most of the internal services are available from commercial sources, internal services billings are not perceived by users as payment for services received.

The current system does not give the County the ability to measure the efficiency or effectiveness of these services. Some users of internal services perceive themselves as captive customers who seem to have little information to make decisions. Departments find examples of similar services offered outside of the County at a lower price and question the value of the internal service.

Further, internal service divisions consider the department users as their customers and strive to provide the services requested by the user. Sometimes the services offered exceed what would be offered from an outside source with a focus on customer service rather than efficiency.

But, some business decisions that need to be made for the County as a whole may not always satisfy individual departments. Without proper balance between departments and countywide interests, overall efficiencies may not be possible. We found several examples of a lack of balance.

- One division negotiated its own contract for cell phones apart from the County not realizing that the County's rate with the contractor was based on the number of users. While the division realized some small savings, the rest of the County users were charged a higher rate from the contractor because of the decrease in usage. Currently, the internal service managers have no authority to prevent such actions.
- Similar incidents have occurred within data processing. Unlike the other internal services, data processing is not fully centralized. We estimated that departments outside of the Data Processing Fund provide 54% of the data processing services in the County. Some of the costs for data processing performed by departments may be duplicative of centralized data processing and cost the county taxpayers in inefficiencies. Rather than use expertise from the Information Services Division, less experienced departmental employees may make poor purchasing or design decisions. To determine the extent of duplication or inefficiency would require an audit, but this should be reviewed by the County.
- Our recent audit of Fleet operations is another example. Fleet Services philosophy was that the Division managed the supply of vehicles while County departments managed the demand. As a result, departments individually determined the fleet size, decided upon fleet alternatives, and assigned take-home vehicles. We estimated that many of the County's vehicles were not needed. According to our audit efficiencies that could have been gained from a Countywide perspective were lost.

To achieve this balance the internal service managers need to be given authority to guide and enforce County standards and good business practices. The Department representatives on various user committees also need to consider what is in the County's best interests which sometimes may conflict with individual department wishes.

Define expectations
and measure results

We found that some of the confusion with internal service billings was the result of vaguely defined services. The users are not always sure what services they are paying for, and the service providers do not always have clear criteria as to what services are being provided. Or, where the service has been defined, it may not be communicated or understood by users.

Each internal service division needs to identify its particular business activity. Facilities and Property Management has several businesses, among them a construction company with both new construction and remodeling; property management and leasing; and janitorial service and moving services. Fleet provides daily rental cars, long-term car leases, and auto repairs. Within each of these businesses, separate services can be identified.

National studies have shown that internal service departments with better definition regarding the service to be performed, had a greater customer satisfaction. The County's Data Processing Division has been working closely with the Information Technology Council and Operating Council to define and articulate their services. The Facilities and Property Management manager has also suggested they may move to written agreements for property management. Written service agreements are only one way of clarifying expectations. Although they do not have individual service agreements, mail distribution has a clear statement of services and charges so users are not confused as to expectations.

One way to clarify expectations and measure results is by using standards for quality and costs. These should be compared with those used by commercial sources. For example, in Facilities and Property Management, under the current system, rent includes the actual operating costs, as well as debt, reserves and overhead. These costs can vary from year to year depending on the condition of the building; and from building to building based on whether the building has debt or reserves attached. The business model for billing office and other space would be to charge for space by a few general categories of buildings at comparable market values.

The County internal service providers may actually have a market advantage because they do not have to make a profit or pay taxes. If the County cannot sell these services on a competitive basis the reason needs to be clear so efficient decisions can be made. Providing a business service internally may not always meet competitive outside pricing. But the County should not shy away from comparison and should clarify why differences exist.

Quality can also be measured by comparison to industry standards and surveying departments' satisfaction with the quality and cost of services. Some of these measurements could be integrated into key results as well as being reported to department users and others. Further, when costs are accurately and consistently calculated, decision-makers and citizens can determine the true cost of providing County services and achieving outcomes.

Separate operating costs from executive initiative costs

In a large business as with a government there are some management responsibilities on the executive corporate level and others on the operating division level. For the County many of the executive level decisions resulting in costs are billed at the operating level as part of internal services. As a result the costs are allocated as overhead. In some instances these can be large and distort the actual operating costs for those divisions.

In our cost study for Facilities and Property Management we found that the planning function for the County is billed as overhead to all renters. The same is true for construction management, where overhead is billed to renters rather than construction projects.

These and other non-operating overhead costs are easily identified. If the County decides to continue to fund these unrelated non-operating costs based on square footage or other space allocation methods, they should be clearly identified and appear as a separate line item from Facilities and Property Management billings. This identification of costs separates the control and responsibility for executive decisions from operating decisions and responsibilities.

Similarly, research and development for new technology represent costs unrelated to the specific service provided. Again on the corporate level these costs would benefit the business as a whole, not simply one operating division. The County has handled these costs inconsistently and funded some projects from the County's General Fund and included others in data processing overhead.

These and other non-operating overhead costs should be identified and a funding method selected. Including them as overhead in internal service billings creates inequities and confusion for users.

Debt service

Debt service costs are another non-operating cost billed at the operating division level. These costs are not handled consistently for all internal service funds. Debt for Telecommunications and Data Processing is included in internal service funds along with the related asset and depreciation. This is correct treatment since the assets are used in those operations.

Debt related to the County's buildings is not recorded in the Facilities Management Fund, nor are the related assets. However this debt is charged to the departments as part of building rent, collected by Facilities and Property Management. The exact amount is then passed along to the Capital Lease Retirement Fund as another internal service reimbursement. Facilities proposed "Simplified Facilities Client Billing" would segregate these so the internal service reimbursement could easily be accounted for directly in the Capital Lease Retirement Fund even though they are shown on one billing. This segregation would provide distinction and responsibility between fixed costs and operating costs.

The allocation of debt for buildings needs additional review. The present method is to charge the tenants for debt directly related to the facility. This method is based on "funding sources" rather than "value" or cost. With the implementation of the new accounting Standard GASB34 from the Government Accounting and Standards Board the County may want to reconsider how debt is allocated into a more fair value basis rather than funding basis.

Reserves for replacement	<p>Reserve funding is how a government legally saves (reserves) money for major capital purchases and carries it into the next year. There are four major capital reserve fundings being billed as internal services. Each of these is handled differently.</p> <p>All departments contribute to a replacement fund for personal computers and software through the PC Flat Fee. Departments have reported that this works well for them. The accounting for the PC Flat Fee is in a separate fund and shown as a line item for internal service billings.</p> <p>Two other reserve type costs are the Capital Surcharge for major maintenance charges; and the Asset Preservation included as part of building rental costs. Some building tenants are confused as to the purpose and use of these charges and feel they should have control over the use of these reserves in a manner similar to the way the PC Flat Fee works.</p> <p>On the surface these charges may appear to be the same as the PC Flat Fee. However, they are quite different. While the departments control PC use, building-use decisions are not solely at the departments' discretion. Because these costs are included as part of building rent, tenants (departments) are confused as to their ability to control costs or decision-making authority. This confusion might be avoided if those reserves went directly to the Asset Preservation and Capital Improvement Funds rather than collected as rent by Facilities and Property Management and then passed through to these funds.</p> <p>The fourth type of reserve, handled differently than the above three, is fleet replacement. The reserve accounting for fleet is a mixture of the Flat Fee and asset preservation methods. Prior to our audit, Fleet Services considered the cars in fleet as belonging to the departments, versus leased or rented. However, the replacement reserve resides in the Fleet Fund. Departments receive one charge monthly for both fleet services and replacement. Fleet services should regularly identify reserves for vehicle replacement.</p> <p>Creating these reserves by the County exhibits good business sense. The current billing method for them, however, creates confusion. Where the property is controlled by the department, the segregation of reserves into a separate fund with individual accounting as is done for the PC Flat Fee makes sense.</p>
Contingency reserves	<p>Good management requires a reasonable reserve that allows for operating contingencies and for capital replacement. Reserves will increase if the internal service divisions make profits from their sales of services. Although County internal services should operate like businesses, they should not make profits at the expense of other departments.</p> <p>Based upon our analysis, both the Fleet Fund and Data Processing Fund may have larger fund balances than needed for capital and contingency reserves by 30% to 40%. The mail Distribution and Facilities Management Funds clearly</p>

need to increase their fund balance reserves to meet operating contingencies. For this analysis we used a contingency of 5%-10% plus capital expenditures.

Policy for contingency reserves needs to be established. If the fund balance is to represent capital replacement reserves it should be designated as such. The policy should also have provisions of how to reduce excess reserves for both operations and capital. Contingency reserves could be used for capital if needed, could be reverted to the General Fund, could be used to decrease price increases or reduce prices, or could be refunded to purchasers.

Recommendations

1. To increase understanding of internal service billings and use the billing system more effectively, the county should establish countywide policies for internal services that:
 - a. Clarifies the internal service manager's responsibility and authority to balance the two objectives of meeting user needs and countywide needs
 - b. Identifies billing for the receipt of an internal service at the operating level separate from costs that are the result of an executive level decision
 - c. Requires internal services reporting and measurement to monitor efficiency
 - d. Sets the level of contingency reserves that should be maintained and the action that should be taken in the event of excess reserves
2. To clarify service expectations and allow measurement of results, internal service managers should clearly define services. This should be accomplished by:
 - a. Separating services into identifiable components or options
 - b. Using commercial equivalents and industry standards
 - c. Establishing written service descriptions when needed
 - d. Measuring the results for both quality and cost based on industry standards and service descriptions
3. To more accurately analyze the impact of executive level decisions and allow clarity in service definition, the County should account for debt and replacement reserve charges on a consistent basis

Responses to
the Audit



Beverly Stein, Multnomah County Chair

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M E M O R A N D U M

To: Suzanne Flynn
 From: Beverly Stein
 Date: November 30, 2000
 Re: Internal Services Reimbursement Audit

Thank you for your thoughtful overview of the purposes and uses of internal service billings. You raise interesting issues, some of which have implications beyond the accounting mechanisms you studied.

The audit suggests careful review of the way each internal service fund bills for its services. That review will require different analyses and may produce different outcomes depending on which fund is being considered.

As my first step, I have asked **Finance Director Dave Boyer to prepare a policy statement to include in the Board's Financial Policies**. The policy will list a number of factors that should be addressed in setting up any internal service fund:

- the reason for the fund
- the objective in having such a fund (as opposed to buying the service or goods from a non-County vendor)
- the person responsible for managing the fund
- the size of its contingency and how that contingency should be paid for
- whether a capital replacement reserve is included in the fund and how it should be paid for
- how each fund will deal with any resources exceeding fund requirements.

Of course, this policy will not apply to all support functions. Many of them are provided at General Fund expense and to some extent are covered by indirect cost allocation formulas negotiated with the Federal government.

As your audit indicates, billing systems can confuse and dissatisfy users of internal services. I will ask the **Operating Council Finance Committee to review the billing processes of each of the funds and report their findings to me**. Where the Operating Council finds existing billing mechanisms unsatisfactory, I will ask the

managers of the specific funds to simplify and clarify the way they bill for their services. This may mean providing a single rate for a service rather than breaking down each service into its component pieces. The labor and expertise involved in maintaining overly detailed billing systems may not be worth the effort.

Improving billing systems may not result in customer satisfaction with internal service fees. The billing systems should be **simple, clear, and allow the cost of a program (including its reliance on internal services) to be compared with other programs**. However, even an ideal billing system will not satisfy a manager who prefers to receive support more cheaply so that he or she can apply more resources to direct service. I welcome your confirmation that the role of an internal service manager must include **stewardship in the County's best interest, as well as responding to individual users**. Along with refining billing systems where appropriate, other actions are required to make the best use of our investment in central support programs, including **thoughtful consideration of what services should be provided centrally and which are more effectively carried out within departments**. I believe this effort will have greater impact than an exclusive focus on improving the ways we spread costs.

I also believe that the cost of internal services should be **measured against industry standards or alternative service delivery mechanisms**. That comparison should be done at the fund level and on a regular basis. I will ask the directors of Support Services and Environmental Services to propose a work plan to make this analysis a routinely scheduled event.

The primary requirement of an internal service billing system is to assure that the cost of providing services is borne by the current and/or potential users of the services. An internal service fund must recover its costs. The rationale underlying a billing system must be that the costs of services are spread equitably across all appropriate programs. **This includes billing departments for services determined to be strategic investments whether or not they appear to directly benefit from those investments**. An example of the latter is the central data center at ISD which is most cost effective for the County when all departments take advantage of the resource.

The County cannot appear to disadvantage one or more of the County's funding streams by allocating internal service costs inequitably. Such a perception would jeopardize the continuation of outside funding. At the same time, the County cannot afford to allow its General Fund to assume a disproportionate share of the cost of internal services. This would jeopardize programs the Board chooses to provide with local resources.

Another key use for internal service billing systems is to **provide incentives to departments to utilize services which are determined at a County-wide level to be strategic uses of resources**. A good example is the Decision Support for

Justice. This data warehouse is not being billed to departments based on usage because the County wants to encourage use of the system to improve decisions, not discourage departments from using the data in a short-sighted attempt to lower their costs.

Resolving the tensions created by these conflicting factors will require careful, program by program analysis. I will ensure that **a complete fund by fund, response to the recommendations on billings is put together**. This response will be scheduled so that the 2002-03 budget process reflects the changes that response suggests.

Thank you for your work on behalf of the County taxpayers and County employees.

- c. Board of County Commissioners
 - Cecilia Johnson
 - Maria Rojo
 - Dave Warren
 - Dave Boyer
 - Tom Guiney
 - Lisa Yeo
 - Delma Farrell



MULTNOMAH COUNTY, OREGON

 DEPARTMENT OF SUPPORT SERVICES

FINANCE DIVISION

COUNTY COMMISSIONERS

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MEMORANDUM

TO: Board of County Commissioners

FROM: Dave Boyer, Finance Director
 Dave Warren, Budget manager

DATE: November 28, 2000

SUBJECT: Internal Service Billing Audit

The following is our response to the Internal Service Billing Audit.

1. To increase understanding of internal service billings and use the billing system more effectively, the county should establish countywide policies for internal services that:
 - a. Clarifies the internal service manager's responsibility and authority to balance the two objectives of meeting user needs and countywide needs
 - b. Identifies billing for the receipt of an internal service at the operating level separate from costs that are the result of an executive level decision.
 - c. Requires internal services reporting and measurement to monitor efficiency
 - d. Sets the level of contingency reserves that should be maintained and the action that should be taken in the event of excess reserves

RESPONSE:

We agree that the Board should establish policy guidelines for internal service funds. We will prepare a policy statement for the Board's consideration. The policy statement will require that the resolution establishing each internal service fund address:

- the purpose of the fund,
- the role of its manager,
- the size of its contingency account and how it should be recovered by the billing system,

- the need for a capital replacement reserve and how it should be recovered by the billing system,
- and how any resources in excess of fund requirements will be handled.

Executive level decisions can be actions that are amenable to separate funding allocations. On the other hand, they may result in costs that are legitimately recovered using an internal billing system. For example, paying custodial contractors a “living wage” results in a service cost that is higher than many non-County operations pay. That cost, we believe, should be allocated to all receivers of custodial services. Separating the cost of the executive level decision in the billing system from the market rate would serve no useful purpose. Analysis of the impact of that decision should be performed as part of comparing the cost of providing custodial services as a whole with market rates so that the Board can determine whether the tradeoff in expense is balanced by a public good. Paying for that decision with General Fund revenue is not the only legitimate way of covering the cost.

2. To clarify service expectations and allow measurement of results, internal service managers should clearly define services. This should be accomplished by::
 - a. Separating services into identifiable components or options
 - b. Using commercial equivalents and industry standards
 - c. Establishing written service descriptions when needed
 - d. Measuring the results for both quality and cost based on industry standards and service descriptions

RESPONSE:

We believe that most of these recommendations could help clarify the billing systems of the internal service funds. Many of them are currently in use in different funds. They should be examined for applicability to each fund.

The one exception is recommendation 2. d. We believe that the internal service funds should be held accountable for the quality of their services and their costs. One way to measure their quality and cost is to measure them against comparable operations. This may include measurement against industry standards, where such exist. But we do not believe that looking at the results of the billing systems facilitates this comparison. We believe that the services themselves should be examined, looking at the operations providing the services.

In sum, the expenditures of a fund (the actual cost of providing the service) should be the basis of comparison to industry standards and external comparables, rather than the revenue side (per unit costs billed to departments). The billing mechanisms may legitimately include indirect overhead, and other costs not related directly to providing the service, which external comparables may not incur or may spread in a different way.

3. To more accurately analyze the impact of executive level decisions and allow clarity in service definition, the County should account for debt and replacement reserve charges on a consistent basis.

RESPONSE:

We agree and will propose to the Board that charges for debt and capital replacement reserves be explicitly addressed for each internal service fund.