



Internal Audit Report

Partner Cost Monitoring Audit - KCM

Report Number: 2019 - 06 | Report Date: October 17, 2019

Executive Summary

Audit Report No.: 2019 - 06

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WE AUDITED the current Partner Cost Monitoring processes to ensure that the agency has effective controls over King County Metro (KCM) Cost Allocation Model (CAM) related to allowability, allocability, and reasonableness of the shared costs and that KCM costs are based on actual expenses.

AUDIT OBJECTIVE was to determine whether the agency has effective controls in place to ensure:

- KCM costs allocated to ST are allowable, allocable, and reasonable.
- KCM costs allocated to ST are actual costs.

The audit examined records as of April 2019 & the latest processes and management controls in place.

WHAT DID WE FIND?

Sound Transit (ST) has outsourced operations & maintenance of ST Express Bus (ST Express), Link Light Rail (Link), and Downtown Seattle Transit Tunnel (DSTT) since 1999 to King County Metro (KCM). For services provided, Sound Transit reimburses the county approx. \$100 million annually.

For cost allocation purposes, ST and KCM have implemented a cost accounting methodology referred to as Cost Allocation Model (CAM), which has been utilized for over 20 years. The model accumulates an overall expense of \$650+ million (2018) related to agency services in 59 cost pools, which are ultimately allocated to the agency share through the use of 28 cost drivers.

ST Operations Business team provides oversight of the CAM to ensure that reimbursement to KCM are based on actual activities benefitting the agency in compliance with applicable terms and conditions.

The audit concluded that the agency controls are not designed well to ensure KCM costs are actual, allowable, allocable, and reasonable.

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Background

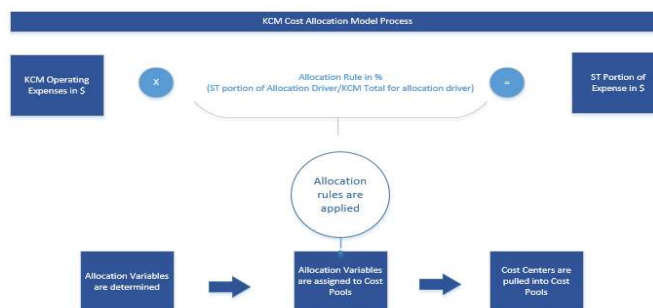
Sound Transit (ST) has outsourced operations & maintenance of ST Express Bus (ST Express), Link Light Rail (Link), and Downtown Seattle Transit Tunnel (DSTT) since 1999 to King County Metro (KCM). The county is one of three partnering agencies¹ and one of the largest service providers for the agency. On average, Sound Transit reimburses the county approx. \$100 million annually. The following tables summarizes payments made to KCM in the last 3 years.

Mode	2016	2017	2018
ST Express	42,400,540	46,676,735	50,593,875
Link	37,481,515	41,669,056	45,928,021
DSTT	9,323,264	11,205,754	10,534,227
Total	\$89,205,319	\$99,551,545	\$107,056,123

Reimbursements are based on allocated costs actually incurred in the provision of services to ST under the following two governing documents:

- Interagency agreement between KCM and ST for Express Bus Service Operations & Maintenance (dated 2015).
- Intergovernmental Agreement between ST and King County for the Operations and Maintenance of the Central Link Light Rail System for the initial and Airport Segments (dated May 2003). The revised agreement (dated 2009) expanded the scope to include DSTT and paratransit.

For cost allocation purposes, ST and KCM have implemented a cost accounting methodology referred to as Cost Allocation Model (CAM), which has been utilized for over 20 years. A budget allocation based on CAM is prepared annually and used as a baseline for the upcoming year where each monthly invoice equals 1/12th of the baseline. At year-end, CAM allocations are compiled based on total actual operating and certain non-operating expenses such as depreciation. The final year-end reconciliation is performed to true up between the baseline and actual expense allocations. The following table provides a flow chart of KCM CAM process.



¹ ST owns the fleet; however, buses are operated and maintained under contracts with local transit authorities (Community Transit, King Country Metro, and Pierce Transit).

Audit Objectives

To determine whether the agency has effective controls to ensure:

- KCM costs allocated to ST are allowable, allocable, and reasonable.
- KCM costs allocated to ST are actual expenses.

Scope and Methodology

We conducted this performance audit in accordance with Generally Accepted Government Auditing Standards and the International Standards for the Professional Practice of Internal Auditing. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusion based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusion based on our audit objectives.

We gained an understanding of King County Metro Cost Allocation Model through documentation reviews, data analysis, analytical procedures, and personnel interviews. We identified risks in the processes and assessed management controls in place to mitigate those risks. Based on the assessment, we determined to focus on management practices related to monitoring of KCM cost allocation practices on cost allocability, allowability and reasonableness.

We examined agreements, procedures, and oversight documentation and records as of April 2019 and the latest processes and management controls in place.

1. To determine whether the agency has the effective controls to ensure that costs allocated to ST are allowable, allocable, and reasonable, we performed the following procedures:
 - a. Reviewed inter-agency agreements, ST internal procedures, best practices and supplemental guidance documents.
 - b. Interviewed ST Operations Business Data Analysis, ST Bus Operations, ST Link, ST Service Planning team staff and management to ensure agreements, ST internal procedures, or other financial oversight documents provide definitions for allowable costs and provide clear guidance to management.
 - c. Analyzed 2016, 2017, & 2018 CAM cost pools and allocation variables to identify any changes in the pools and variables.
 - d. Analyzed cost centers, cost pools, or allocation variables that appear to have indications of “non-allocability” to ST in 2018 CAM to determine whether they were agreed-upon by both parties to be excluded.
 - e. Tested 7 from a total of 28 allocation variables from 2018 CAM.
 - i. Reviewed 2018 staffing allocation model for reasonableness.
 - ii. Compared ST allocated staff (2018) to 2018 CAM allocated expenses line items (salary/wages, benefits, & overtime) for reasonableness.

- iii. Analyzed 2 staffing allocation variables in the 2018 model supporting 2 cost pools.
 - iv. Analyzed 4 allocation variables based on service hours supporting 20 cost pools for \$26M of the total of \$105M allocated to Sound Transit in 2018.
 - f. Tested 13 from a total of 59 cost pools from 2018 CAM to determine allocability, allowability, and reasonableness.
 - i. Interviewed Sound Transit Operations staff and management to determine the extent to which their input contributes to the CAM review process.
 - ii. Reviewed allocation variable relationship to the cost pools.
 - g. Tested a risk-based selection of adjustments from 2018 year-end reconciliation to assess allocability.
 - h. Tested 3 cost pools from 2018 CAM with federal grants (i.e., CFDA² 20.519 Clean Fuels) awarded to KCM to assess allocability.
 - i. Tested Non-ST cost pools to ensure that no amounts were allocated to Sound Transit in 2016, 2017, & 2018.
 - j. Tested 2018 Non-ST related cost centers to determine the impact to Sound Transit if they were excluded from the KCM baseline expense calculation.
2. To determine whether the agency has the effective controls to ensure that KCM costs allocated to ST are actuals, we performed the following procedures:
- a. Conducted management and staff interviews to determine control effectiveness over expense allocability.
 - b. Compared 2017 & 2018 CAM totals to King County Public Transportation Enterprise Fund audited financial statements to determine whether there were year-end adjustments/restatements that could have impacted the CAM model's completeness and accuracy.
 - c. Tested 7 from a total of 28 allocation variables from 2018 CAM to the supporting documents to determine whether they are actual expenses.
 - d. Recalculated 2018 CAM allocation variable percentages to test whether percentages agreed to the source calculation.
 - e. Tested 13 from a total of 59 cost pools from 2018 CAM to supporting document (e.g., subledger/GL detail) to determine whether they are actual expenses.

² The Catalog of Federal Domestic Assistance (CFDA) is a government-wide compendium of Federal programs, projects, services, and activities that provide assistance or benefits to the American public.

Conclusion

The audit concluded that the agency controls are not designed well to ensure that allocated KCM costs are actual, allowable, allocable, and reasonable.

See Finding #1

Findings and recommendations

1. ST Controls over KCM Cost Allocation Model review are limited and should be strengthened

The cost sharing agreement with the King County Metro (KCM) is based on a system of “blended” costs of directly and indirectly assigned costs. As such, blended costs are not designed to represent true cost of KCM services. Nonetheless, the method is used to approximate true cost as it helps to avoid an unduly administrative burden to manage the cost allocation process.

Directly assigned costs are fairly simple to capture for allocation purposes. Typically, there is a clear-cut expense-to-cost relationship (e.g., salary to various activities based on timesheet entries) that can be used for cost allocation without an intermediary. Generally, there is an automated system (e.g., payroll system) that captures and processes expenses. In comparison, indirectly assigned expenses represent those that bear some relationship to cost but may not share an obvious link. Because of the indirect relationship, these expenses go through additional cost allocation processes.

Indirect expense allocations start with the establishment of pools of similar expenses, followed by a determination as to what drives these expenses toward a particular activity. A cost driver can be viewed as a common activity thread that all expenses in a particular pool share. Example, a cost driver for bus operator training expenses could be driving hours as the driving is the reason why the expenses are incurred. In such cases, driving hours are used as a means to allocate expenses among various cost groups. Given these additional cost allocation steps, indirect costs require more and detailed consideration to verify allocability, allowability and reasonableness.

The current Cost Allocation Model (CAM) appears to be largely based on indirect allocations. With exceptions of certain Link costs³, the majority of the remaining expenses are indirectly assigned to the agency. Expenses go through allocations using the intermediary cost driver. According to 2018 CAM, the agency is responsible for 59 cost pools (out of 122 and \$688M in expenses) that results in allocations of about \$60 million annually representing mainly bus and DSTT through the use of 28 (out of 43) cost drivers. This level of complications require the consistent application of well-designed management controls.

The agency oversight function of CAM is chiefly based on a variance analysis between budget and actual by Operations’ Business team. The efficacy of the analysis as a management tool is based on its ability to identify material and/or unusual budget-to-actual variances that warrant further inquiries. Such analyses are most effective with the pools of original costs directly charged to the cost group of interest with no allocations. Further, variance analyses are a quantitative tool. They do not comprehensively examine the qualitative aspects (e.g., plausibility of a cost deliver) of cost allocations in detail. As such, it

³ According to 2018 CAM, approximately \$39M of Link costs are directly charged to ST.

has inherent limitations and disadvantages in a cost system where indirect cost assignments are heavily used. While the current oversight function based on the variance analysis has been reasonably effective, it does not examine cost pools and cost drivers at a level commensurate with the level of complexity (i.e., inherent risk) in CAM.

The following exceptions as a whole demonstrate the shortcomings of the variance analysis as the agency's primary means to ensure allocated costs are actual, allowable, allocable, and reasonable.

1. Certain Key Definitions Are Missing

One of the critical steps in ensuring clarity in a complex cost accounting system is to define significant terms. These definitions would provide guidance and facilitate a shared understanding of cost responsibility. The audit, however, noted that some key definitions are lacking in the agreements.

Operating Expenses

The current CAM is based on operating expenses, but there is no definition of an operating expense. It is not clear whether expenses should only include cash transactions; if it did, prior CAMs would be incorrect as they included non-cash depreciation expenses in each year. Additionally, there are many references in the agreement to Generally Accepted Accounting Principles (GAAP) as it relates to pertinent financial books, records and documents. If expenses were based on GAAP, there would be additional operating expenses that should have been part of CAM. For example, there were differences of \$42M and \$24M for 2018 and 2017⁴, respectively, between CAM operating expenses and the county's audited Financial Statements prepared in accordance with GAAP. In the absence of an agreed-upon definition, CAM includes some but not all non-cash transactions.

Cost pools, allocation variables, allocation rules, etc.

In 2018 CAM, there are 122 cost pools, 59 of which were allocated to the agency. There were 43 allocation variables, and KCM utilized 28 to assign costs to the agency cost pools. Both ST and KCM staff are generally in agreement as to what constitutes a cost pool, cost driver or allocation rule, but there does not appear to be agreed-upon definitions of these critical terms. The audit noted an outdated "Cost Pools Description" document, but neither the document nor the agreements, provides clear definitions.

In addition to cost pools, the agency pays a share of depreciation expenses related to "project" assets, equipment, computers, and information systems. There was no definition of a "project" asset and what should be included in "equipment, computers, and information systems" assets.

⁴ Differences were mostly related to GASB Statement No.68, Accounting and Financial Reporting for Pension, fair valuation of pension liability account.

2. Allowable And Allocable

External Funding Assistance

Grant financing from external government agencies have a direct impact if grants cover the very activity that is reimbursable under the terms and conditions of CAM. KCM had executed a federal grant (CFDA #20.519 for a hybrid electric cooling system) and received grant reimbursements of ~\$1.6M during 2017 and 2018. The grant revenue should have been a deduction to CAM expenses in its entirety each year. If not deducted, it would be considered double dipping as the underlying activity received funding from two different sources. The audit noted no deductions for the grant revenue in 2017 and 2018 CAM. Concurrently, the agency reimbursed the county approximately \$188,000 for the activity covered by the federal grant.

Unallocable Expenses

One of 59 cost pools allocated to the agency is a group of expenditures related to maintenance coach parts. The cost pool contains expenses from many locations including ones where no agency related activities occur. In particular, the cost pool includes expenses from South Base Shop which hasn't been utilized since 2011 for the agency fleet. The inclusion of the admittedly non-allocable location in CAM is necessary to accommodate the complicated ways of cost assignments. For 2018, the agency share of the cost attributable to South Base Shop was \$711,000. This allocation, when combined with others in the cost pool, does represent an amount that the agency should be responsible for coach parts. However, the method clearly demonstrates the need for an increased level of monitoring by agency staff to review details.

During the audit period, there were six changes in cost pools. Some were either merged or removed in the following year. Moreover, there were five additional cost pools from 2017 through 2019 and three changes in allocation variables. However, there was no formal review and agreement as to their allocability.

3. Readily Available Information Is Not Part Of The Variance Analysis

The agency annually receives a myriad of CAM related information from KCM. The information as a whole explains intricate relationships at a reasonable level of cost detail. However, the current management control, the variance analysis, does not always incorporate the examination of the available information, as evidenced by the following:

Duplicated staff count

A staffing allocation model calculates and assigns an FTE count to certain cost pools as a precursor to cost allocations. The calculated FTE counts are directly related to 8 cost drivers that are used to allocate 11 cost pools and other worksheets. In 2018, the FTE drivers allocated approximately \$3.2 million to the agency.

The audit noted that 54 employees were duplicated (represented as 156 employees out of total 4615) in the 2018 model which impacted the cost drivers and other worksheets (i.e., depreciation).

Duplicated assets

KCM provides a depreciation schedule as support for the agency share of capital projects at East Base since 2000. In 2018, approximately \$384,000 was allocated to agency. Additionally, the agency also pays a share of annual depreciation for equipment, computers, and information systems. The total allocated amount to agency in 2018 was approximately \$596,000.

The audit noted three duplications in the schedules for the audit period.

4. Agency Subject Matter Experts Are Not Involved In The Variance Analysis

CAM utilizes a variety of performance measures for the cost driver. Example, CAM utilizes parts as a driver to allocate vehicle maintenance costs and bus service hours for fare collection. These driver choices differ from the best industry practices⁵ where miles and ridership are utilized to allocate vehicle maintenance and fare collection costs, respectively. Given the different choices which are presumed to be based on certain rationale, there needs to be regular reviews of these performance measures to ensure that the assumed relationship between the measure and the cost remains valid. Further, while financial analysts who perform the analysis are better informed than a layperson, they may not be aware of all the nuances of operations related to these measures as agency subject matter experts are.

The agency has dedicated staff in each mode who have intimate operational familiarity and knowledge about KCM activities on behalf of the agency. However, the variance analysis does not consistently involve these subject matter experts. Incorporating the expertise to supplement the analysis could improve the process significantly in determining whether actual costs are allowable, allocable, and reasonable.

Reasonableness of costs

Inquiries with ST Operations staff indicated that they are seldom involved with the variance analysis. For almost all of 13 cost pools tested, ST Bus Operations team does not always provide input as to the reasonableness of costs. Example, forcoach parts, there are certain parts allocated to ST utilizing a percentage of direct coach parts. However, there is no validation from ST Bus Operations team whether the charges pertain to ST buses.

⁵ US Department of Transportation: Federal Transit Administration – Uniform System of Accounts, Appendix A. Cost Allocation Handbook

The current CAM is a complex model with numerous intermediaries in cost allocations. It is designed to lessen the administrative burden of both ST and KCM, but the very structure of heavy indirect allocations requires a high level of ST administrative involvement to verify agency financial obligations. An expected level of due diligence on the agreements with average annual disbursements of \$60 million must be closely proportional to a level of inherent risk of incorrect misstatements from the complex model.

Recommendations:

We recommend management:

1. Improve the true-up process to reasonably ensure that allocated costs are actual, allowable, allocable, and reasonable.

The following specific procedures are suggested for management consideration:

- Review audit exceptions for potential under/over payments to KCM.
- ST and KCM should agree to the definitions of key terms: operating expenses, allowability, allocability, reasonableness and exclusions. The agreement should be memorialized in writing and revisited annually for update.
- Create a series of documents for each cost center and cost driver with a description of a plausible relationship to activities benefiting Sound Transit.
- Consult subject matter experts in the reviews of performance measures and expenses.
- Compare KCM total expenses to audited financial statements.
- Revisit the current model to explore the possibility of incorporating more direct costs, especially ones that are readily available such as fuel, parts, driver hours, etc.
- Review the current staffing level to determine sufficiency to perform a level of necessary monitoring.

Management Response:

Introduction:

Sound Transit Internal Audit performed an audit of the current partner cost monitoring processes to ensure that the agency has effective controls over the King Country Metro (KCM) Cost Allocation Model (CAM) related to allowability, allocability, and reasonableness of the shared costs, and that KCM costs reflect actual expenses. The audit had one finding – “ST Controls over the KCM Cost Allocation Model review are limited and should be strengthened.” There were several recommendations that followed the finding.

This audit provided valuable insight and recommendations on how we can refine and further tighten up oversight of our cost monitoring process over KCM service, particularly for ST Express. Many of the audit recommendations have already been addressed in the new Intergovernmental Agreement (IGA) for ST Express Bus service with KCM, which is expected to be ratified by KCM and Sound Transit (ST) by the end of 2019. Management concurs with four of the specific recommendations and have provided action steps below that are already underway. Three recommendations we believe will be challenging to address and resolve given the current model and resourcing which is developed per the Intergovernmental Agreements, and we have provided our management response accordingly below.

Given the increasing complexity of the cost allocation model as our system expands, we would like to seek an objective third party reviewer to comprehensively examine the current model and provide the best approach for Sound Transit to proceed in the future.

For historical reference, we have also provided background information and operational context on the CAM.

Background - Cost Allocation Model (CAM):

It has been a part of a longstanding conversation as we enter into negotiations of IGAs with our partners whether the direct cost of work performed and/or staffing required should be directly reported as actual cost allocated to Sound Transit. Over time, there were several attempts to introduce a more direct costing approach or develop a more customized CAM model. In 2014, after an internal audit (report date 9/24/14) recommended more rigorous documentation to support a customized CAM, one partner eliminated the tailored model leading to increased costs passed on to Sound Transit.

Even with its complex nature, the CAM has been leveraged to date as the most viable cost allocation approach for past 20 years with our partners (KCM, Pierce Transit (PT), and Community Transit (CT)) to approximate operational and maintenance costs for services provided. Sound Transit and the regional bus partners have leveraged existing infrastructure, systems and personnel, to provide more services to the region at minimal incremental capital investment costs. The CAM method saves Sound Transit money in that operating costs allocated to Sound Transit can be estimated through a pro-rated approach rather than establishing separate organizations and systems within each partner agency to assign and track direct expenses specific only to Sound Transit. The CAM process, in place for all three ST Express partner agreements since start-up, has enabled an efficient financial approach

to fund bus operators, mechanics, systems, and administration to support the broad array of service needs and support functions.

Link related KCM costs are mostly directly reported and can be transparently monitored by operator, mechanic, administration, and management. Sound Transit owns the vehicles, the Operations Maintenance Facility (OMF), most of the system infrastructure (SCADA) and all employees at the OMF are designated as Link employees. A relatively small amount of expenses are allocated to Link for KCM overhead and system related charges.

Therefore, given the audit finding and recommendations, the most important area to focus on is how to provide better oversight of KCM costs associated with service for ST Express and the DSTT, where pro-rated cost pools make up a larger portion of the CAM.

For ST Express, the Operations Business division allocates resources to review six CAM's during each calendar year – three CAMs in March to reconcile actual costs from prior year, and three CAMs in November for the next year budget. Each of the three partner CAMs are different and quite complex. Each initial CAM review takes two to three weeks to conduct. The general review process performed is to re-calculate the CAM to ensure formulas are correct, compare actual CAM costs to the Budget CAM cost, identify and address any major variances or changes in cost pools or allocation variables and validate key operations metrics such as platform hours comparing them to Sound Transit Service Planning statistics. The entire process for KCM and other partners can take several months to complete given other deliverables for both Sound Transit and KCM staff involved in this process. To date, the Operations Business division has not been staffed for the intensive detailed review requirement.

Management Conclusions to Improve Oversight:

The essential spirit of the CAM approach used by each ST Express partner and Sound Transit is to work together to ensure costs reflect a fair, pro-rated, approach for services provided. That, combined with our relationship that's based on trust and partnership ensures one agency isn't benefitting at the cost of the other. The recent IGA developed between KCM and ST memorializes this spirit and partnership, again using the CAM model, and also addresses several of the Internal Audit Recommendations to focus on cost efficiencies and oversight.

Responses to Internal Audit recommendations provided below:

1. "Review audit exceptions for potential under/over payments to KCM."

The Internal audit review testing found errors in the Cost Allocation Model. We found this testing to be very helpful and both KCM and Sound Transit will work together to reconcile the cost adjustments as well as work together to reconcile costs to true up. Both KCM and Sound Transit will also work together to tighten up process around excluding grant funding costs that should be excluded from charge to Sound Transit, ensure staffing model counts for allocations accurate, and develop method to ensure no depreciation allocations are duplicated.

2. "ST and KCM should agree to the definitions of key terms: operating expenses, allowability, allocability, reasonableness and exclusions. The agreement should be memorialized in writing and revisited annually for update."

Sound Transit was able to work with Internal Audit in parallel to KCM IGA ST Express negotiations for a new contract, and already incorporated this recommendation.

3. "Create a series of documents for each cost center and cost driver with a description of a plausible relationship to activities benefiting Sound Transit."

During recent IGA negotiations, KCM and Sound Transit agreed to develop a more detailed description of the CAM review process, enhance definitions of costs centers and document logic for allocation drivers. This work is in the process of commencing.

4. "Consult subject matter experts in the reviews of performance measures and expenses".

During recent IGA negotiations, KCM and Sound Transit committed to more structured operational and financial reviews of KCM provided service that will be implemented immediately.

5. "Compare KCM total expenses to audited financial statements"

We already compare the total KCM expenses to audited NTD and financial records. We don't believe that Sound Transit should employ resources to audit KCM financials in greater detail.

6. "Revisit the current model to explore the possibility of incorporating more direct costs, especially ones that are readily available such as fuel, parts, driver hours, etc."

We have approached our partner with this request, but given background presented above and partner response, we don't think this is feasible in the short-term, but will continue to work with KCM to explore the potential for a more direct costing method.

7. "Review the current staffing level to determine sufficiency to perform a level of necessary monitoring"

We feel the current process relative to staff costs provides proper oversight to identify any material cost errors per the cost allocation model. We will work with KCM to tighten issues identified in this audit with existing resources. However, if we were required to audit KCM operating statistics and costs in more detail, we would need additional staff to conduct this detailed review including resources from internal audit and our accounting department. More than likely KCM would also need to employ more resources leading to increased administrative cost allocations to Sound Transit.