

Office of the City Auditor

CONSENT CALENDAR

October 26, 2010

To: Honorable Mayor and Members of the City Council

From: Ann-Marie Hogan, City Auditor

Subject: Audit: Lack of Support for Payroll Adjusting Journal Entries: Grant Revenue at Risk?

RECOMMENDATION

Request the City Manager report back by March 2011 and every six months thereafter regarding the implementation status of each recommendation in the attached audit report until all recommendations have been reported implemented.

SUMMARY

The Department of Health Services (DHS) made 94 percent of Citywide adjustments to grant funds in fiscal year 2009. A major reason for the DHS Adjusting Journal Entries (AJEs) was to align budget based time charges to actual time. Following are the results of the performance audit of payroll adjusting journal entries.

Are DHS' Payroll AJEs Necessary and Supported?

- 1) DHS did not attach sufficient support to the sampled payroll AJEs to allow an independent assessment of whether the adjustments were necessary and the amounts accurate. Starting in January 2010, DHS began attaching more documentation to the AJEs that it submits to accounting.

Would it be More Efficient for DHS to Enter Actual Staff Time in the FUNDS\$ Payroll System?

- 2) DHS employees often work on multiple projects throughout the year. Time constraints in the City's payroll reporting process make it impractical to report actual time spent on each project each pay period.

Can the Large Number of Payroll AJEs Be Significantly Reduced?

- 3) The Interim Director of Health Services explained various reasons for payroll adjusting journal entries, and why entering actual time worked on each project would not significantly reduce their number. We agree that, with most of these stated reasons, AJE's would still be needed. Without adequate supporting documentation, however, we could not reasonably assess whether entry of actual time on each project could significantly reduce the need for AJEs.

The Department of Health Services provides a variety of health related services to Berkeley residents, such as family planning, immunizations, HIV testing and counseling, psychological assessment and counseling, restaurant inspection, and vector control.

FISCAL IMPACTS OF RECOMMENDATION

DHS has a variety of funding sources, including Medi-Cal (the state's Medicaid program), state realignment revenue,<sup>1</sup> the Mental Health Services Act, and federal, state, and county grants.

In the first six months of fiscal year 2009, DHS expended almost \$8 million on federal, state or county grants, which equates to almost \$16 million annually. If just one percent of this amount was disallowed due to lack of support, it would cost the city almost \$160,000. Over a five-year period the loss could accumulate to almost \$800,000.

RATIONALE FOR RECOMMENDATION

DHS made over 300 AJE to grant funds in fiscal year 2009. We are concerned that the City could lose future funding or be required to return funds should a federal or state audit find a pervasive lack of support.

CONTACT PERSON

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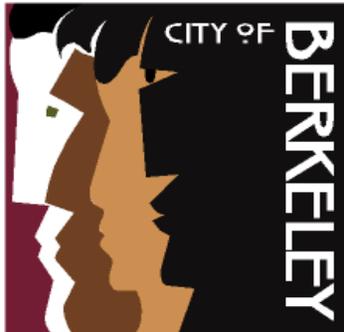
Attachment:

1. *Lack of Support for Adjusting Journal Entries: Grant Revenue at Risk?*

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<sup>1</sup> "Realignment" refers to funding provide by the Bronzan-McCorquodale Act, which redirects a portion of sales tax and vehicle license fees to fund community health services.

# City of Berkeley



## Lack of Support for Payroll Adjusting Journal Entries Grant Revenue at Risk?

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## Table of Contents

I.	Executive Summary .....	1
II.	Background .....	2
III.	Findings and Recommendations .....	3
	Finding 1: Provide Guidance for Adjusting Journal Entries .....	3
	Finding 2: Attach Sufficient Support to Journal Entries Sent to Accounting .....	4
IV.	Fiscal Impact .....	6
	Appendix A: Scope and Methodology .....	7

## I. Executive Summary

**Audit objectives were to determine if:**

- 1) Payroll adjusting journal entries (AJEs) prepared by the Department of Health Services (DHS) were necessary and supported.**
- 2) It would be more efficient for DHS to enter actual staff time worked on each project in the FUND\$<sup>1</sup> payroll system each pay period, instead of using budget based default time codes.**
- 3) The large number of DHS payroll AJEs could be significantly reduced.**

We focused on DHS because the department made 94 percent of Citywide year-end payroll adjustments to grant funds in fiscal year 2009.<sup>2</sup> Federal guidelines specify requirements for supporting personnel costs charged to grants.

DHS did not provide sufficient support for our sample of payroll AJEs. We could not independently determine if the adjustments in our sample were necessary, the amounts accurate, or if entry of actual staff time could eliminate some AJEs or increase efficiency. Also, DHS did not attach support to all AJEs it sent to Accounting (See Finding 2 below).

It was not practical for DHS to report actual time spent on each project each pay period.

One reason DHS generates payroll AJEs is to align personnel costs in FUND\$ (derived from budget based default time codes) to actual costs.<sup>3</sup> DHS employees often work on multiple projects throughout the year. Time constraints in the City's payroll reporting process make it impractical to report actual time spent on each project each pay period.

<sup>1</sup> FUND\$ is the City's financial and work management system.

<sup>2</sup> DHS had \$9,422,233 in grants at December 31, 2009, which was 29 percent of Citywide grant funding. (Source: grant reports prepared by Accounting). Amount and percent reflect the total amounts awarded under active grants. We initially obtained year-end AJE data that included data for all City departments. We did not obtain additional AJE data made by other departments and do not know the volume of AJEs made by those departments throughout the year.

<sup>3</sup> The adjustments to align to actual costs were based on either actual time recorded on timesheets, or time studies required by some federal and state grants.

## Lack of Support for Payroll Adjusting Journal Entries: Grant Revenue at Risk?

Entry of actual time each pay period to FUNDS might be accomplished by implementing a distributed time entry system. Individual employees would enter actual time spent on each project each pay period.<sup>4</sup> As an alternative, the City might consider establishment of a pool of qualified staff available to City departments for 1 to 1 ½ days per pay period.

We asked the Interim Director of Health Services if either of these alternatives would significantly reduce the number of payroll AJEs. She explained various reasons for payroll adjusting journal entries, and why entering actual time worked on each project would not significantly reduce their number. We agree that with most of these stated reasons, AJE's would still be needed. But without adequate supporting documentation, we could not reasonably assess whether entry of actual time on each project could significantly reduce the need for AJEs.

The City does not have a formal written policy on review and approval of journal entries.

The City does not have a current Administrative Regulation to address review and approval of AJEs or a description of what constitutes adequate support. Also, supporting documentation for AJEs was decentralized and appeared to be retained in the department that makes the adjustment (See Finding 1 below).

### III. BACKGROUND

The Department of Health Services provides a variety of health related services to Berkeley residents, such as family planning, immunizations, tuberculosis skin testing, HIV testing and counseling, psychological assessment and counseling, crisis counseling, restaurant inspection, and vector control.

DHS operates clinics for Public Health and Mental Health services, a Family, Youth, and Children's Services facility, and a Berkeley High School Health Center.

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<sup>4</sup> The City's Information Technology Master Plan for Fiscal Years 2009-2011 includes a project for implementing distributed time entry. The Plan refers to distributed time entry as "electronic timecard software."

A major reason for AJEs is to align budget based time charges to actual time.

DHS has a variety of funding sources, including Medi-Cal (the state's Medicaid program), state realignment revenue,<sup>5</sup> the Mental Health Services Act, and federal, state, and county grants.

According to the Interim Director of Health Services, DHS makes payroll adjusting journal entries for various reasons, including:

- Staff time is charged to budget based default labor distribution codes, and may have to be adjusted to actual time.
- Program budgets are established months before external grant funders determine the amount of funding the City will receive, and adjustments might be necessary to realign costs with available funding.
- When staff are reassigned during the year, there is often a time lag of up to two pay periods before default labor distribution codes reflect the new assignment. Adjustments are needed to correct personnel costs incurred during the delay period. (Conclusion)
- DHS might need to retroactively reassign staff time due to mid-year increases or decreases in external grant funding.
- Errors in timecards, data entry, or default labor distribution codes.

#### IV. FINDINGS AND RECOMMENDATIONS

##### Finding 1: Provide Guidance for Adjusting Journal Entries

Formal written procedures help to ensure consistent practice throughout the organization.

The City did not have formal written policies and procedures covering preparation and review of journal entries. Also, there was no guidance as to what constitutes adequate support, nor directive as where to file an AJE and its accompanying support. AJE filing was decentralized.

It is considered a desirable accounting practice for support to be attached to all journal entries, and for support to be filed centrally. The lack of a central location for journal entry support increases the risk that support could be misplaced. The City's external auditors agreed that Finance should be the custodian for journal entry support.

<sup>5</sup> "Realignment" refers to funding provided by the Bronzan-McCorquodale Act, which redirects a portion of sales tax and vehicle license fees to fund community health services.

Lack of Support for Payroll Adjusting Journal Entries: Grant Revenue at Risk?

Finance is drafting an Administrative Regulation on journal entries as a result of a recommendation by the City's outside auditors. However, the outside auditor's recommendation was limited to review and approval of journal entries.

Centralized filing makes it easier to retrieve support should questions arise, or to assess AJE propriety.

**City Manager's Response to Finding**

*Agrees.*

**Recommendation for Finance**

- 1.1 Include in the new Administrative Regulation on journal entries a requirement to support each entry. Provide guidance on documentation to include with an AJE to support its necessity, and the amount(s). The supporting documentation should be sufficient to enable an auditor or other qualified reviewer to reasonably determine that the entry was necessary, and the amounts accurate.

**City Manager's Response**

*Finance agrees with the recommendation. The new administrative regulation will be issued by the end of January 2011, and will provide clear guidance on documentation to be included with AJEs.*

**Finding 2: Attach Sufficient Support to Journal Entries Sent to Accounting**

In their Single Audit Report for the fiscal year ended June 30, 2009, the City's outside auditors reported that journal entries sent to Accounting did not always have supporting documents attached. We also observed that not all AJEs that DHS submitted had supporting documents. Instead, DHS retained supporting documents.

DHS did not adequately support payroll AJEs. None of the five FY 2009 payroll AJEs we tested had sufficient documentation attached to

## Lack of Support for Payroll Adjusting Journal Entries: Grant Revenue at Risk?

explain the reason for and necessity of the AJEs, or how amount(s) were derived. We were dependent on the management analyst that prepared the five AJEs to explain the reasons. If this individual had no longer been employed by the City, it is likely that the explanation would have been unknown.

An AJE should stand on its own, with adequate support.

Sound accounting practice requires that adjusting entries have enough support to enable a qualified reviewer to reasonably verify that the adjustment was necessary, and that the amount(s) were accurate. Such documentation should be attached to an AJE.

DHS made over 300 AJEs to grant funds in FY 2009.<sup>6</sup> We do not know if the City would be required to refund grant revenue should a federal or state audit find that adjustments to grant funds are not supported.<sup>7</sup> But we are concerned about the possibility that the City could lose future funding or be required to return funds should a federal or state audit find a pervasive lack of support.

DHS staff told us that starting sometime in fiscal year 2010, the department began to attach supporting documents to the AJEs sent to Accounting.<sup>8</sup>

### **City Manager's Response to Finding** *Agrees.*

#### **Recommendation for DHS**

2.1 Immediately begin to include additional supporting documentation with adjusting journal entries. This documentation should be in sufficient detail that an auditor or other qualified reviewer can reasonably determine that the entry was necessary, and the amounts accurate.

#### **City Manager's Response**

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<sup>6</sup> This number included 281 adjustments to grant funds in accounting periods 12 and 13 (year-end), or 94% of Citywide adjustments to grant funds during those accounting periods. DHS had 29% of Citywide grant funding at December 31, 2009.

<sup>7</sup> DHS stated that it makes payroll AJEs to bring personnel costs into compliance with funding agency requirements, which reduces the risk that the City will have to refund grant revenues.

<sup>8</sup> They were not sure of the exact month they started attaching support, but it was not at the beginning of the fiscal year.

## Lack of Support for Payroll Adjusting Journal Entries: Grant Revenue at Risk?

*DHS agrees and in 2010 began attaching more documentation to AJEs that the Department submits to Accounting. DHS is working with Accounting to determine what constitutes sufficient documentation. This recommendation is partially implemented.*

### **Recommendation for Finance**

- 2.2 Require Accounting to periodically test a judgmental sample of support submitted with journal entries to determine if it is adequate.

### **City Manager's Response**

*Finance agrees with the recommendation and began testing AJE support in August 2010.*

## **V. FISCAL IMPACT**

In the first six months of fiscal year 2009, DHS expended almost \$8 million on federal, state, and county funded health programs,<sup>9</sup> which is equivalent to almost \$16 million annually. If just one percent of this amount was disallowed due to lack of support, it would cost the City almost \$160,000. Over a five-year period the loss could accumulate to almost \$800,000.

DHS uses AJEs as a tool to manage grant funds. DHS stated that it makes payroll AJEs to bring personnel costs into compliance with funding agency requirements, which reduces the risk that the City will have to refund grant revenues. However, a finding of pervasive lack of support for adjusting journal entries could place future grant funding at risk. Given the current scenario of declining grant funding, it is likely that funding agencies will consider weaknesses in internal accounting controls when deciding future awards.

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<sup>9</sup> Source: Grant report prepared by Accounting. This amount was 49 percent of the City's total grant expenditures for the period.

## APPENDIX A

### SCOPE AND METHODOLOGY

Our audit was limited to: 1) FY 2009 payroll adjusting journal entries that DHS entered to FUND\$, and 2) current DHS procedures for preparing and entering payroll AJEs, and conducting time studies.<sup>10</sup> We focused on DHS because it made 94% of Citywide year-end payroll adjustments to grant funds in FY 2009.<sup>11</sup> We perceive adjustments to grant funds as greater risk because they might be scrutinized by a federal or state audit. We attempted to accomplish our audit objectives by:

- Interviewing DHS management and staff.
- Inspecting documents related to journal entries and time study procedures.
- Testing a sample of FY 2009 DHS payroll AJEs to determine if they were necessary, supported, and could have been avoided had DHS staff entered the exact time worked on each project every pay period.
- Review of audit reports issued by the City's outside auditors to identify issues that might impact our survey objectives.

We did not assess the reliability of the data in computer-based systems, nor did we perform detailed tests of internal controls. DHS did not provide support sufficient to enable us to reasonably determine the necessity of adjustments and whether they could have been avoided by entry of actual time spent on each project each pay period (See above). This report was drafted upon completion of the survey phase of the audit.

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<sup>10</sup> We reviewed time study procedures because time studies were represented as the basis for a significant portion of DHS payroll AJEs.

<sup>11</sup> As of December 31 2009, DHS had 29 percent of Citywide grant funding (Source: grant reports prepared by Accounting. Percent based on amounts awarded under grants that were active at that date). We originally planned to focus on year-end adjustments. Our scope covered all DHS payroll adjustments made in fiscal year 2009 because DHS emphasized that it makes payroll adjustments throughout the year and the procedure is no different for year-end adjustments.

## Lack of Support for Payroll Adjusting Journal Entries: Grant Revenue at Risk?

Fieldwork was conducted from January 25, 2010 through May 27, 2010, and was limited to those areas specified above. We conducted this audit in accordance with *Generally Accepted Government Auditing Standards (GAGAS)*. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our conclusions based on our objectives.

This performance audit was initiated by the Auditor's Office and scheduled as part of the fiscal year 2010 Audit Plan, which was presented to Council on June 23, 2009.