Internal Audit Report

Limited Operational Audit

Port of Seattle Corporate Cost Allocations

January 1, 2011 – December 31, 2011

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Table of Contents

Transmittal Letter

Audit Committee
Port of Seattle
Seattle, Washington

We have completed a limited operational audit of the Corporate cost allocations.

We examined information related to a twelve-month period from January 1, 2011 through December 31, 2011.

We conducted this performance audit in accordance with generally accepted government auditing standards. 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 findings and conclusions based on our audit objectives.

We extend our appreciation to the management and staff of the Finance and Budget department for their assistance and cooperation during the audit.

Kirangi

Joyce Kirangi, CPA
Director, Internal Audit

Executive Summary

Audit Scope and Objective We examined the Port Corporate Cost allocations for a twelve-month period from January 1, 2011 to December 31, 2011. We also evaluated the 2012 budget allocations.

The purpose of the audit was to determine whether:

1. The Port Corporate costs are allocated to the operating divisions based on a reasonable and cost effective basis.

   Specifically, we determined whether:

   - The current default allocation formula is reasonable.
   - The selection of the default formula by corporate departments is reasonable and in accordance with the Operating Cost Allocation Policy.
   - The special allocation formula by corporate departments is reasonable, supportable, and in accordance with the Operating Cost Allocation Policy.
   - Direct Charges by corporate departments are in accordance with the Direct Charge Policy.

Background The Port of Seattle is organized into five divisions/groups; three are operating divisions that generate revenues and two provide support services to the three operating divisions.

The Port has implemented policies for costs allocation. Per the Operating Cost Allocation Policy, the Port distributes the costs of the two service support groups (Corporate and Capital Development) to the three operating divisions (Aviation, Seaport, and Real Estate). This is done in order to properly reflect the full costs associated with the operating divisions and to match revenues with the related expenses. For the 2011 budget, the total Corporate expenses allocated to the operating divisions were budgeted at $73.3 million.

Corporate costs are allocated to the operating divisions through any combination of the following Port approved methodologies:

1. Direct charges
   Per the Port Direct Charge Policy, support service groups/departments direct charge their costs to the operating divisions if the cost of the service can be accurately and effectively tracked and the service clearly benefits a particular operating division. Direct charges may include salaries, employee benefits, and other costs directly attributable to performing the services. The direct charge is the most accurate way to assign costs and as such, the Policy encourages its usage.

2. Special allocations
   Costs that are not direct charged are allocated to the operating divisions in accordance with a special allocation formula or a standard/default allocation. Special allocations are encouraged when there is a clear cause and effect relationship to the operating divisions. Corporate support service groups work closely with the operating divisions to evaluate and determine whether it's practical to use a special allocation formula.

3. Default allocations
   When a corporate support service group provides services that are not specifically attributable to a particular operating division, the operating costs are allocated to the operating divisions using a default allocation formula. The current default cost allocation formula is 64% to the Aviation Division, 27% to the Seaport Division, and 9% to the Real Estate Division.

Audit Result Summary The Port Corporate costs are allocated to the operating divisions based on a reasonable and cost effective basis.

Background

The Port of Seattle is organized into five divisions/groups as follows: Three are operating divisions that generate revenue and two provide support services to the operating divisions.

Support Services Group	Operating Division
• Corporate	• Aviation
• Capital Development Division	• Seaport
	• Real Estate

Business groups within the operating divisions generate revenues whereas the service support groups within Corporate support revenue-generating activities.

The service support costs are allocated to the operating divisions to appropriately reflect full costs associated with generating operating revenues. Support services by Corporate and Capital Development Division are necessary in revenue-generating activities. Thus, a true cost of operating revenue should include service support costs.

The Port distributes all of the net operating costs of the service support groups in accordance with the Cost Allocation Policy through any combination of the following allocation methodologies:

1. Direct charges (14% of 2011 budget)

   Per the Port Direct Charge Policy, support service groups/departments direct charge their costs to the operating divisions if the cost of the service can be accurately and effectively tracked and the service clearly benefits a particular operating division. Direct charges may include employee salaries, benefits, vendor invoice, and other costs directly attributable to performing services for a business unit in the operating division. The direct charge is the most accurate way to assign costs and as such, the Policy encourages its usage.

2. Special allocation (54% of 2011 budget)

   Costs that are not direct charged are allocated to the operating divisions in accordance with a special allocation formula or a standard/default allocation. Special allocations are encouraged when there is a clear cause and effect relationship to the operating divisions. Corporate support service groups work closely with the operating divisions to evaluate and determine whether it's practical to use a special allocation formula.

   An example is the personal computer support costs which are allocated based on the number of PCs per business unit.

3. Default allocation (32% of 2011 budget)

   The operating costs of the service support groups are allocated using a default allocation formula under the following conditions:

   - The services are not specifically attributable to a particular operating division.
   - There are cost relationships, but the administration cost of allocation exceeds benefits.

The most recent budget guideline states that the default formula is based on the number of FTEs and direct operating & maintenance expenses. In accordance with the guideline, the 2011 calculated default formula is as follows:

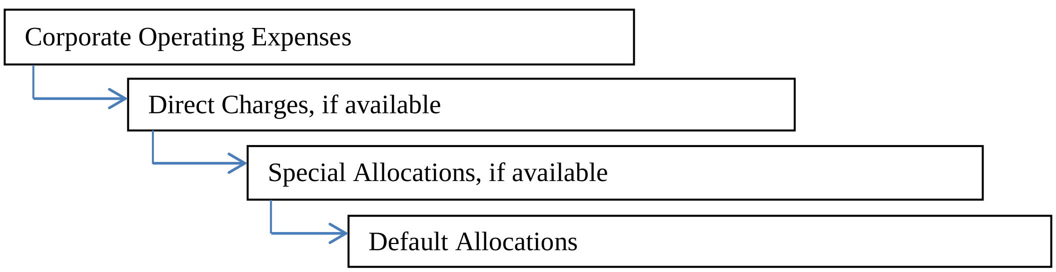
	Aviation	Seaport	Real Estate
Based on FTE	77%	6%	17%
Based on Operating Exp.	71%	12%	17%

However, the default formula in use for 2011 was different than the calculated ratios. Specifically, 2011 ratios were 64%, 27%, and 9% to the Aviation, Seaport and Real Estate Division, respectively. The difference is due to the budget guideline requiring a cap on the default formula at 64% Aviation, 27% Seaport, and 9% Real Estate if the ratio to Aviation is greater than 65%.

A cap has been imposed since 2003, and the current cap has been in place since 2008.

Cost allocations and direct charges are budgeted annually as part of the budget process. Service unit allocations are approved by the Finance & Budget in each operating division.

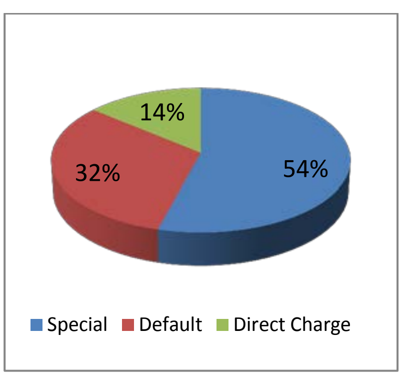
The following describes the sequential application of the existing cost allocations methodologies:



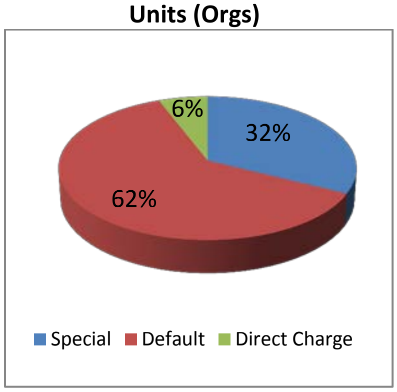
Financial Highlights

Total Corporate operating expenses were allocated as indicated in the charts below.

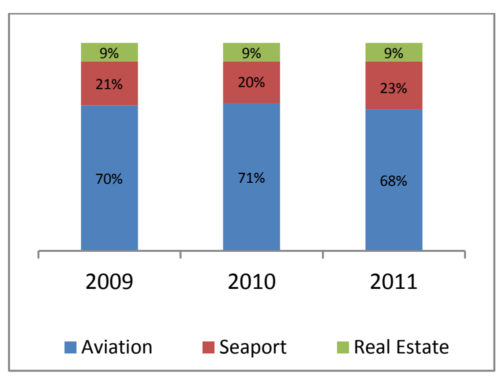
2011 Budget $73.3 Allocation & Direct Charges



2011 Budget – Primary Allocation Method Used by Organization Units (Orgs)



Actual Allocations to Operating Divisions



Source: Budget vs. Actual Comparison, F&B

Highlights and Accomplishments

During the course of the audit, we observed the following effective and efficient management practices:

- The Operating Division finance staff review and approve during the budget season the allocation methodology of each service organization unit to ensure complete and reasonable cost assignments.

- The majority of the cost allocation process is automated (via PeopleSoft) thereby minimizing processing errors.

Audit Scope and Methodology

We reviewed information for the twelve-month period from January 1, 2011 to December 31, 2011, which included the 2012 budget. We utilized a risk-based audit approach from planning to testing. We gathered information through research, interviews, observations and analytical reviews, in order to obtain a complete understanding of the allocation process. We identified and tested management controls to determine the areas of audit focus with the highest likelihood of significant negative impact. We applied additional detailed audit procedures as follows:

1. To determine if the default allocation formula is reasonable and current:
    - We reviewed the Operating Cost Allocation Policy, the Direct Charge policy, the Allocation formula, and budget guidelines.
    - We analyzed FTEs and operating expenses budgeted for 2011 and 2012, and recalculated the formula based on those factors.
    - We discussed at length with management in the various budget groups the assumptions related to the default allocation formula and the historical context.
    - We calculated the impact of imposing a cap on the allocation formula.

2. To determine if the selections of default formula was reasonable and in accordance with the Operating Cost Allocation Policy, we selected and tested a judgmental sample of 6 Corporate departments which represented 53% of 2011 budgeted expenses through the default formula:
    - We reviewed the department budgets and activities.
    - We reviewed the allocation forms for consistency and proper approval by the operation divisions.
    - We analyzed actual allocations for 2011.
    - We discussed with management the rationale for the default selection, and any alternatives, and assessed the reasonableness of the default selection.

3. To determine if the selection of a special allocation formula was reasonable, supportable and in accordance with the Operating Cost Allocation Policy, we selected and tested a judgmental sample of 6 Corporate departments which represented 94% of 2011 budgeted expenses through the special allocation:
    - We reviewed their department budgets and activities.
    - We reviewed their allocation forms for consistency, approval, and the supporting documentation.

- We analyzed actual allocations for 2011.
- We discussed with management the rationale for the special allocation.

4. To determine if the direct charges by Corporate departments were in accordance with the Direct Charge Policy, we selected a judgmental sample of 6 Corporate departments that represented 88% of actual direct charges:
   - We reviewed their department budgets and activities
   - We reviewed their allocation forms for consistency and approval
   - We analyzed actual allocations for 2011
   - We tested a sample of vouchers of $3.1 million, 78% of the vendor payments in 2011 by these departments, to determine if the underlying information supports and is directly linked to the business group being charged.

Conclusion

The Port Corporate costs are allocated to the operating divisions based on a reasonable and cost effective basis.