TO: Chair and Members
Audit and Administration Committee

WARD(S) AFFECTED: CITY WIDE

COMMITTEE DATE: May 19, 2010

SUBJECT/REPORT NO:
Follow Up of Audit Report 2008-07 - Capital Planning and Budgeting - CPI Division (AUD10015) (City Wide)

SUBMITTED BY:
Ann Pekaruk
Director, Audit Services
City Manager’s Office

PREPARED BY:
Ann Pekaruk 905-546-2424 x4469

SIGNATURE:

RECOMMENDATION

That Report AUD10015 respecting the follow up of Audit Report 2008-07, Capital Planning and Budgeting – CPI Division, be received.

EXECUTIVE SUMMARY

Audit Report 2008-07, Capital Planning and Budgeting – CPI Division, was originally issued in April, 2009 and management action plans with implementation timelines were included in the Report. In March, 2010, Internal Audit conducted a follow up exercise to determine that appropriate and timely actions had been taken. Regarding the implementation of the fourteen (14) recommendations made in the original Report, eight (8) have been completed, one (1) has been initiated (without significant progress), two (2) are in progress and one (1) has not been implemented. In two (2) cases, an alternative has been put in place.

Alternatives for Consideration – Not Applicable
Vision: To be the best place in Canada to raise a child, promote innovation, engage citizens and provide diverse economic opportunities.
Values: Honesty, Accountability, Innovation, Leadership, Respect, Excellence, Teamwork

FINANCIAL / STAFFING / LEGAL IMPLICATIONS (for Recommendation(s) only)

Financial: None.
Staffing: None.
Legal: None.

HISTORICAL BACKGROUND (Chronology of events)

Audit Report 2008-07, Capital Planning and Budgeting – CPI Division, was originally issued in April, 2009. The report indicated fourteen (14) recommendations identifying areas for improvement with respect to financial and administrative controls as well as operational effectiveness.

It is normal practice for Internal Audit to conduct follow up reviews within a 12-18 month period following issuance of the original report in order to determine whether action plans committed to by department management have been implemented.

POLICY IMPLICATIONS

Corporate Capital Policies
City of Hamilton Reserve Policies

RELEVANT CONSULTATION

The results of the follow up were provided to management and staff responsible for capital planning and budgeting in the CPI Division of Public Works and in Corporate Services.

ANALYSIS / RATIONALE FOR RECOMMENDATION

.include Performance Measurement/Benchmarking Data, if applicable

The report attached as Appendix “A” to Report AUD10015 contains the first three columns as originally reported in Audit Report 2008-07, along with an added fourth column indicating Internal Audit’s follow up comments.

Eight recommendations have been implemented. They include: a documented and systematic methodology for allocating incurred CPI operating costs; management review and approval of the cost allocation worksheets; the development of a policy respecting the management of annual capital projects; the creation of a Work in Progress (WIP) Committee to regularly review the status of the Capital WIP Program and investigate funding sources; formalization of the capital project prioritization practices to ensure rationale and justification for including projects; and a review of reserve policies limiting spending from the Development Charge Reserve.
The allocation of budget funds on multi-year capital projects to match expected cash outflows (i.e. cash flow budget process) has been initiated for a few water/wastewater projects in 2010.

Implementation of recommendations concerning the development of a Public Works capital budget procedures manual and the investigation of alternative means of obtaining funding to support sustainable asset management practices while maintaining a suitable credit rating are in progress.

Alternatives were implemented for two (2) of the recommendations. Budget co-ordination meetings are held monthly to review budget submissions and related costs of projects to maximize the co-ordination efforts for moving projects forward. Instead of pre-determining a spending threshold to be reached on multi-year capital projects before further allocations are made, staff review prior years’ spending on individual projects and recommend budget adjustments.

The only recommendation not completed is the review and harmonization of the capital policies related to amounts transferred from the operating surplus to the Unallocated Capital Reserve. Implementation is expected by the end of 2010.

**ALTERNATIVES FOR CONSIDERATION**

(include Financial, Staffing, Legal and Policy Implications and pros and cons for each alternative)

Not applicable.

**CORPORATE STRATEGIC PLAN** (Linkage to Desired End Results)


**Financial Sustainability**

- Delivery of municipal services and management of capital assets/liabilities in a sustainable, innovative and cost effective manner
- Address infrastructure deficiencies and unfunded liabilities

**Healthy Community**

- Plan and manage the built environment

**APPENDICES / SCHEDULES**

Appendix “A” to Report AUD10015.

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<th>FOLLOW UP (March 2010)</th>
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<tr>
<td>1.</td>
<td>Recovery of CPI Costs</td>
<td>That a comprehensive and systematic methodology to support the allocation of incurred CPI costs to individual projects be developed and documented.</td>
<td>PW: Agreed. A comprehensive and systematic methodology to support the allocations of CPI costs to capital projects will be developed and documented. The methodology will include the allocation of direct and indirect project costs. The policy will be developed for the 2009 capital projects and will be completed by May 2009.</td>
<td>Completed. A methodology and procedures for allocating CPI costs to individual capital projects have been developed and documented. The allocation of CPI operating costs to various divisions is based on an estimate of the time that CPI staff spend in each division. The total allocated costs are then assigned to projects within each division in the proportion of each capital project’s budget to the total capital budget of the division. CPI costs for 2009 were allocated to capital projects using this methodology.</td>
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<td></td>
<td>The Capital Planning and Implementation (CPI) division recovers all administrative, staff and operating costs from capital projects in water, wastewater, roads and storm sewers. In 2007, a total of $11.5 million of CPI’s operating costs were charged to capital projects. There is no consistent basis for the allocation of CPI operating costs. For example, it would be expected that the costs would be allocated based on the staff time actually spent on the project or the proportion of the project’s budget to the CPI division’s budget. Instead, a staff member uses his/her discretion to arbitrarily apportion costs to projects in a manner that seeks to ensure that project expenditures do not exceed budget by allocating to projects where there is “room” to absorb the costs. In some cases, the cost allocation journal is used to credit capital projects with CPI costs in order to bring project costs down to be within the budget, even if no CPI costs had previously been charged (i.e. debited) to that project. There is no evidence that the schedule that apportions CPI costs to capital projects is reviewed and approved by a senior official before being processed.</td>
<td>That cost allocation worksheets be reviewed and approved by a senior official within CPI before being processed.</td>
<td>PW: Agreed. Presently, the cost allocations to capital are reviewed by management. However, there is not a formal sign off of the allocation that is submitted for the journal entries to be completed. A procedure will be implemented for CPI management to sign off the cost allocation worksheet. This will be implemented immediately.</td>
<td>Completed. The cost allocation worksheet has been modified to indicate that it must be reviewed and signed off by senior officials before the posting of amounts to the general ledger. In the sampled documents, only one isolated instance of approval after the posting into the general ledger was noted.</td>
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<td>2.</td>
<td>Development of a Policy on Annual Projects</td>
<td>That the development of a policy respecting the management of annual capital projects be completed and implemented.</td>
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<td>CPI and other Public Works divisions budget a significant amount of funds for annual capital projects. Annual projects are recurring capital projects that get a lump sum budget allocation on a continuous basis because the work to be performed is of a recurring nature and/or the cost and frequency cannot be anticipated with certainty (e.g. annual minor road repairs). Some annual projects relate to strategic projects whose work is to be phased over several years (annual sidewalk program). Presently, there is no formal policy that provides guidance as to how annual projects are to be managed, especially in the following areas:</td>
<td>CS: Disagreed. It is important to ensure that any policy adopted is not overly restrictive and allows sufficient flexibility to deal with in year funding requests. However, to ensure best practices, by the summer of 2009, staff in the Budgets and Finance division will review current practices and consider input from other municipalities.</td>
<td>PW: Disagreed. The three (3) year rule (which states that a project cannot stay open for more than three (3) years) is applied to the annual capital projects so there is no need for the development of a special policy specific to annual capital projects.</td>
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<td>1. The minimum level of expenditure to have been reached in the preceding year(s)’ budget(s) before additional funds are approved for the ensuing year.</td>
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<td>2. Staff first demonstrating that clear, specific work plans related to the proposed annual project have been determined for the coming year before budget funds are approved.</td>
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<td>Without a clear policy on annual projects, there is a risk that limited capital budget funds could be tied up in annual projects whose budgets may remain unspent for several years. A policy would also allow for accountability for funding requested.</td>
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<td>Staff in Budgets and Finance are currently seeking input from user departments that will be used in the development of a policy for annual projects.</td>
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<td>Completed. Upon Council’s request, management developed a policy that provides guidance on how annual projects are to be managed. This policy addresses the two areas specified in the observation, namely:</td>
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<td>1. That the current year’s capital project submission for recurring annual projects will be deferred if the “percentage completion” is less than 50%; and,</td>
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<td>2. That the Recurring Annual Capital Project include a breakdown of associated works within the capital detail sheet when submitting the project for approval.</td>
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<td>This policy was approved by Council on December 4, 2009.</td>
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### OBSERVATION OF EXISTING SYSTEM

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<td>3.</td>
<td>A significant amount of co-operation between budget staff in Corporate Services and staff in the CPI division is required in order to develop the capital budget. During the audit, it was noted that some expenditures contained in Council reports (Capital Project Closing Lists and Capital Budget Status Reports) differed with amounts recorded in the PeopleSoft financial system. In some cases, projects were submitted to Council for closure before outstanding orders had been cleared from commitments, resulting in Council approving reserve and debenture transfers that were inaccurate. Communication between the Budgets and Finance and CPI groups could be improved in order to enhance the accuracy and reliability of reports provided to Council.</td>
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At senior management level, continuous consultation and liaison between the two divisions will contribute to a better appreciation of constraints faced by both Corporate Services and Public Works regarding funding for the City’s aging infrastructure and may lead to solutions that comprehensively address the City’s increasing funding deficit.

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<td>3.</td>
<td>That staff within the CPI division review Capital Project Closing Lists and Capital Budget Status Reports for accuracy and timeliness of financial data prior to submitting them to the Budgets and Finance division of Corporate Services.</td>
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That senior management from both the CPI division and Corporate Services regularly meet to seek sustainable funding strategies to the City’s growing capital funding deficit. (Also see recommendation #4.) The implementation of such a process may also include other departments (divisions) which are also significant stakeholders in addressing the capital funding deficit (i.e. Community Services - Recreation). |  |

That senior management from both the CPI division and Corporate Services will begin for the following years’ budget process. This will commence for the 2009 Capital Budget starting in May or June with the lead department being Corporate Services. |

PW & CS: Agreed. Monthly meetings of the relevant departments will begin for the following years’ budget process. |

PW: Agreed. However, the differences are usually small. Starting in 2009, Finance will not close any project if expenditures differ from what was submitted to Council in Closing Reports. If any expenditure discrepancies are noted following project closure, they will be re-submitted to Council in the next round of reports. |

Completed. The Capital Projects Closing Lists and Capital Budget Status Reports are reviewed by CPI staff as to the accuracy and timeliness of the financial data. Occasionally, differences due to timing arise between the submitted reports and the PeopleSoft system. In such cases the projects are not closed until the additional expenditure or revenue noted in PeopleSoft is either transferred to the more current annual project or, for non annual projects, re-submitted to Council in the next round of approvals. |

Completed. Meetings between senior management from the CPI division and Corporate Services (Budgets and Finance) occur as needed during the capital budget process. A Work In Progress (WIP) Committee, comprised of staff from Budgets and representatives from major program areas, has been established to review the status of the Capital WIP Program and investigate methods to increase funding for new strategic priorities. Discussions with senior management from both the Public Works and Corporate Services departments indicate an awareness of the City’s issues with the capital funding deficit. |  |

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<td>Completed.</td>
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## OBSERVATION OF EXISTING SYSTEM

### Capital Budgeting Constraints

It was noted that the CPI division's capital planning and forecasting practices for Right-of-Way projects represent leading industry practice. The division prepares multi-year expenditure forecasts using a database of asset conditions and rehabilitation cycles as well as recommendations from reports prepared by external consultants (State of the Infrastructure Report).

Funds allocated to the capital budget, however, do not necessarily correlate to the growth and rehabilitation needs identified in the forecasts. In order to keep borrowing costs at affordable levels, the City, working with credit rating agencies, has determined that an AA credit rating optimally balances the City's borrowing costs with its capital funding requirements while maintaining the City's ability to repay debt. To that end, Council approved the setting of an internally determined borrowing limit of $360 million. As a result of this restriction, capital budget allocations have been driven less by the work needed to be done and have resulted in a capital funding deficit that is currently estimated to be over $100 million annually.

Given these funding limitations and the City's aging infrastructure, the funding deficit is likely to continue and asset maintenance costs will increase as asset conditions continue to deteriorate.

## RECOMMENDATION FOR STRENGTHENING SYSTEM

That the City's Senior Management Team (SMT) along with other relevant stakeholders continue to investigate alternative means of obtaining optimal funding levels that support sustainable asset management practices without adversely affecting the City's credit rating and its ability to service the debt. The results of such work should be communicated to Council.

## MANAGEMENT ACTION PLAN

**PW – Public Works; CS – Corporate Services**

**CS:** Agreed. The fiscal strategy to address the infrastructure deficit is reviewed annually with Council as part of the Capital Budget deliberations. The Capital Financial Plan is included in the Capital Budget along with the level of debt and reserves which will be dedicated to address the shortfall. Discussions are also held with the credit rating agencies annually since this is one of the major issues and concern.

The City's success in pursuing a number of different fiscal strategies and fund sources over the last number of years has helped in addressing the infrastructure deficit in the future without incurring debt (i.e. Federal Gas Tax Fund extended to 2010-2014). The City will continue to take advantage of government infrastructure funding initiatives as they come forth. It has established a staff committee to review the criteria and to submit applications for the new Building Canada Plan. The City has also participated in a study with the Province and other municipalities to develop and quantify, on a consistent basis, the level of municipal infrastructure shortfall in this province.

**PW:** Agreed. Department staff will assist SMT. This is a specific deliverable within the Corporate Strategic Plan.

## FOLLOW UP

(March 2010)

In Progress. The approved 2010 Tax Supported Capital Budget estimates projected annual infrastructure deficits of approximately $60 million in 2010 and beyond. There has been some movement in addressing the sustainability of municipal infrastructure, particularly in the road and recreation facilities categories.

As of December 2009, the Council approved internally determined borrowing limit is approximately $400 million, allowing the City to maintain its AA credit rating.
## Capital Planning and Budgeting – CPI Division
### Follow Up - March 2010

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<td>5.</td>
<td><strong>Project Prioritization</strong></td>
<td>That the cause of differences in project scores in the project Detail Sheets and Summary Sheets be investigated and rectified.</td>
<td>PW: Agreed. Staff in Public Works will consult the Information Technology division to investigate and rectify the cause of differences in project scores in time for the 2009 capital budget process.</td>
<td>Completed. The cause of the differences in the project scores in the TeamBudget system and the Detail Sheets was investigated and corrected. The correction occurred in time for the 2010 capital budget process.</td>
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Divisions in Public Works utilize the City’s corporate capital project ranking criteria to prioritize non Right-of-Way capital projects. Using the City’s four capital rating attributes and six strategic directions, each project is evaluated and assigned a project score. The assigned score is used to rank projects, produce a project summary sheet and allocate limited capital budget funds to short-listed projects. The reliability of this process is compromised by the following factors:

- **a)** The calculated project scores in the project Detail Sheets differ from the scores in the Summary Sheet that is produced from the TeamBudget system (formerly Capital Financing and Budgets (CFAB) system). While the calculation in the Detail Sheets could be verified, staff could not explain why scores on the summary sheet were significantly different.

- **b)** Notwithstanding the amount of time spent calculating a multitude of project scores as described above, projects do not appear to be prioritized and selected on the basis of the assigned scores. Staff discretion and other qualitative factors appear to be overriding considerations. As a result, projects with a much lower ranking are included in the capital budget while others with higher scores, in comparison, may be excluded. Staff do not always provide written justification for such decisions.

Such practices seem to indicate that the capital prioritization process is not formally recognized.

- **PW: Agreed.** Staff in Public Works will consult the Information Technology division to investigate and rectify the cause of differences in project scores in time for the 2009 capital budget process.

- **PW & CS: Agreed.** Capital project prioritization practices within each program be formalized through written procedures. Rationale and justification for including a project in the capital budget should be documented in the project detail sheets.

- **Completed.** The cause of the differences in the project scores in the TeamBudget system and the Detail Sheets was investigated and corrected. The correction occurred in time for the 2010 capital budget process.

- **Completed.** Written procedures outlining the processes for the prioritization of capital projects within each major program (roads, bridges, water, sewer) have been developed. In addition, the project detail sheets provide a rationale for including a project in the capital budget.

- **Completed.** Written procedures outlining the processes for the prioritization of capital projects within each major program (roads, bridges, water, sewer) have been developed. In addition, the project detail sheets provide a rationale for including a project in the capital budget.
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| 6 | Written Capital Budget Procedures | - The CPI division does not have written procedures that provide guidance on the division’s capital planning and budgeting process. While staff within CPI and other Public Works divisions appear to have a good understanding of their roles, such knowledge could be lost if business processes are not formally documented. A procedure manual that provides a detailed outline of the following key processes would be a useful reference point that ensures that processes are consistent across Public Works’ divisions:  
  a) Criteria for selecting and prioritizing projects for each division of Public Works;  
  b) Maintenance of the capital asset database for right-of-way assets and the basis for selecting such assets for inclusion in the budget;  
  c) Methodology for determining capital project cost estimates including the calculation of the operating cost impact (source of data, review of estimates and approval procedures);  
  d) Internal deadlines for the submission of budget proposals (to ensure corporate deadlines are met);  
  e) Budget approval process at divisional and departmental levels;  
  f) Process for monitoring and reporting project expenditures;  
  g) Process for project closures, including authorization for closure and documentation to be submitted to Budgets and Finance; and  
  h) Re-evaluation of projects approved in previous years and the treatment of inactive projects.  

The department may wish to consider the corporate procedures that are available for customizing according to the departmental needs and requirements. | That a comprehensive procedures manual that provides guidance on the process for developing and managing capital projects within Public Works be developed and distributed to all appropriate staff. | PW: Agreed. Even though CPI staff and other Public Works divisions appear to have a good understanding and knowledge of the capital budget process, a formal procedure manual addressing all aspects of the capital budget will be prepared to assist existing/new staff involved with the capital budget. These procedures will be developed for the 2009 Capital Budget and completed by May 2009. | In Progress. The first draft of a PW Capital Budget Procedures manual has been prepared. It is organized in order of the processes noted in the observation. This draft provides a useful background to the entire capital budget process. A final procedures manual is expected to be in place by the end of 2010. |
7. Multi-Year Projects

The allocation of budget funds to multi-year capital projects is not always timed to match with the project's expenditures. As such, approved projects that remain inactive for several years tie up limited funds that could be utilized to complete other pressing capital projects left without funding. The following examples illustrate some budgeting practices that need to be investigated and improved upon:

a) Projects whose construction is expected to be undertaken over several years receive a budget allocation of the full project cost in the first year. For example, the full cost for a project approved for inclusion in the 2003 budget. Only 16% of the project’s budget had been spent more than 5 years after the project’s approval and funds allocation.

b) Some projects appear to have been submitted for approval before necessary consultative and planning work had been concluded. A $660,000 project for railway crossing improvements approved in 2003 is less than 2% complete. The five year delay is due to negotiations still underway between a private partner and the Federal government. In another example, the construction of a park approved in 2005 has continued to receive budget allocations that have accumulated to $1 million in four years. Only 2.2% ($22,000) has been spent over a four year period. The delay has been due to ongoing land purchase negotiations.

c) Large multi-year projects continue to receive additional budget allocations when funds allocated in the first year are less than 25% spent. Since 2005, one project has continued to receive budget allocations that have accumulated to $4.4 million. To date, a total of $192,000 (or 4%) of the project’s budget has been spent.

The elimination or significant reduction of the City’s $100 million annual capital funding deficit may not be realized if budget allocations are not timed to coincide with the projects’ expenditures and funds have been pre-allocated to projects with little or no progress, year to year.

That budget funds allocated to multi-year capital projects be matched with the projects’ expected cash outflows.

PW & CS: Agreed. Capital budget staff will meet with all program area capital project managers to re-enforce this recommendation by July 2009.

That prior to submitting capital projects for approval, staff ensure that consultative and planning work necessary to carry out the project has been finalized.

PW & CS: Agreed. Capital budget staff will meet all Project Managers to highlight this recommendation by July 2009.

That management put in place a mechanism that ensures that a project does not continue to receive budget allocations before a pre-determined spending threshold has been reached on any previously allocated funding.

PW & CS: Agreed. Refer to response above for recommended action plan. However, there is a balancing act between initial multi-year project approvals and delaying the balance of these projects. One of the goals of good fiscal management is to smooth out capital requests so that the capital program across all areas is sustainable.

When sending out the 2010 capital budget instructions, staff from CPI included a reminder for Project Managers to consider these audit recommendations. Also, a Work In Progress (WIP) Committee was set up in November 2009 to review project expenditures and ensure that budget funds are not needlessly tied up in inactive projects.

Initiated. Project Managers have been encouraged to match budgets with the projects’ expected cash outflows. A few water/wastewater rate funded projects were cash flowed in an effort to manage the City’s financing capacity. However, there were still many instances in which staff budgeted for the full cost of multi-year projects in the first year. Until the City of Hamilton fully adopts a cash flow budget process, this recommendation cannot be completely implemented.

Alternative Implemented. Budget co-ordination meetings are held monthly to ensure budget submissions are reviewed, all costs are included and co-ordination efforts to move projects forward are maximized.

Alternative Implemented. A pre-determined spending threshold for multi-year projects has not been determined as per the recommendation made. However, for each budget year, CPI staff review prior years’ spending on individual projects and recommend budgeting adjustments (closing or re-allocation), as needed.
## OBSERVATION OF EXISTING SYSTEM

### Compliance with Capital and Reserve Policies

8. Council approved capital and reserve policies that provide guidance on how capital reserves are to be funded, maintained and utilized are not always complied with. In some cases, practices that have been developed over several years appear to have been adopted as policy.

Capital policies stipulate that annually the lesser of 50% of the yearly capital financing surplus or the overall operating surplus is to be transferred to the Unallocated Capital Levy Reserve. Over the years, the practice has been to transfer $2.5 million annually from the operating surplus to the Unallocated Capital Levy Reserve. This practice appears to have replaced the policy. In the past three years, this practice, while providing a steady and predictable inflow into the reserve, has however resulted in transfers to the Unallocated Capital Levy Reserve of $11 million less than would have been the case if the policy had been adhered to.

Reserve policies require that spending from the Development Charge Reserve for development related capital be limited to the reserve’s previous year ending balance. A review of spending from the reserve shows that since 2005 spending has progressively exceeded the preceding year's ending balance. In 2005 spending was 33% over the limit, in 2006 and 2007 spending was 92% and 149% over the limit respectively. As a result, the Development Charge Reserve balance has continued to decline from over $30 million in 2004 to just over $9 million at the end of 2007.

The City's ability to provide for future capital expenditure requirements could be adversely affected when capital and reserve policies are disregarded.

### Recommendation for Strengthening System

That capital policies be updated to incorporate the existing practice of transferring a set amount from the operating surplus to the Unallocated Capital Reserve.

That reserve policies limiting spending from the Development Charge Reserve be reviewed and updated, as necessary.

### Management Action Plan

**PW – Public Works**

- CS: Agreed. This policy will be reviewed and submitted to Council for approval. All discretionary transfers to reserves are subject to an overall corporate surplus. Had the total amount ($11 million) as noted in the observation been transferred to the capital reserves, the City would have experienced an overall deficit. Creating an overall corporate deficit because specific programs have surpluses is not a sound financial strategy. However, staff agree that the policy needs to be updated in order to address these issues.

- CS: Agreed. Development Reserve policies will be reviewed and updated for the tax-supported Development Charges By-law with an implementation to be completed by July 2009.

### Follow Up (March 2010)

- Not Completed. Capital policies have not been updated. However, in practice, when transferring funds to the Tax Capital Levy Reserve, Corporate Services has complied with the Reserve Policy which permits an unspecified portion of the year-end Capital Financing Surplus to be transferred to that reserve. Staff from Corporate Services have indicated that the two policies will be reviewed and harmonized by the end of 2010.

- Completed. Since the conclusion of the audit in 2008, staff have complied with the requirement of limiting capital spending to the prior year’s ending balance as per the Development Charge Reserve policy. At the end of 2008, the balance in the reserve had increased from $9 million in 2007 to $36 million even though spending slightly exceeded the prior year’s ending balance. At the end of 2009, the balance stood at $35 million with the year’s spending well below the prior year’s ending balance.