### CITY OF HAMILTON

**CITY MANAGER’S OFFICE**
**Audit Services**

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<td>Chair and Members</td>
<td>Ann Pekaruk</td>
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<tr>
<td>Audit and Administration Committee</td>
<td>Director, Audit Services</td>
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<tr>
<td>April 7, 2009</td>
<td>Ann Pekaruk</td>
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<td>905-546-2424 x4469</td>
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**SUBJECT:** Audit Report 2008-07 - Capital Planning and Budgeting - CPI Division (CM09005) (City Wide)

#### RECOMMENDATION:

(a) That Report CM09005 respecting Audit Report 2008-07, Capital Planning and Budgeting – CPI Division, be received; and

(b) That the management action plans as detailed in Appendix “A” of Report CM09005 be approved and the Acting General Managers of Public Works and Finance and Corporate Services direct the appropriate staff to have the plans under their responsibility implemented.

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Ann Pekaruk  
Director, Audit Services  
City Manager's Office

#### EXECUTIVE SUMMARY:

The 2008 Internal Audit work plan approved by Council included an audit of capital planning and budgeting in the Capital Planning and Implementation (CPI) Division of Public Works. The review evaluated the processes used to identify, prioritize, select and approve projects for inclusion in the capital budget as well as comparing the planned and actual results to determine the degree of accuracy and completeness in considering all pertinent information in the budgeting exercise.

The results of the audit are presented in a formal audit report containing observations, recommendations and management responses, all attached as Appendix “A” of Report CM09005.
BACKGROUND:
The Capital Planning and Implementation (CPI) Division of Public Works is responsible for planning, designing and budgeting for the department’s capital projects. The Division is directly responsible for identifying, prioritizing and designing capital projects for Roads and Water and Wastewater using data obtained from the City’s capital asset database, Hansen. As well, the CPI Division co-ordinates the capital budgeting process for all Public Works divisions (Waste, Transit, Fleet, Parks, Facilities and Forestry). All CPI operating expenses ($11.5 million in 2007) are recovered from capital projects.

Approximately $72 million in the 2008 Capital Budget relates to Public Works divisions as noted above.

The audit was completed in late 2008. The results of this audit are attached as Appendix “A” of Report CM09005.

The Audit and Administration Committee receives and approves final audit and review reports as part of its responsibilities for the oversight of governance and control.

ANALYSIS/RATIONALE:
There are many factors and processes involved in identifying, costing and prioritizing capital projects for inclusion in the City’s capital budget.

Capital budgeting policies and procedures for the City as well as any particular processes in the CPI Division were reviewed. Specific projects were also selected to evaluate the adequacy of documentation and other information in prioritizing and selecting the projects for inclusion in the Capital Budget. Actual costs were compared to the budget in a post closure assessment of the quality and accuracy of the cost estimations.

The audit identified areas for improvement. A formal audit report containing observations, recommendations and management action plans was issued and is attached as Appendix “A” to Report CM09005.

Among the several recommendations made are included:

- The development of a comprehensive and systematic methodology to support the allocation of incurred CPI operating costs to individual capital projects. The cost allocations also should be approved, in writing, by senior staff in the Division.
- The formalization of capital project prioritization practices within each program with documented written procedures.
- The updating of capital reserve polices which provide guidance on how capital reserves are to be funded, maintained and utilized. Some current practices do not follow the documented policies.
- The matching of funds allocated to multi-year projects with the projects’ expected cash outflows. As well, it should be ensured that a project does not continue to receive budget allocations before a pre-determined spending threshold has been reached on any previously allocated funding.
- The written documentation of the capital planning and budgeting process. Although there is a good base of knowledge and understanding amongst CPI and other divisions of Public Works (PW) about this subject manner, in order for consistency across all divisions of PW, a comprehensive procedures manual needs to be developed and distributed to all appropriate staff. Several key processes are recommended for documentation.
**ALTERNATIVES FOR CONSIDERATION:**
Not applicable.

**FINANCIAL/STAFFING/LEGAL IMPLICATIONS:**
**Financial**
The strengthening of controls for budget funds allocated to multi-year capital projects and recurring annual projects would result in more direct accountability for the dollars proposed and spent.

**Staffing**
None.

**Legal**
None.

**POLICIES AFFECTING PROPOSAL:**
Corporate Capital Policies
City of Hamilton Reserve Policies

**RELEVANT CONSULTATION:**
The attached report includes management action plans which reflect the responses of management and staff responsible for capital planning and budgeting in the CPI Division of Public Works and also in Corporate Services.

**CITY STRATEGIC COMMITMENT:**
By evaluating the “Triple Bottom Line”, (community, environment, economic implications) we can make choices that create value across all three bottom lines, moving us closer to our vision for a sustainable community, and Provincial interests.

- **Community Well-Being is enhanced.** ☑ Yes ☐ No
  Capital projects, for the benefit of the taxpayers of the City, are planned and delivered in a fair and co-ordinated manner.

- **Environmental Well-Being is enhanced.** ☑ Yes ☐ No
  Several planned capital projects have a positive impact on the environment.

- **Economic Well-Being is enhanced.** ☑ Yes ☐ No
  City Council’s strategic commitment to “Best Practices – Best Value” under “A City That Spends Wisely and Invests Strategically” is addressed through audits and reviews and their subsequent follow up to ensure controls are in place to protect the assets of the City and promote efficient, effective and economic services and programs.

- **Does the option you are recommending create value across all three bottom lines?**
  ☑ Yes ☐ No

- **Do the options you are recommending make Hamilton a City of choice for high performance public servants?**
  ☐ Yes ☑ No

ap:dt
Attachment – Appendix “A”
## CITY OF HAMILTON
INTERNAL AUDIT REPORT 2008-07
CAPITAL PLANNING AND BUDGETING – CPI DIVISION

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<td>1.</td>
<td><strong>Recovery of CPI Costs</strong></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>
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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.

That cost allocation worksheets be reviewed and approved by a senior official within CPI before being processed. | 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. |
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<td>2.</td>
<td><strong>Development of a Policy on Annual Projects</strong>&lt;br&gt;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:&lt;br&gt;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.&lt;br&gt;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.&lt;br&gt;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.&lt;br&gt;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>
<td>That the development of a policy respecting the management of annual capital projects be completed and implemented.</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.&lt;br&gt;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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### Interdepartmental Communication

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.

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>Interdepartmental Communication</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>
<td>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.</td>
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<td>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).</td>
<td>PW &amp; CS: Agreed. Monthly meetings of the relevant departments 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.</td>
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### OBSERVATION OF EXISTING SYSTEM

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<td>4.</td>
<td><strong>Capital Budgeting Constraints</strong>&lt;br&gt;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.</td>
<td>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.</td>
<td>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.</td>
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| 5. | **Project Prioritization** 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. | That the cause of differences in project scores recorded in the Detail Sheets and Summary Sheets be investigated and rectified. | 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 on a program-wide basis would formalize how sections rank projects within their own areas based on stakeholder inputs, condition assessments, master plans, etc. This process would be implemented prior to the next budget process. |
### OBSERVATION OF EXISTING SYSTEM

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.

### RECOMMENDATION FOR STRENGTHENING SYSTEM

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.

### MANAGEMENT ACTION PLAN

(PW – Public Works; CS – Corporate Services)

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.
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<td>7.</td>
<td>Multi Year Projects</td>
<td>Multi Year Projects</td>
<td>PW &amp; CS: Agreed. Capital budget staff will meet with all program area capital project managers to re-enforce this recommendation by July 2009.</td>
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<td>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:</td>
<td>That budget funds allocated to multi-year capital projects be matched with the projects’ expected cash outflows.</td>
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<td>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 was 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.</td>
<td>That prior to submitting capital projects for approval, staff ensure that consultative and planning work necessary to carry out the project has been finalized.</td>
<td>PW &amp; CS: Agreed. Capital budget staff will meet all Project Managers to highlight this recommendation by July 2009.</td>
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<td>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.</td>
<td>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.</td>
<td>PW &amp; 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.</td>
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<td>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.</td>
<td>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.</td>
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CAPITAL PLANNING AND BUDGETING – CPI DIVISION
DECEMBER 2008
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<td>8.</td>
<td>Compliance with Capital and Reserve Policies</td>
<td>That capital policies be updated to incorporate the existing practice of transferring a set amount from the operating surplus to the Unallocated Capital Reserve.</td>
<td>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 corporate deficit. Creating an overall corporate deficit because certain 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.</td>
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<td>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.</td>
<td>That reserve policies limiting spending from the Development Charge Reserve be reviewed and updated, as necessary.</td>
<td>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.</td>
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