Budgeting, Accounting, And Internal Control Processes

Budgeting and Internal Controls

Our analysis focused on use of the annual operating budget as a management tool to control the financial performance of the agency. We analyzed the development of the budget, trends in budget variances, and management and Board reaction to budget variances. We did not examine internal controls in an auditing sense, as these are addressed in the annual external audit. We did review audit letters and found no unresolved control issues.

We noted from interviews that, from a budget and financial management standpoint, control is materially vested in the Executive Director to manage the operations of the agency within the adopted budget. The adopted budget is interpreted by the Executive Director as the variance between total revenues available to operations, less operating expenses.

We found that the use of the MTA operating budget as a management and oversight tool can be enhanced significantly. Material account-level variances are the norm, and deficits are mitigated by unbudgeted capitalization of maintenance expenses. Although this practice does not violate Federal transit grant rules, it does draw money that might be used for approved capital projects. It also confuses true operating results and makes year over year trend analysis and budgeting problematic.

The capital budgeting process consists of three elements. The Transportation Improvement Program is approved by the Board. The Board then approves the program of projects and grant application for the annual capital grant. Frequent amendments to grants, however, tends to limit the usefulness of these documents as an expenditure control. Although capital expenses are controlled to authorized purposes, the capital budget does not receive a great deal of management attention. We did not observe a comprehensive capital plan, which incorporated a fleet replacement plan plus other capital assets. Our review of the Capital budgeting process was limited.

Our analysis of the operating budget is presented below. It addresses the budget development process, budget variances 1997–2000, monthly budget variances for FY2000, and variance analysis, and budget control and reporting practices.

Budget Development Process

The budget development process at the MTA is highly centralized. An account-level budget is developed by the Executive Director, after he considers requests from the departments. Following Board discussion

and approval (February through May, generally), the annual budget for each account is allocated to each month by the Director of Accounting. MTA has used various means to estimate the monthly budgets. In FY2000, the monthly budget was simply stated as one-twelfth of the annual total.

Trend in Variances, 1997–2000 – Exhibit 9-1 shows the actual and budgeted values, and variances, for each of the MTA fiscal years 1997–2000. The source for these values is the pre-audited "Statement of Operations Compared to Budget" as of year-end June 30, for each of the four years examined. These are the primary financial reports provided to the MTA Board. The presentation of information in our exhibit (9.1) has been reorganized from the actual report to Board in a number of ways listed below. None of the financial information, however, has been altered from the original reports.

- Variances are labelled as favorable or unfavorable, based on the condition of the item being reported (e.g., if actual revenues were less than budget, the variance is unfavorable);
- Capitalized maintenance costs are shown distinctly rather than presented as an offset to expenses
- Budgeted and unbudgeted use of capitalized maintenance is presented distinctly to highlight the use of unbudgeted allocations of capital funds to cover operating deficits.

The trend in budget variances indicates that the budgets adopted by the MTA Board are not an effective control on operating costs, considering these factors:

- Expense budgets adopted in 1997, 1998, and 1999 were not balanced to budgeted revenues, thereby building a cumulative deficit through FY2000.
- Revenue variances have been unfavorable every year.
- Expense variances were unfavorable every year.
- Operating deficits, prior to capitalization of maintenance expenses, ranged from $0.7 million to over $2 million. All vehicle maintenance expenses are an eligible use of Federal capital funds under TEA-21, the Federal funding program.
- Budgeted capitalization of maintenance expenses totaled $7.7 million for the period. This total corresponds to the capital funds requested for maintenance that are included in the regional Transportation Improvement Program adopted by the Metropolitan Planning Organization.
- Unbudgeted capitalization of maintenance expenses totaled approximately $5 million cumulatively. These are funds that have been reallocated away from capital funds.

Clearly, some of the budget variances are affected by events that render the original forecast inaccurate. Budgets are, after all, estimates. A good example is increased fringe benefit costs that explains a portion of the labor and fringe cost variance noted above. Taken as a whole, however, the consistency of the budget variances and the use of unbudgeted capitalized maintenance suggests the budget process needs enhancement.

Capitalization of maintenance expenses is a double-edged sword. It does help to reduce the local and state funding requirements. But it tends to lead to an understatement of the true ongoing financial needs of the operation, and it reduces the capital available for capital costs such as fleet replacement. In the case of the MTA, its use for bus repairs was viewed as a solution to overcome a major maintenance backlog. At the same time, the fleet age of the MTA increased and the number of over age buses increased.

The MTA makes the case that the lack of a committed local share of capital for fleet replacement made the use of the Federal monies for new buses a moot point, and made the use of the funds for operating purposes more advantageous. This is another reason why the MTA needs to develop a financial strategy for capital and operating costs.

Management Reporting, Variance Analysis and Budget Control

Regular financial reporting to management and the board showing actual performance versus expected "budgeted" results is a fundamental tool for the management and oversight of any enterprise. We examined the financial reporting to the Board and found the following weaknesses in the current presentation: (see Exhibit 9-2 for the actual February 28, 2000 report to the Board.)

- There is no indication of year to date line item variances (favorable or unfavorable) to the budget. Only the annual budget is shown. A board member would have to perform a somewhat complicated calculation to determine where the agency actually stands relative to the budget.
- Since the monthly budget is simply 1/12 of the annual budget, the calculation described above will only produce rough guidance.
- Monthly variances are not labeled favorable or unfavorable.
- Mid-year forecasts or "budget reestimates" are not captured on the monthly report to the board. Only the original budget is referenced. This means the Board has no way to track performance against the new, presumably more accurate, estimate of future activity.
- Other observations regarding the Board reporting are highlighted in the Recommendation section that follows the end of this section.

Variance analysis refers to a systematic review of budget variances to determine if budget modifications are necessary as the year progresses. This is a fundamental tool for managing budgeted costs to actual program activity. It also has policy implications - Board members should be apprised of activities that are consuming materially more or less resources than planned, so that surplus resources can be reallocated or other programs trimmed consistent with their policies.

Based on interviews with the MTA Executive Director, the Director of Accounting and other staff members, attendance at Board meetings and review of Board minutes, we did not observe a rigorous variance analysis process.

Revenue Collection Security

MTA fare media are generally of two types: cash and pre-paid fares. Cash fares are collected on MTA vehicles. These represent about 70% of fare revenue. On buses, cash fares are deposited in registering fareboxes. On paratransit vehicles, cash is deposited in secure, but non-registering, grey boxes.

The remaining 30% of revenues, for prepaid fare media, are collected at the Landport and Deaderick Street ticket booths, and at the MTA accounting offices at headquarters. Ticket booths sell directly to individual customers, while accounting handles sales to companies and organizations. Overall, about 95% of fare revenue is collected from bus passengers, and about 5% from paratransit passengers.

Cash Collected on Buses

Our review of revenue collection security focused on cash collected on buses. This security system has three components — collection of cash on board a bus and its transfer to a larger, secure vault; rotation of the large vaults between the bus servicing aisle and the money room, where it is counted; and transfer of the cash via secure transport to the bank where it is deposited. A cash count by electronic fareboxes aboard the buses is the basis for reconciling cash collections to the bank deposits.

The electronic registering fareboxes count cash (coins and bills) and store the totals in on-board memory. The cash drops into a secure vault within the farebox, separated into coin and bill bins. During the nightly servicing procedure for each bus, the farebox vault is removed from the bus and dumped into a large secure vault at the servicing aisle.

The farebox vault and the larger vault are designed such that the cash is not accessible during the transfer procedure. When the farebox vault is pulled and the contents dumped into the larger vault, the servicer extracts the contents of the on-board memory with an infrared probe. The data is transferred to a computer that maintains a database of revenue collected from each bus.

The fareboxes are pulled nightly, Monday through Friday. On the following morning, the large cash vault on the servicing aisle is towed into the money room, and an empty vault is brought to the servicing aisle. Each outgoing vault is locked and sealed, using a serialized seal that is crimped and recorded by staff from the accounting office. When an incoming vault is opened by a money room clerk, the money room supervisor verifies the serial number.

Cash is counted and bagged daily. The bags are sealed and recorded, then transported by armored truck to the bank. Bank deposits are reconciled against the registering farebox counts. Complications to the reconciliation process are introduced by two factors — lags between the farebox count and the day of the deposit, and bypassing of the electronic farebox system due to mechanical or electronic failure.

Lags in the counting-depositing process are due to the Monday-Friday operation of the money room. Cash collected on Saturday, Sunday, and Monday is counted on Tuesdays (Friday cash is counted on Monday, the normal lag of one business day). When the cash volume is very large, some of the Tuesday count may not be counted and deposited until the following day. This affects the monthly totals, since several days of cash collected in a prior month may be credited to the current month. Based on an analysis we performed it would not be cost beneficial to employ counters over the weekend to shorten the cash counting and deposit lags

Bypassing of the farebox system can also skew the reconciliation process. A radio supervisor must authorize a by-pass. These occur one to two times a day, system wide. When this occurs, the cash is not counted by the on-board system. If the farebox is unable to securely accept cash (e.g., if jammed), a supervisor takes a secure, serialized gray box to the bus. The money is counted at the end of a day by a supervisor, and logged. Only a small amount of cash is collected in gray boxes, usually less than $10 but occasionally as much as $20.

Monthly cash reconciliation is nonetheless fairly close to bank deposits. We reviewed the reconciliation reports for several months and noted no meaningful exceptions.

Cash Collected for Prepaid Fare Media

The cash collected for prepaid fare media (i.e., tickets and passes) is somewhat less complicated to control since the points of sale are fewer.

All prepaid fare media are initially stored in the money room. The customer service outlets are restocked quarterly from the money room inventory. Any media that have expired are returned to the money room. The returns and daily sales are reconciled against the stock issued to each location. Customer service provides accounting with a daily inventory that is reconciled to cash deposits daily.

In summary, MTA has reasonable procedures in place to secure its cash revenues. Initial counting, deposits, and reconciliation are handled by separate staff. The procedures appear to be followed regularly.

Safeguarding of Physical Assets

Physical assets are safeguarded by a tag system and biennial physical inventory. Items are added to the inventory from capital expenditures. A paper trail is maintained by Accounting for each capitalized item. When a capital item is recorded as paid, the Director of Accounting assigns an inventory number, identifies a depreciation schedule, and assigns a property tag.

Capitalized assets entered into the fixed assets inventory semiannually, usually in December and June. Capitalized items greater than $1,000 value (for grant purchases) and replaceable assets under $1,000 value are placed in the fixed assets system. The fixed assets system maintains the inventory of fixed assets, and calculates annual depreciation. The annual depreciation amount is transferred manually to the general ledger system at the end of the fiscal year.

The physical inventory procedure compares existing tagged assets to the current fixed assets listing. The most recent physical inventory was March 1998. An inventory was scheduled for March 2000 but was deferred due to a staffing shortage in Accounting. A new inventory must be conducted prior to the FTA triennial audit, scheduled for calendar 2001.

There have been no recent financial audit issues associated with the fixed assets system. According to the Director of Accounting, the inventory procedure has been reviewed and accepted by the external auditor and the FTA.

Conclusions

- Reasonable controls exist for revenue collection and reconciliation.
- Reasonable controls exist to safeguard assets, but physical inventory is behind schedule.
- MTA has exceeded its budgeted operating expenses for each of the last four years.
- MTA uses maintenance capitalization in a manner we consider innappropriate.
- Capital expenditures and budgets receive inadequate attention, and are modified without consideration of long-term capital replacement needs.
- The budget development process needs refinement in light of the year over year budget shortfalls.
- Budget variance analysis process needs to be enhanced.
- Monthly financial reports to the Board need to be revised.

Recommendations

- The MTA should develop a comprehensive asset replacement plan, including fleet replacement, to guide its board approved capital budget.

- The unbudgeted capitalization of maintenance expenses should be seriously examined in light of the MTA's other capital needs and the distortion created to true operating results.
- The operating budget should be refined and developed under a more conservative set of assumptions, with perhaps greater input from MTA department managers. It may also be helpful to develop the budget on a program basis specifying the activities that are to be funded by the budget. This would include miles and hours of operation by mode, passengers carried, routine and special maintenance activities, planning, and other activities that are to be carried out under the budget.
- The MTA should develop and implement a combined operating and capital budget that specifies the proposed operating and capital expenses for the upcoming budget year, and a capital budget for the subsequent five years. This should also include a proforma for the entire six-year period that illustrates the long-term financial picture of the MTA assuming the implementation of planned projects.

There are several features of the current Board report that warrant improvement:

- The monthly budget should better reflect monthly activity. In 2000, monthly budgets were simply one-twelfth of the annual budget. This leads to inaccurate portrayal of monthly financial position. Financial assistance from Metro and from the state, for example, is drawn down by February of each year. There is no expected draw in June, yet the June report shows a budgeted draw. Correspondingly, draws for earlier months would be understated.
- The report should clearly identify favorable and unfavorable variances. Currently, revenues that exceed budget are shown in brackets, conveying what would normally be considered an unfavorable variance, while revenue shortfalls are not bracketed.
- Year-to-date expenses should be compared to a year-to-date budget. The current report compares YTD expenses to the annual budget. The only time this comparison is meaningful is at year-end. In intervening months a somewhat complicated manual calculation is required to understand year to date performance to year to date budget.
- If the budget is re-cast to provide a more accurate forecast of future activity, this view should also be captured in monthly reporting. A standard financial report format would typically show Year-to-date actuals with a better(worse) comparison to year-to-date budget next to a better(worse) comparison to the new forecast.
- Capital grant funds used for maintenance should be displayed as a revenue item, under Federal/State/Local income, instead of being applied as a credit to parts, materials, & supplies expense. Presenting the capitalized expense as a credit to materials is factually incorrect, since maintenance capitalization includes labor costs as well. When unbudgeted transfers of capital grants are made, an addendum or note to the report should identify the projects from which the funds were drawn, and the implications of the transfer for that project.

- The bottom line of the report should indicate whether the agency has an operating surplus or deficit.
- Given the MTA's cash flow problems, the report should also present MTA's current cash on hand, and draws against working capital reserves or lines of credit.

The above changes would aid the Board and MTA management in focusing on budget variances before they become a year-end problem.

Cost Estimate

Costs associated with adding a new finance director position are described in the *Governance* section.