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2018 OPERATING BUDGET BRIEFING NOTE

Auditor General's Annual and One-time Potential Savings (**with Confidential Attachment**)

Issue/Background:

- At its December 18, 2017, meeting, the Budget Committee requested the Auditor General to provide a briefing note on the following:
  1. An explanation of the $8 million annual recurring savings referred to on page 7 of the Auditor General's presentation (December 14, 2017), including how these savings were determined and if they have been verified as 2017 savings; and
  2. An explanation of the $9.4 million in one-time savings in the real-estate services division, referred to on page 7 of the Auditor General's presentation (December 14, 2017), including how these savings have been quantified and verified.
- Budget Committee Request #1 relates to the Auditor General's May 2017 report entitled "Review of Toronto Transit Commission Procurement Policies and Practices: Improving Materials Management and Purchasing Policies Can Result in Significant Savings".
- Budget Committee Request #2 relates to the Auditor General's June 2017 report entitled "Real Estate Services Division – Restore Focus on Union Station Leasing".

Key Points:

- It is important to note that Page 7 of the Auditor General's 2018 Operating Budget presentation provides a table summarizing **potential savings** related to audit reports issued in 2017. These savings are **potential** because the audit recommendations were issued in 2017 and it will take time, likely more than a year, for the division and agency to fully implement the recommended changes to realize the savings or revenue increases.
- While we have taken steps to make reasonable and conservative estimates, potential savings are **not** included in our table of **realized** savings or in the calculation of the return on investment for the Auditor General's Office.

<u>Budget Committee Request #1 - $8 million annual recurring potential savings from the review of the TTC's procurement policies and practices</u>

- The $8 million in potential annual savings were identified during the Auditor General's 2017 audit of the TTC's procurement policies and practices.
- A brief explanation of the potential savings is provided in the table 1 below.

Table 1: A Brief Explanation of Recommended Changes and Potential Savings

Initiatives	Explanation	Estimated Minimum Potential Annual Savings (in millions)
Expanding Blanket Contracts	Over an 18-month period from January 2015 to June 2016, TTC spent $174 million (or $116 million annually) procuring goods or services from 229 vendors. Each of these vendors supplied TTC with goods or services over $50,000, through individual purchase orders rather than Blanket Contracts or price agreements. By establishing additional blanket contracts for at least half of the annual purchases and taking advantage of volume discount pricing, TTC can potentially reduce costs by one to five per cent, or $0.5 to $2.5 million per year.	$0.5
Improving Retrieval and Tracking of Cores	A core is a vehicle part that can be rebuilt instead of buying a new part, or returned to a supplier for a waiver of core charges. The value of cores from TTC is worth millions over the life of its vehicles. In our 2016 audit of TTC inventory controls, we identified deficiencies in the retrieval and tracking of cores. During our 2017 audit, we noted that TTC has not fully implemented a process to ensure the recovery and tracking of cores. Based on an analysis of eight frequently used types of parts, the potential savings from improved controls of cores from these eight parts alone will be approximately $1 to $1.5 million per year.	$1.0
Pursuing Aftermarket Parts Warranty	TTC uses aftermarket parts (meaning parts that are not from the original new vehicles) to maintain and repair revenue-generating vehicles after the new vehicle warranty expires. TTC spent an estimated $260 million per year on aftermarket parts. Although aftermarket parts are under warranty, TTC does not systematically claim the warranty when the parts fail. By our estimate, TTC can potentially save at least $4 million per year assuming it can achieve an 80 per cent warranty claim rate.	$4.0
Expanding Alternate Sourcing for Parts	After the warranty for new vehicles expires, TTC can, after proper technical review and testing, purchase replacement parts from comparable alternate sources at lower prices. TTC staff had procured parts from alternate suppliers in a few instances in the past and were able to reduce costs by about 20 per cent. Even if only 10 per cent of the parts ($130 million in purchases through sole/single source) are purchased from comparable alternate suppliers, TTC can potentially realize $2.5 million in annual savings based on 20 per cent saving rate.	$2.5
	Total minimum potential savings	**$8.0**

- The $8 million cited on page 7 of the Auditor General's budget presentation represents conservative, estimated annualized potential savings that can be achieved when TTC fully implements the audit recommendations.

- It is important to recognize that TTC has been pursuing some of the saving initiatives prior to the 2017 audit. Our audit identified additional saving opportunities by expanding the initiatives and improving the management processes.

- TTC staff agreed with the audit recommendations, but it will take some time to fully implement the recommendations because they involve substantial system and process changes. In response to the City Council recommendation, TTC has retained an external consultant with expertise in customized transit parts to assist in implementing the audit recommendations.

- TTC staff have only recently begun to implement the audit recommendations, but they have already earmarked $2.19 million in cost reductions in the TTC's 2018 operating budget (page 21 of TTC budget presentation).
  https://www.toronto.ca/legdocs/mmis/2017/bu/bgrd/backgroundfile-109933.pdf

  This is because after TTC staff's own assessment of the audit recommendations, they too found the recommended changes are feasible and they are confident that the changes will lead to savings for TTC in 2018. TTC continues to validate future savings opportunities identified by the Auditor General.

- Table 2 below shows the cost reductions noted on page 21 of TTC's budget presentation (see "Service Efficiencies", page 1, Attachment 1) and how they align with the minimum savings estimates from our procurement audit:

Table 2: TTC Budget Reductions Compared to Audit Estimates

TTC Service Efficiency (p. 21 of presentation)	**Reduction in TTC 2018 Operating Budget (before full implementation of audit recommendations)**	**Audit estimated minimum annual savings after full implementation of recommendations**
Increased Use of Blanket Orders	$1.0 million	$0.5 million
Core Management Process Improvements	$0.5 million	$1 million
Aftermarket Warranty Program	$0.69 million	$4 million
Expanding Alternate Sourcing for Parts	-	$2.5 million
Total	**$2.19 million**	**$8.0 million**

- Note that the cost reductions earmarked by TTC are based on TTC staff's initial assessment and the early stages of implementing the audit recommendations. As TTC continues its effort to fully implement the recommended changes, it is possible that the actual annual savings will meet or exceed the Auditor General's estimated potential savings.

- The Auditor General will assess the implementation status and verify the savings in early 2019 as part of its annual follow-up process. The follow-up results will be reported to Audit Committee.

Budget Committee Request #2 - $9.4 million in one-time savings in the Real Estate Services Division

- First, we would like to emphasize that, similar to TTC's savings discussed above, these are **potential** savings and are **not** included in the Auditor General's annual calculation of the Office's return on investment. Saving amounts are included in that calculation only when the recommended changes have been implemented by staff, and the savings are then verified by audit staff.
- The Auditor General's 2017 report on Union Station leasing identified that the City was recovering some, but not all, operating costs from the Station's occupants. The main Union Station occupants during the period covered by the audit were Metrolinx and VIA Rail.
- As the primary owner and landlord of Union Station, the City incurs operating expenses for security, utilities, building maintenance and repairs, cleaning services, and waste removal.
- Contractual agreements allow the City to recover these operating expenses from tenants and occupants based on their share of the rentable area. This is done through advance instalments and a year-end settlement process to recover any amounts in excess of instalments.
- Our audit found that City staff had not settled actual annual rents and recoveries with Union Station occupants for more than four years.
- An estimated $9.4 million in outstanding lease revenue has yet to be finalized, recorded and collected from the main anchor occupants. This estimate was based on our analysis of:
  - occupancy agreements and proportionate share of rentable area
  - expenditures incurred by the City for operating Union Station
  - a comparison with lease revenue that had already been collected
- This estimate was discussed with management and is consistent with their preliminary calculation of the lease revenue outstanding from the main anchor occupants.
- We provided a detailed explanation of the estimated $9.4 million outstanding lease revenue in a Confidential Attachment to the 2017 audit report. The Confidential Attachment is also attached to this Briefing Note as Confidential Attachment 1. (Reason for Confidential information - attachment involves the security of property belonging to the City or one of its agencies or corporations.)
- Management agreed with the audit recommendations to ensure accurate and timely settlement and collection of lease revenue, and is in the process of implementing the recommendations.

Questions & Answers:

1. **Why are the Auditor General-identified savings not reflected in the division or agency budget report or presentation?**

   In some cases, divisions or agencies do cite the Auditor General's reports or recommendations in their budget reports.

   Example 1:

   TTC 2018 Operating Budget Report, p. 29 (Appendix 4), highlights the Auditor General's 2016 report on inventory controls reflecting a portion of the $3.1 million in net efficiency savings for 2018, and $2.7 million in additional annualized net savings for 2019 (see page 2, Attachment 1).

   The audit report is available at:
   https://www.toronto.ca/legdocs/mmis/2016/au/bgrd/backgroundfile-94504.pdf

   Example 2:

   The Office of the Treasurer, 2018 Budget Report, p.38, indicates that on the Auditor General's recommendation, City Council requested staff to evaluate whether an administrative fee can be charged for processing water bill refunds resulting from customer payment errors. The Division's budget report indicates net revenue impact of $54,000 and $10,800 in 2018 and 2019 respectively (see page 3, Attachment 1).

   The audit report is available at:
   https://www.toronto.ca/legdocs/mmis/2017/au/bgrd/backgroundfile-102139.pdf

   In other cases, division or agency budget reports do not contain a direct reference to the Auditor General's reports even though the savings are related to the audit recommendations.

   Example 1:

   The TTC budget presentation, p. 21, notes a total of $2.99 million from service efficiencies (see page 1, Attachment 1). While the presentation does not refer to the Auditor General's reports, TTC senior management staff confirmed that these budgeted savings are largely in response to recommendations from the two Auditor General's 2017 reports on TTC procurement and TTC accounts payable functions.

   The audit reports are available at:
   https://www.toronto.ca/legdocs/mmis/2017/au/bgrd/backgroundfile-105264.pdf
   https://www.toronto.ca/legdocs/mmis/2017/au/bgrd/backgroundfile-108077.pdf

Example 2:

Facilities, Real Estate, Environment and Energy (FREEE), 2017 Operating Budget report, p.11 and 13, note $0.85 million in cost reduction by aligning the custodial service level at Toronto Police locations with corporate standards for all City facilities (see page 4, Attachment 1).

While the Budget Report makes no reference to the Auditor General's report, the Facilities Management's Operating Budget Briefing Note (p.1 and 2) highlights that the change was in response to the Auditor General's 2016 audit on cleaning services (see page 5, Attachment 1).

The audit reports are available at:
https://www.toronto.ca/legdocs/mmis/2016/au/bgrd/backgroundfile-94477.pdf
https://www.toronto.ca/legdocs/mmis/2016/au/bgrd/backgroundfile-94618.pdf

In addition, for audit recommendations requiring substantial system or process improvements, it may take several years for the division or agency to fully implement the recommended changes. During the course of the multi-year implementation, the division/agency may realize a certain amount of savings from gradually improving the system or process. These savings would be captured in a variety of ways in the financial system of the division or agency, and are frequently used to offset its yearly operating budget. In other words, without the savings achieved by implementing the audit recommendations, the division or agency would have requested a larger operating budget.

A good example of the above scenario is the $5.8 million annual savings from improving bus warranty practice at the TTC. This is noted in Table 2 (p.6) of the Auditor General's 2018 Operating Budget presentation.

In our 2014 audit report on bus maintenance and warranty administration[1], we identified that TTC had forgone significant savings opportunities by not claiming a large percentage of new bus warranties. Following our 2014 audit, the Bus Maintenance and Shops Department, along with a number of other departments, have made a concerted effort to develop and implement a new warranty claim process in bus garages. As of April 2017, the new process has been implemented to a large extent in all seven bus garages, and it has improved the warranty claim rate from approximately 30 per cent in 2013 (baseline) to 80 per cent in 2017.

For the period between 2011 and 2013, the Department received on average $1.9 million per year from warranty claims relating to defective parts and labour hours, compared to approximately $7.7 million in 2016 assessed by audit staff during our annual recommendation follow-up process[2]. This represents an additional $5.8 million in annual

[1] Report available at https://www.toronto.ca/legdocs/mmis/2014/au/bgrd/backgroundfile-67395.pdf

[2] 2016 warranty revenues included: $2.5 million from manufacturers' direct credits for repairs undertaken by TTC staff using TTCs' own parts and labour, and $5.2 million in equivalent repair costs undertaken by third parties including a key bus manufacturer and other equipment vendors.

warranty revenues by improving the new bus warranty process. Further increases in warranty revenue is possible in future years as TTC's target for warranty claim is 90 per cent (currently 80 per cent).

The $5.8 million increased warranty revenue, however, is not shown in the TTC's 2018 budget report as a separate line item. This is because the $5.8 million represents the overall warranty revenue increase between 2013 and 2016. Whereas in practice, TTC would gradually realize a higher amount of warranty revenue and decreasing material and labour costs over the past years, and used the savings to offset its operating budget.

2. **How does the Auditor General determine the actual savings attributable to the audit recommendations?**

   The Auditor General's Office conducts an annual follow-up process to determine the implementation status of audit recommendations. During the annual follow-up process, for audit recommendations that have potential savings, audit staff conduct additional work such as reviews of staff reports, system data, financial records, work orders, or invoices to estimate the amount of savings from increased revenues, decreased operating costs, or improved efficiencies. The savings estimate would then be discussed with management to ensure the estimate is reasonable and accurate to the extent possible. These verified savings are then highlighted in the Auditor General's follow-up reports to the Audit Committee.

3. **Why does the Auditor General report on potential savings if they have not been realized?**

   One of the common questions to auditors is whether it will be cost-effective or worthwhile for management to implement additional controls or to enhance an existing process or system.
   The Auditor General, in making audit recommendations, is cognizant of their implementation cost and benefits. Careful consideration is given to ensuring that recommendations are relevant, practical and cost-effective.

   In issuing her audit reports, where potential savings are identified, the Auditor General will highlight the potential savings for the purpose of providing management staff and elected officials a sense of the potential or possible financial benefits that would result from implementing the audit recommendations.

   In addition, at the July 4, 2016 Audit Committee meeting, a motion was adopted requesting the Auditor General to report to the Audit Committee on the estimated savings associated with outstanding audit recommendations (i.e. potential savings).

   In response to the motion, the Auditor General has incorporated the potential savings information in her follow-up reports to the Audit Committee, as well as in her operating budget report.

4. Are the potential savings included in the Auditor General's calculation of return on investment for her Office?

No, potential savings highlighted in audit reports or budget documents are not included in the Auditor General's calculation of return on investment for her Office. Only savings that have been verified by audit staff (during the audit or the subsequent annual follow-up process) are included in the Auditor General's return on investment calculation.

The Auditor General tracks and reports to City Council, through the Auditor General's Annual Report, the estimated cost savings and increased revenues resulting from the implementation of audit recommendations. The 2016 Annual Report entitled "Demonstrating the Value of the Auditor General's Office" is available at:
https://www.toronto.ca/legdocs/mmis/2017/au/bgrd/backgroundfile-101860.pdf

5. Do Divisional staff concur with the potential and realized savings reported by the Auditor General?

As part of our audit process, audit staff are required to discuss potential savings with management staff before finalization of the audit report and recommendations. Comments from management staff regarding the assessment of potential savings are carefully considered by audit staff and frequently result in adjusted estimates in the final audit report.

As well, when management reports that an audit recommendation has been implemented, audit staff, during the recommendation follow-up process, will verify the implementation status and assess the estimated one-time and annual savings. The savings are estimated based on staff reports to standing committee, system reports and other management-provided information, followed by detailed discussions with management staff to ensure accuracy and reasonableness of the saving estimates.

6. How are the implementation costs accounted for in the Auditor General's calculation of return on investment for her Office?

Where additional costs have been incurred by the division or agency to implement a specific audit recommendation (e.g. costs for developing a new system or hiring extra staff), this additional cost is deducted from the one-time savings or the first year of the annual recurring savings, whichever is applicable. This is consistent with the Auditor General's approach to ensure any realized savings are net of implementation costs.

Attachments:

Attachment 1: Excerpts from Division and Agency Reports
Confidential Attachment 1: Real Estate Services Division – Restore Focus on Union Station Leasing

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