

FILED
by the Board of Directors of
The Metropolitan Water District
of Southern California
at its meeting held

JUL 11 1995



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METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

Dawn E. Wolf
EXECUTIVE SECRETARY

June 26, 1995

To: Board of Directors (Engineering and Operations Committee - Information)
(Finance and Insurance Committee - Information)
From: General Manager
Subject: Accounting for Overhead Expense

RECOMMENDATION:

For information only.

John R. Wodraska
General Manager

Submitted by:

Lamberthus H. Becker
Lamberthus H. Becker
Chief Financial Officer

Concur:

for *John R. Wodraska*
John R. Wodraska
General Manager

Attachment

MCF:jg
P:\finance\boardltr\overhead.doc

REPORT:

In response to questions raised by the Board of Directors regarding administrative overhead expense, this report summarizes the current methodology used to calculate and account for overhead expense.

Administrative overhead expense is defined as those costs not directly associated with and chargeable to a specific capital improvement project, reimbursable project, or O&M activity. They are centralized support services that benefit the District as a whole and include human resources, finance, administrative service, information systems, legal and audit functions, expenses of the Board of Directors, Office of the General Manager, and the Executive Secretary. These expenses are also referred to as "General and Administrative" costs.

As with any business, it is important to know the total cost of manufacturing a product or providing a service. This is achieved by allocating indirect or overhead expense to direct expenses. This is in accordance with generally accepted accounting practices and appropriately assigns the costs of general management to the project or activity requiring support services.

There are base overhead expenses and engineering overhead expenses which combine to make up the total overhead cost pool. The total of these costs is allocated to capital, reimbursable, and O&M accounts in proportion to the direct labor charged to these categories. This is accomplished by multiplying the labor costs in these categories by an overhead rate. The specific method of calculating the District's overhead rate is shown on Attachment A.

A study was conducted in 1987 to evaluate the procedures used for determining and allocating overhead costs. As a result of the study, a number of changes were implemented in the 1988-89 fiscal year. The changes included revising the pool of overhead costs to exclude costs associated with Public Affairs, Planning and Resources, lobbying expense and association dues; and discontinuing the practice of allocating overhead to individual O&M activities. Your Board approved these revisions in November 1987.

With the implementation of the Oracle financial applications, staff feels that is appropriate to again review the District's accounting treatment of administrative overhead. A study has been initiated to review the historical and current accounting policies as well as the procedures used in calculating and applying indirect costs to capital, reimbursable, and O&M accounts. It is expected that the study will be completed by December 1995 and the results will be presented to your Board for consideration.

ATTACHMENT A

The total of all centralized support services is allocated to capital, reimbursable, and operations and maintenance accounts in proportion to the direct labor charged to these categories. The direct labor charges are multiplied by an overhead rate which is calculated as follows:

$$\text{Overhead Rate} = \frac{\text{Overhead Expense}}{\text{District Payroll Less Overhead Payroll}}$$

To minimize any large fluctuations in the rate, a 12-month moving average of overhead expense and payroll costs is used.

Added to the base overhead rate shown above, is a rate (Engineering Overhead Rate) for charges associated with only capital and reimbursable projects. The component includes costs associated engineering management (the Chief Engineer, the Assistants, and branch managers) attributable to capital and reimbursable projects. The cost allocation is handled in the same way as the base overhead expense. The calculation is as follows:

$$\text{Engineering Overhead Rate} = \frac{\text{Capital Portion of Engineering Management Payroll}}{\text{Capital and Reimbursable Payroll}}$$

Here again, a 12-month moving average is used to minimize large fluctuations in the rate. Shown below are the calculations for April 1995, based on financial data for the 12 months ended March 31, 1995. The current overhead rate is 61.95 percent and the engineering overhead rate is 11.79 percent.

$$\text{Overhead Rate} = \frac{12 \text{ Months of District Overhead Expense}}{12 \text{ Months of District Payroll less Overhead Payroll}}$$

$$\text{Overhead Rate} = \frac{\$54,066,829}{\$87,268,768} = 61.95\%$$

$$\text{Engineering Overhead Rate} = \frac{12 \text{ Months of Capital Portion of Engineering Management Payroll}}{\text{Capital and Reimbursable Payroll}}$$

$$\text{Engineering Overhead Rate} = \frac{\$ 3,040,987}{\$25,783,089} = 11.79\%$$

$$\text{Total Overhead Rate} = 73.74 \text{ percent}$$