

April 28, 1999

**To:** Board of Directors (Special Audit Committee--Information)  
(Budget and Finance Committee--Information)

**From:** Deputy General Manager  
Timothy H. Quinn

**Submitted by:** Lambertus H. Becker  
Chief Financial Officer

**Subject:** Policies and Procedures on Accounting for Research and Development Costs and Intangible Assets

**RECOMMENDATION(S)**

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For Information only.

**DETAILED REPORT**

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On October 28, 1998, KPMG Peat Marwick, LLP (KPMG) issued its annual Letter of Recommendations to management relating to its review of the internal control structure of Metropolitan. This review was performed as part of KPMG's planning and performance of its June 30, 1998 year end audit. In its letter, KPMG addressed the accounting for research and development costs and recommended, among other things, that Metropolitan establish policies and procedures to account for such costs in the future. Staff agreed with the recommendations and reported that the recommended policies and procedures would be completed by April 30, 1999.

At the January 19, 1999 Special Audit Committee meeting, Committee Chairman Grandsen suggested that upon development of the research and development policies and procedures, information thereon be submitted to the Rules Committee for referral to the Budget and Finance Committee. This letter has been prepared for that purpose.

Final drafts of the new research and development policies and procedures are attached for your information. They have been reviewed by both the internal auditors and KPMG, who found them acceptable. They are currently being routed for final management review and General Manager approval.

TED:jg

**Attachment 10-5A**



MWD  
METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

### OPERATING POLICIES

O.P. NUMBER	TITLE	ISSUE DATE	REVISION DATE
<b>C-19</b>	<b>Accounting for Research and Development Costs and Intangible Assets</b>		<b>FINAL DRAFT</b>

#### SUMMARY

This document establishes the policies governing the identification, accounting and reporting for research and development costs and intangible assets (e.g., patents, copyrights, trademarks).

#### AUTHORITY

The General Manager delegates the authority to establish and maintain policies relating to the accounting for research and development costs and intangible assets to the Controller’s office in the Finance and Business Services Division. The Controller shall develop appropriate procedures pertaining to identifying, tracking, and reporting research and development costs.

#### DEFINITIONS

**Research** - is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (hereinafter *product*) or a new process, method or technique (hereinafter *process*) or in bringing about a significant improvement to an existing product or service.

**Development** - is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of bench-scale units, pilot plants and demonstration plants. It does not include routine or periodic alterations to existing products, production lines, manufacturing processes, and other ongoing operations, even though those alterations may represent improvements, and it does not include market research or market-testing activities.

**Intangible Assets** - are long-lived assets used in the production of goods and services. They are similar to fixed assets (i.e., property, plant and equipment) except for their lack of physical properties. Examples are patents, copyrights, trademarks and other intellectual property as described in Operating Policy F-03, Intellectual Property. The costs of intangible assets that have been capitalized are generally amortized over the period estimated to be benefited, not exceeding 40 years.



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**OPERATING POLICIES**

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<b>C-19</b>	<b>Accounting for Research and Development Costs and Intangible Assets</b>		<b>FINAL DRAFT</b>

**DEFINITIONS (cont.)**

**Patent** - is a grant by the federal government giving the owner the exclusive right to manufacture and sell a particular invention for a period of 17 years.

**Copyright** - is a grant by the federal government giving an author, creator or artist the exclusive right to publish, sell, or otherwise control literary or artistic products for the life of the author plus fifty years.

**Trademark** - Trademarks, trade names and secret formulas are property rights that can be leased, assigned, or sold. They are a means of building and holding customer acceptance for the products of a company.

**POLICIES**

**Elements of Costs to be Identified with Research and Development Activities**

1. *Materials, equipment, and facilities.* The costs of materials and equipment or facilities that are acquired or constructed for research and development activities and that have alternative future uses (in research and development projects or otherwise) shall be capitalized as tangible assets when acquired or constructed. However, the costs of materials, equipment, or facilities that are acquired or constructed for a particular research and development project and that have no alternative future uses (in other research and development projects or otherwise) are research and development costs at the time the costs are incurred. The cost of materials consumed in research and development activities and the depreciation of equipment and facilities used in those activities are research and development costs.
2. *Personnel.* Salaries, wages, and other related costs of personnel engaged in research and development activities shall be included in research and development costs.



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**POLICIES (Cont.)**

**Elements of Costs to be Identified with Research and Development Activities (cont.)**

3. *Intangibles purchased from others for research and development purposes.* The costs of intangibles purchased from others for use in research and development activities and that have alternative future uses (in research and development projects or otherwise) shall be capitalized and amortized as intangible assets. However, the costs of intangibles purchased from others for a particular research and development project which have no alternative future uses (in other research and development projects or otherwise) are research and development costs at the time the costs are incurred. The amortization of those intangible assets used in research and development is a research and development cost.
4. *Contract services.* The costs of services performed by others in connection with the research and development activities of an enterprise, including research and development conducted by others on behalf of the enterprise shall be included in research and development costs.
5. *Indirect costs.* Research and development costs shall include a reasonable allocation of indirect costs.

**Elements of Costs to be Identified with Intangible Assets**

1. If intangible assets are acquired from others for non-research and development purposes, the cost of any specifically identifiable intangible assets shall be recorded as an asset.
2. The amortization of capitalized intangible assets shall be recorded as amortization expense unless such assets are used in research and development, in which case such amortization shall be recorded as research and development costs.
3. All costs associated with intangible assets that are created through internal efforts shall not be recorded as assets, but instead charged to expense as incurred.



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<b>C-19</b>	<b>Accounting for Research and Development Costs and Intangible Assets</b>		<b>FINAL DRAFT</b>

**POLICIES (Cont.)**

**Accounting for Research and Development Costs**

1. All costs determined to be research and development costs shall be charged to expense when incurred.
2. All research and development costs shall be recorded in Metropolitan’s accounting system in a manner that permits disclosure in the financial statements of total research and development costs incurred in each period for which an income statement is presented.

**Accounting for the Costs of Intangible Assets**

1. The costs of intangible assets purchased from others are capitalized and amortized by systematic charges to income over the periods estimated to be benefited, not exceeding 40 years.
2. Metropolitan’s accounting system shall record intangible assets in a manner which permits a description of the intangible assets, method of amortization, and estimated useful lives to be disclosed in Metropolitan’s financial statements.
3. The costs of intangible assets which are developed internally shall be charged to expense as incurred.

**REFERENCES**

- ◆ Accounting Standards of the Financial Accounting Standards Board pertaining to Intangible Assets and Research and Development Costs (Sections I60; R50)
- ◆ Operating Policy F-03, Intellectual Property
- ◆ Procedures for Identifying, Tracking and Reporting Research and Development Costs, Attachment 1

**APPROVAL**

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General Manager

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Date

**Metropolitan Water District of Southern California**  
**Procedures for Identifying, Tracking and Reporting**  
**Research and Development Costs**

**Purpose**

To document procedures to identify, track and report research and development (R&D) costs in accordance with operating policies and generally accepted accounting principles.

**Procedures**

1. All research and development projects will be identified with a unique 'activity' chart of account number at the time the project number is assigned.
2. Requesting party responsibilities:
  - A. Notify Project Control Supervisor in the Engineering Division or the Administrative Analyst in the Office of Asset Management (if business development project) that the project to be undertaken is an R&D project, as defined in Operating Policy No. C-19. Notification is made using the project authorization form pursuant to General Instruction 7f (currently being revised).
  - B. Notify Project Control Supervisor in the Engineering Division or the Administrative Analyst in the Office of Asset Management (if business development project) whether the R&D project to be undertaken includes capital costs, as defined in Operating Policy No. C-19. Notification is made using the project authorization form pursuant to General Instruction 7f (currently being revised).
3. Project Control Section of Engineering Division responsibilities:
  - A. Assign the appropriate project number based on whether the project is capital, O&M or reimbursable project.
  - B. Assign the chart of account Activity No. 230002 to identify the project as R&D.
  - C. Set up an Oracle chart of account alias to include fund, appropriation, project and activity values.
4. Administrative Analyst of the Office of Asset Management responsibilities:
  - A. Assign a business development project number for O&M-type projects.
  - B. Request a capital project number from Project Control Section in Engineering for the capital portion of the R&D project.
  - C. Assign the chart of account Activity No. 230002 to identify the business development project as R&D.
  - D. Set up an Oracle chart of account alias to include fund, appropriation, project and activity values.

5. Controller's responsibilities:

- A. Prepare Oracle reports for R&D activities using the chart of account Activity No. 230002 to identify all costs.
- B. Analyze R&D costs to determine appropriate accounting and reporting for both R&D and intangible assets as defined in Operating Policy No. C-19.
- C. Prepare journal entries, as required, to conform to R&D accounting policy.
- D. Disclose R&D activity in annual financial statements, as required by applicable accounting standards and Operating Policy C-19.

**Effective Date**

- 1. This procedure is effective immediately.

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Approved: David I. Furukawa, Controller

Date: \_\_\_\_\_