

May 14, 1999

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

From: General Manager _____

Submitted by: Lambertus H. Becker _____
Chief Financial Officer

Subject: Operating Equipment Capitalization

RECOMMENDATION

For information only.

EXECUTIVE SUMMARY

The recently completed Budget Analysis Project Final Report by Price Waterhouse Coopers supported a recommendation to increase the capitalization threshold for operating equipment. Staff has reviewed that recommendation, including research of professional publications, peer bench-marking, and independent audit review findings. Based on this review and additional input from the Audit Department, and as a follow-up to a presentation made to the Special Audit Committee on June 2, 1998, staff recommends that the capitalization threshold for operating equipment be increased from \$500 to \$5,000. This change can be made without authorization from the Board of Directors. The 1999-2000 fiscal year budget reflects adoption of this change in the capitalization threshold.

DETAILED REPORT

The recently completed Budget Analysis Project Final Report by Price Waterhouse Coopers supported a recommendation to increase the capitalization threshold for operating equipment. The report concluded that doing so would be a first step in modifying internal controls to achieve cost efficiencies by permitting Metropolitan to stratify the review of operating equipment to focus on high dollar items, thus reducing paperwork for less expensive items.

Although the recommendation to increase the capitalization threshold for operating equipment was first proposed by a multi-division operating equipment task force in late 1995, it was formalized as Recommendation No. 12 of the Material Management Process Improvement Project (MMPIP). This recommendation was first presented to the Special Audit Committee on June 2, 1998. Although the MMPIP recommended increasing the capitalization threshold for operating equipment from the current \$500 level to \$2,500, research of professional publications, peer bench-marking, independent audit review findings, and input from the Audit Department indicated a threshold of \$5,000 to be more

appropriate. While the committee generally concurred with the recommendation, it requested that staff complete the move to Union Station and document the procedures for tracking operating equipment that falls below the proposed new threshold before implementing the change. Operating Policy F-01 is being modified to reflect the proposed capitalization threshold change so that all procedures currently in place to track equipment valued at less than \$500 will be applied to equipment less than \$5,000.

Recently updated benchmarking of five comparable agencies confirms that our capitalization threshold is too low. The results are as follows:

AGENCY	CAPITALIZATION THRESHOLD
Los Angeles Dept. of Water & Power	\$1,000
East Bay Municipal Utility District	\$5,000
California Department of Water Resources	\$5,000
Metropolitan Transportation Authority	\$2,500
West Basin Municipal Water District	\$ 500

Staff also found supporting justification in a number of professional publications over the last several years, including:

- ❑ Government Finance Officers Association (GFOA) publication, *Recommended Practices for State and Local Governments* (1997): In this publication, the GFOA concluded that a principal objective for capitalization thresholds should be to meet the anticipated needs of the users of the governmental agency's external financial reports. GFOA recommended that in no case should a governmental agency establish a capitalization threshold of less than \$1,000 for any individual item.
- ❑ Governmental Accounting, Auditing and Financial Reporting (GAAFR) (May, 1997): This issue states that the GFOA was motivated to make these recommendations because it believes that many state and local governments are using unreasonably low capitalization thresholds that needlessly add to the cost and complexity of fixed asset systems without providing any substantial compensating benefits.
- ❑ Ernst & Young (E&Y) assessment of the operating equipment management process (1995): The final report found that while MWD "exhibits leading practices in several areas," it maintained a low capitalization threshold at \$500. As a result, E&Y recommended that the threshold be increased to \$1,000 or greater.
- ❑ OMB Circular A-87 (May 1995): This publication refers to "equipment" as an article of non-expendable, tangible personal property having a useful life of more than one year and an acquisition cost which equals the lesser of (a) the capitalization level established by the governmental unit for financial statement purposes, or (b) \$5,000. It also states that items of

equipment with an acquisition cost of less than \$5,000 are considered to be supplies and are allowable as direct cost of federal awards without specific awarding agency approval.

- ❑ Office of Management and Budget (OMB) Circular A-102 (October, 1994): This publication refers to “equipment” as tangible , non-expendable, personal property having a useful life of more than one year and an acquisition cost of \$5,000 or less per unit.

As recommended by the GFOA, a governmental agency should exercise control over non-capitalized fixed assets by establishing and maintaining adequate control procedures at the departmental level. These controls are currently in place. This is evidenced by the results of the last several inventories, all of which have exceeded audit requirements. Implementation of the recommendations to increase the capitalization level to \$5,000 would provide efficiencies without compromising business need nor increasing risk of loss. The recommendations are supported by government accounting guidelines, independent auditor findings and practices adopted by other agencies.

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