



● **Board of Directors**
Business and Finance Committee

7/13/2010 Board Meeting

9-1

Subject

Accounting for the capital component of the State Water Project

Description

The appropriate accounting for Metropolitan's share of the State Water Project (SWP) has been an area of analysis and study since the contract was first executed. Metropolitan's historic accounting treatment includes booking the capital component of the project as an asset on Metropolitan's balance sheet. As noted in the February 12, 2007, Board Report on this issue ([Attachment 1](#)), this accounting treatment recognizes the long-term value of the project to Metropolitan.

KPMG has confirmed this approach utilizing existing Government Accounting Standards Board (GASB) pronouncements, as well as a proposed rule, GASB Statement No. 51, which deals with accounting for intangible assets. In 2007, staff committed to update the Board as to the impacts of GASB 51 at the time the proposed rule became final. GASB 51, *Accounting and Financial Reporting for Intangible Assets*, is now final, and it is appropriate to review SWP accounting in light of that statement. After careful review of the statement and analysis of the project and its accounting treatment, finance staff has concluded that GASB 51 requires no change to Metropolitan's historical accounting for the SWP for the following reasons:

- (a) The State of California owns the water rights for the SWP;
- (b) The State Water Contractor provides rights (entitlements) to access the transportation system of the SWP, regardless of whether there is water available to be delivered; and
- (c) Metropolitan will likely exercise its option to extend its contract with the state through at least 2052.

Therefore, the capital payments are considered prepayments which are deferred until the future economic benefit underlying the asset is used. KPMG has reviewed management's analysis and concurs that continuing the historical accounting for the SWP is appropriate.

Policy

Metropolitan Water District Administrative Code Section 5106: Accounting System. The General Manager shall prescribe the method of installing, keeping and rendering all accounts of the several officers and employees of the District; provided that any material change in the general system of accounting shall be authorized by the Board.

Fiscal Impact

None



Brian G. Thomas
Chief Financial Officer

6/30/2010

Date



Jeffrey Knightlinger
General Manager

7/1/2010

Date

Attachment 1 – Board Letter 9-5 from February 13, 2007 Board Meeting

Ref# cfo12606679



- **Board of Directors**
Business and Finance Committee

February 13, 2007 Board Meeting

9-5

Subject

Accounting for the Capital Component of the State Water Contract

Description

Background

On November 4, 1960, Metropolitan entered into a contract with the State of California under which Metropolitan agreed to pay a portion of the cost of construction of the State Water Project (SWP) in the form of annual capital payments. Metropolitan records its annual capital payments to the California Department of Water Resources (DWR) as participation rights and amortizes those rights over 80 years. Metropolitan has worked with its internal and external auditors since 1972 when water from the SWP was first made available to Metropolitan to ensure the proper accounting treatment for these costs. In 1972, Metropolitan's external audit firm at the time, Haskins & Sells, provided guidance that shaped the accounting for these costs.

Metropolitan's current and past accounting is based on the fact that Metropolitan did not construct the SWP. Instead, the total capital payments to DWR are the capital costs for Metropolitan's participation rights. These participation rights are amortized and charged based on the water delivered and the life of the contract. This accounting treatment has been consistently applied through June 30, 2005, with only a few modifications reflecting events on the SWP; e.g., loss of funding for the Peripheral Canal that was reflected in 1985. Furthermore, all such changes to cost or delivery estimates were made on a prospective basis. Metropolitan has received unqualified opinions on its financial statements from its outside auditors including Haskins & Sells, Touche Ross, Ernst & Whinney and KPMG. These national auditing firms determined that Metropolitan's accounting methods for the SWP participation rights were consistent and acceptable methods of accounting for these assets.

For fiscal year 2006, Metropolitan changed external audit firms, and contracted with PriceWaterhouseCoopers (PWC) to complete the annual audit. During the course of its work, PWC reviewed the accounting for the SWP participation rights and opined that a change to a "preferable accounting method" was required. A preferable accounting method is defined as a method that results in improved financial reporting. In reaching its conclusion, PWC examined several accounting models for the SWP participation rights and found that while there was no perfect fit, the "intangible asset" model fit best. This model requires that intangible assets used in operations be reported and accounted for as capital assets. PWC has interpreted this to mean that Metropolitan should record the SWP participation rights on its books as if Metropolitan had constructed the facilities. In essence, PWC has argued that the State Water Contract is a financing vehicle and Metropolitan should look through the invoice to components of the capital cost, including principal and interest. While DWR identifies principal and interest on portions of the invoice, neither the rate nor the payment equals Metropolitan's share of the debt service paid by DWR during the billing year. If Metropolitan adopted this model for accounting for the SWP, Metropolitan would be expensing the interest portion of the DWR invoice in the year paid instead of capitalizing the interest costs and amortizing these costs over future periods. Further, this change would also require an immediate write-off of \$737.5 million and a corresponding reduction in equity, or net assets. The immediate write-off of \$737.5 million of net assets would reduce Metropolitan's water revenue bonding capacity in accordance with the additional indebtedness provisions of the MWD Act.

It is important to note that PWC has agreed that the existing accounting treatment was not in error but that a change to a preferable method is required for PWC to issue an unqualified opinion. As such, prior financial

statements are fairly presented and restatement is not required. Further, PWC has not found or reported any internal control weaknesses associated with the accounting methods used by Metropolitan.

In December 2006, the Governmental Accounting Standards Board (GASB), the agency responsible for developing accounting rules and reporting requirements for state and local governments, issued an exposure draft on the accounting and financial reporting for intangible assets (including water rights). The exposure draft is not expected to become effective until fiscal year ending June 30, 2010. Staff's initial reading of this exposure draft is that, if adopted, the guidance would not require Metropolitan to account separately for the interest component of the DWR invoice as proposed by PWC. However, the exposure draft could change before it becomes part of generally accepted accounting principles (GAAP).

PWC has indicated that if Metropolitan does not change to this "preferred" accounting treatment, they would disassociate from their work at Metropolitan. PWC would not issue an opinion, but would send a letter to Metropolitan indicating their reasons for disassociating. As a result, Metropolitan would retain the services of KPMG to complete the audit. KPMG indicated they could assemble a team and complete the 2005/06 audit work within 30-60 days.

Table 1, Alternative Actions to Complete the 2005/06 Audit, compares the impacts of a change in accounting method to a change in audit firms. In either case Metropolitan would disclose the changes to the rating agencies and financial markets.

[Attachment 1](#) shows Metropolitan's balance sheet with and without the change in accounting treatment.

Table 1—Alternative Actions to Complete the 2005/06 Audit

Action	Pros	Cons
Change Accounting Method for SWP	<ul style="list-style-type: none"> • Conservative • Publish financials sooner (2-3 weeks) • Future exposure to write-offs reduced • No impact on rates, budget, or coverage ratios (cash basis) • No near-term impact on bond ratings 	<ul style="list-style-type: none"> • Perception that Metropolitan's past accounting treatment was in error • Recognize write-off in one year, so financials not comparable to prior year. But, Metropolitan would show net assets with and without the write-off and discuss the impact of the accounting change in footnotes. • Reduce net assets and bonding capacity by \$737.5 million • Limited choices for future audit firms
Change in Audit Firms	<ul style="list-style-type: none"> • Consistent with accounting treatment over past 35 years • Preserve \$737.5 million of bonding capacity • No impacts on rates, budget, or coverage ratios (cash basis) • No near-term impact on bond ratings 	<ul style="list-style-type: none"> • Must retain new auditor to complete 2005/06 audit • Financials will take longer to publish (6-8 weeks) • Market may perceive change in auditors as "shopping" for a favorable opinion • Limited choices for future audit firms

Staff has discussed these issues with the bond rating agencies and the investment banking team. We believe that Metropolitan's bond ratings or ability to issue debt in the next few years would not be adversely affected by either course of action. That is, whether Metropolitan changes its accounting treatment or its external auditors will not affect the bond markets' view of Metropolitan's credit worthiness. This is due, in large part, to the fact that these accounting issues do not impact Metropolitan's fundamental credit attributes, which include the ability to raise


water rates, ample liquidity, and the fact that Metropolitan enjoys a strong and diverse service territory. Given these two alternatives and considering the historical acceptance of Metropolitan’s accounting treatment by reputable accounting firms, staff (including the Chief Financial Officer, Controller and General Auditor) have determined that Metropolitan’s current accounting method is sound and reasonable. Furthermore, without compelling evidence to change to a “preferable method” and without specific guidance from the GASB, Metropolitan believes that the historical presentation of financial condition is fairly stated and properly reflects the nature of the accounting transactions with the DWR. Accordingly, Metropolitan believes that the historical accounting is justified and should be maintained. As a result, Metropolitan’s balance sheet will not include a reduction in net assets. As circumstances change (e.g., significant changes in cost or delivery estimates) and/or additional guidance and accounting pronouncements become available, staff will work with the Board to determine if changes to accounting treatment (including changes to amortization or the balance sheet) are warranted.

Policy

Metropolitan Water District Administrative Code Section 2417 (15): Executive Committee Duties and Functions

Fiscal Impact

None


 Brian G. Thomas
 Chief Financial Officer

2/6/2007
 Date


 Jeffrey Kightlinger
 General Manager

2/7/2007
 Date

Attachment 1 – Proforma 2005/06 Financial Statements

Balance Sheet

The Metropolitan Water District
of Southern California

(Dollars in thousands)	6/30/06	Adjustments			Adjusted 6/30/2006
		Write-off net SWP interest as of June 30, 2005	Expense Current Year SWP Interest	Adjust Current Year SWP Amortization	
		(A)	(B)	(C)	
ASSETS					
Current Assets:					
Cash and investments, at fair value:					
Nonrestricted	\$ 193,528				\$ 193,528
Restricted	301,501				301,501
	<u>495,029</u>	-	-	-	<u>495,029</u>
Receivables:					
Water Sales	145,169				145,169
Annexation charges	1,719				1,719
Interest on investments	13,315				13,315
Other	38,342				38,342
	<u>198,545</u>	-	-	-	<u>198,545</u>
Inventories (at moving-average cost):					
	<u>84,970</u>				<u>84,970</u>
Deferred charges - current portion					
	<u>84,109</u>				<u>84,109</u>
Total current assets					
	<u>862,653</u>	-	-	-	<u>862,653</u>
Noncurrent Assets:					
Cash and investments, at fair value:					
Nonrestricted	273,214				273,214
Restricted	208,956				208,956
	<u>482,170</u>	-	-	-	<u>482,170</u>
Capital assets:					
Plant and equipment	7,888,179				7,888,179
Participation rights	4,197,418	(1,851,162)	(86,913)		2,259,343
	<u>12,085,597</u>	<u>(1,851,162)</u>	<u>(86,913)</u>	-	<u>10,147,522</u>
Less accum depr and amort	(3,578,246)	1,142,093		58,474	(2,377,679)
	<u>8,507,351</u>	<u>(709,069)</u>	<u>(86,913)</u>	<u>58,474</u>	<u>7,769,843</u>
Other noncurrent assets:					
Deposits, deferred charges and other	163,411				163,411
Annexation charges - noncurrent portion	-				-
	<u>163,411</u>	-	-	-	<u>163,411</u>
Total noncurrent assets					
	<u>9,152,932</u>	<u>(709,069)</u>	<u>(86,913)</u>	<u>58,474</u>	<u>8,415,424</u>
Total Assets					
	<u>\$ 10,015,585</u>	<u>(709,069)</u>	<u>(86,913)</u>	<u>58,474</u>	<u>\$ 9,278,077</u>
Net change in assets					<u>\$ (737,508)</u>

Balance Sheet

The Metropolitan Water District
of Southern California

(Dollars in thousands)	6/30/06	Adjustments			Adjusted 6/30/2006
		Write-off net SWP interest as of June 30, 2005	Expense Current Year SWP Interest	Adjust Current Year SWP Amortization	
		(A)	(B)	(C)	
LIABILITIES AND NET ASSETS					
Current Liabilities:					
Accounts payable and accrued expenses	\$ 325,102				\$ 325,102
Current portion of long-term debt	74,884				74,884
Current portion of obligation for off-aqueduct power facilities	6,361				6,361
Current portion of accrued compensated absences	13,700				13,700
Current portion of customer desoposits and trust funds	13,371				13,371
Current portion of worker's compensation and third party claims	6,316				6,316
Current portion of other long-term obligations	30				30
Accrued bond interest	49,028				49,028
Matured bonds and coupons not presented for payment	1,251				1,251
Other	2,095				2,095
Total current liabilities	492,138	-	-	-	492,138
Noncurrent Liabilities:					
Long-term debt, net of current portion	3,791,451				3,791,451
Obligation for off-aqueduct power facilities, net of current portion	73,376				73,376
Accrued compensated absences, net of current portion	26,064				26,064
Customer deposits and trust funds, net of current portion	24,996				24,996
Other post employment benefits	21,718				21,718
Worker's compensation and third party claims, net of current portion	14,222				14,222
Other long-term obligations	5,290				5,290
Total noncurrent liabilities	3,957,117	-	-	-	3,957,117
Total liabilities	4,449,255	-	-	-	4,449,255
Commitments and Contingencies					
Net Assets:					
Invested in capital assets, net of debt	4,626,701	(709,069)	(86,913)	58,474	3,889,193
Restricted for:					
Debt Service	280,927				280,927
Operating expenses	130,642				130,642
Unrestricted	528,060				528,060
Total net assets	5,566,330	(709,069)	(86,913)	58,474	4,828,822
Total Liabilities and Net Assets	\$10,015,585	\$ (709,069)	\$ (86,913)	\$ 58,474	\$ 9,278,077
Net change in equity					<u>\$ (737,508)</u>

Statement of Revenues, Expenses and Changes in Net Assets

The Metropolitan Water District
of Southern California

(Dollars in thousands)	6/30/06	Adjustments			Adjusted 6/30/2006
		Write-off net SWP interest as of June 30, 2005 (A)	Expense Current Year SWP Interest (B)	Adjust Current Year SWP Amortization (C)	
Operating Revenues:					
Water sales	\$ 864,213				\$ 864,213
Readiness-to-serve charges	80,002				80,002
Power Recoveries	26,795				26,795
Total operating revenues	971,010	-	-	-	971,010
Operating Expenses:					
Power and water costs	309,826				309,826
Operations and maintenance	357,459				357,459
Total operating expenses	667,285	-	-	-	667,285
Operating income before depreciation and amortization	303,725				303,725
Less depreciation and amortization	(209,805)			58,474	(151,331)
Operating Income	93,920	-	-	58,474	152,394
Other Income (Expense):					
Taxes-net	102,705				102,705
Bond interest, net of \$58,731 of capitalized interest	(109,978)				(109,978)
Investment income	32,510				32,510
Interest and adjustments on off-aqueduct power facilities obligation	(4,919)				(4,919)
Interest on state water project contract	-		(86,913)		(86,913)
Other - net	4,558				4,558
Total other income - net	24,876	-	(86,913)	-	(62,037)
Income before Contributions	118,796	-	(86,913)	58,474	90,357
Capital contributions	15,165				15,165
Change in net assets	133,961	-	(86,913)	58,474	105,522
Net assets, beginning of year before restatement	5,432,369				5,432,369
Less: Cumulative effect of a change to a preferable accounting method (Note X)	-	(709,069)			(709,069)
Net assets, beginning of year after restatement	5,432,369	(709,069)	-	-	4,723,300
Net assets, end of year	\$ 5,566,330	\$ (709,069)	\$ (86,913)	\$ 58,474	\$ 4,828,822
Net change in equity					<u>\$ (737,508)</u>

Statement of Cash Flows

The Metropolitan Water District
of Southern California

(Dollars in thousands)	6/30/06	Adjustments			Adjusted 6/30/2006
		Write-off net SWP interest as of June 30, 2005	Expense Current Year SWP Interest	Adjust Current Year SWP Amortization	
		(A)	(B)	(C)	
Cash Flows from Operating Activities:					
Cash received from water sales	\$ 813,814				\$ 813,814
Cash received from readiness-to-serve charges	79,631				79,631
Cash received from capacity charges	31,747				31,747
Cash received from power recoveries	29,892				29,892
Cash received from wheeling/exchange transactions	12,904				12,904
Cash paid for operating and maintenance expenses	(159,526)				(159,526)
Cash paid to employees	(191,750)				(191,750)
Cash paid for power and water costs	(340,918)				(340,918)
Member agency distribution	(8,982)				(8,982)
Other cash flows from (for) operating activities	2,045				2,045
Net Cash Provided By Operating Activities	268,857	-	-	-	268,857
Cash Flows from Capital and Related Financing Activities:					
Acquisition and construction of capital assets	(439,400)				(439,400)
Payments for participation rights in state water facilities	(128,894)				(128,894)
Payments for participation rights in other facilities	(65,369)				(65,369)
Proceeds from long-term debt	198,284				198,284
Proceeds from short-term debt	-				-
Proceeds from capital grants	948				948
Principal and interest paid on long-term debt	(233,337)				(233,337)
Proceeds from tax levy	97,825				97,825
Transfer (to) from escrow trust accounts	2,180				2,180
Transfer to revenue bond reserve/redemption fund	6,345				6,345
(Payment) refund of rebatable arbitrage	(1)				(1)
Proceeds from real estate sales	13,061				13,061
Collection of notes receivable	7,506				7,506
Net Cash Used By Capital and Related Financing Activities	(540,852)	-	-	-	(540,852)
Cash Flows from Investing Activities:					
Purchase of investment securities	(12,586,450)				(12,586,450)
Proceeds from sales and maturities of investment securities	12,819,461				12,819,461
Investment Income	34,794				34,794
Net Cash Provided (Used) By Investing Activities	267,805	-	-	-	267,805
Net increase (decrease) in cash and cash equivalents	(4,190)				(4,190)
Cash and Cash Equivalents, Beginning of Year	5,154				5,154
Cash and Cash Equivalents, End of Year	\$ 964	\$ -	\$ -	\$ -	\$ 964

Statement of Cash Flows

The Metropolitan Water District
of Southern California

(Dollars in thousands)	Adjustments				Adjusted 6/30/2006
	6/30/06	Write-off net SWP interest as of June 30, 2005	Expense Current Year SWP Interest	Adjust Current Year SWP Amortization	
Reconciliation of Operating Income to Net Cash Provided by Operating Activities		(A)	(B)	(C)	
Operating Income	\$ 93,920			\$ 58,474	\$ 152,394
Adjustments to reconcile Operating Income to Net Cash Provided by Operating Activities:					
Depreciation and amortization expense	209,805			58,474	268,279
Increase in accounts receivable	(9,359)				(9,359)
Increase in inventories	(4,319)				(4,319)
Increase in prepaid expenses	(6,351)				(6,351)
Decrease in accounts payable	(13,117)				(13,117)
Other - Net	(1,722)				(1,722)
Total Adjustments	174,937	-	-	58,474	233,411
Net Cash Provided by Operating Activities	\$ 268,857	\$ -	\$ -	\$ 116,948	\$ 385,805
Significant Noncash Investing, Capital and Financing Activities:					
Refunding bonds proceeds received in escrow trust fund	\$ 74,008				\$ 74,008
Debt defeased through escrow trust fund with refunding debt	\$ (73,365)				\$ (73,365)
Deferred loss on refunding debt	\$ (712)				\$ (712)
Change in fair value of investments	\$ (12,549)				\$ (12,549)
Reconciliation of Cash and Investments to Cash and Equivalents					
Unrestricted cash and investments	\$ 466,742				\$ 466,742
Restricted cash and investments	510,457				510,457
Total cash and investments, at fair value	977,199	-	-	-	977,199
Less carrying value of investments	(976,235)				(976,235)
Total Cash and Cash Equivalents	\$ 964	\$ -	\$ -	\$ -	\$ 964

Notes Referenced on Other Worksheets:

- Write-off net post-construction SWP interest and OMP&R component recorded as SWP Participation Right -- Per PwC audit recommendation write-off cumulative effect through June 30, 2005 to recognize change to preferable accounting method. Restatement of prior years not required.
- (A)
- (B) Expense current year SWP interest -- Per PwC audit recommendation expense interest component of SWP capital payments as incurred.
- Adjust current year SWP amortization -- To reflect lower annual amortization expense as a result
- (C) of expensing interest charges as incurred instead of recording as Participation Right, expensing OMP&R previously capitalized, and use of entitlements vs. actual/estimated deliveries.