

**UNIVERSITY OF CALIFORNIA, DAVIS
INTERNAL AUDIT SERVICES**

**University of California, Davis Health System
UCDMC Depreciation Expense
Internal Audit Services Project #13-18**

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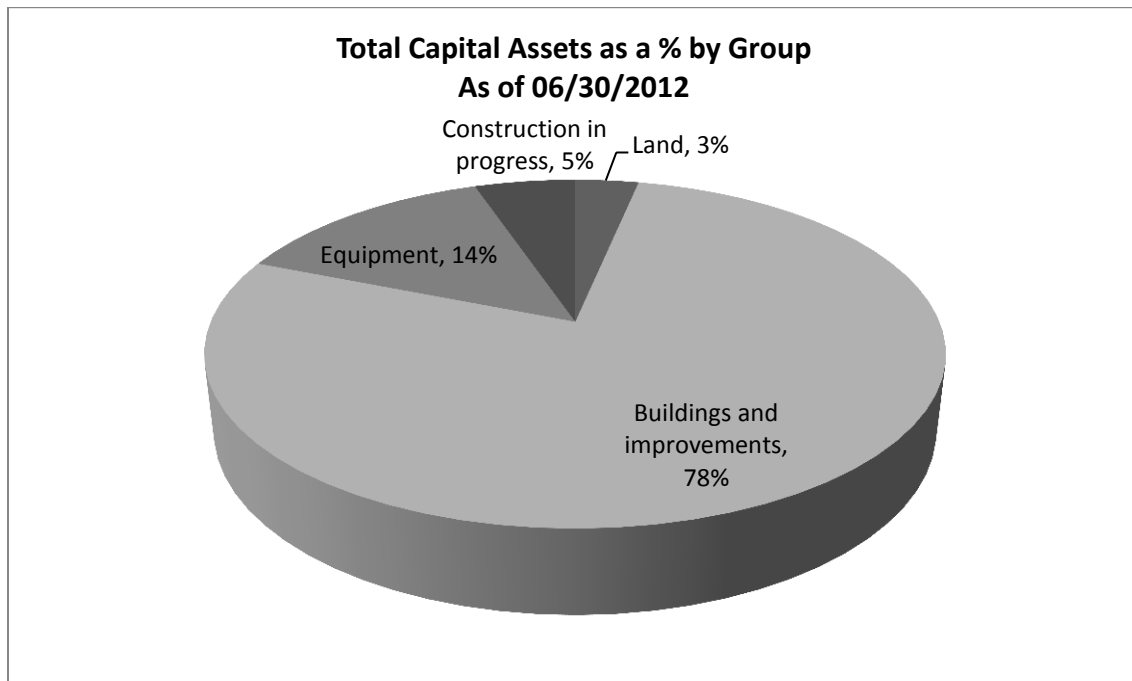
Approved by:

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MANAGEMENT SUMMARY

BACKGROUND

Capital assets totaling \$1.1 billion make up approximately 71% of the UC Davis Medical Center (UCDMC) total assets. Annual depreciation and amortization expenses totaling \$84.8 million equal approximately 7% of the total operating expenses. As a result of the significance, effective internal controls should be designed and implemented to provide reasonable assurance over the financial reporting and management of capital assets so that capital assets and related depreciation expenses are recorded accurately, completely and timely.



Capital assets are reported at cost. Depreciation is recorded on a straight-line basis over the estimated useful lives of the assets. The ranges of the estimated useful lives are 5 to 40 years for buildings and land improvements and 3 to 20 years for equipment. Records for UCDMC non-equipment capital assets are maintained within the Sage FAS100 fixed asset accounting system while major UCDMC equipment records are maintained in the Quali Financial System Capital Assets Management module (CAMS). At the time of the audit, we estimated UCDMC owned or leased facilities with approximately 81 different addresses and 272 UCDMC operating departments were associated with those addresses at a total of about two million square feet of designated work space.

Capital asset requisition, approval and construction monitoring is handled by the UCD Health System (UCDHS) Facilities Design & Construction department. Recording of capital asset capitalization is performed by the UCD Campus Capital Asset Accounting division. UCDHS Financial Services is responsible for recording UCDMC depreciation expenses and equipment disposal. Facilities Design & Construction handles physical custody over disposal of UCDMC equipment.

PURPOSE AND SCOPE

UCD Medical Center depreciation expense was audited as part of our planned reviews for fiscal year 2012. The purpose of the audit was to review the UCDMC asset base and depreciation expense calculations to ensure appropriate reporting as well as identify opportunities for internal control and process improvements.

To conduct our review, we interviewed UCDHS Financial Services and Facilities Design & Construction personnel to understand the authorization, encumbrance, capitalization, depreciation and disposal processes. We performed analytical procedures to test the accuracy and completeness of depreciation expense as reported. We examined items from various capital asset lists from multiple sources on a test basis. We used a risk based approach to focus our review on specific key processes such as capitalization, depreciation, and disposal. Our testing included determining the following:

- Office improvements from expired leases are written off from the balance sheet.
- All capital assets (properties and equipment) are capitalized.
- All recorded UCDMC properties are used principally for clinical purposes.
- Depreciation expense is recorded accurately.
- Fully depreciated or old equipment no longer in use is written-off.
- Losses reported from biannual physical counts are within reasonable levels.

CONCLUSION

We concluded that sufficient separation of duties exists and adequate internal controls are implemented over the authorization, purchase, capitalization and depreciation of capital assets to provide reasonable assurance that capital assets are capitalized and depreciated accurately on a timely basis. We also identified opportunities for improvement in the following areas:

- Maintaining records for UCDMC capital assets.
- Ensuring the appropriate allocation of property tax payments.
- Accounting for some capitalized assets.
- Accuracy in the reporting of depreciation expenses.

Our observations and recommendations are presented within the body of this report along with corresponding corrective actions management has agreed to implement.

OBSERVATIONS, RECOMMENDATIONS, AND MANAGEMENT CORRECTIVE ACTIONS**1. UCDMC Capital Asset Records**

The process for maintaining the records for UCDMC capital assets could be improved.

Properties no longer used principally for clinical purposes remained in the UCDMC balance sheet. We identified 10 property items reflected in the UCDMC balance sheet with a net carrying value of \$880,000 that were no longer used principally for clinical purposes. UCDHS Financial Services was not timely notified regarding UCDMC properties that were no longer used for clinical purposes.

UCOP Accounting Manual H-576-62, *Hospital Plant Asset Accounting*, states that depreciation on University-owned buildings and equipment used in connection with patient care will be recorded as an operating expense for each hospital. Insufficient review over recorded capital assets may result in capital asset overstatements in the financial statements.

Recommendation

UCDHS Facilities & Space Management should collaborate with UCDHS Financial Services to improve the process for maintaining capital asset records.

Management Corrective Action

Facilities & Space Management will collaborate with UCDHS Financial Services in improving the process for evaluating changes in the overall usage characterization of listed UCDMC properties for accounting purposes by June 30, 2013.

2. Property Tax Payments

Procedures for ensuring the appropriate allocation of property tax payments could be strengthened.

Property taxes paid by the UCDMC for a School of Medicine (SOM) facility were not recharged to the SOM. In fiscal year 2012, UCDMC paid \$92,650 in back property taxes registered to the Institute of Regenerative Cure facility for the tax periods 2002 to 2012. However, the building was transferred from the UCDMC to the SOM in FY 2008. Therefore, an estimated \$32,000 in property taxes should have been charged to the SOM.

According to UCOP Business Bulletin A-47, *University Direct Costing Procedures*, a recharge as a direct cost is categorized as a cost charged to a University department for specific goods or services provided by another University department. Included in this category are goods and services provided by auxiliary and service enterprises, academic department support units, plant services departments, and other departments - other than central campus administrative offices - with approved recharge budgets. In practice, however, prior year expenses are not recharged retrospectively due to the impact on the financial process.

Recommendation

UCDHS Financial Services should recover the taxes paid on behalf of the SOM and ensure that future property tax payments attributed to SOM departments are expensed directly to SOM or recharged to SOM departments.

Management Corrective Action

UCDHS Financial Services will absorb the back property taxes for the periods 2002 to 2012. Financial services will work with Facilities, Design and Construction to establish procedures to ensure that future property tax payments attributed to SOM departments are expensed directly to SOM or recharged to SOM departments by June 30, 2013.

3. Parking Structure III***Accounting for some capitalized assets should be evaluated.***

Parking Structure III has a reported asset value of \$26 million. The asset and related accumulated depreciation are recorded in the UCDMC accounting records. However, the operating revenues and expenses associated with the structure are recorded in the UC Davis (UCD) accounting records. The parking structure was financed with parking reserves and Limited Project Revenue Bonds. The parking reserves are recorded in the UCD accounting records and the bonds are recorded as a UCD obligation. Parking revenues are recorded in the UCD accounting records because the revenues are pledged for the bonds.

The matching principle is an underlying concept of accrual basis accounting that offsets revenue against expenses on the basis of their cause-and-effect relationship. In measuring net income for an accounting period, all costs (including depreciation) incurred in that period should be matched against the revenue generated in the same period. Accordingly, the UC System-wide Controller advised that it would be more appropriate if the parking structure asset and related depreciation was recorded on the UCD books along with all the other related transactions, and that this could be accomplished by transferring the asset to the campus this fiscal year.

There are other capital assets that are not accounted for consistent with the matching principle. Parking Structure I was also funded by debt that is not identified as a UCDMC obligation. Parking Structure II was funded by Hospital Revenue Bonds. However, the operating revenues and expenses associated with this structure are recorded in the UC Davis accounting records. The application of accounting and reporting principles should be consistent to ensure the accuracy of the financial reporting.

Recommendation

UCDHS Financial Services should collaborate with the UC System-wide Controller and UCD Accounting & Financial Services in determining the appropriate accounting treatment for capital assets.

Management Corrective Action

UCDHS Financial Services will collaborate with the UC System-wide Controller and UCD Accounting & Financial Services in determining the appropriate accounting treatment for capital assets by August 31, 2013.

4. Other Depreciation Expenses***Accuracy in the reporting of depreciation expenses could be improved.***

We noted that depreciation expense was not recorded for 30 capitalized equipment items, resulting in a \$53,000 understatement in depreciation expense for fiscal year 2012. The un-depreciated items were isolated within a few of the custodial codes that were not configured for depreciation. UCDHS Financial Services conducts a periodic schedule review to detect and correct these un-depreciated items, but missed some of them due to the high volume of items within the schedule population. We also noted that equipment depreciation expense was not reconciled accurately to the general ledger. For fiscal year 2012 CAMS equipment depreciation expense per the depreciation schedule varied from the general ledger by about \$220,000 because the CAMS depreciation schedule was not closed as part of the fiscal year-end closing process and changes were updated to the CAMS depreciation schedule past the established report cutoff date.

UCOP Accounting Manual H-576-62, *Hospital Plant Asset Accounting*, states that depreciation on University-owned buildings and equipment used in connection with patient care will be recorded as an operating expense of each hospital. Depreciation computation will be based on the cost method of capital asset valuation and useful life over a straight-line method of computation. The UCD Administrative Responsibilities Handbook states that income and expenses recorded in departmental financial subsystems must be reconciled to general ledger in DaFIS Decision Support.

UCDHS Financial Services will continue to review the depreciation schedule on a periodic basis to detect un-depreciated items that should be configured for depreciation. UCDHS Financial Services will also collaborate with UCD Accounting & Financial Services in establishing a process to close the CAMS depreciation schedule report by the scheduled report cutoff date for financial reporting purposes. These actions will suffice to address the issues identified because the amounts involved were relatively insignificant to the total depreciation expense of \$29 million for fiscal year 2012.
