CAPITAL PROGRAMS

CAPITALIZATION PROCEDURES AND PRACTICES

 AUDIT REPORT #18-2101

Audit & Advisory Services

June 2018

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# Background

In accordance with the Campus fiscal year 2017-18 audit plan, Audit & Advisory Services (A&AS) performed an audit of internal controls and procedures related to cost capitalization for major construction projects administered by UCLA Capital Programs.

The Capital Programs department is responsible for conceptualizing, planning, designing, and constructing major capital construction and renovation projects at UCLA. Projects having total costs of $750,000 and above are consider major capital construction. Since its establishment in 1986 to the end of 2017, Capital Programs has expended approximately $6.3 billion to complete a variety of new construction, renovation, and infrastructure projects; two replacement hospitals and related parking facilities; nearly 58 buildings or building complexes; 27 major building additions; and five new parking facilities. In addition, seismic renovations have been completed on approximately 63 buildings, and a large number of existing buildings throughout the campus have been modernized. Capital Programs develops financial strategies, obtains project approvals, reviews plans and specifications, completes environmental reviews, prepares and negotiates construction contracts, coordinates staging plans, and serves as a repository for project records and as-built plans.

Per Generally Accepted Accounting Principles and the University of California (UC) Accounting Manual, Section P-415-3, “Plant Accounting: Investment in Plant – Capitalization and Elimination in Current Funds,” when a capital project is complete or substantially complete, the University will capitalize qualified project-related expenditures for future depreciation purposes. Expenditures related to a capital project are accumulated throughout the project’s life against their designated plant account(s). In December and June of each fiscal year, UCLA Corporate Accounting personnel make the appropriate journal entries to capitalize expenditures for those projects that are approximately 90 percent complete based on the general contract value. The UC Accounting Manual also specifies that a project that has been issued a Certificate of Occupancy for a portion of the project space should be considered for capitalization if the space has been placed into service, even if the total project is less than 90 percent complete. Prior to executing the journal entries, Capital Programs Financial Services (CPFS) has the opportunity to review the candidate projects and to recommend to UCLA Corporate Accounting staff whether or not these projects should be capitalized.

Annual depreciation calculations are completed by staff from the UC Office of the President and are provided to the campuses for reporting. The campuses are not responsible for calculating the depreciation amounts.

The CPFS unit is directed by an Associate Vice Chancellor, who is supported by a Finance Manager and three professional staff.

# Purpose and Scope

The primary purpose of the audit was to evaluate Capital Programs’ processes and controls associated with project cost capitalization activities to ensure business practices comply with applicable University accounting principles and standards. Where applicable, compliance with campus and University policies and procedures were also evaluated.

The scope of the audit focused on the following areas:

Cost Coding and Approval

Cost Classification

Capitalization Procedures

The audit was conducted in conformance with the *International Standards for the Professional Practice of Internal Auditing* and included interviews, tests, and other procedures considered necessary to achieve the objective.

Summary Opinion

Based on the results of the work performed within the scope of the audit, Capital Programs has established effective business practices and internal controls surrounding the recording of major construction expenditures to ensure they are properly classified and capitalized. There were no significant control weaknesses identified during the audit.

The audit results are detailed in the following sections of the report.

# Audit Results and Recommendations

## Cost Coding and Approval

The proper and consistent capitalization of expenditures are important to accurately capture University capital assets for financial reporting purposes. The majority of project costs recorded by Capital Programs in plant accounts are capitalized into asset groups; however, certain types of expenditures are noncapital, and must be coded accordingly. Every financial entry made to an expenditure account must have a subaccount and an object code (sub object code) that appropriately identifies the nature of the cost incurred. Departments must utilize object codes in a consistent manner and exercise care that expenditures are recorded to the code that most accurately describes the charge. Ultimately, sub object codes used to record financial entries to plant accounts determine whether the transactions are treated as capital costs or expenditures.

Capital Programs Financial Services is responsible for coding cost items when purchase orders are created, and for receiving invoices into BruinBuy, UCLA’s online purchasing application, after they are reviewed and approved by Project Managers. Interviews were held with management, and reviews were performed of UC Policies and guidelines and the Capital Programs Current Plant Acct Sub and Object Codes listing, to obtain an understanding of cost categories, and the type of items that are ordinarily capitalized.

A judgmental sample of 10 expenditure transactions were selected from the Detail General Ledgers for five projects capitalized in fiscal year 2016-17. Invoices were reviewed to verify that the appropriate personnel approved the transactions, costs were properly coded and recorded in the correct categories, moveable equipment and land costs were not capitalized with the construction cost of buildings and structures, and invoiced items were applied to the appropriate project plant accounts. Based on the work performed, internal controls over cost coding practices appear to be adequate and functioning for capitalization purposes.

There were no significant control weaknesses noted in this area.

## Cost Classification

For a judgmental sample of five plant accounts with combined costs of $228.4 million as of December 2016 and June 2017, a total of 3,884 expenditure transactions from the Campus Detail General Ledgers were reviewed to identify any inconsistencies in cost classification that could impact the capitalization of the projects. The Current Plant Acct Sub and Object Codes listing was reviewed and interviews with management were held to understand how project costs are coded, and which sub object codes accumulate the transactions for capitalization. Data analytics was used to test all general ledger transactions from inception-to-date by grouping payee names together and determining whether the expenditures in each group were consistently treated for capitalization purposes based on the assigned sub object codes. Further analysis was done for any transactions that were inconsistently coded to determine whether the expenditures were misclassified and if the overall impact on the capitalization of the project could be significant. Based on the work performed, A&AS determined that transactions were consistently recorded to accurately reflect capital costs of the projects.

There were no significant control weaknesses noted in this area.

## Capitalization Procedures

As part of the capitalization review process, a list of candidate projects is prepared biannually by UCLA Corporate Accounting and provided to CPFS for review. Plant account projects that have gone through the capitalization process in previous periods are coded “Y” and are also listed on the report. Capital Programs Financial Services will then analyze the list, recommend to Corporate Accounting which projects and related studies should be capitalized, and provide information about the status of other projects that may be approaching the capitalization threshold based on the 90 percent completion rule. Factors that are also taken into account during the review include whether or not a project has been issued a Certificate of Occupancy or a Notice of Completion, if one portion of a multi-phase project has been completed and received its Certificate of Occupany, or/and if a significant scope change has been made that would alter the life of the project.

The June 2017 candidate project list was reviewed to verify that it included all projects that were in the construction and post-construction phases according to the departmental Master Project Schedule. Also, based on a judgmental sample of eight plant accounts selected from the candidate project lists for the periods ending December 2016 and June 2017, A&AS verified that capitalization was considered for projects that were at least 90 percent complete.

Of the eight plant accounts, CPFS recommended that six projects should be capitalized. A&AS verified that a basis was established for the recommendations by reviewing supporting documents, such as the Certificate of Occupancy or a Notice of Completion. A&AS staff also determined that study plant accounts that were capitalized with the projects were related to the specific buildings or structures. The budget from the approved Capital Improvement Budget report was compared to the appropriation amount to determine whether there were large variances that would have a significant impact on how each project is capitalized, and if the matter was addressed by CPFS. The audit test results confirmed that the plant accounts managed by Capital Programs were eligible for capitalization and properly recommended to UCLA Corporate Accounting by CPFS staff. Based on the work performed, A&AS verified that adequate controls exist over the capitalization review process.

There were no significant control weaknesses noted in this area.

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