CAPITAL PROGRAMS

CAPITALIZATION PROCEDURES AND PRACTICES

AUDIT REPORT #22-2101

Audit & Advisory Services

June 2022

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Background

In accordance with the Campus fiscal year 2021-22 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. As of June 2021, 380 plant accounts were considered for capitalization and had approximately $847 million in costs.

The Capital Programs department is responsible for conceptualizing, planning, designing, and constructing major capital construction and renovation projects at UCLA. Projects greater than $1 million are considered major capital construction projects. Since Capital Programs was established in 1986, the department has overseen approximately $6.3 billion in expenditures to complete a variety of new construction, renovation, and infrastructure projects. By late 2017, 58 buildings or building complexes, five new parking facilities (and expansion of two others), and 27 major building additions have been constructed on campus. In addition, 63 buildings have been seismically renovated, and an extensive number of renovations to modernize portions of existing buildings throughout the campus have been completed. Two replacement hospitals and related parking facilities have also been constructed, one on the Westwood campus and the other in Santa Monica.

UCLA 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. The department’s mission is to create projects that “support the instruction and research mission of the University by providing a physical campus environment that fosters excellence, creativity, and a sense of community.” Capital construction projects are developed with consideration given to UCLA land use priorities, established physical designs, University policies and procedures, environmental and regulatory requirements, and community interests.

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 cycle and recorded within 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) staff have the opportunity to review the candidate projects and to recommend to UCLA Corporate Accounting staff whether or not these projects should be capitalized.

Staff from the UC Office of the President perform annual depreciation calculations that are then provided to the campuses for reporting purposes. Personnel at the campuses are not responsible for calculating the depreciation amounts.

The CPFS unit consists of three professional staff overseen by an Assistant Director, who reports to the Associate Vice Chancellor for Capital Planning & Finance.

Purpose and Scope

The primary purpose of the audit was to evaluate Capital Programs’ processes and internal controls associated with 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 was also evaluated.

The scope of the audit focused on the following areas:

* Cost classification and approval
* Cost coding and approval
* Capitalization procedures

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

Summary Opinion

Based on the results of the work performed within the scope of the audit, Capital Programs’ processes and internal controls associated with cost capitalization activities ensure that business practices comply with applicable University accounting principles and standards. However, management could further strengthen controls and improve efficiency of operations by implementing the following:

Management should collaborate with Business & Finance Solutions to develop written procedures or guidelines to formalize the existing methodology for the capitalization process, as well as to further define the roles of CPFS and Business and Finance Solutions personnel in the capitalization review process. UCLA Policy 360 – “Internal Control Guidelines," requires department management to maintain an effective internal control environment that includes ensuring the validity, accuracy, and reliability of accounting records and financial reports; and promoting adherence to prescribed management policies and procedures and regulatory requirements.

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

Audit Results and Recommendations

Capitalization Procedures

As part of the capitalization review process, a list of candidate projects is prepared semi-annually by UCLA Corporate Accounting and provided to Capital Programs Financial Services (CPFS) staff for review. Plant account projects that have gone through the capitalization process in previous periods are coded “Y” and are listed on a capitalization report. Capital Programs Financial Services will then review 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, whether one portion of a multi-phase project has been completed and received its Certificate of Occupancy, and/or whether a significant scope change has been made that would alter the life of the project.

A&AS reviewed the June 2021 candidate project list to verify that it included all projects that were in the construction and post-construction phases according to the UCLA Capital Programs Master Project Schedule. A judgmental sample of five plant accounts was selected from the candidate project list for audit review to verify that capitalization was considered for projects that were at least 90 percent complete. Of the five plant accounts reviewed, CPFS recommended that all five projects be capitalized. A&AS also verified that a basis was established for the recommendations by reviewing supporting documentation, such as the Certificate of Occupancy or a Notice of Completion. Moreover, A&AS determined that plant accounts initially established for project studies were properly capitalized with those related to the specific buildings or structures noted in the studies. For each of the five projects reviewed, the budget from the approved Capital Improvement Budget report was compared to the project appropriation amount from the Detail General Ledger to determine whether there were large variances that could impact how each project is capitalized, and if so, whether the matter was addressed by CPFS staff. Audit testing disclosed that only two of the five plant accounts showed a variance. The variance amounts were less than one percent and, therefore, deemed immaterial. The plant accounts reviewed that were managed by Capital Programs personnel were properly recommended to UCLA Business and Finance Solutions for capitalization.

Based on the work performed, A&AS determined that adequate controls exist over the project capitalization review process, and the project capitalization process generally aligns with UC Accounting Manual recommendations. However, Capital Programs does not currently have supplemental written procedures to formalize the existing coordination with Business & Finance Solutions staff for capitalization review. As an ongoing practice, CPFS and UCLA Business and Finance Solutions routinely collaborate to determine how and when to record capitalization entries.

Currently, the methodology used to determine whether a plant account is ready for capitalization is if the plant account has reached at least a 90 percent cost threshold; however, there may be additional factors (e.g., projects that are under the 90 percent threshold but have received a Certificate of Occupancy or Notice of Completion, etc.) that are taken into consideration before the plant account costs are capitalized. These additional considerations are left to staff discretion and are not explicit within the current Accounting Manual as a basis for capitalization entries. Although Capital Programs staff do not complete capitalization transactions independently, their feedback to Business and Finance Solutions personnel on plant accounts and their status help to determine when the accounts should be capitalized. Formalized, written procedures could clarify and assist in defining additional responsibilities and methodologies used in the process.

Recommendation**:** Management should collaborate with Business & Finance Solutions to develop written procedures or guidelines to formalize the existing methodology for the capitalization process, as well as to further define the roles of CPFS and Business and Finance Solutions personnel in the capitalization review process. UCLA Policy 360 – “Internal Control Guidelines," requires department management to maintain an effective internal control environment that includes ensuring the validity, accuracy, and reliability of accounting records and financial reports; and promoting adherence to prescribed management policies and procedures and regulatory requirements.

Response**:** In consultation with Business & Finance Solutions, procedures have been drafted to outline the capitalization business process. A copy of the procedures has been provided to Audit & Advisory Services.

Cost Coding and Approval

The proper and consistent capitalization of expenditures is important to accurately identify and capture the University’s 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 considered non-capital, and must be coded accordingly to ensure accurate financial reporting.

Every financial transaction that is made to an expenditure account must have a sub-account 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 activity. Ultimately, sub-object codes are used to record financial entries to plant accounts and determine whether the transactions are treated as capital costs or operating expenditures. In order to allocate various expenditures to the plant account, a cost center code and fund number are assigned. To ensure the clarity of financial reporting, plant accounts are summarized by their plant account number, regardless of the cost center code and fund number assigned.

After review and approval by the relevant project manager, CPFS staff are responsible for coding cost items when purchase orders are created, and for receiving invoices into BruinBuy, UCLA’s online purchasing application. A&AS conducted interviews with department management; reviewed pertinent UC Policies and guidelines, and the UCLA Capital Programs Current Plant Acct Sub and Object Codes listing, to obtain an understanding of cost categories, and the types of expenditure items that are typically capitalized.

A&AS obtained a list of capital construction projects from a June 2021 capitalization worksheet maintained by Capital Programs staff. Data analytics was used to analyze more than 600 line items and identify those projects that had expended at least 90 percent of their budget appropriation and, therefore, could be considered candidates for having their costs capitalized. A judgmental sample of six plant accounts totaling $9.3 million was selected for audit testing from the Detail General Ledger for projects capitalized in fiscal year 2020-2021. Project invoices were reviewed to verify that appropriate personnel approved the transactions, costs were properly coded and recorded in the correct categories, and invoiced items were accurately 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

A&AS selected an additional judgmental sample of five plant accounts with combined expenditures of approximately of $5 million, as of June 2021 to determine whether project costs had been properly classified and coded correctly. Detail General Ledger information was reviewed for each sample test item 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 to understand how project costs are coded, which sub object codes accumulate the transactions for capitalization, and their overall impact on the capitalization of the project, which could be potentially significant if coded incorrectly. Based on the work performed, A&AS determined that transactions were consistently recorded to accurately reflect the capital costs for the projects.

There were no significant control weaknesses noted in this area.

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