GLWA
Great Lakes Water Authority

Financial Services
Audit Committee Communication

Date: January 19, 2018

To: Great Lakes Water Authority Audit Committee

From: Nicolette N. Bateson, CPA, Chief Financial Officer/Treasurer

Re: Capital Overhead Cost Allocation Project

Background: The FY 2017 budget for the Great Lakes Water Authority (GLWA) was prepared in late calendar year 2015 and early calendar year 2016. This spanned GLWA's operational effective date of January 1, 2016. GLWA's financial system was launched in March 2016. The predecessor entity's financial system was challenging at best. In addition, financial staff vacancy approached a 50% mark as staff for one consolidated entity was now split between two entities at the time of bifurcation.

As we approach the second anniversary of the launch of GLWA's financial system, basic functions are running well and we now have one full fiscal year of data for analysis. This was sorely needed to begin to establish financial patterns and expectations. One area that was more elusive in the prior system was the accumulation and tracking of internal capital project time and overhead. Today, while progress has been made, cost allocation (a high priority need for GLWA) is largely manual via spreadsheets. Tracking time is time consuming, and worse, untimely, inconsistent, and difficult to implement. In the long-term, the Information Technology group is evaluating options for tracking time by project.

Aside from the technology and business process issues, we need to formulate an informed policy related to capital project overhead.

Analysis: There are two aspects of this topic that we want to bring to the Audit Committee's attention: 1) Self-constructed Asset Capitalization Policy (under evaluation) and 2) Impact on FY 2017 Budget.

1) Self-constructed Asset Capitalization Policy: Many public entities, including water and sewer systems, have capitalization policies with wording akin to the following.

Self-Constructed Assets: When the entity uses internal staff, resources, equipment, and/or materials to construct a building or piece of machinery or equipment for its own use that meets the capitalization dollar criteria, an acquisition cost will be established and the asset will be recorded as if it had been purchased.

All direct costs, including material and labor costs, will be included in the total cost of the asset. Overhead (indirect) costs will not be included unless they are increased by the construction of the asset.

The above policy statement is consistent with generally accepted accounting principles which references any “ancillary charges necessary to place the asset into its intended location and condition for use”.

Given the intensive capital nature of GLWA’s operations, the question of indirect overhead allocations is complex (especially with limited, quality data from our short life) but is also significant. This is especially true in areas where costs are incurred to provide internal services that are clearly related to projects, but not to one specific project.

Revolving Fund guidelines address “force account costs” as “direct labor costs, indirect costs, and other project allocable expenses, such as travel, printing, or postage incurred by an applicant for administration and technical services are eligible for reimbursement if such costs are adequately documented, as described in the “Instructions for Completing the Project Cost Worksheet” (requires detailed project time accounting)”.

There are several considerations in evaluating the indirect overhead allocation.

1. How those costs should be funded. The predecessor entity’s practice was to optimize the use of debt for capital improvements. That may not be consistent with GLWA’s long-term financial sustainability objectives.
2. System limitations and the cost/benefit of work-arounds may impact an approach.
3. Implementing business processes and systems to align the CIP cost build-up by project, by year and the budget for each year.
4. Preventing bloating of the asset cost (and related annual depreciation expense) with a high percentage of indirect costs.
5. Ensuring that soft costs do not accumulate in construction work-in-progress (CWIP) that do not materialize into capitalizable assets.

2) Impact on FY 2017 Budget: As we were closing the books for FY 2017, to varying degrees, all five of the above considerations led us to a conservative application of overhead allocation. In hindsight, the original FY 2017 overhead allocation budget may have been high (even though they were significantly lower than the predecessor entity). We had no history. Also, as a new entity, our level of capital delivery was lower which may have overstated asset value if we applied indirect overhead in addition to capitalized interest on CWIP. And, as a new entity, we simply did not have the people, processes, or technology in place to develop and manage an effective indirect cost allocation plan.

The result is a material variance in "contra-expenses" of $24.2 million or 92%. It should be noted however, that a significant portion of this variance is offset by many related expense categories being under budget. The preliminary FY 2017 overall operations and maintenance budget is expected to have a positive variance of approximately $32 million, inclusive of this variance.

Category	FY 2017 Original Budget (No Amendments)	FY 2017 Activity (Direct Labor Only)	Variance	Variance Percent
Water - Capital Program Allocation	$ (2,895,500)	$ (869,300)	$ (2,026,200)	70.0%
Wastewater - Capital Program Allocation	(3,061,400)	(1,150,300)	(1,911,100)	62.4%
Centralized - Capital Program Allocation	(20,225,100)	(108,300)	(20,116,800)	99.5%
Administrative - Capital Program Allocation	(195,000)		(195,000)	100.0%
Total	$ (26,377,000)	$ (2,127,900)	$ (24,249,100)	92%

Next Steps: The next steps include the following.

1. Given the closing of FY 2017 as we are preparing the FY 2019+ Budget, a further review of the proposed O&M budget will occur.

2. Assignment of staff to plan and conduct a Capital Overhead Cost Allocation Project including policy, process, technology, and the next level of alignment with CIP.

3. Fiscal Note for FY 2018 based on review of capital spend-to-date versus capital program allocation.

Proposed Action: Receive and file report.