

Capital Project Fund Eligibility Guidelines

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Introduction:

The purpose of this document is to establish accounting guidelines for expenditures related to Capital Assets. The discussions presented in the following pages are intended to clarify two distinct issues relative to the District's Capital Improvement Plan. They are:

- Allowable charges that may be charged to a Capital Project Fund
- Expenses that are eligible for capitalization

The School District of Philadelphia is committed to maintaining a high degree of excellence in all matters relating to budgeting, financing, accounting and project planning. As a public entity, we are bound by state and federal law, local acts, professional standards, and generally accepted accounting principals. Because of the multiplicity of governing bodies that affect the District, policies and procedures must be crafted so that the sometimes conflicting guidelines are reconciled. Therefore, these Guidelines have drawn on principals promulgated by various authoritative bodies, state law, outside counsel, bond covenants, external auditors and the practices of other governmental bodies engaged in similar activities.

These include:

- Government Accounting Standards Board (GASB)
 - Various publications including GASB 34
- American Institute of Public Accounting
 - Various Publications
- Financial Accounting Standards Board
 - Various Publications
- Government Financial Officers Association
 - Various Publications
- The Internal Revenue Service
 - IRS Publication 4079, Tax Exempt Government Bonds Compliance Guide
- The Controllers Office of the City of Philadelphia
 - Audits and Memoranda
- The Pennsylvania Department of Education
 - Manual of Accounting and Related Financial Procedures
- Commonwealth of Pennsylvania
 - Local Unit Government Unit Debt Act

Clarification of terms

The terms Capital, Capital Funds, Capitalization and Expense are frequently misunderstood and often used interchangeably. In reality, they each have independent meanings. This often leads to communication problems and operational difficulties. With that in mind, the following definitions have been established:

- **Capital Asset** - In general, “Capital Asset” refers to the expenditures associated with the acquisition, renovation, construction or improvement of School District of Philadelphia (SDP) owned tangible assets. The outcome of the expenditures must result in tangible assets that have a component value that meets the SDP Capitalization threshold (currently \$500¹) and have an estimated useful life of at least 1 year. These types of assets include land, improvements to land, vehicles, machinery, equipment, works of art, etc.
 - Personal Property – This is a subset of Capital Assets. Personal Property refers to capital assets that are not part of a capital project (e.g. personal computers, desks, copy machines etc). They tend to be portable and are not related to the construction or renovation of a structure.
 - Capital Project – This is a subset of Capital Assets. Capital Projects tend to be much larger and more complex than Personal Property acquisitions.
- **Capitalize** – This is an accounting term which refers to the process of grouping expenditures related to capital assets and booking them on the SDP Balance Sheet. Once the item is capitalized, an entry is also made in the FAS Gov Fixed Assets Accounting subsidiary system. FAS Gov is the system used by the SDP to track fixed assets for financial statement purposes. The item is assigned an expected useful life and depreciated over the length of that life. Not all expenditures will be capitalized. Some will be expensed.
- **Capital Project Fund** – The fund type used to account for financial resources to be used for the acquisition or construction of major capital facilities (other than those financed by proprietary funds and trust funds). Capital outlays financed from general obligation bond proceeds should be accounted for through a capital projects fund. [NCGA Statement 1 Paragraphs 10 & 26, as amended by NCGAS 6, Paragraph 13 and GASB34, Paragraph 69]
- **Capitalization Threshold** – The dollar value at which the SDP elects to capitalize tangible or intangible assets that are used in operations that have initial useful lives greater than 1 year
- **Expense** – A point in time expenditure that reduces the available balance of a fund, but does not get recorded on the balance sheet. Note that certain items may be expensed through a Capital Project Fund, but may not be capitalized.

¹ A proposal to raise the capitalization threshold to \$5000 is currently being prepared.

Discussion on the difference between Capitalization and Expense

When the District expends money for any purpose, whether to pay the electric bill for a school, pay a teacher's salary or construct a new school building, those payments are expensed. That is, a portion of District funds are used up and are no longer available for other uses. In the case of tangible assets (e.g. buildings, computers, televisions) and software those expenses are captured, grouped and identified on the District's Balance Sheet. This process is called **capitalization**.

All Expenditures are expenses but not all expenses can be capitalized.

Two of the basic qualifications for capitalization are (1) the item is tangible and (2) the item will have a useful life of more than one year. Regular expenses required for the ongoing operations of the school district, such as teacher's salaries, do not result in a tangible asset and do not have a useful life of more than one year (i.e. the teacher is paid for the last two weeks of work). Therefore, these expenses cannot be capitalized.

Projects and Activities that may be charged to Capital Funds (whether expensed or capitalized)

A Capital Fund is simply the collection of money to which expenditures for a capital project may be charged. The fund consists of money that is set aside for capital projects. However, not all of the costs associated with a capital project are eligible for capitalization (i.e. some charges must be simply expensed). Costs that are not directly attributable to a specific capital project, but are capital project related may be **expensed** to the Capital Fund (as opposed to expensing to the Operating or some other fund). These costs will reduce the amount of money available in the Capital Fund but will not be capitalized.

The criteria to determine whether **non-capitalized expenses** may be charged to a Capital Project Fund are governed by the following:

Bond Covenants and definitions – If the money for the fund was raised via a Bond Issue – the documentation for each bond issue must be reviewed to determine how the funds are intended to be used. For example, the \$109 million dollar Bond financed through the Dauphin County General Authority states:

Article 1-Definitions -Section 1.04 (d) - District Representations - Page 3
The District will apply the Loan Amount for the purpose of financing the original cost of the acquisition, construction or installation of the Capital Improvements and Facilities identified on Exhibit 1 Attached hereto.

Nowhere in the documentation are there any prohibitions against charging capital program related but non-capitalized expenses to the fund. Furthermore, the exhibit referred to itemizes several costs that clearly cannot be capitalized (e.g. Minority/Women Business Enterprise compliance monitoring).

Disclosed Weighted Average Useful Life – If the money for the fund was raised via a bond issue the bonds are typically collateralized by the Capital Assets which are created with the money borrowed. Typically, an itemization of the projects to be funded is part of the bond documentation. This itemization further estimates the useful life of each project. From that, a weighted average useful life of the entire project portfolio to be financed is calculated. As a rule, the weighted average useful life will be greater than the

repayment period for the bonds (e.g. Bond Life is 30 years and Weighted Average useful life is 38 years).

By definition, a non-capitalized expense has a useful life of zero (0) years. The non-capitalized expenses can reduce the weighted average useful life of the underlying assets. The District should monitor the impact of non-capitalized expenses charged to a capital projects fund so that they do not bring the weighted average useful life of the underlying assets to less than 120 percent of the payback time of the bond (e.g. if the bond is 30 years, then the weighted average useful life of the underlying assets should not dip below 36 years).

IRS Arbitrage Rules – If the money was raised via Tax Exempt Government Bonds – The district may not use the proceeds of capital project bond issues to fund ongoing operations. This would therefore preclude the charging of daily operational expenses against the capital project fund.

Commonwealth of Pennsylvania Local Government Unit Debt Act (Act of 1978-52) – This is applicable if the money for the fund was raised via a Bond Issue - This Act governs the legal authority and limitations of the District to borrow funds. It further defines what a Project is and the allowable costs of a project:

Allowable Capital project costs:

- payments to contractors
- acquisition of a project or for lands, easements, right and other
- appurtenances deemed necessary for the project
- fees of architect, engineers, appraiser, consultants, financial advisors, and attorneys incurred in connection with the project financing costs
- costs of necessary printing and advertising
- costs of preliminary feasibility studies and tests, cost estimates and interest on money borrowed to finance the project, if capitalized, to the date of completion of construction and, if deemed necessary, for one year thereafter,
- amounts to be placed in reserve funds, if any,
- reasonable initial working capital for operating the project and a proper allowance for contingencies
- certain insurance related to the capital project covering SDP risk on the project

Discussion with the District's Bond counsel has confirmed that the Act does not preclude charging capital program related but non-capitalized expenses to the Capital Project Funds.

School District Policy – The District's Capital Fund policy should describe the philosophical basis of the SDP towards allowable expenditures (capitalized and non-capitalized expenses) to the capital project fund. This is particularly true for capital related but non-capitalized overhead and administrative expenses directly related to the Capital Improvement Program. Accounting rules preclude the capitalization of certain types of expenses (see "Support Function Payroll Expenses that Cannot be Capitalized" for exclusions on page 7). However, assuming these expenses do not violate any of the governing covenants of the funds (e.g. bond covenants, Federal rules, etc.), the District may allow them to be paid from the fund, as long as the expenses are treated consistently.

Whether or not non-capitalized expenses can be charged to a capital project fund, unless otherwise required or precluded by the governing sources cited above is largely a philosophical issue. There are no authoritative references that spell out which non-capitalized expenses may be charged to a capital project fund. Discussions with state and city financial areas have confirmed this. This determination should be made outside of discussions regarding whether an expense is eligible for capitalization (i.e. added to the balance sheet). The relevant question is: Can the expenditure be charged to the capital project fund or should it be charged to the General or other fund?

In general the following considerations need to be included in this determination:

1. Is charging the expenditure to the capital projects fund specifically disallowed by any legal or other authority?
 - Bond Covenants
 - Average Weighted Useful Life impact
 - IRS Arbitrage Rules (Are we using tax exempt bond proceeds to finance ongoing operations that are not reasonably assignable to a capital project?)
 - Commonwealth of Pennsylvania Local Government Unit Debt Act
 - Policy
2. Is the expenditure clearly tied to the completion of those projects identified in the District's Capital Improvement Program?
3. Can these charges be readily supported with sufficient documentation to justify charging them to the capital project fund?

Payroll Charges

A significant part of the costs associated with the Capital Improvement Program is District personnel payroll and related payroll benefits. All of these expenditures are expenses. However, not all of these expenses can be capitalized. Therefore payroll expenses need to be examined from two distinct points of view:

1. Can these payroll expenses be charged to the capital project fund?
2. Can these payroll charges be capitalized?

In general, payroll and related benefit expenses can be charged to a capital fund, provided that those personnel are clearly engaged in activities related to the Capital Improvement Program. As a practical matter, unless individuals track their time engaged in Capital Improvement Program activities, it may be necessary to determine this on an all-or-nothing basis. That is, if the individual is engaged in capital related work 100% of the time, their salary and benefit related expenses may be charged to the capital project fund. Otherwise, it should be charged to another fund.

Payroll and related benefits that may be capitalized are subject to more stringent record keeping requirements. That is, in order to capitalize them, the time must be clearly related to work spent on activities related to a specific capital project. The expenses must be assigned at a project level and the charges must be supportable through payroll or some other time tracking documentation. In addition, the payroll dollars associated with certain specified activities is explicitly precluded from capitalization. They are listed below:

Support Function Payroll Expenses that cannot be capitalized

- Executive Management
- Corporate Accounting
- Acquisitions
- Purchasing
- Corporate Legal

- Office Management & Administration
- Marketing
- Human Resources

Again, the above payroll expenses cannot be capitalized. However, depending on the Policy and other criteria previously discussed, they may be charged to a capital project fund.

Direct Charge of Eligible Salaries

Beginning in Fiscal Year 2008, the School District of Philadelphia (SDP) now has the ability to direct charge full time regular salaries using the LDAT tables in advantage. All current capital guidelines and procedures are still in effect, it is only this part of the process that is changed.

This outline below recognizes these new steps related to direct charging of eligible salaries to capital projects:

1. A project request is submitted upfront by facilities services to the SVP-Capital programs and the following process begins upon approval.
2. Funds are identified and set up by the Director of the Capital Financial Management Unit.
3. The appropriation unit(s) and expense budget line(s) are created by the Director Capital Financial management Unit and forwarded to the appropriate staff.
4. The LDAT is created based on the project(s) currently being worked on by facilities by Director Capital Financial management Unit and updated in Advantage.
5. The LDAT is reviewed and uploaded into advantage by the Principal Financial Analyst in the budget office (modified as new projects come on line or off line).
6. A facilities resource scheduler identifies employees working on the specific project(s) and the number of days in the pay cycle by worksheet (repeated until project(s) are completed)
7. The worksheet is reviewed by the Director of the Capital Financial Management Unit and uploaded by Principal Financial Analyst OBM (repeated until project(s) are completed)
8. Monthly monitoring begins as part of the overall monitoring process. If charges are deemed ineligible a request to transfer back to the operating budget is made by the Director of the Capital Financial Management Unit to the Principal Financial Analyst in the budget office.

Appendices

Appendix A - Recommendations

The following is a list of recommended next steps:

Create Policies

Capital Fund Eligibility Policy

The principals for evaluating expenditures to be charged to the capital fund need to be defined so that previously unrecognized situations can be evaluated. Clear indication of responsibilities should be delineated and codified. The District may also consider establishing a dollar threshold for expenditures to be considered eligible for capital funding. Note: This threshold should not be confused with the capitalization threshold which states the dollar value at which expenditure may be capitalized.

As a practical matter, it would be helpful to establish broad categories of projects to which capital expenditures can be evaluated. The **City of Philadelphia's Policy Statement for Expenditure Eligibility for Capital Funding** establishes the following categories:

- **Acquisition**- refers to the purchase of land, buildings or machinery
 - **Allowable costs include:**
 - cost or preparing plans and specifications, obtaining appraisals and legal assistance directly related to acquisition. Planning studies that generate preliminary plans and acquisition estimates. Equipment and machinery that have a useful life of 5 years and a cost of \$7,500. Note: PCs are specifically excluded from Capital Funding. Vehicle purchases are excluded by Policy for purchase with Capital Funds
- **Construction** – refers to building, erecting or installing tangible assets that are owned by the City.
 - **Allowable costs include:**
 - cost or preparing plans and specifications, obtaining appraisals and legal assistance directly related to acquisition. Planning studies that generate preliminary plans and acquisition estimates.
 - Cost of soil tests, boring and other architectural or engineering tests
 - When constructing new facilities, the cost of purchasing furniture and equipment to operate the facility (with a life expectancy of greater than 5 years).
 - Site preparation expenditures such as demolition. The removal of and/or testing for hazardous materials (including, but not limited to PCBs and asbestos) when directly related to an otherwise eligible construction project.
- **Improvements** – refers to renovation, rehabilitation or reconstruction of buildings, structures, parkland, machinery, equipment or other tangible assets owned by the City. This includes landscape and pathway improvements to City owned public space. Improvements must result in extending the useful life of the asset by at least 5 years and cost at least \$7,500. For an improvement to be eligible it must substantially increase the

asset value. Projects which merely maintain or repair an asset cannot be funded through loan proceeds.

- **Allowable costs include:**
 - cost or preparing plans and specifications, obtaining appraisals and legal assistance directly related to acquisition. Planning studies that generate preliminary plans and acquisition estimates.
 - Cost of soil tests, boring and other architectural or engineering tests
 - When constructing new facilities, the cost of purchasing furniture and equipment to operate the facility (with a life expectancy of greater than 5 years).
 - Site preparation expenditures such as demolition. The removal of and/or testing for hazardous materials (including, but not limited to PCBs and asbestos) when directly related to an otherwise eligible construction project.
- **Loan funds are specifically excluded from use to clean and seal buildings.**

The City's policy uses a \$7,500 threshold for capital funding eligibility. Please note that the above criteria do not include certain expenditures that the District has designated for Capital funding. For example, \$8.9 million for vehicle procurement is itemized in the recent Dauphin County and SPSBA bond issues. Also, the City's policy only allows capital funding for asbestos removal when it is part of a larger project that otherwise qualifies. Therefore, the District's Policies must be geared towards its particular needs within the framework of the purpose for which the capital funds were raised.

Beyond the above defining the types of projects that can be considered for capital project funding, the policy should specifically identify those District payroll charges that may be included.

Capitalization Policy

This policy should be a distinct and separate document. Its purpose is to clearly identify those types of expenditures that can be capitalized and how they are to be treated from an accounting perspective. It does not address in any way, funding considerations for the expenditures. The following topics should be included:

- Capitalization Threshold
- Definition of Capital Asset
- Definition of Personal Property
- Definition of Capital Project
- Guidelines for timing of Capitalization
- Description of Expenses to be capitalized
- Construction in Progress
- Non-Capitalized Expenditures
- Estimated Useful Lives for asset Categories
- Depreciation method and calculation
- Transfers and disposals
- Inventory of sensitive Items
- Responsibilities

Analyze and quantify financial implications

Based on the policy criteria that are to be established, the District needs to perform an analysis of the financial/budgeting implications of any changes. The analysis should include:

- A review of Payroll expenses budgeted for Capital Project Fund
- Quantification of potential impacts of policy changes to the Operating Fund

Annual Budgeting to include analysis of allowable payroll expenses to Capital Fund

As part of the Annual Budgeting process, individual salaries should be reviewed to determine:

- Overhead and administration salaries charged to Capital Funds as expenses
- Estimated time allocations by job position that can be supported through time tracking system (to be capitalized)

Establish Time Tracking mechanism

Only those payroll expenses that can be tied directly to a capital project can be capitalized. This must be supported by either payroll records or some other time tracking mechanism. Capturing this information allows the District to capitalize the expenses. This tends to maintain the disclosed weighted average useful life calculations.

Perform periodic Weighted Average Life Calculation

As noted previously, the district needs to be aware of the impact of non-capitalized expenses on the weighted average life calculation presented in various Bond disclosures. Therefore, the weighted average life calculation of the underlying assets needs to be monitored.

Appendix B – Capitalization Policy Considerations

The following Guidelines should be considered when defining the SDP Capitalization Policy.

Expenses eligible for capitalization

If the costs are **directly identifiable** with the specific Property Plant & Equipment (PP&E) they may be capitalized. Otherwise they must be expensed as incurred. Directly Identifiable cost include only:

1. **Direct cost** - or the District for a specific capital project that will result in a tangible asset with a useful life of at least 1 year. These costs include:
 - purchase price of land, construction materials, machinery and equipment.
 - external consulting costs
 - travel costs incurred in connection with activities relating to the acquisition, construction , or installation of PP&E
 - rental costs of equipment used in construction , or installation of PP&E
 - equipment installation costs by a contractor
 - sales and use taxes on materials or services purchased
 - import duties
 - freight and transportation-related insurance (for example, a rider resulting in a premium increase).ⁱ

2. **Payroll and Payroll Benefits** and related costs (e.g. health insurance) **directly related** to the construction, installation, or other necessary activities required to prepare the capital asset for use that are performed by **SDP Personnel** or **independent third party contractors**. These costs can only be capitalized to the extent of time the employees **spent directly on the capital project** and in proportion to the total hours employed (including compensated absences).

Payroll costs must be tracked to specific projects using a time tracking mechanism that identifies the specific time and activities related to the project. If appropriate time tracking is not maintained, then the costs cannot be capitalize and must be expensed.

3. **Additional Costs during the construction phase**- the following additional costs may be capitalized:
 - **Depreciation** of machinery and equipment **used directly in the construction or installation** of PP&E during the time it is directly being used for the project.
 - **Property taxes**
 - **Ground rentals** should be capitalized for the portion of the property under construction, during the time that activities that are necessary to get the asset for its intended use are in progress.
 - **Insurance Allocations** - should be capitalized for the portion of the property under construction, during the time that activities that are necessary to get the asset for its intended use are in progress.
 - **Interest on Bonds** during the time of construction of the PP&E.

Expenses that may NOT be capitalized:

General Administrative and Overhead Costs must be expensed as incurred. These items include the following types of expenditures: ⁱⁱ

- Rent for physical space occupied by employees
- Depreciation of machinery not used directly in the construction or installation of the PP&E.
- Other occupancy costs of the physical space occupied by employees
- All costs including fully loaded payroll of support functions. Support functions include:
 - Executive Management
 - Corporate Accounting
 - Acquisitions
 - Purchasing
 - Corporate Legal
 - Office Management & Administration
 - Marketing
 - Human Resources

Appendix C - Capital Fund Eligibility Policy Considerations

The following Guidelines should be considered when creating the SDP Capital Fund Eligibility Policy.

Potential Non-Capitalized Expenses Eligible for Capital Funds

Legitimate Capital related costs may be charged to the Capital Project Fund regardless of whether they are capitalized or not. Therefore the District needs to establish Guidelines for those items that may be charged to the Capital Project Funds. Costs that should be evaluated include:

- Non-capitalized salaries
 - capital program executive salaries
 - capital program support personnel salaries
 - other non-capitalized salaries
- Renovations required to maintain building code standards
 - Lead Abatement Costs
 - Asbestos removal/containment
 - Water Quality
- Other capital expenditures resulting from government mandated programs
- Leased equipment (e.g. PCs)
- reserves and contingencies,
- Initial outfitting of a school (e.g. supplies, books etc.)
- Costs associated with projects that have been abandoned
- Legal fees in regard to bond issuance
- Title insurance costs
- Consultant costs for bond issuance

Initial Startup costs specifically allowed by the Commonwealth of Pennsylvania

Current state law allows capital funds to be used for all costs associated with the initial operation of a building and the fixed assets contained therein in order to bring the asset to a state of usefulness. However, many such items are not capital assets by definition. Therefore, they must be expensed. These include:

- General Education supplies
- Computer material supplies
- Afterschool activity supplies
- Office Supplies
- Business machine supplies
- Custodial Supplies
- Building Maintenance supplies
- Medical supplies
- Consumable supplies
- Non Consumable supplies
- Miscellaneous supplies

In addition, the following items are allowable under the Commonwealth of Pennsylvania chart of account expenditure definitions and conditional usage of capital funds as contained in bond issues. Many of the following costs typically would not be capitalized if they fall below the capitalization threshold. However, if these are part of the initial startup costs of a new school or facility, they can be tracked at a project level

and capitalized regardless of the dollar amount. These items may only be charged to a capital fund for the startup of a new school building.

- Textbooks
- Library books
- Courses of study
- Instructional Aids
- Educational Software
- Furniture & Furnishing
- Office Equipment
- Educational Equipment
- Maintenance Equipment
- School Computer Equipment
- Admin Computer Equipment
- Cafeteria Equipment

ⁱ AICPA Proposed Statement of Position: Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment

ⁱⁱ AICPA Proposed Statement of Position: Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment