

Appendix E: Capitalization Guidelines

These guidelines establish management and control procedures for METRO's internal and external cost (labor and non-labor) for the purchase of capital assets belonging to or in the custody of METRO.

Capital assets are defined as:

Personal property and equipment owned, leased under a capital lease, controlled or possessed by METRO that meet the following conditions:

- a dollar cost of at least \$5,000 for any building improvements –this threshold includes all building component assets that operate as an integral part of the building (i.e. HVAC).
- a dollar cost of at least \$5,000 for any movable and other fixed equipment (per base unit)
- a useful life of more than ONE year, and
- not consumed in the normal course of business

Assets not meeting this definition of a capital asset should be expensed in the period in which the costs are incurred.

Assets may be acquired by purchase, lease/purchase, loan, gift, transfer, or by trade-in. In addition, assets may be retired by sale, surplus or impairment.

Direct Labor is defined as:

- employees or workers who are directly involved in the production of an asset or services. Direct labor costs are assignable to a specific project or service.

Support Labor is defined as:

- employees or workers whose activities are established for the central administration of operations, services, and functions of the Agency as well as those activities related to general legal tasks. Support functions include (but not limited to): Audit, Board, Executive Management, Finance, Human Resources, Marketing, Procurement, and Legal.

Overhead is defined as:

- those items of METRO's cost which are not assigned directly to a specific project or transit operations because they are either common to all projects/operations (rent) or they would be far too difficult or expensive to track and allocate back to each project or transit operations (paper clips).

- the sum of indirect costs form what is sometimes referred to as the overhead pool.
- overhead is the ratio of the overhead pool to direct labor where the overhead pool is the numerator and direct labor is the denominator. The resulting overhead “rate” is commonly expressed as either a percentage of direct labor, or as a multiple of direct labor.

Any labor or purchase coded as a capital asset is subject to criteria testing by the METRO Controller, and is subject to reclassification to operating expense if any of the criteria are not met. All capital requests require Advance Procurement Plan (APP).

CONSTRUCTION, BUILDINGS AND OTHER IMPROVEMENTS

Construction, buildings and improvements include direct costs related to a project with a capitalizable dollar value greater than \$5,000 and a useful life of more than one year. Furniture, fixtures, software, equipment, or other expenses which are not an integral part of a project are not considered in this category.

Activated projects that have subsequently been put on hold will have a maximum of two budget cycles to carry forward costs as construction in process. These costs will be considered useful if the project is submitted in the next budget cycle and the manager has a reasonable expectation that the budget will be approved. If the project is not reactivated within this time frame, all incurred costs on the project will be expensed.

Construction Costs - examples of construction costs include but are not limited to architect and engineering fees, site preparation, demolition costs, building permit fees, contractor and sub-contractor fees, building materials, construction equipment rental and job-site utilities, construction equipment operating and maintenance costs, owner controlled construction insurance policies and wages and benefits, as compensation for construction work performed.

Costs to move furniture, equipment, and tenants due to construction will be capitalized. This also includes temporary storage of office contents, which is necessary during capital construction.

Signage and other printed material (including internal labor) used for the purpose of informing the public of construction work being performed will be capitalized

Building Components - consists of items permanently affixed/installed to the building shell, necessary for the building to be used as intended, which are integral to the building and cannot be removed without damaging the building. Examples include, but are not limited to, elevators, HVAC, plumbing, electrical wiring, fixed theater or classroom seating, telecommunication/data wiring, fire alarm and sprinkler systems, and

other fixtures and equipment installed with the intent of permanent use in the building. Telecommunication/data wiring is considered a building improvement if any part of it is installed inside of a wall and would remain with the building if the department moved. In contrast, cables/wiring that would be removed from the building if the department moved is considered a separate piece of equipment and will have to meet the capital threshold in order to be capitalized.

Labor - the cost of employees working directly on a capital project must be capitalized. This includes employee payroll and related payroll expense (OH) when known and available.

The labor costs capitalized include only that portion of the employees' payroll (not support labor) and OH directly related to time spent working on the capital project. The portion of the employees' payroll and OH related to time spent working on activities not directly related to a project should be expensed.

Land Improvements – long-lived capital assets that are normally stationary in nature and normally can be preserved for a significantly greater number of years than most capital assets. Items in this category can include: roads, bridges, curbs, sidewalks, tunnels, drainage systems, water and sewer systems, lighting systems, fencing, and parking lots.

Building Improvements – building improvements are additions, alterations, renovations or structural changes that extend the useful life or enhance the value of an existing building. Building improvements or additions to an existing building which are not integral parts of the original asset will be treated as a separate asset and depreciated over the appropriate useful life.

Leasehold Improvements – leasehold improvements to leased facilities will be capitalized and amortized over the lesser of the useful life of the asset or the remaining life of the existing lease not including any options to renew.

Rehabilitation - for a replacement to be capitalized, it must be a part of a major rehabilitation project that meet the capital threshold for assets, it increases the value, and/or useful life of the facility/equipment (offices, garages and power generators), such as installation of new roof. A replacement may also be capitalized if the new item/part is of significantly improved quality and higher value compared to the old item/part - a replacement of old windows with new hurricane proof windows with a longer life expectancy for example. Ordinary repairs and the replacement of minor parts are considered operating expense as: they do not extend the asset's life, they are not separately identifiable assets, and they only restore the assets to their original operating condition. If a facility/equipment being repaired was not identified as a capital purchase to begin with, the repair would not be considered capital. (See MFRI guideline for more information)

Completion Date - costs for construction projects described above will be capitalized until the asset is deemed placed in service: the walkthrough and final checklist have been completed, and the work is accepted as complete by the project manager. Costs incurred after the work is accepted as complete will be expensed, including costs incurred under the project's warranty.

Feasibility Study – feasibility costs incurred prior to management's commitment of funds to the project will be expensed. This preliminary stage of a project includes design, consulting, internal labor, and other feasibility costs related to evaluating the length and cost of a construction project. Prior to construction, if the design stage of the project is the only stage that is currently approved for capital budget, the project definition and full scope (including deferred costs) must be submitted to Finance to determine the correct accounting treatment.

Capitalized Interest Costs – interest costs incurred during construction should be capitalized in accordance with the provision of Financial Accounting Standards Board (FASB) Statement No. 34, Capitalization of Interest Cost.

Support Labor

All general and administrative (Central Services) and overhead costs incurred, including all costs of support functions, should be expensed. Support functions include (but not limited to):

- Audit
- Board
- Executive Management
- Finance
- Human Resources
- Marketing
- Procurement
- Legal
- Community Outreach

Central Services employee labor is not directly chargeable to capital projects. In major projects where one or more Central Services groups are established within the project staff the labor cost including overhead is directly capitalizable to the project (i.e. – METRO Rail Expansion).

Note: Eventually a portion of the support labor will be charged to capital projects.

Bus, Rail and Support Equipment

Vehicle Replacements and Additions-replacement or additional revenue and non-revenue vehicles (includes buses, rail cars, METRO-Lift vans and support vehicles), all

expenses incurred prior to putting a vehicle in service, including plant inspections and make ready, can be capitalized.

Rail and Bus Improvements-upgrades or major component replacements that meet the capital threshold for assets can be capitalized. Upgrades should increase the value or extend the life of the vehicles. Major components should be at the end of their useful life due to normal wear and tear.

Capital Tools and Equipment-tools and off-road equipment meeting the capital threshold and with a useful life of more than one year can be capitalized.

SOFTWARE AND INFORMATION TECHNOLOGY (IT) PROJECTS

Conditions to Determine if an IT Project Should be Capitalized – in general, computer software, either purchased or developed internally, is considered a capital project if there is significant new functionality gained or if it implements a new technology. Significant new functionality includes, but is not limited to: a new vendor product, a software implementation that involves integration into other existing systems, or a system implementation that results in changes in the workflow processes by other areas not directly affected by the new software. Not included in this definition are software upgrades and system “fixes”.

Stages of Computer Software Development - there are three stages of computer software development: the preliminary project stage, the application development stage, and the post implementation/operation stage. Only the application development stage may be capitalized. The preliminary project and post-implementation/operation stage costs are expensed as incurred.

Preliminary Project Stage (costs are expensed)

- Conceptual formulation of alternatives
- Evaluation of alternatives
- Determination of existence of needed technology
- Final selection of alternatives

Application Development Stage (costs can be capitalized)

- Design of chosen path, including software configuration and software interfaces
- Coding
- Installation to hardware

- Testing, including parallel processing phase

Post-Implementation/Operation Stage (costs are expensed)

- Training
- Application maintenance

Major software projects should be separated into components or modules so that as each module becomes ready to use, it can be capitalized while the other modules remain in process. If a software project is expected to have multiple phases, documentation should be provided to Accounting defining the functionality of each phase and what type of costs there will be in each phase. The document should also include the expected timeframe for the project, and consulting fees need to include a description of the work performed.

Externally Purchased Software - computer software packages and new website design purchased from third parties shall be treated as any other equipment. The individual license agreement must have a useful life of greater than one year, and the cost must meet the capital threshold.

All user licenses will be capitalized with an initial software purchase, up to 90 days after the purchase. Additional software user licenses purchased after 90 days will be capitalized only if each license meets capital threshold and will be used for more than one year. However, additional licenses purchased for existing software which require an IT capital project to add functionality or enhancement to the software, will be capitalized along with other project costs. Licenses associated with added functionality or enhancement to the software will have to meet the \$5,000 capital threshold.

All software licenses that individually meet capital threshold will be capitalized. Software that is on a production server is considered existing in the environment will not be capitalized.

Memberships and subscriptions to website resources and software licenses will not be considered capital.

IT Maintenance contracts and other prepaid services that meet the \$5,000 threshold are expensed to operating and amortized over a 12 month period for which they apply.

Installation of major software renewals and upgrades that are not included in a maintenance contract may be capitalized if they provide additional functionality to the existing software and meet the \$5,000 threshold.

Internally Developed Software – the standard test to determine if software is internally developed is met if the following characteristics are met:

- the software is internally developed, or acquired and modified solely to meet the entity's internal needs
- during the software's development or modification, no substantive plan exists or is being developed to market the software externally

Only the portion of labor costs related to time spent working on the IT project is capitalized. Labor costs to be capitalized include METRO employee payroll and related payroll overhead (OH), temporary labor, personal service agreements, consulting firms, and third party software developers. This does not include employee labor used to cover the work normally performed by the individual directly assigned to the project (backfill labor).

The portion of the employees' payroll and OH related to time spent working on other activities should be expensed. All general and administrative and overhead costs incurred, including all costs of support functions should be expensed. Support functions include administrative assistants and office managers who perform general office duties.

When to Capitalize an IT Project – capitalization of costs should begin when both

- The preliminary project stage is complete, and
- Management commits to funding a computer software project and it is probable that the project will be completed and the software will be used to perform the function intended.
- Capitalization should cease when all substantial testing is completed and/or the system goes live.

Costs not to Capitalize as part of an IT Project:

- General and administrative costs and supplies should not be capitalized as costs of internal-use software. Internal and external costs incurred during the preliminary project stage should be expensed.
- Training costs should be expensed as incurred.
- Website subscriptions should be expensed as incurred.
- Software web hosting where application is not owned by METRO should be expensed as incurred

OTHER ASSETS MANAGEMENT ISSUES

Designation of Property as a Controlled Item

Sensitive or walk-away property items with a value of less than \$5,000 may be subject to control as if they were fixed assets. Examples include police guns, tasers, and vests, certain shop and garage equipment, radios, computers, etc. These items will be tracked within the fixed asset system by serial number and if available METRO's fixed asset tag. Accounting, Property Management and Asset Custodians are jointly responsible for tracking, reconciling, reporting, disposing and protecting METRO's assets.

Major Capital Project

Only a small group of all the METRO's transportation projects are considered "major capital projects (MCP)." They are large projects with a significant effect on the capacity of the region's transportation system, including extensions or additional lanes on the interstate system, entirely new expressways, or similar changes to the passenger rail system. Arterial expansions and intersection improvements are not defined as major capital projects; neither are bus facilities, unless they involve a dedicated lane on a transit corridor. MCP cost for dedicated administrative staff such as, "procurement, finance, and community outreach", may be charged directly to the project and capitalized.

To be included in the Major Capital Project category, a project must meet ONE of the following requirements (criteria):

- It is a new construction, expansion, renovation, or replacement project for an existing facility or facilities. The project must have a total cost of at least \$250 million over the life of the project. Project costs can include Internal overhead staffing, community outreach, land, engineering, architectural planning, and contract services needed to complete the project.

- OR -

- It is a purchase of major equipment (assets) costing \$250 million or more with a useful life of at least 10 years.

- OR -

- It is a major upgrade project for existing facilities with a cost of \$250 million or more and an economic life of at least 10 years.