

# INTERNAL AUDIT REPORT

Operational Audit  
Capitalization of Assets

March 2021 – August 2021

Issue Date: November 24, 2021  
Report No. 2021-12

## TABLE OF CONTENTS

|   |   |
|---|---|
| Executive Summary .....                       | 3 |
| Background .....                              | 4 |
| Audit Scope and Methodology .....             | 5 |
| Schedule of Findings and Recommendations..... | 6 |
| Appendix A: Risk Ratings .....                | 8 |

## Executive Summary

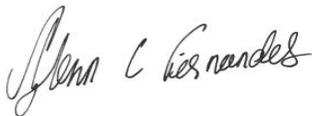
Internal Audit (IA) completed an audit of Capitalization of Assets for the period March 2021 through August 2021. The audit was performed at the request of Management to review newly established controls, which were designed to assure the accurate transfer of assets from construction work-in-process (CWIP) to capital assets.

As of December 31, 2019 CWIP and Capital Assets were \$1.085 billion and \$8.334 billion. As of December 31, 2020, CWIP increased to \$1.347 billion and decreased slightly to \$8.164 billion. Port Accounting Policy AC-8b establishes standards for capitalization of major expenses related to the acquisition, construction, and modification of tangible capital assets. Construction costs, according to the Policy, are recorded against CWIP when they satisfy following criteria:

- The Port has ownership and control over the capital asset.
- The capital asset has a useful life of three years or more.
- The total capital project costs must be \$20,000 or more.

In 2021, the Port's external auditor, Moss Adams, reported on a control deficiency which resulted in \$19.2 million of assets that were placed in service in 2019, but were not properly transferred to Capital Assets until 2020. In February 2021 management documented and adopted a new standard operating procedure (SOP). Our audit was designed to review the newly adopted SOP and provide recommendations that might reduce the risk of of future misstatements. The Capitalization of Assets processes involve many individuals, and is dependent on them to accurately record information and report on that information in a timely manner. Our audit identified three areas where internal controls could be further strengthened. These are reflected in the below issue and are discussed in more detail beginning on page six of this report.

1. (Low) – A Standard Operating Procedure (SOP) was documented and adopted in February 2021. However, internal controls need to be enhanced whereby, project leads formally review and approve their work, a year end re-confirmation is performed, and a final notification is sent out to all stakeholders. Doing so will reduce the likelihood that assets are not transferred from CWIP to capital assets in the correct period.



Glenn Fernandes, CPA  
Director, Internal Audit

### Responsible Management Team

Jeffrey Brown, Chief Operating Officer, Aviation  
Rudy Caluza, Director, Accounting and Financial Reporting  
Wayne Grotheer, Director-PMG, Aviation  
Lance Lyttle, Managing Director, Aviation

## Background

The Port's Annual Financial Report, reflects construction-work-in process (CWIP) of \$1.347 billion and capital assets of 8.164 billion as of December 31, 2020. As of December 31, 2019, CWIP was \$1.085 billion and capital assets were \$8.334 billion.

Accounting Policy AC-8b (*Capital Assets: Tangible Assets*) establishes "standards for capitalization of major expenses related to the acquisition, construction, and modification of tangible capital assets, and for the depreciation of such assets."

Capital construction costs that do not meet requirements one through three below are recorded as operating expenses. Otherwise, construction costs are recorded against construction work-in-process (CWIP) when they satisfy following criteria:

- 1) The Port has ownership and control over the capital asset.
- 2) The capital asset has a useful life of 3-years or more.
- 3) The total capital project costs must be \$20,000 or more.

Tangible assets are captured into five categories:

Land – Real property owned by the Port that is recorded in King County with a parcel ID. Cost include the initial acquisition cost, legal and title fees, survey and appraisal fees, and land preparation costs.

Land Improvements – Consists of depreciable betterments (not including buildings) with a limited useful life. Examples of improvements include site preparation costs, retaining walls, parking lots, fencing, gates, and landscaping.

Buildings – Permanent structures including – wharfs, marinas, administrative building, parking garage, passenger terminal, transit shed, warehouses.

Infrastructure – Stationary in nature and normally preserved for a significant number of years. Examples include roads (airport taxi way and runway), utility systems (heating, ventilation and air-conditioning, sanitary and storm sewer system) and other structures (baggage system, central control system, subway, tunnel, satellite transit, floats, docks, piers, bulkheads).

Furnishing, Equipment and Vehicles – Represents moveable assets such as furniture, computer equipment, office equipment, survey equipment, cranes, snow plows, passenger loading bridges, cars and trucks.

Leasehold Tenant Improvements – A contractual understanding between the Port and a tenant where the Port grants the tenant the right to use or improve specific Port property for a specific period of time.

Moveable collections of works of art and historical treasures – Assets of historical, natural, cultural, educational significance, or artistic importance not permanently affixed to a building.

## Valuation and Costs

Assets directly purchased or construction (by the Port or third party) are recorded at historical/original cost less discounts at time of acquisition. Grants, donations, and contributions are recorded at fair market value. Capitalized costs include direct labor and materials, indirect labor, architects, engineers, electricians and carpenters. Preliminary costs are expensed and not capitalized. These costs are incurred during the initial stage of construction or acquisition, such as a feasibility study. Pre-acquisition costs, acquisition or construction costs, and ancillary costs are capitalized.

Prior to the issuance of the 2019 external audit, Port management identified approximately \$12 million in CWIP that should have been reclassified to Capital Assets. In January 2021, Port management identified an additional \$19.2 million of assets that were placed in service in 2019 but not transferred to Capital Assets until 2020.

## **Audit Scope and Methodology**

We conducted the engagement in accordance with Generally Accepted Government Auditing Standards and the International Standards for the Professional Practice of Internal Auditing. Those standards require that we plan and conduct an engagement to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our engagement objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our engagement objectives.

The period audited was March 2021 through August 2021 and included the following procedures:

- Evaluated the Aviation division Standard Operating Procedures (SOPs) to determine whether sufficient internal controls were embedded within the capitalization of assets process and whether it was aligned with Port Policy AC-8b.
- Determined whether Maritime and Economic Development divisions had developed SOPs.
- Performed analytical procedures to obtain the values of CWIP and capital assets in the Aviation, Maritime, and Economic Development divisions.
- Assessed whether assets capitalized complied with documented procedures as per the SOPs and the Port Policy.
- Obtained a schedule of assets transferred from CWIP to a capital asset between March and August 2021 and calculated the number of days between the in-use date and the date it was communicated to Capital Services (AFR). We also calculated the number of days between the date it was communicated to Capital Services and the date it was recorded.
- Obtained a sample of projects in CWIP and interviewed project managers to determine whether the projects are correctly classified as CWIP.
- Evaluated the design of the process and recommended primary and secondary internal controls to be implemented.
- Conducted discussions with key management and staff to gain a comprehensive understanding of roles and responsibilities.

## Schedule of Findings and Recommendations

### 1) Rating: Low

A Standard Operating Procedure (SOP) was documented and adopted in February 2021. However, internal controls need to be enhanced whereby, project leads formally review and approve their work, a year end re-confirmation is performed, and a final notification is sent out to all stakeholders. Doing so will reduce the likelihood that assets are not transferred from CWIP to capital assets in the correct period.

Aviation Project Management Group (AVPMG) documented and implemented a SOP in February 2021 at the request of a previous review conducted in 2020. We reviewed the SOP together with Port Policy AC-8b Capital Assets – Tangible Assets, to gain an understanding of the process and to evaluate whether the SOP was designed with sufficient controls. During this review, Internal Audit made the following recommendations that if implemented will help assure assets are transferred from CWIP to Capital Assets in a complete, accurate and timely manner.

#### Recommendations:

##### 1. Annual Review Process

This is a relatively new process that is facilitated by Projects Control. Project Managers are responsible for this process and should coordinate with other stakeholders to validate that the information contained in the asset plans is accurate. Internal Audit recommends:

- Program Leads should formally review and approve the information before it is submitted to Capital Services for booking of assets in the financial system.
- This process should be documented in the SOP highlighting the responsible individuals and the expected outcomes.

##### 2. Facility Asset Review Meeting

In addition to regularly scheduled meetings, a meeting should also be scheduled close to year end so that key stakeholders, e.g., Capital Services, Projects Control, Maintenance and Facilities & Infrastructure have an opportunity to re-confirm information relating to the assets.

##### 3. Complete Workflow for the Notification Process

As per the SOP, a notification should be sent by AFR Capital Services to key stakeholders to complete the capitalization of assets process. Internal Audit recommends completion of the workflow for this process to inform all the relevant stakeholders that the process is complete and provides an opportunity for Project Controls to validate that all asset transfers have been recorded.

**Management Response/Action Plan:**

Aviation Management appreciates Internal Audit reviewing the newly defined Aviation SOP to help mitigate risk associated with the late identification and communication of assets. Our response to the individual recommendations is below:

**1. Annual Review Process**

Management agrees with the recommendation to document the Annual Review Process in the SOP including roles, responsibilities, and next steps depending on the outcome of the asset review (i.e., all reported/no changes, something missed, etc.). All projects being reviewed will also include a review and sign-off from the appropriate Program Leads upon the completion of the review.

**2. Facility Asset Review Meeting**

Management disagrees with recommendation that a Facility Asset Review meeting should be scheduled at the end of the year to reconfirm assets for every project. While a comprehensive evaluation measure may appear attractive, Accounting Policy AC-8B requires a more frequent turnover cadence. Considering the number of assets and project-specific complexities commonly experienced, a large-scale year-end review may not yield intended results or be an efficient use of personnel across multiple departments. Consequently, a year-end Facility Asset Review meeting will likely not be effective.

Instead, Management will evaluate making a Facility Asset Review meeting required for qualifying projects in the design phase, where preliminary asset plans are developed, and again during construction, prior to asset plan submission, to ensure a timely, coordinated asset plan final submission.

This evaluation will begin Q1 2022 to coincide with the one-year anniversary of the SOP. Decisions will be communicated to Internal Audit relative to management's decision.

**3. Complete Workflow for the Notification Process**

Management agrees with this recommendation. AFR Capital Services has committed to begin notifying project stakeholders after recording the assets identified in the submitted asset plans. This process will begin prior to December 31, 2021, via email notification while a formal workflow process is developed (to be completed and enacted in 2022).

**DUE DATE: 03/31/2022**

## Appendix A: Risk Ratings

Findings identified during the audit are assigned a risk rating, as outlined in the table below. Only one of the criteria needs to be met for a finding to be rated High, Medium, or Low. Findings rated Low will be evaluated and may or may not be reflected in the final report.

| Rating        | Financial Stewardship | Internal Controls                               | Compliance   | Public   | Commission/ Management               |
|---------------|-----------------------|---|--|--|--------------------------------------|
| <b>High</b>   | Significant           | Missing or not followed                         | Non-compliance with Laws, Port Policies, Contracts       | High probability for external audit issues and / or negative public perception     | Requires immediate attention         |
| <b>Medium</b> | Moderate              | Partial controls<br>Not functioning effectively | Partial compliance with Laws, Port Policies<br>Contracts | Moderate probability for external audit issues and / or negative public perception | Requires attention                   |
| <b>Low</b>    | Minimal               | Functioning as intended but could be enhanced   | Mostly complies with Laws, Port Policies, Contracts      | Low probability for external audit issues and/or negative public perception        | Does not require immediate attention |