

April 22, 2004

Internal Audit Report 2004-8
Engineering Overhead Rate Calculation
Municipal Light and Power

Introduction. Overhead costs are operating costs incurred for common or joint purposes that benefit more than one organizational objective or unit. These costs, which are not easily adaptable to charging directly to individual projects or services, include but are not limited to the following: general administration, supervision, office supplies and equipment, building rent or lease expenses, utilities and communications, training, records management, and general clerical support. According to an Accounting for Public Utilities guide, overhead allocations are required for those general expenses which are, at least in part, due to utility construction. In order to develop an effective comprehensive cost allocation system, the goals of rate regulation must be known since capital becomes part of the rate base while expense is reflected only in the current year. Accordingly, a current and reasonable overhead rate for engineering is important to Municipal Light and Power (ML&P).

Objective and Scope. The objective of this audit was to arrive at an engineering overhead rate that was consistent with the capitalization policy of ML&P and was representative of the administrative costs associated with capital-type work. Our analysis and computations included capital and administrative labor and benefits, utilities, office supplies, and communication costs for the Engineering Division during 2003. The audit was conducted in accordance with generally accepted government auditing standards, except for the requirement of an external quality control review, and accordingly, included tests of accounting records and such other auditing procedures as we considered necessary in the circumstances. The audit was performed during the first half of 2004. The audit was requested by the Administration.

Overall Evaluation. Based on our analysis and computations, we recommend an engineering overhead rate of 36%. This is consistent with ML&P's capitalization policy and is representative of the administrative costs associated with capital work. Our review of industry overhead rates revealed that general expenditures such as office supplies and communication and utility expenses are normally included in overhead rate calculations. Accordingly, we included these types of expenses in our methodology used to arrive at the recommended engineering overhead rate. Our calculations also included labor costs for employees who did not charge direct time to capital work orders but provided support to capital projects.

Discussion With Responsible Officials. The results of this audit were discussed with appropriate Municipal officials on April 9, 2004.

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