WEDNESDAY'S
News You Can Use

Accounting for Capital Assets

Presented by **Amanda M. Wilkson, CPA**

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Learning Objectives:

a) Differentiate between capital outlay and period costs

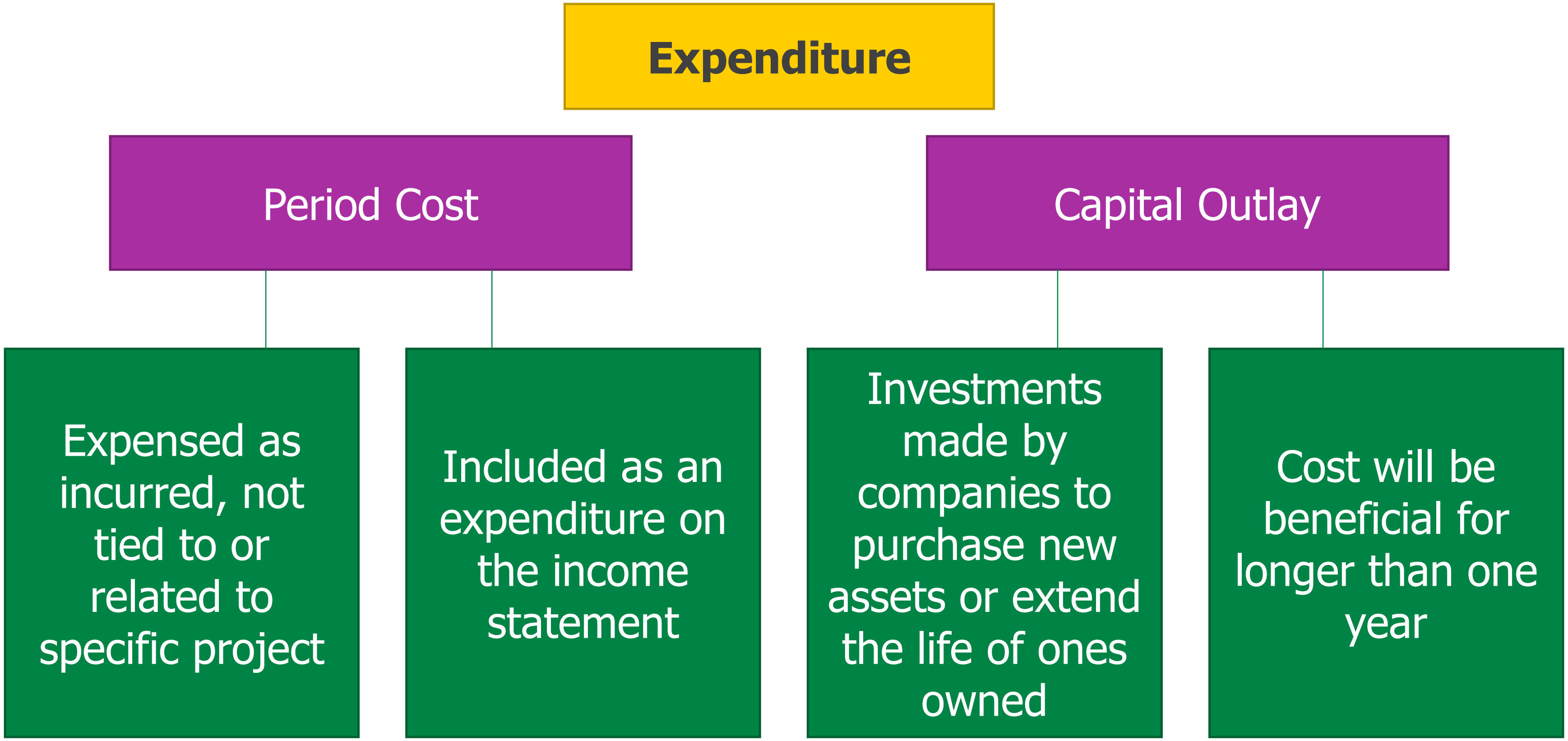
b) Identify policies and procedures related to capital assets

c) Understand the importance of internal controls related to capital assets

Capital Outlay vs. Period Costs

Understanding the differences that matter

What is the difference between these two expenditures?



Capitalizable Costs

Internal costs

General and administrative costs should never be capitalized

overhead (e.g., use of office facilities, executive management, accounting, human resources)

Costs directly related to the acquisition of a specific asset should be capitalized (e.g., salaries specific to a construction project)

Capitalizable Costs

GAAP establishes the basic principle that the cost of a capital asset should include:

- Cost to purchase or construct the asset, and
- Ancillary charges necessary to place the asset into its intended location and condition for use.

Training

Should not be capitalized for two reasons:

1. Does not affect the intended location and condition for use
2. Does not provide benefit throughout the useful life

Acquisition Costs

Pre-conditions for capitalization:

- Capitalize a cost only if it is ***directly*** **identifiable with a** ***specific*** **asset**.
- Capitalize a cost only if incurred after acquisition of the related asset is considered **probable**.

Improvements or Repairs

Improvements (vs. repair or maintenance):

- Lengthen a capital asset's estimated **useful life**; or,
- **Increase a capital asset's ability to provide service** (i.e., greater effectiveness or efficiency)

Improvements should be capitalized and recognized as depreciation expense over the estimated useful life of the asset.

Improvements (betterments)

- An improvement provides additional value by:
  1. Increasing the estimated useful life
  2. Increasing ability to provide service

- Repairs and maintenance
  - Retain value rather than provide additional value

The Grey Areas

Care is sometimes needed to distinguish actions that lengthen the useful life of an asset from those that merely avoid shortening it.

Valuation of Capital Assets

Initial Valuation:

- **Purchased** - assets acquired through purchase or construction should be reported at their historical cost
- **Donated** - assets acquired for a nominal amount should be handled as a donation for accounting purposes rather than at the actual/nominal cost.

Valuation of Capital Assets

No Cost Known = Estimating Historical Cost:

- Direct Costing - for particularly long-lived assets, the detailed documentation needed for direct costing may no longer be available, or impractical to access
- Two methods are available for *estimating* historical cost:
  - ✓ Standard Costing, or
  - ✓ Normal Costing (Back-Trending)

Donated Capital Assets

Capital Assets acquired through Donation:

- Donated capital assets should be reported at their estimated fair value at the time of acquisition:
  - ✓ *Fair Value* is what the government would have had to pay to acquire the asset on its own.
- Donations of infrastructure (roads, stretch of roads, etc.), value determined by:
  - ✓ Cost of government to construct the road; or
  - ✓ Developer's cost.

Capital Outlay or Period Cost?

What is the Paving of an Existing Dirt Road Considered to be?

What is the Expansion of an Existing Reservoir Considered to be?

What is the Draining & Re-Piping of Dam on a Existing Reservoir Considered to be?

Capital Outlay or Period Cost?

What is a Paint Job on a Building Considered to be?

What is a New Roof on a Building Considered to be?

What is Road Re-Surfacing Considered to be?

Polling Question #1

Policies and Procedures

Understand the operational aspects of capital outlay

System Design and Policies

- A capital asset system is essential to ensure that all the necessary data is **collected and kept current**.

- Asset listing can not only include items reported in financial statements, **but also items not capitalized** but for which information needs to be maintained to:

  - Ensure legal compliance

  - Compensate for a heightened risk of theft

Capital Asset Policies

- Capital asset policy approved by the governing body
- GASB does not provide specific policy information

When establishing the capital asset policies, one should consider the questions on the following slides:

Setting Policies - Thresholds

Which items should be capitalized?

- Single capitalization threshold or different thresholds for different classes
- What will be the capitalization threshold
- How will capitalization thresholds be applied (individual or group)

Setting Policies - Components

How should discrete components of larger assets be treated? Cost of a component can be:

- Treated as a separate capital asset (preferable, but rarely done in practice). This is also known as "**cost segregation**";

  or,

- **Included in the cost of the larger asset**, with the component's eventual replacement treated as a repair.

Setting Policies – Donations

- How and when do you determine a donation has occurred?
- How should **fair value** be determined for donated capital assets?
  - What methodology will be used?
  - How do you determine ***fair value***?
  - <u>**Who**</u> will be charged with making and documenting estimated of fair value?

Setting Policies – Major Classes

What major classes of capital assets should be used?

- What will the Major Classes be?
  - Land
  - Buildings, Improvements (Fences, etc.), Furnishings & Equipment, Infrastructure, Construction in Progress, Other…..
- Which specific items will be reported in each class?

Setting Policies – Depreciation

Which items should be depreciated or amortized and how?

Capital assets must be depreciated or amortized unless they have an indefinite useful life:

- Land
- Construction in Progress
- Networks or subsystems of infrastructure assets for which the government has qualified for, and elected to use the modified approach

Setting Policies – Depreciation

- Will useful lives be estimated for **individual** assets or **major** classes?
- What will be the basis for those estimates?
- How will the reasonableness of estimates be evaluated on an ongoing basis?
- What **method** will be used to calculate depreciation?
- Will depreciation be applied to individual (component) items or groups of items?
- How will depreciation be applied to partial years?

Setting Policies- Impairments

What is an impairment?

- A decline in service value that must be **<u>both</u>** of the following:
  - Significant (in relation to its utility)
  - Unexpected (not foreseeable)
- The decline must be **<u>permanent</u>**, and not temporary.
  - School is 5 years old => to be used as storage for a year?
  - School is 5 years old => to be used as storage forever?
- Burden of proof on gov't. to prove it is temporary

Setting Policies- Impairments

Events or circumstances should be prominent?

- Discussions by governing board, management and media. Examples:
  - Physical damage;
  - Changes in laws, regs., or environmental factors that affect service utility;
  - Technological advances that cause decline of demand = obsolescence;
  - Change in manner or duration of use of the asset;
  - Stoppage of construction or development.

Setting Policies - Control

How should disposals be handled?

- Who can authorize a disposal?
- What procedures are followed to ensure the gov't receives maximum benefit from the disposal?

How often should physical inventory be performed?

- Establish an inventory cycle, rotating among departments each year
- Determine who will be responsible for performing the inventory.

Setting Policies - Control

Which capital assets should be tagged?

- Which items will a unique identification number be necessary?
- Where will tags be placed on each type of property item?
- Who will be responsible for tagging?

Setting Policies - Control

How should control be maintained over items that were not capitalized?

- How will departments ensure that there is proper control over such items?
- How will the central accounting function ensure that departments are doing this?

Setting Policies - Control

What about a physical inventory?

- How often will physical inventories of capital assets be performed?
- Who will be responsible for performing the inventories?

Internal Control related to Capital Outlay

Understanding how to safeguard these assets

Polling Question #2

Why are Internal Controls related to Capital Assets Important?

Capital Assets

=

large

investment of

public dollars

Control Objectives for Internal Controls

Control operations

- Establish levels of authority for approval of transactions
- Adequate reporting system for approvers to monitor

Safeguard assets

- Waste, inefficiency, error, theft or fraud

Control Objectives for Internal Controls

Provide timely and reliable information

- Supports control structure

Compliance

- Knowledgeable about laws to follow
- Educate employees
- Monitor to ensure compliance

Capital Asset I/C Objective Steps:

1) Purchases properly authorized by management and for business purpose.
2) Purchases recorded timely and accurately
   - Source documents
   - Accounting records

Capital Asset I/C Objective Steps:

3. Maintain detailed subsidiary records
   - Reconcile with control accounts
4. Physical inventory
   - Existence
   - Condition

Capital Asset I/C Objective Steps:

5. Report and account timely for
   - Transfers, retirements, gains/losses
6. Maintain records accurately
7. Adequate segregation of duties

Risk Assessment:

Objective No. 1: Purchases properly authorized by management and for business purpose.

Risk: Unauthorized purchases of capital assets are made or are not for valid business purposes.

Risk Assessment:

Objective No. 2: Capital asset acquisitions should be recorded timely and accurately in source documents and accounts records.

Risk: Capital assets not recorded in the period purchased. Not recorded in proper amount or to proper account.

Risk Assessment:

Objective No. 3: Detailed subsidiary records maintained for individual capital assets and reconciled to control accounts.

Risk: Purchase is not recorded in asset management system. Reconciliation between subsidiary ledger and control accounts should catch those items

Risk Assessment:

Objective No. 4: Periodic physical verification should be made of the existence and condition of property.

Risk is that capital assets are in subsidiary ledger and on general ledger that the government no longer has/ or condition of asset has deteriorated.

Risk Assessment:

Objective No. 5: Issues, transfers, retirements, and losses should be reported and accounted for timely.

Risk: Capital assets have been sold/scrapped and proper accounting not made for gains/losses or disposition of assets.

Risk Assessment:

Objective No. 6: Capital asset records should be accurately maintained.

Risk: Capital asset records do not accurately reflect the physical capital assets.

Risk Assessment:

Objective No. 7: Adequate segregation of duties in the capital asset function.

Risk: Inadequate segregation of duties allows for fraud and/or innocent errors not likely to be found and corrected.

Polling Question #3

Monitoring and Capital Assets

- Are controls operating as intended?

- Unmonitored controls deteriorate over time.

Internal Controls must be monitored on a regular basis to ensure that all controls are operating efficiently and effectively to prevent or detect and correct misstatements.

QUESTIONS?

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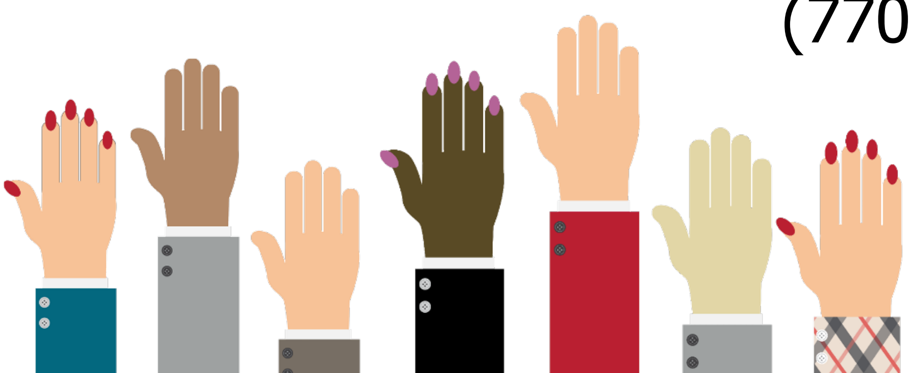

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