

Capital Asset Headaches: Common Deficiencies and How to Avoid Them

CSMFO Annual Conference 2018
Riverside, California

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Definitions and Basic Accounting

- Basic definition – material tangible and intangible assets *used in operations* and useful lives exceeding one reporting period
- Capital assets only reportable by one entity
 - Ownership is critical criterion (but it is not always clear)
 - Responsibility for management and maintenance very often a determining factor
- Capital assets only reported with the economic resources measurement focus

What's Up with Capital Asset Management??

- Still a primary reason for modified audit opinions
- Reasons?
 - Volume of transactions
 - Extent of properties in most governmental entities
 - BUDGET VS. GAAP!!
 - Procrastination
 - Unreasonable capitalization thresholds

Asset Classifications

- Common classifications (GAAP requires reporting by “major class”)
 - Land
 - Buildings
 - Improvements other than buildings/land improvements
 - Furnishings/Machinery/Equipment
 - Construction in progress
 - Historical treasures

Asset Classifications (cont.)

- Intangible classifications should be descriptive and may include multiple identifications
- Must delineate depreciable and non-depreciable assets at a minimum on the face of the basic financial statements and in the note disclosures
- Land under infrastructure should be classified as land and not part of overall infrastructure (e.g., roads)

Capitalization Thresholds

- Capitalization thresholds are a *financial reporting* concept
- Capitalization thresholds are *not* an appropriate tool for internal control purposes
- Not uncommon to see different thresholds for different classifications of assets

Capitalizable Costs

- Capitalize if costs are *directly identifiable* to a specific asset
 - Costs incurred to place in service
 - What about feasibility studies?
- Internal costs
 - Administrative costs *not* capitalized
 - Costs directly related (e.g., salary of employees working on project) capitalized
- Internally-generated software (GASB Statement No. 51)

Capitalizable Costs (cont.)

- Interest capitalization
 - Affects enterprise funds, fiduciary funds, business-type activities only
 - Generally, interest should *not* be capitalized in an internal service fund that is going to be consolidated into governmental activities
 - No interest capitalization for grant-financed projects

Capitalizable Costs (cont.)

- Methods of Capitalization
 - Specific tax-exempt debt (date of borrowing until completion – net interest revenues earned during the time)
 - Non-specific (date of construction commencement to completion – do *not* net interest revenues)

When is capitalization an option?

- Older infrastructure (assets acquired in fiscal years that ended prior to 7/1/80)
- Art and Historical Treasures *if*
 - Purpose is display/research,
 - Collection is maintained, and
 - Policy that sale proceeds would be used to fund other collections
- Immaterial items

Improvements vs. Repairs

- Expenditures that preserve an asset's utility should be considered maintenance and repairs
- Improvements that should be capitalized
 - Increase the utility or service capacity
 - Extends useful life

Asset Valuations

- Historical cost
- Estimated historical cost
- Donations at acquisition value (“entry” price as per GASB Statement No. 72)
- Changes in fair value of assets irrelevant until actual sale may occur
- Trade-in valuations are net book value of traded asset *plus* additional monetary consideration

Asset Valuations (cont.)

- Transfer of assets between funds
 - Governmental *to* proprietary
 - No effect on general fund
 - Contributed capital in proprietary fund
 - Proprietary *to* governmental
 - Non-operating expense in proprietary fund
 - No effect on general fund

Asset Valuations (cont.)

- Foreclosure
 - Intent to resell (difference between value of tax due and value of property – *expenditure*)
 - Reported as asset held for resell
 - No intent to resell (*expenditure* for amount of tax due....asset reported in government-wide statements)
- Donated assets held for resell commonly are *not* reported in the governmental funds
 - Such assets would be reported in the government-wide statements

Asset Impairments

- GASB Statement No. 42, *Accounting and Financial Reporting of Capital Assets and for Insurance Recoveries*
- Governments are not required to “search” for impairments

Asset Impairments (cont.)

- Impairment indicators (must be permanent)
 - Physical damage
 - Changes in laws/regulations
 - Technological obsolescence
 - Change in manner of use
 - Construction stoppage
- Reduced demand *not* an impairment (easily confuses with change in manner of use)

Asset Impairments (cont.)

- Valuation of impairments
 - “...portion of book value proportionate to the asset’s lost service utility”
 - Restoration cost approach (e.g., physical damage)
 - Service units approach (e.g., change in laws/obsolescence/change in manner of use)
 - Deflated depreciation replacement cost approach (e.g., alternative to service units approach).
 - Fair value declines (e.g., construction stoppage)

Asset Impairments (cont.)

- Clarifications
 - Decline in appraised value does not typically indicate impairment (contrast with decline in service utility)
 - Change in estimated useful life *not* impairment, while change in *duration* is impairment
 - Infrastructure reported under modified approach cannot be impaired due to physical damage
 - Unanticipated increase in construction costs *not* an impairment

Asset Impairments (cont.)

- Clarifications (cont.)
 - Outsourcing the operation of a capital asset is *not* an example of a change in use
 - Debris removal is *not* an impairment (considered to be a temporary issue)
 - Again....impairments have to be deemed to be permanent

Depreciation

- Estimated useful lives should primarily be based on an entity's experiences
- Changes in useful lives should be applied *prospectively*
- Single versus composite depreciation (no gains or losses with composite methods)
- Straight-line method basically universal in the public sector

Depreciation (cont.)

- Integral components of larger assets (e.g., roof with 20 yr. life and the associated building with 60 yr. life)
 - Preferable to treat component as separate asset
 - Acceptable to treat component as part of larger asset and depreciate based on larger asset's life, thus treating component replacement as repair
 - Same as above except treat replacements as disposals (undepreciated cost considered loss on disposal)

Depreciation (cont.)

- Clarifications
 - There should not be significant quantities of fully-depreciated assets
 - Modified approach issues
 - Appropriate for either governmental or business-type activities
 - Asset still reported but not depreciation expense
 - Replacements are treated as repairs
 - Any change to/from modified approach is *prospective*

When is depreciation not recognized?

- Capital assets with indefinite useful lives
- Infrastructure accounted for with the modified approach
- Historical treasures
- Construction in progress

Financial Reporting of Capital Assets

- Depreciable and non-depreciable assets must be reported separately
- Net investment in capital assets
 - Includes all capital assets
 - Excludes debt related to capital assets owned by another entity
 - Excludes internal borrowings
 - Includes refundings of capital-related debt

Financial Reporting (cont.)

- Reporting of depreciation expense
 - By function or multi-functions
 - Unallocated options for governmental activities
- Impairments may be treated as *either* part of program costs, extraordinary item, or special item as circumstances warrant
- Insignificant gains and losses are often directly adjusted to depreciation expense

Financial Reporting (cont.)

- Gains on disposals for governmental activities should be in general revenue; losses on disposals should be expensed in general government functions
- Business-type activity gains are general revenue and losses part of program costs
- Enterprise fund statements reflect gains and losses as nonoperating revenue/expense

Specific Reporting Conventions

- Capital assets should be reported net of accumulated depreciation on the statement of net position
 - Accumulated depreciation may be reported on the face of the statement or simply in the notes
 - Accumulated depreciation by type of asset reported in the note disclosures

Conventions (cont.)

- Depreciation expense for both governmental and business-type activities reported in the statement of activities
 - Depreciation expense reported within functional categories
 - Note disclosures detail the amount of depreciation expense included in each functional category

Conventions (cont.)

- Summary of significant accounting policies
 - Policy for capitalizing *all* assets, including governmental activity infrastructure
 - Policy for estimating useful lives
 - Useful lives by category of capital asset

Conventions (cont.)

- Capital asset activity disclosed by governmental and business-type activities
 - Beginning and ending balances
 - Capital acquisitions
 - Sales or other dispositions
 - Current period depreciation expense
 - Reductions in accumulated depreciation

Conventions (cont.)

- Disclosures (cont.)
 - Changes in accumulated depreciation by type of asset
 - Summary of depreciation expense by governmental function or business-type activity
 - Description and rationale for assets not being depreciated

Capital Asset Policies and Procedures

- Governments should have established capital asset policies
- Periodic capital asset inventories help ensure continued reliability
- Inventory methods are a great complement to the external independent audit

GFOA Best Practices & Advisories

- Capitalization thresholds (2006)
- Periodic inventories (2006)
- Estimated useful lives (2007)
- Consideration of the modified approach (2002)

GFOA Best Practices (cont.)

- Control over noncapitalized assets (2005)
- Capital asset management (2010)
- Role of the finance director in capital asset management (2011)