

3.

ACCOUNTING

3.3 Capital Assets

3.3.10 Capital Asset Accounting

3.3.10.10 Once the capital asset system is in operation, the government needs to make sure that assets which should be capitalized are properly recorded and that records are brought up to date when assets are disposed.

3.3.10.20 DETERMINING OWNERSHIP of CAPITAL ASSETS

While assets may be jointly acquired, constructed or used, an asset can only be asserted to be owned by one government and therefore may only be reported as such on one set of financial statements. Generally, the government that owns the asset and holds the title determines who should report the asset even if used or paid for by someone else. For example, a city pays to construct a park on port property. The port owns the land and as such, should report the asset. However, when a title is not available, it may be difficult to determine who owns the asset. In such cases, the party responsible for managing and maintaining the asset should be considered the owner and report it. In the previous example, even if the city assumed responsibility for maintaining the park, the port would report the asset since they own the land.

Whenever there is a question about ownership or the correct classification or reporting of an asset that was acquired, constructed or used jointly, the government should check with the other parties involved to ensure consistency in reporting the asset and clarify any applicable contracts or agreements as needed.

3.3.10.30 COST TO BE RECORDED

Original cost (historical cost) is the amount spent to acquire an asset. This cost is based on the actual price paid, including related taxes, commissions, installation costs and any other costs related to acquiring the asset or preparing the asset for use. Costs should only be capitalized when directly attributable to a specific asset. As such, costs related to studies that determine feasibility or the best location of an asset should not be capitalized. On the other hand, legal, engineering, architectural and other ancillary fees related to acquiring, or putting in service, a specific piece of property could be capitalized.

Land costs typically include: the purchase price; closing costs, such as title to the land, attorney fees, and recording fees; assumptions of any liens, mortgages, or encumbrances on the property; costs incurred in getting the land in condition for its intended use, such as excavation, grading, filling, draining, clearing, removal, relocation or reconstruction of property of others; retaining walls; parking lots; fencing; landscaping; and any additional land improvements. Any proceeds obtained in the process of getting the land ready for its intended use, such as salvage receipts on the demolition of an old building or the sale of cleared timber, should be treated as a reduction in the price of the land.

The actual price should approximate fair market value. If the information regarding original cost is not available, the government needs to estimate the original cost. This cost principle applies to both governmental and proprietary capital asset acquisitions.

3.3.10.40 Excess Costs

Costs that do not add to the utility of an asset should not be capitalized. For example, expenditure to repair a piece of equipment that was damaged during shipment should be expensed. In addition, training on how to use a newly acquired asset should not be capitalized as it would not meet the criteria of a

necessary cost to place the asset into service. Each capital asset purchase should be analyzed carefully to determine which portions of the cost should be capitalized.

Specific guidance on this topic may be provided in industry publications or mandated by certain regulatory agencies. For example, FERC guidance for PUDs, provides that any amounts incurred for plant additions that are in excess of just and reasonable charges should be expensed. Likewise, if excess costs are incurred to replace individual units of property damaged in a storm so as to restore the utility system to operating condition without delay, then only the normal or fair cost is charged to plant, the balance to maintenance.

3.3.10.50 Capitalization of Interest

Interest cost incurred in connection with the acquisition, construction, or improvement of capital assets are considered part of *the ancillary charges necessary to place the asset into its intended location and condition to use*.

Interest should never be capitalized on capital assets accounted and reported in governmental activities including capital assets in internal service funds that are incorporated into governmental activities in the government-wide financial statements. So, interest capitalization is limited to capital assets reported in the enterprise funds. The [GASB Statement 62, Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements](#), paragraphs 5-22 provides requirements regarding capitalization of interest cost.

3.3.10.60 Donated Assets

Assets are sometimes donated to a government. Donations of cash to be used to purchase or construct a specific asset should be reported as revenue (BARS 367, *Contribution and Donations from Nongovernmental Sources* in governmental funds; BARS 374/379, *Capital Contributions* in proprietary funds).

Contributed capital assets intended to be used in operations should be reported at the acquisition value. Acquisition value is the price that would be paid to acquire an asset with equivalent service potential in an orderly market transaction at the acquisition date, or the amount at which a liability could be liquidated with the counterparty at the acquisition date (further described in [GASB Statement 72, Fair Value Measurement and Application](#)). Contributed capital assets intended to be sold should be reported at fair value.

3.3.10.70 Works of Art and Historical Treasures

Works of art, historical treasures, and similar assets are considered to be capital assets and as such they should be capitalized at their historical cost if purchased or acquisition value if donated.

Exhaustible assets (such as exhibits whose useful lives are diminished by display or educational or research applications) should be depreciated over their estimated useful lives. Governments should not depreciate collections or items considered inexhaustible (i.e., the individual works of art or historical treasures that have extraordinarily long useful lives). Distinctions of exhaustible and inexhaustible items or collections, or their useful lives need to be made by each government.

3.3.10.80 Improvements, Repairs and Maintenance

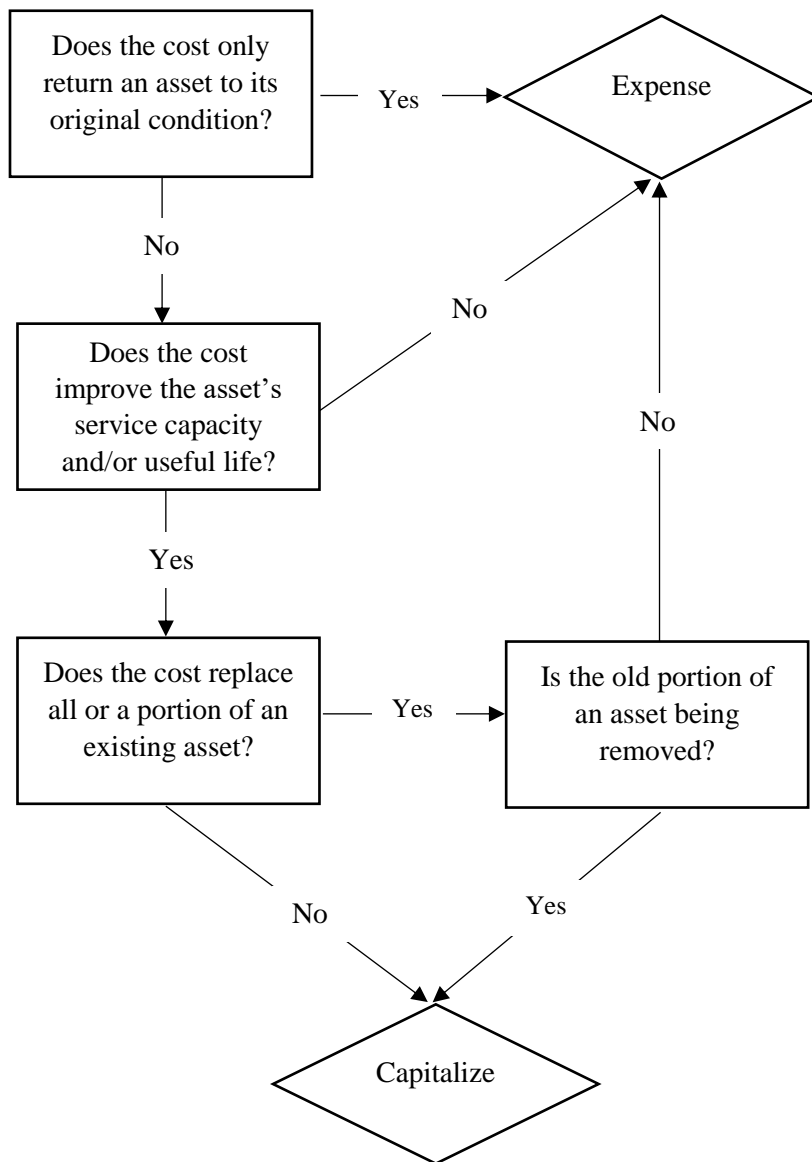
Costs relating to an existing asset need to be carefully evaluated as they are incurred to determine whether they should be classified as maintenance or repair expenses or capitalized as improvements. This evaluation will depend on the nature of the cost as well as the assumptions embodied in the government's policy approach to capitalizing the existing asset in terms of componentization (as discussed in section 3.3.10.150) and useful life. For example, if a new building is capitalized as a single asset and the useful life is set at 80 years, then this would assume regular replacement of different parts of the building that will last less than 80 years (such as the roof, landscaping, sidewalks, HVAC, furnishing, boilers, elevator, etc.) as maintenance or repair expenses. In contrast, if a new building was capitalized as multiple assets – such as the building structure at 80 years but the roof, HVAC, boilers, and other major components each with its own useful life – then replacement of each major component would be capitalized (and the old asset removed).

Repair and maintenance costs that keep or restore an asset at its original condition (as anticipated by the asset's estimated useful life) should be expensed as they are incurred, regardless of dollar amount. Costs should only be capitalized if they result in betterments/improvements that 1) extend useful life, or 2) increase the service capacity or efficiency.

For example, when a new roof for a building is purchased, classification will depend on the government's policy embodied in how the building is capitalized and its estimated useful life. If the roof has been componentized as its own asset, the old roof asset would be removed and the new roof added as a new capital asset record. If the roof was not separately capitalized, then costs would normally be expensed since the useful life for the building as a whole would normally already assume replacement of the roof and other parts. However, it is possible that the decision to replace the roof was a result of changing circumstances that were not factored into the original estimate of the building's useful life. In that case, costs should only be capitalized to the extent that the new roof increases the useful life of the building – that is, beyond the current estimated useful life used to depreciate the building to this point – *and* that the building asset is adjusted to remove the original cost and accumulated depreciation associated with the old roof.

A difficulty arises in the case of capital outlays that are partly replacements and partly betterments/improvements. For example, consider a building being depreciated as a single asset where a remodel project replaces some parts such as flooring and fixtures (which do not appreciably add to service capacity or extend the useful life of the building as a whole), as well as adds a new addition (more square footage) to the original building. To the extent that the project replaces the *old* part of a capital asset, the normal approach would be to expense those costs. To the extent that the project is a betterment/improvement, such as with the building addition, the outlays should be capitalized. The distribution of the total cost in such a case is a matter of managerial determination. When the distinction between replacement and betterment/improvement is not easily determinable, or not estimable, the government should expense the entire cost of the project.

The following chart highlights the primary decision points for determining if a project should be expensed as a repair/maintenance cost or capitalized.



When there is a change in the estimated useful life due to an improvement of an asset, depreciation charges for future periods should be revised based on the new book value and the new estimated remaining useful life. No adjustment should be made to prior periods.

3.3.10.90 DATE PLACED in SERVICE

Construction in progress reflects the status of construction activities of buildings, other structures, infrastructure, etc. Construction in progress is a non-depreciable capital asset. Constructed assets should be re-classified from construction in progress and begin to be depreciated when they are substantially completed/placed in service.

There is no specific definition of *substantially completed* and the local governments should use professional judgement to determine the timing of the transition from construction in progress to

depreciable capital asset. The constructed asset would be considered substantially completed when it can at least partially perform its intended function (e.g., an empty or partially occupied building for which the government obtained the occupancy permit; the structure is completed except for the landscape; a multilane road with cars using some of the lanes; the asset is being used even if not all “punch list” items are completed or the dispute with a contractor is resolved; equipment [e.g., a fire truck, etc.] is delivered and being used despite some unfinished modifications; etc.).

3.3.10.100 DEPRECIATION

Most capital assets, including infrastructure should be depreciated. There are some exceptions for assets such as land and depreciating art and historical treasures, if they are inexhaustible. In addition, an asset that has been surplus or that is held for possible future use is an investment and should not be depreciated. For quarries, timberlands, and mineral rights, depletion expenses must be recorded. Since properly maintained infrastructure assets have the potential of indefinite useful lives, there is an option of not applying depreciation for infrastructure assets that meet certain criteria as defined in [GASB Statement 34](#); this is referred to as the modified approach.

The objective of depreciation is to spread the costs of capital assets incurred in one period equitably over multiple periods for which the capital asset will benefit. Several items should be considered when depreciating assets, as discussed below.

3.3.10.110 Salvage Value

Salvage value is the estimated fair value of a capital asset, infrastructure or otherwise, remaining at the conclusion of its estimated useful life. In most cases, it is probable that many infrastructure assets will have no salvage value, given the cost of demolition or removal. For other asset types, salvage value is typically expected to be trivial and if so, can be ignored in establishing the amount to depreciate. However, if scrap or sale proceeds are expected upon disposal, this value can be factored into the depreciation calculation.

3.3.10.120 Estimated Useful Life

Depreciation must be based on a reasonable estimate of expected useful life; that is, the number of years, miles, service hours, etc., that the government expects to use that asset in operations. Ideally, governments should base useful life estimates on its actual experience and plans. However, if this information is not available, the government can look to industry guidelines for a starting estimate and then revise the estimate as additional information becomes known.

This estimate should be made and updated based on:

- a. Current condition;
- b. Expected future use, including anticipated changes in future usage rates or patterns;
- c. The government’s policy, practice and/or capital planning regarding when assets of this type are disposed or replaced;
- d. Construction quality
- e. Maintenance policy
- f. The government’s historical experience with assets of this type as well as any industry, manufacturer or regulatory guidelines on the life-expectancy of the asset.

Governments should maintain support for their useful life estimates.

Useful life is a managerial estimate and should be periodically reviewed and adjusted prospectively when needed to ensure an asset's cost is allocated over its useful life.

3.3.10.130 Fully-Depreciated Assets

Depreciation is intended to allocate the cost of a capital asset over its entire useful life. As useful lives are estimated, periodically, local governments should consider information available about the existing estimates and make adjustments as needed. It normally is not appropriate to report assets that are still in service as fully depreciated. Instead, the annual amount of depreciation expense should be reduced prospectively as soon as it becomes clear that an asset's useful life will be longer than originally expected. In practice, however, the use of average estimated useful lives for entire classes of assets means that at least a few fully depreciated capital assets typically will be reported (i.e., those whose actual lives exceed the group estimate). Such reporting of fully depreciated capital assets is acceptable, but only if such balances do not become material, in which case the estimated useful life for the group would need to be changed. If an asset is not expected to last as long as originally estimated, the useful life should be adjusted to ensure it becomes fully depreciated at the end of its service.

3.3.10.140 Depreciation Method

There are two depreciation methods: straight-line or group life. Whether group-life or individual asset depreciation is used, the amount of depreciation charged must be constant for each time period (called straight-line depreciation) or for each unit of service (such as quantity of output, hours or miles of operation, etc.).

Straight-line depreciation

Straight-line depreciation is the typical method used. With the straight-line method, the cost of an individual capital asset (less any salvage value) is allocated equally over its estimated useful life.

Group-life depreciation

Group-life depreciation should only be used in appropriate circumstances, and should be supported by rationale documented in the capital asset policy. There are two entirely different applications of group-life depreciation. The first type is applied to a set of very similar assets, such as a fleet of police cars or a suite of office furniture that are placed in service at about the same time. For this type of group-life depreciation, the group of assets should be treated as a single asset; any gain or loss on disposal is delayed until the entire group has been retired.

When some items within the group are retired ahead of schedule, the original cost of the items is removed from both the asset and the accumulated depreciation account. Depreciation continues to be charged only for the remaining assets at the original rate. This defers any gain or loss until the entire group has been retired. When some items in the group require major repair, the book value of the group should be adjusted and the periodic depreciation recalculated for the remaining life of the group.

The second type of group-life depreciation is used primarily in utilities, and it is applied to dissimilar assets, which are related by the mode of operation in which they are used. The rate of depreciation is a weighted average of the rates applicable to the individual assets, which comprise the group. The use of this method is intended to eliminate gains and losses on individual asset retirements, except when an entire operating system or facility is retired from service.

When depreciation charges are based on time periods, charges should be made for each month that an asset is in service. Exceptions such as the half-year convention or excluding depreciation in the first year

of service are acceptable, unless capital asset additions to a fund in one year exceed 50 percent of net capital assets before the addition. When such large additions are made in one year, depreciation must be charged for no less than each whole month the additions are in service, because it is likely that material distortions in operating income would result from applying more approximate methods.

3.3.10.150 Componentization of Assets

Assets, such as a building, may be recorded as one asset, or be recorded in various components (structure, roof, HVAC, etc.). The decision to componentize assets of different types should be addressed in the government's policy and be consistently applied. A benefit of componentization is that it is easier to record replacements; however this must be considered with the cost of tracking additional capital asset records.

If a local government chooses to componentize assets by separating the various parts, they should track each individual component and depreciate them over a reasonable useful life. When replacements of components, such as the roof occur, the government should ensure the value of the old roof is removed from the capital asset listing to ensure the asset balances are not inflated. Alternatively, the government could choose not to componentize assets and treat replacements as repairs to the larger asset and expense them as they occur.

3.3.10.160 Depreciation on Donated Assets

Depreciation of assets acquired from contributions is calculated in the same manner as for other assets and is reported in the same way on the operating statement.

3.3.10.170 CAPITAL ASSET IMPAIRMENT

[GASB Statement 42, Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries](#) requires the immediate recognition of decreases in the productive capacity of capital assets that are expected to remain in service, even if there is no change in the estimated useful life of the asset. The Statement identifies five indicators of possible impairment:

1. **Evidence of physical damage** – such as an office building damaged in a storm;
2. **Changes in legal or environmental factors** – such as an underground storage tank that is no longer usable due to changes in environmental standards;
3. **Technological changes or obsolescence** – such as medical equipment that still can be used, but for which the demand is expected to significantly decrease with the advent of more attractive treatment options;
4. **Changes in manner or duration of use** – such as a school building being used as a warehouse;
5. **Construction stoppage** - legal or practical reasons may cause to abandon a construction project, such as a road construction that threatens the habitat of endangered species).

The presence of one of these indicators does not automatically prove that the impairment has occurred. For example, the alternative use of capital asset could have the same value as its original use. The presence of an indicator, however, does put management on notice that it needs to consider the possibility that an impairment may have occurred.

Only permanent impairments of capital assets should be recognized in the financial statements. If a government recognizes impairment because it cannot determine that the situation is only temporary, it may not recognize a subsequent recovery in value should the impairment ultimately prove to be temporary.

The following flowchart is designed to help the governments determine if there is a need to calculate and disclose the assets impairment.

3.3.10.180 Calculating Capital Asset Impairment

For permanently impaired assets, the appropriate accounting and financial reporting depends on whether the asset is expected to remain in service. For capital assets expected to remain in service, the impairment loss must be recognized according to methods prescribed in the Statement.

3.3.10.190 Reporting

In some cases, capital asset impairment will qualify as an extraordinary item. Capital asset impairments subject to management control (e.g., change in manner or duration of use) may qualify as special items. Otherwise, capital assets impairment should be treated as an element of net program cost in appropriate functional category.

The notes to financial statements should disclose the amount and classification of impairment losses not visible on the face of financial statements. Also, any capital assets that are idle either permanently or temporarily as a result of impairments, should be disclosed.

All insurance recoveries, including those not associated with the impairment of capital assets, should be reported net of the related loss as soon as the recovery is either realized or realizable.

ASSET IMPAIRMENT DECISION PROCESS

