NEWSLETTER NO. 10

A Discussion of "Costs"

by Dan Cowin, Executive Director, MFOA

Newsletter 6 and Newsletter 7 dealt with the use of historic costs to determine the value of tangible capital assets for the purposes of PS 3150. This Newsletter focuses on the notion of cost. An understanding of costs, as defined in the PSA Handbook, will be important as you:

- Determine opening values for assets in your inventory,
- Undertake ongoing TCA accounting and reporting, and
- Review your municipality's capitalization policies to ensure consistency with your approach to assets under PS 3150.

Our next Newsletter will deal with techniques for estimating costs where historic records are absent. It will also discuss the issues related to evidence of costs that you establish for your assets. Other future Newsletters will deal with issues related to the amortization of assets and annual depreciation.

Costs You Will Be Required To Disclose

We have noted previously that future Newsletters will describe in detail the new financial statements and the reporting framework. However, as municipalities begin to build asset inventories and identify asset costs, it is useful to have some knowledge of the types of cost information that you will be required to disclose so you can plan for the types of information you will gather and how you will organize it.

PS 3150.40 requires disclosure of the following information for each major category[1] of tangible capital assets:

- Cost at the beginning and end of the period;
- Additions in the period;
- Disposals in the period;

[1] An asset category groups assets of a similar nature or function in a local government's operations and is disclosed as a single item in the financial statements. Selection of asset categories will be specific to the nature and objectives of a particular local government. For example, an upper tier municipality may have a category for a water system that produces potable water for distribution by lower tier municipalities. It might be appropriate to use the category "water distribution system" at the lower tier level to distinguish the two water systems or to differentiate between a local government that has responsibility for both treatment and distribution.

- The amount of any write-downs in the period;
- The amount of amortization of the costs of tangible capital assets for the period;
- Accumulated amortization at the beginning and end of the period; and
- Net carrying amount at the beginning and end of the period.

PS 3150.42 identifies additional information to be disclosed, including:

- The amortization method used, including the amortization period or rate for each major category of tangible capital asset;
- The net book value of tangible capital assets not being amortized because they are under construction or development or have been removed from service;
- The nature and amount of contributed tangible capital assets received in the period and recognized in the financial statements;
- The nature and use of tangible capital assets recognized at nominal value;
- The nature of the works of art and historical treasures held by the government; and
- The amount of interest capitalized in the period.

Key Cost Concepts in the PSA Handbook

Cost is “the gross amount of consideration given up to acquire, construct, develop or better a tangible capital asset, and includes all costs directly attributable to acquisition, construction, development or betterment of the tangible capital asset, including installing the asset at the location and in the condition necessary for its intended use.” (PS 3150.05(b)).

“Directly Attributable” Costs Included

PS 3150.10 makes it clear that costs “directly attributable” to the purchase or acquisition of an asset form part of the cost of the asset:

> The cost of a tangible capital asset includes the purchase price of the asset and other acquisition costs such as installation costs, design and engineering fees, legal fees, survey costs, site preparation costs, freight charges, transportation insurance costs, and duties. The cost of a constructed asset would normally include direct construction or development costs (such as materials and labour) and overhead costs directly attributable to the construction or development activity. The activities necessary to prepare a tangible capital asset for its intended use encompass more than the physical construction of the tangible capital asset. They include the technical and administrative work prior to the commencement of and during construction.

The PSA Handbook does not define the term ‘directly attributable.’ However, the Public Sector Accounting Group’s Guide to Accounting for and Reporting Tangible Capital Assets offers the following observation with respect to certain central overhead costs:

- The salary, wages and benefits of the staff of the design department directly related to completing engineering drawings for the constructed asset could be allocated to the gross cost of the asset provided they are directly attributable to that particular asset.
- Allocation of a portion of fixed costs (eg. Occupancy costs or general administrative overheads associated with the City Engineer's office, etc) is **not** generally considered directly attributable costs (emphasis added).

The glossary in the Guide to Accounting for and Reporting Tangible Capital Assets offers the following important cost definitions, including additional guidance on the concept to directly attributable costs.

> **Directly attributable overhead costs** refers to direct incremental expenses incurred for technical and administrative activities related to the construction of a tangible capital asset. These costs could include the salaries and benefits for internal staff doing design work related to the construction project. It would not include an allocation of fixed costs incurred by the local government such as occupancy costs for the design department or an allocation of the costs of corporate departments such as human resources, legal, purchasing and accounting. These latter costs are incurred whether or not the construction project is undertaken and, therefore, would not be incremental overhead expenses directly attributable to the cost of the project. (p. 100).

The glossary also distinguishes between "directly attributable" costs, "direct costs" and "indirect costs."

> **Direct costs** are incremental costs incurred by a local government for the acquisition, construction or development of a tangible capital asset. Direct costs would not have been incurred other than to acquire, construct or develop the tangible capital asset. For example, directly related employee salary and benefits, materials and supplies, equipment, temporary site buildings, legal and other professional fees, etc., could be considered direct costs. (p. 100).

> **Indirect costs** are costs incurred for a common or joint purpose and, therefore, can not be identified readily and specifically with an activity related to the acquisition, construction or development of a tangible capital asset. For example, executive management, occupancy costs for general administrative buildings, corporate services (accounting, payroll, legal, technology, etc.), general local government, etc., would be considered indirect costs. (p. 101).

The OMBI Guide (pp 27-29) also addresses the issue of capitalizing "directly attributable" costs. The benchmarking work undertaken by OMBI employs standardized techniques for allocating central overheads to program areas. The OMBI Guide concludes its discussion on directly attributable costs with this advice: "In any event, municipalities may have to revisit their methodology of allocating overhead costs to ensure only costs directly attributable to TCA are capitalized."[2]

Carrying Costs Can Be Included

Many large assets are constructed over time. The PSA Handbook makes it clear that carrying costs related to the acquisition of an asset are part of the overall cost of the asset. PS 3150.15 states that the "cost of a tangible capital asset that is acquired, constructed or developed over time includes carrying costs directly attributable to the acquisition, construction or development activity, such as interest costs when the government's policy is to capitalize interest costs." It should be noted that if you establish a policy to capitalize interest costs, your policy should apply to all tangible capital assets in all asset categories.

On the other hand, "carrying costs incurred while land acquired for building purposes is held without any associated construction or development activity do not qualify for capitalization." (PS 3150.16). PS 3150.17 notes that "capitalization of carrying costs ceases when no construction or development is taking place or when a tangible capital asset is ready for use in producing goods or services. A tangible capital asset is normally ready for productive use when the acquisition, construction or development is substantially complete."

Costs of Contributed Assets

It was noted in Newsletter 8 on Assets, that a municipality's assets include assets contributed by others, including developer contributed assets, even though these were acquired at no cost to the municipality. The PSA Handbook states that the cost "of a contributed tangible capital asset, including a tangible capital asset in lieu of a developer charge, is considered to be equal to its "fair value" at the date of contribution.[3]

Cost Includes Capital Grants

Capital grants are not netted against the cost of the related tangible capital asset. (PS 3150.05(b)). For example, the cost of a bus acquired at a time when transit capital grants were paid, would be the total cost of the bus, including the grant funding, and would not be the net cost of the bus to the municipality.

---

[2] OMBI Guide, p. 29.

[3] Fair value"is the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act." (PS 3150.05(c)) Fair value may not always be determinable where there is no ready market. Alternatives might include getting the cost information from the developer; using costs of similar constructed assets; use of standard cost curves or unit costs; indexed historical cost, etc. Whatever method is used, the external auditor should be consulted as to acceptability, documentation, etc. For accounting, the other side to the entry will be a revenue on the statement of operations.

Cost of Assets Reflects "Betterments"

PS 3150.15 states: "costs of betterments are considered to be part of the cost of a tangible capital asset and would be added to the recorded cost of the related asset. A betterment is a cost incurred to enhance the service potential of a tangible capital asset. In general, for tangible capital assets other than complex network systems, service potential may be enhanced when there is an increase in the previously assessed physical output or service capacity, where associated operating costs are lowered, the useful life of the property is extended or the quality of the output is improved."

Distinguishing between maintenance and betterments, especially for complex networks, can be difficult. The PSA Handbook offers the following guidance on this issue at PS 3150.21:

> For complex network systems, therefore, the following basic distinctions can be used to identify maintenance and betterments:
> (a) Maintenance and repairs maintain the predetermined service potential of a tangible capital asset for a given useful life. Such expenditures are charged in the accounting period in which they are made.
> (b) Betterments increase service potential[4] (and may or may not increase the remaining useful life of the tangible capital asset). Such expenditures would be included in the cost of the related asset.

The approach taken to accounting for TCA's may also impact the accounting for betterments. For example, if you replace a major component of an asset that is accounted for as a single asset, it would likely be maintenance (e.g. the roof on a building; resurfacing of the roadway, would likely be maintenance as it does not extend the life of the asset. Replacements of these components would be considered normal over the life of the asset.) If the component approach is used, the replacement of a major component would be considered an addition and disposal. (e.g. If the roof were a component of the building, the replacement of the roof would be a new asset and amortized over its useful life. The cost and accumulated amortization of the old roof would be relieved from the account and a gain or loss (if any) recognized in the statement of operations.)

Acquisitions and Disposals

The costs of newly acquired assets will be reflected in the financial statements and costs associated with assets that have been disposed will not. We note this obvious truism because costs associated with new acquisitions and disposals[5] are independently disclosed, as noted

[4] Service potential embodies both the quality of service provided and the efficiency with which it is provided.
[5] Disposals include sale, trade-in, destruction, demolition, abandonment, decommissioning of tangible capital assets. The difference between the carrying amount (cost less accumulated amortization) and proceeds on disposal is treated as a gain or loss in the statement of operations.

above. Your inventory will need to be able to identify, for each reporting period, the new assets you acquire and those that you no longer have in your possession or control.

A Few Special Cases

Assets Not In Use

A municipality might acquire an asset that it does not intend to use. For example, you might acquire land for a park that comes with a building that you might intend to demolish. In this case, where "a portion of the acquired tangible capital asset is not intended for use, its costs and any costs of disposal, net of any estimated proceeds, are attributed to that portion of the acquired tangible capital asset that is intended for use. For example, the cost of acquired land that includes a building that will be demolished includes the cost of the acquired property and the cost of demolishing the building." (PS 3150.13)

Assets Need Further Expenditures

A municipality might acquire a property that requires additional expenditures to bring it to a condition where it is ready for use. An obvious example of this would be the purchase of land where some type of environmental remediation is expected. The cost of the asset would include any subsequent expenditure provided they do not exceed the fair value of the asset.[6]

Spare Parts

The Public Sector Accounting Group Guide notes the following with regard to spare parts:

> Generally, spare parts and servicing equipment are usually carried as inventory and recognized as an expense as consumed. However, major spare parts and standby equipment may qualify as tangible capital assets when a local government expects to use them during more than one period. Similarly if spare parts and servicing equipment can only be used with a tangible capital asset and their use is expected to be irregular, they can be accounted for as tangible capital assets and amortized over a time period not exceeding the useful life of the related asset.[7]

Single Payment for Multiple Assets

On occasion, several assets might be acquired with a single purchase or where multiple assets and contributed by a developer. In a case such as this, PS 3150.15 states "The cost of each tangible capital asset acquired as part of a single purchase (for example, the purchase of a building and land for a single amount) is determined by allocating the total price paid for all of the tangible capital assets acquired to each one on the basis of its relative fair value at the time

[6] CICA, Guide To Accounting And Reporting For Tangible Capital Assets, p. 18
[7] CICA, Guide To Accounting And Reporting For Tangible Capital Assets, p. 18

of acquisition." In the example above, this is important since the building cost will be amortized while the land cost will not.[8] PS 3150.05(c) says that fair value "is the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act."

For more information and resources regarding tangible asset management, go to PSAB/Asset Management, or contact:

Dan Cowin
Executive Director
MFOA
dan@mfoa.on.ca
Tel: 416-362-9001 ext: 223

Andy Koopmans
Executive Director
AMCTO
akoopmans@amcto.com
Tel: 905-602-4294 ext: 26

[8] PS 3150.24 states "Land normally has an unlimited life and would not be amortized."