NEWSLETTER NO. 43

BUDGETING FOR TANGIBLE CAPITAL ASSETS (1) - PURCHASES

By Bruce Ratford, CMA

This Newsletter has been made available as a result of financial support from the Province of Ontario

In the previous newsletter, we took an overview perspective as to how municipal budgeting may change in the PS 3150 environment. In this and subsequent newsletters, we will look at how you may want to budget for a number of specific situations relating to tangible capital assets.

First, let us look at TCAs that you purchase from a supplier.

Off-the-shelf items

Many tangible capital assets are stock items, or ones requiring minimum customization. Examples would be small vehicles, furniture, computers, etc. These items are sold at a fixed or negotiated price, with delivery usually being within 30 or 60 days of placing the order. If you order something in 2009, you are reasonably certain that delivery will take place in 2009, so that it will be accounted for and reported as a 2009 transaction.

Thus you can budget for the acquisition of such tangible capital assets in the year you intend to acquire them. If the cost of the asset, including any applicable taxes and associated acquisition costs is below your capitalization threshold, then you will budget the purchase as an expenditure – for a tangible capital asset – in your operating budget.

If the total cost will be higher than the capitalization threshold, then you will likely include the asset as part of your capital investment plan or capital budget, to be added to your TCA inventory and to be amortized, once acquired.

Items requiring preparation prior to entering service

Some items need major additional customization before they can enter service. An example of this is an ambulance, which is usually bought as a basic panel or cube van, and then substantially bettered with all the requirements for operation as an ambulance. Another would be a major accounting system, which requires considerable implementation and configuration work before it is ready to go live.

In order to be able to cover all of the costs of having a usable asset, you will need to budget for the acquisition cost of the "raw" asset, plus all of the additional costs of customizing it to your operating requirements and specifications. The above comments about where to budget also apply here, though this kind of acquisition will almost certainly cost more than your capitalization threshold, so that it will likely be part of your capital investment plan.

If you were planning to take delivery of the van in December, and do the customizing in January, then you would split the budget appropriately between the two years, as you will be financing the acquisition in two separate fiscal years. Note that the accounting would add the cost of the van to the December valuation of Work-In-Progress, as the final enhanced asset is not ready to go into service as an ambulance, until all of the betterments have been finished. In short, you may have a van, but only half or three-quarters of an ambulance, which is the asset that you are acquiring. Once the ambulance is ready to go into service, it will be added to the tangible capital asset inventory (in the second year) as an ambulance, including customizing costs, and the valuation of Work-in-Progress will be reduced appropriately.

Custom items and special orders, long-term contracts with advance payments

When buying very large, high-value items that are being custom manufactured over an extended period of time, the manufacturer will commonly require a deposit and/or cash advances, partly to confirm intent to purchase, but also to help defray the costs incurred in completing the order. Aircraft manufacturers and shipbuilders normally require such advance payments, as often do train and bus manufacturers. The alternative is for them to factor in interim financing during manufacturing into the purchase price.

If you are buying subway cars or buses for delivery one or more years in the future, you would budget these payments as part of your capital investment plan, as these are being made to acquire tangible capital assets at some point in time, and the payment has to be financed.

Although you have no TCA to record and account for until each vehicle is delivered, you have paid out the funds in anticipation of acquiring the assets. The accounting is really no different than before,. As mentioned in the previous newsletter, the amount of the payment will be posted against the asset account Work-in-Progress, as you are paying some of the future cost in advance. This would be very similar to the accounting for a multi-year construction project that you are undertaking and managing.

When you actually take delivery, the final payment, along with the total balance previously posted to Work-in-Progress will hopefully equal the contracted cost of the assets acquired. The amount in Work-in-Progress will be journalled out, and the assets added to the TCA inventory at the contracted cost. This capitalization of the asset will be dated as of the day the asset goes into service. While this may occur several years down the road, you would budget the advance payments required, for the period when you are contractually obligated to make them.

As part of your operating budget? …..

Or as part of a capital investment plan/capital budget?

Up until December 31st, 2008 any outlay for a capital asset is considered to be an expenditure, charged either against the Revenue Fund or the Capital Fund – wherever the approved funding will be. At year end, the financial reports show the total cost of all capital expenditures, including those paid for directly out of the Revenue Fund. The current budget numbers that you include in your financial statements are consolidated in a manner that parallels the consolidation of the actual expenditures that are reported.

Starting this year, the implementation of PS 3150 will change how you report on transactions relating to tangible capital assets, but does not necessarily change how you have to budget for them and finance them. There will be two concerns that you may want to take into account.

The first are your capitalization thresholds. To reiterate, if the total cost is below the threshold, then it will be reported as an operating expenditure, and should probably be budgeted accordingly. If the cost is above the threshold, then it is a tangible capital asset, and the acquisition should perhaps be financed as part of the capital investment plan or capital budget. This does not preclude raising tax revenues in the operating budget to pay for a large-value item out of operating funds, but then the amount will not be accounted for as an expense, but as a contribution to the capital investment plan, because the asset will still be added to asset inventory, and amortized over its estimated life expectancy.

The second concern may be the issue of whether work on an asset is maintenance or a betterment. Maintenance has to be expensed in the financial reporting, whereas a betterment can be capitalized. PS 3150.19 states "*A betterment is a cost incurred to enhance the service potential of a tangible capital asset.*" In short, a betterment is like an upgrade, whether qualitative and/or quantitative in nature. While PS3150 is quite specific as to how you must report this type of work in your financial statements, it does not necessarily change where and how you budget and finance them. For example, you may follow a single asset approach for roads. Your annual resurfacing program is likely therefore a maintenance item, by definition. However, traditionally, it has been budgeted in your Capital Works Program. Indeed, it may even be financed from debt. The move to accrual accounting does not have to change this in any way. You will probably have to move the budget to match the accounting treatment of the expenditure very similarly to how you disaggregate and reconsolidate the operating and capital budgets for Revenue and Capital Fund reporting today.

Please note that the same piece of work could be either maintenance or betterment depending on how you define and identify your asset. If your administration building is a single asset, with a 60-year life expectancy, then replacing the roof will be maintenance, because you have not upgraded the service potential of your building at all, just tried to keep the rain out for another 20 years. However, note that the third reroofing job **will** be a betterment, because it will effectively extend the useful life of the total asset by a further 20 years.

If you identify the roof as a separate component of the building, and account for it separately, then the same work is always a betterment, because it is a replacement, and the total cost can be capitalized, including the cost of ripping off the old roof. Regardless, it will be your choice as to where you budget the expense, and how you finance it.

Finally, as mentioned with respect to advanced payments for assets, the capitalization of a tangible capital asset begins on the day it goes into service. This may have significance in terms of the calculation of amortization. Depending on timing, there may be budget implications, if you opt to budget for and finance amortization expense. This was discussed in more detail in Newsletter #38.

Summary

Does this sound very different from your current practice?

-----ooooo-----

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

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

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

This Newsletter is published to assist you with your implementation of tangible capital asset accounting and with related matters. The Public Sector Accounting Handbook is the only authoritative primary source on matters relating to GAAP, and you should consult with your auditor to resolve specific issues that you may have.