NEWSLETTER NO. 44

BUDGETING FOR TANGIBLE CAPITAL ASSETS (2) - CONSTRUCTED ASSETS

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In the previous newsletter, we looked at how you may want to budget for the purchase of tangible capital assets. Now let us look at those assets that you construct or develop from scratch – major capital construction projects. Regardless of where or how you may choose to budget for them and finance them, they will be tangible capital assets, unless you use a high value capitalization threshold.

These are the most valuable tangible capital assets that you have or will have. They comprise the lion's share of the value of any capital works program. They are infrastructure projects, or the construction of major facilities. From initial design to inauguration, they almost always extend over at least two fiscal years, but may require 10 or more years, such as for a major road. Unlike the type of asset acquisition discussed in the previous newsletter, one is not planning and budgeting for an expenditure that will be made in its entirety within the year of the budget.

Current Practice

You have an approach or methodology in place for budgeting and financing these large construction and development projects. In essence, the total project gets approved in principle, as does the anticipated source(s) of funding, so that work can proceed. However, each year's requirements for financing, and anticipated expenditures, will be budgeted as though this is a new project that happens to have a past history, the so-called "to-date."

As has been noted in previous newsletters, the financing being provided in any year is budgeted and accounted for as "revenue," and costs to be incurred during the year are budgeted and accounted for as "expenditures." The day that the project goes into service, or, better, is deemed to be complete, all associated costs incurred to arrive at that point will have been expensed over the duration of the project.

Currently, the asset is effectively amortized during development and construction, at a rate equal to the annual disbursements. On the day it goes into service and/or is deemed to be complete, it will have a net book value for accounting and financial reporting of zero. This is why we have referred to the asset as being written off before its service life has even really begun.

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2009 and Beyond - budgeting

Planning the financing for such projects will not really change in the new accounting environment. Financing must still be provided to cover the estimated disbursements that will be made over the life of the construction project. However, budgeting for the financing will not necessarily match the timing of disbursements, which represent the actual timing of gradually acquiring the asset. This could well be an issue for many municipalities with respect to the Statement of Changes in Net Debt.

For the line "Acquisition of Tangible Capital Assets," the figure will be the "total capital expenditure" or the total amount spent in the year to acquire TCAs, including progress payments. What budget figure will you use? Is it the amount of financing you expect to raise and/or allocate to TCA acquisitions, or a reasonable forecast of what is expected to be spent in the accounting period? Current practice is the former, which means that the actual number reported will have a limited relationship to the corresponding budget figure at best, and be early, and likely overstated. Alternatively, one budgets and finances for the timing of actual disbursements, rather than for projects as a whole, which may be simply impractical operationally.

Sources of financing will be identified, including from whom or from where, and when they are expected to be received. Once the project has been approved to go ahead, the budget for future years would be determined and not normally be an annual issue, unless there is a significant change. You would finance the project to the approved plan, and variance reporting would be comparing actual disbursements against plan, as of that point in time.

2009 and Beyond - accounting

Here is a major change, as all of these projects will involve the acquisition of a tangible capital asset over time, and now any and every related and relevant expenditure will be a part-payment towards the purchase of a tangible capital asset, not just the contract payments. Until the day that each goes into service, the incomplete asset will be reported in the financial statements as part of "works in progress," at a value equal to the total disbursements or expenditures as of the reporting date. Note that Paragraph PS 3150.18 gives some guidance as to when an asset is deemed to go into service:

> *Determining when a tangible capital asset, or a portion thereof, is ready for productive use requires consideration of the circumstances in which it is to be operated. Normally it would be predetermined by a government by reference to factors such as productive capacity, occupancy level, or the passage of time.*

For financial reporting and for management control, you would likely still identify the disbursements by project, and by account, or nature of the disbursement, whether in service or not and whether complete or not, as the case may be.

The project will not have "revenues," but financing. A parallel issue, or variance, will be whether the financing has been secured and received, and whether this is coming from outside parties, such as another government or a property owner. However, PS 1200.80 is quite specific that "*Financial statements should disclose the gross amounts of revenue..*" The statements, unlike the budget, are concerned with revenues as distinct from financing. For example, PS 1000.47 states that "*revenues do* *not include borrowings, such as proceeds from debt issues or transfers from other governmental units in the government reporting entity, or amounts collected on behalf of others."* Clearly revenues for financial statement purposes have a different meaning from that used for budgeting purposes, and will generally be reported for the municipality as a whole, rather than for an individual project or program.

Ultimately, this funding will end up as an increase to your Municipal Equity, as someone has given you money (debit Bank Account) to build something in which they have an interest. You will record the completed asset at gross cost, and amortize on the basis of gross cost, though the net cost to your municipality may be significantly less. Thus each such contribution increases your municipality's net worth. For example, assume the Provincial Government funds 25% of your project. You receive the cheque:

Debit Bank Account	25	
Credit Provincial Capital Grants (or whatever)		25

You pay the construction costs:

Debit Work-in-Progress	100	
Credit Bank Account		100

The project goes into service:

Debit Tangible Capital Assets	100	
Credit Work-in-Progress		100

You now have a TCA worth $100, the bank account is $75 lighter, and you had a Provincial Grant of $25. This could be added into the Statement of Operations for the current year, as Other Revenue, and flow through to Municipal Equity at year-end.

Work-in-Progress and TCAs

To re-iterate, you will still budget for external financing and for anticipated disbursements in the year in which they are expected to occur. However, all disbursements made during the development and construction of a tangible capital asset will be charged to a TCA that will be reported in your statements as a Work-in-Progress, and will be reported as the acquisition of a TCA. They will be reported on the Consolidated Statement of Financial Position, and no longer on the Consolidated Statement of Operations. The day the asset goes into service, the total amount will be moved in the accounts from Work-in-Progress to Tangible Capital Assets, and amortization will begin. It should be noted that the total amount of disbursements or expenditures to acquire tangible capital assets will be reported in the Consolidated Statement of Change in Net Debt.

Summary

Does the budgeting sound very different from your current practice? It is the accounting for such assets that will change.

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Our next newsletter will look at how you may want to budget for tangible capital assets that will be donated or transferred in the years to come, and how that may be impacted by PS 3150.

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

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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.