PSAB/Asset Management

NEWSLETTER NO. 46

BUDGETING FOR TANGIBLE CAPITAL ASSETS (4) - DISPOSALS AND WRITE-DOWNS OF ASSETS

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In this series of six newsletters, we have been looking at how you may want to budget for a number of specific situations relating to tangible capital assets. In this, the fourth one, we will look at disposals and write-downs of TCAs.

Nothing lasts forever, and at some point you have assets that will be disposed of or destroyed. Similarly, you will have assets whose value has diminished substantially and unexpectedly, due to external circumstances. The net book value should therefore be written down to reflect its reduced value.

How do you budget for such situations?

Current Practice

Currently, you do not budget for these. When all of your tangible capital assets effectively have a net book value of zero, you cannot write the value down any further. If you sell the assets, any proceeds for the sale are 100% profit, and increase general or "other" revenues. If you trash or demolish an asset, there will be an expense recorded for doing so, unless this is included in the cost of acquiring a replacement, such as when digging up an old roadway as part of laying down a new one.

2009 and Going Forward

In theory, you should probably not be budgeting for these, except in the case where you have required replacement dates, such as within seven years or after 100,000 Km of service. If you have amortized the asset, using a judicious life expectancy and allowing for an appropriate residual value, then the net book value at date of disposal should roughly equal your proceeds, so why waste time budgeting for an amount that should be next to nothing?

A budget is a plan. If a tangible capital asset will need to be written down significantly next year, due to circumstances that will change next year, then budget for that write down. If the amount of the write down will be significant, you may mention this in this year's notes as a subsequent event. But do not

provide in next year's budget for a write down that should be taken in this fiscal reporting period. If you do, you are knowingly over-stating the value of the TCAs involved in this year's financial statements.

Similarly, if you feel a compulsion to include in your operating budget a provision for the writing-down of tangible capital assets in the coming year, this implies that your amortization rates and/or asset life expectancies are not appropriate. Better to adjust them instead.

In short, these are actions that should not normally be budgeted.

Exceptions to the rule

You acquire tangible capital assets to provide an on-going stream of service or benefits that you expect and want to continue into the foreseeable future. An asset may not last that long, so that along the way, you may do major maintenance, such as a new roof on a building, a betterment, such as change a motor for a higher volume, more fuel-efficient one, or replace the asset entirely. Usually the cost of the replacement asset will include provision for demolition and disposal of the old asset it is replacing as part of the contract, so that budgeting specifically for disposal of the old asset is not required.

You may have a handful of assets that have a defined life, at the end of which they can no longer provide further benefits, but which cannot be replaced as such. The classic example of this is the landfill site that has reached capacity. A building or piece of land that is contaminated would be another. While the services of the landfill will be provided by a new alternate facility, the asset is still there, spent, and with substantial post-closure costs. The building or land could perhaps be sold as is, but a prudent buyer would likely prefer to acquire a usable property, not one subject to approvals and clearances.

Any such asset will generate substantial costs that it would be prudent to budget for. Let us look as these two types of situations. Note that this is not budgeting for a tangible capital asset, but for post-service costs incurred after decommissioning a TCA.

Post-closure Costs

Landfills have two endearing qualities resulting from the breaking down of the materials that are deposited in them. First, they get rained and snowed upon, so that it is not generally a dry process, like a garden composter. This results in the production of a toxic brew, or leacheate, that must be pumped out into a sanitary sewer for treatment. The breaking-down process also produces copious volumes of methane gas, flammable and toxic, which can be collected for industrial use. Both processes continue for at least 50 years after the last ton of garbage is laid to rest.

Someone has to pay for all of this, normally the municipality that was operating the landfill. The costs over 50 years can be estimated, but cannot be capitalized, because they are not known until after the fact. PS 3150 requires the use of historical costs. How do you budget for this?

PS 3270 (Solid Waste Landfill Closure and Post-Closure Liability) requires that the accounting already accrues a liability for these costs on an ongoing basis as capacity is used. Estimates of costs are reviewed annually with detailed studies required on a regular basis. Theoretically, once the landfill

stops receiving waste, a liability has been booked for the total estimated closure and future post closure costs, and all such costs would be charged against the liability as they are incurred

This means that the annual operating budget for the functioning landfill would account for the accrual of closure and post closure costs in each year of operation so that elected officials understand the total cost of operating the landfill. The "non-cash" closure and post closure care costs, along with the annual amortization of the landfill's tangible capital assets, including the land, would be added back to the current operating surplus or deficit for the calculation of the tax rate/fees required to finance the facility on a fully-financed basis.

In summary, the budgeting for these costs would be included in the annual operating budget, and financed out of the tipping fee. Should the accrued liability for closure and post-closure costs turn out to be insufficient, the overage would be an expense in the year(s) in which it occurs.

The Impaired Property

If you can sell a contaminated or impaired asset as is, then there is no problem, as the sales price may factor in the cost of rehabilitation. Then it is simply a case of budgeting for the likely loss on the disposal of the impaired asset.

If your municipality is required to undertake the rehabilitation, this will be an expense as you have not bettered the asset, only rehabilitated it. Then it will be necessary to budget and account for the costs involved accordingly.

Unless, that is, you have taken a write-down to reflect the impairment of the asset, so that it is valued at its impaired value. Then rehabilitation expense would be a betterment, as you are restoring the property to an unimpaired state, and the expense can therefore be capitalized. Either way, there will be a cost involved.

If you are then able to sell the asset for higher than book value, this would be a gain on sale of asset, but probably not something you can budget for.

Summary

Disposals and write-downs should not be items for inclusion in either your operating budget or your capital budget or investment plan. The one exception to this is where there may be substantial costs involved in rehabilitating an inactive asset that is seriously impaired. If the asset has been drastically written down to reflect the impairment, then the rehabilitation can be budgeted as a capital expense, and the actual expenditure capitalized, and added to the book value of the asset. That is, to the extent that it is recoverable, and the future service potential is greater than the cost of rehabilitation, or in the case of an asset being rehabilitated for resale, such as brownfield properties, its fair value. Otherwise, the difference between costs and recoveries will be an expense.

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Our next newsletter looks at how you may want to budget for the purchase and utilization of inventory of tangible capital assets in the years to come, and how that may be impacted by PS3150.

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.