NEWSLETTER NO. 47

BUDGETING FOR TANGIBLE CAPITAL ASSETS (5)
- PURCHASE AND UTILIZATION OF INVENTORY

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

We have been looking at how you may want to budget for a number of specific situations relating to tangible capital assets. In this newsletter, we look at how you may want to budget and account for inventories. While collections of tangible capital assets are referred to in the literature as asset inventories, which they are, this newsletter looks at inventories that are a collection of items acquired and held for some future purpose or transaction.

You may have three types of such inventories, comprising:

1. items held for sale or distribution;
2. consumable items held for internal use or consumption; and
3. tangible capital assets bought in bulk for future service..–

Let us look at each in turn.

1. Items Held for Sale or Distribution

In Newsletter #40 on Burning Issues, we talked about the gravel in gravel pits and about cemetery plots. Municipalities have inventories of more mundane items that are given or sold to clients or residents, such as the three types of garbage container distributed by the City of Toronto to residents. While the gravel is a natural resource by definition, the others probably could be tangible capital assets, save and except that they are for sale or distribution, which means that they therefore are not TCAs. [PS 3150.05(a)(iv)]

They are still assets, until sold or given away, and will be reported in your Statement of Financial Position or balance sheet as Financial Assets – Inventories for Resale (PS1200.046(d)). They must meet the 6 criteria listed in PS 1200.051 to be classed as assets held for sale:

> *An asset held for sale should be recognized as a financial asset when all of the following criteria are met*:

(a) *prior to the date of the financial statements, the government body, management board or an individual with the appropriate level of authority commits the government to selling the asset;*
(b) *the asset is in a condition to be sold;*
(c) *the asset is publicly seen to be for sale;*
(d) *there is an active market for the asset;*
(e) *there is a plan in place for selling the asset; and*
(f) *it is reasonably anticipated that the sale to a purchaser external to the government reporting entity will be completed within one year of the financial statement date.* [APRIL 2005]

This is current accounting practice which will not change in 2009. The purchase of the items for Inventory is not an expense, as one is buying an asset:

Debit Inventory of Goods on Hand	$X	
Credit Bank Account (pay for Inventory items)		$X

Since one is buying an asset for resale or distribution, there is nothing to budget or plan for, except to determine that there is sufficient funding available in the bank account to pay for the purchase. In preparing an operating budget, one will estimate the revenues from sales in the coming year, and the cost of drawing those units from inventory in the coming year as an expense, whether tons of gravel, cemetery plots or garbage cans and rain barrels.

Where the items are being distributed free, there will be no revenues, but one will estimate the cost of the units planned to be distributed in the fiscal year, and budget for that as an expense of the managing program. This is or should be current budgeting and accounting practice that will not change at all in 2009 or beyond. Note that the resulting expense is for what is actually sold or distributed, not what is in inventory.

2. Consumable items held for internal use or consumption

These are materials and supplies that the municipality intends to consume internally in operations, or which may be used in the development or construction of one or more tangible capital asset. These types of inventories are deemed to be Non-Financial Assets (PS 1200.053(b)), and would be reported as "inventories held for consumption or use."

Otherwise, the budgeting and accounting would be the same as for product inventories. The budgeting would be for the consumption of the items in the inventories, not the inventory itself, and this would be a charge against operations for the year in which the consumption occurs. Where the items are used in the development or acquisition of a tangible capital asset, the cost of the items will be added to the total acquisition cost of the TCA, and will result in an increase in the value of Work-in-Progress, until the asset is capitalized. In both cases, the charge applied would offset the resulting drop in value of the inventory.

3. Tangible capital assets bought in bulk for future service

Now what about those situations where you maintain inventories of items that are tangible capital assets, and which will be included in your asset inventories? How do we budget for them? Typical examples would be street lights, firefighters' uniforms, police weaponry, fire hydrants, utility meters and street and park furniture.

In every case, your "inventory" is probably an asset pool of relatively small value items, where you probably purchase in bulk, and the individual units are put into service as and when required, just as others are taken out of service. Normally, you would expect to replace a certain percentage of the units each year, and would budget to replace them with an equivalent number of new ones. This would certainly not apply to tangible capital assets costing more than your capitalization thresholds – you would likely not have an inventory of cars or network segments, or of high-capacity pumps.

This is a special case of the previous situation, where you are buying and holding tangible capital assets for future use, rather than a consumable. For cash-based budgeting, you would budget for what you intend to purchase in the fiscal year, as the concern will be to have sufficient program financing on hand to acquire what will be bought. An accrual-based budget will budget for the units that are expected to go into service during the fiscal year, with the concern that this consumption of units has sufficient program financing. If you buy a two-year supply, you need to have sufficient cash available to pay the supplier when due, but that is not a budget issue, unless you use cash-based budgeting.

In short, cash-based budgets would budget on the basis of availability for service, whereas accrual-based would budget on the basis of when the assets go into service.

Either way, you would still have an inventory of TCAs on hand, which would be a subset of your inventory of TCAs, of these items which are actually in service.

An alternative approach would be applicable where you may buy the units in quantity, which then sit in a yard or warehouse until required for replacing spent units. This may be an unorthodox interpretation of the definition in PS 3150.05(a), but such units could be deemed to be product inventory, as discussed in the first section, until they are actually put into service. As before, you would budget for when they go into service, not when they are bought, though you will have to have cash available to purchase the units.

When the units go into service, they will be capitalized as TCAs, and amortized over their respective estimated useful lives. Note that if the number of units that go into service each year, or the annual rate of replacement, does not change significantly, and if there are not significant price variations, you may prefer to budget and account for the cost of the units put into use as an operating expense, being a surrogate for the amortization of the pool. This would be where the cost of acquisitions would be similar to the gross book value of dispositions, and similar to the annual amortization expense for the entire asset pool. A number of municipalities have decided to budget and account for desktop computers this way, for example.

Summary

Budgeting and accounting for assets in a product inventory that are for sale or distribution, or for internal consumption or use, will be no different in 2009 and future years from what you currently do. However, where your inventory of assets is for use, and they will be subject to the requirements of PS 3150, your budgeting for acquisitions should ideally be congruent with how you will account for them.

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Our next newsletter will look at capital leases, and how you may wish to budget for them. This will be the last in this series of looking at budgeting for specific types of tangible capital assets. .

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

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