

GUIDE TO ACCOUNTING FOR AND REPORTING TANGIBLE CAPITAL ASSETS

**Guidance for Local
Governments and Local
Government Entities That
Apply the Public Sector
Handbook**

April 2007

"This Guide is a useful reference for local governments when implementing the new reporting requirements of the Public Sector Accounting Board. It contains valuable information on the need for and benefits of accounting for tangible capital assets, what you need to consider for implementation, subsequent accounting requirements, and how that information could be linked with ongoing asset management practices."

Kent Kirkpatrick,
City Manager,
City of Ottawa.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

This guide has been prepared by the Public Sector Accounting Group of the Canadian Institute of Chartered Accountants (CICA). This Group supports the Public Sector Accounting Board in its mission to serve the public interest by setting standards and providing guidance for financial and other performance information reported by the public sector. The guidance and interpretations contained in this guide are those of the staff of the Public Sector Accounting Group. They have not been adopted, approved, disapproved or otherwise acted upon by a Board, Committee, the governing body or membership of the CICA or any provincial Institute/Ordre.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

FOREWORD

Over the years, local governments have invested billions of dollars in tangible capital assets. These assets play an essential role in a community's ability to diversify, expand and cope with population growth and improve environmental conditions. Unfortunately, there is growing anecdotal evidence that the backlogs of maintenance, renewal and replacement of aging infrastructure is causing financial stress on local government and jeopardizing the sustainability and affordability of services.

The financial ability to sustain capital assets and the services they help deliver is not just a local government issue. It is a critical underpinning to the health, welfare and economic vitality of the nation overall. The federal, provincial and territorial governments, therefore, all have a vested interest in the sustainability of local government services.

The 2002 CICA research report *Accounting for Infrastructure in the Public Sector* concluded that "a major factor in determining a local government's financial ability to maintain its existing service levels is access to financial information about the stock and use of its capital assets." Yet, for the majority of local governments in Canada, financial information about the stock, use and condition of capital assets is generally not available.

The situation is about to change. Effective with fiscal years starting January 1, 2009, the Public Sector Accounting Board will require local government to present information about the complete stock of their tangible capital assets and amortization in the summary financial statements.

Purpose of this document

The purpose of this publication is to provide:

- Guidance on the process for transition.
- A framework that might be applied generically.

This document is *not* intended to:

- Provide definitive guidance that suits all local governments and every situation.
- Be an accounting manual.
- Be an authoritative source for accounting practices or standards.

It is likely that each local government will have to face its own unique issues resulting, for example, from the extent of information it currently has available, the nature of its operations and its size.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Organization of the Guide

This document is organized as follows:

- Chapter 1 The benefits of accounting for tangible capital assets.
- Chapter 2 A comprehensive view for understanding the accounting.
- Chapter 3 Tangible capital asset implementation planning.
- Chapter 4 Developing a comprehensive tangible capital asset policy.
- Chapter 5 Good asset management practices.
- Chapter 6 Asset registers that support accounting and management needs.
- Chapter 7 Insights into initial valuation of tangible capital assets methods.
- Chapter 8 Insights into the new reporting model.
- Chapter 9 External audit implications.
- Chapter 10 Lessons learned by others.

Several appendices provide additional information that may be useful.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

CHAPTER 1 NEED FOR AND BENEFITS OF REPORTING TANGIBLE CAPITAL ASSETS.....7

1.0	TYPES OF CAPITAL ASSETS	7
2.0	THE NEED FOR INFORMATION	8
3.0	THE ROLE OF ACCOUNTING STANDARDS	8
4.0	FINANCIAL VERSUS MANAGEMENT ACCOUNTING	10
5.0	MANAGEMENT BENEFITS OF ACCOUNTING FOR TANGIBLE CAPITAL ASSETS	11

CHAPTER 2 UNDERSTANDING ACCOUNTING STANDARDS..... 14

1.0	DEFINITION OF AN ASSET	14
1.1	<i>Accounting Standard</i>	14
1.2	<i>Application of Standard PS 3150</i>	14
1.3	<i>Concept of Control</i>	15
1.4	<i>Computer Hardware and Software</i>	16
2.0	WORKS OF ART AND HISTORICAL TREASURES	16
3.0	MEASUREMENT OF ASSETS	16
3.1	<i>Accounting Standard</i>	16
3.2	<i>Why Historical Cost?</i>	16
3.3	<i>Measurement of Cost</i>	18
3.4	<i>Grants and Donations</i>	19
3.5	<i>Capitalization of Interest Costs</i>	19
4.0	DONATED OR CONTRIBUTED ASSETS	19
5.0	SINGLE ASSET OR COMPONENT APPROACH	20
5.1	<i>Single Asset Approach</i>	20
5.2	<i>Component Approach</i>	20
6.0	CAPITALIZING UPGRADES AND IMPROVEMENTS – “BETTERMENTS”	20
7.0	DISPOSAL	21
7.1	<i>Accounting Standard</i>	21
7.2	<i>Application of Standard</i>	21
8.0	AMORTIZATION.....	22
8.1	<i>Accounting Standard</i>	22
8.2	<i>Estimated Useful Life</i>	23
8.3	<i>Revising Amortization Method and Estimated Useful Life</i>	23
8.4	<i>Accounting for Deferred Maintenance and Renewal Expenditures</i>	24
9.0	DISCLOSURE REQUIREMENTS AND IDENTIFYING ASSET CATEGORIES.....	26
9.1	<i>Accounting Standard</i>	26
9.2	<i>Application of Standard</i>	27
10.0	IMPAIRMENT OF ASSETS	28
10.1	<i>Accounting Standard</i>	28
10.2	<i>Application of Standard</i>	28
10.2.1	Impairment of service potential.....	28
10.2.2	Impairment of future economic benefits.....	29
10.3	<i>Testing for Impairment</i>	29
10.4	<i>Accounting for Asset Impairment</i>	29
11.0	LEASED ASSETS	30
11.1	<i>Accounting for Capital Leases</i>	30
11.2	<i>Recognition of Leased Assets</i>	32
11.3	<i>Sale-Leaseback Transactions</i>	32
12.0	VALUATION TRANSITIONAL PROVISIONS	34
13.0	RETROACTIVE APPLICATION OF THE NEW ACCOUNTING STANDARD.....	34
13.1	<i>Accounting Standard</i>	34
13.2	<i>Application of Standard</i>	35
14.0	TRANSITIONAL IMPLEMENTATION GUIDANCE.....	36
14.1	<i>Accounting Standard</i>	36
14.2	<i>Application of Standard</i>	36

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

CHAPTER 3	IMPLEMENTATION PLANNING	37
1.0	MANAGING THE PROCESS	37
2.0	IMPLEMENTATION PLAN.....	37
3.0	INVOLVING THE EXTERNAL AUDITOR	38
CHAPTER 4	TANGIBLE CAPITAL ASSET ACCOUNTING POLICY	39
1.0	DEVELOPMENT OF TANGIBLE CAPITAL ASSET ACCOUNTING POLICIES	39
2.0	SINGLE ASSET OR COMPONENT APPROACH	39
2.1	<i>Analysis of Advantages and Disadvantage</i>	40
2.2	<i>Component Approach Implementation Issues</i>	42
2.3	<i>Asset Segmentation</i>	42
3.0	ASSESSMENT OF USEFUL LIVES	44
4.0	RECOGNITION THRESHOLDS.....	45
4.1	<i>Capitalization/Reporting Threshold</i>	45
4.2	<i>Selecting the Capitalization/Reporting Threshold</i>	45
4.3	<i>Capitalization of Assets Below Capitalization/Reporting Threshold</i>	47
4.4	<i>Recording “Portable” Assets</i>	47
4.5	<i>Recording Threshold for Betterments</i>	47
4.6	<i>Accounting for Replacements under Component Approach</i>	48
CHAPTER 5	ASSET MANAGEMENT PRACTICES	50
1.0	STRATEGIC ASSET MANAGEMENT PLANS	50
2.0	RESPONSIBILITY FOR ASSET MANAGEMENT	50
3.0	ASSET OPERATING POLICIES AND PROCEDURES	50
4.0	ASSET CONDITION ASSESSMENTS	52
5.0	ESTABLISHING A PLANNING AND INVESTMENT FRAMEWORK	54
6.0	GUIDELINES FOR INFRASTRUCTURE MANAGEMENT PLANS.....	56
CHAPTER 6	ASSET REGISTERS	58
1.0	DESCRIPTION AND PURPOSE.....	58
2.0	DESIGN AND DEVELOPMENT	59
3.0	INFORMATION SOURCES.....	59
4.0	INTEGRATION OF ASSET REGISTERS WITH THE GENERAL LEDGER.....	61
5.0	VALIDATION OF ASSET REGISTERS	61
6.0	SUMMARY	62
CHAPTER 7	INITIAL RECOGNITION OF TANGIBLE CAPITAL ASSETS	64
1.0	ESTABLISHING OPENING VALUES WITHOUT HISTORICAL COST RECORDS	64
2.0	ASSET ACQUIRED AT NO OR NOMINAL COST.....	65
3.0	FULLY AMORTIZED ASSETS	65
4.0	PRE AND POST-ADOPTION ASSET CLASSES.....	67
5.0	COMPLETING THE VALUATION.....	67
5.1	<i>Asset Valuators</i>	67
5.2	<i>Valuation Policies</i>	67
5.3	<i>Full Population or Sample</i>	67
5.4	<i>Instructions for Valuators</i>	68
5.5	<i>Information Required by Valuators</i>	69
5.6	<i>Selection of Valuators</i>	69
5.7	<i>Management Review of Valuation</i>	69
5.8	<i>Check for Asset Impairment</i>	70

Guide to Accounting for and Reporting Tangible Capital Assets

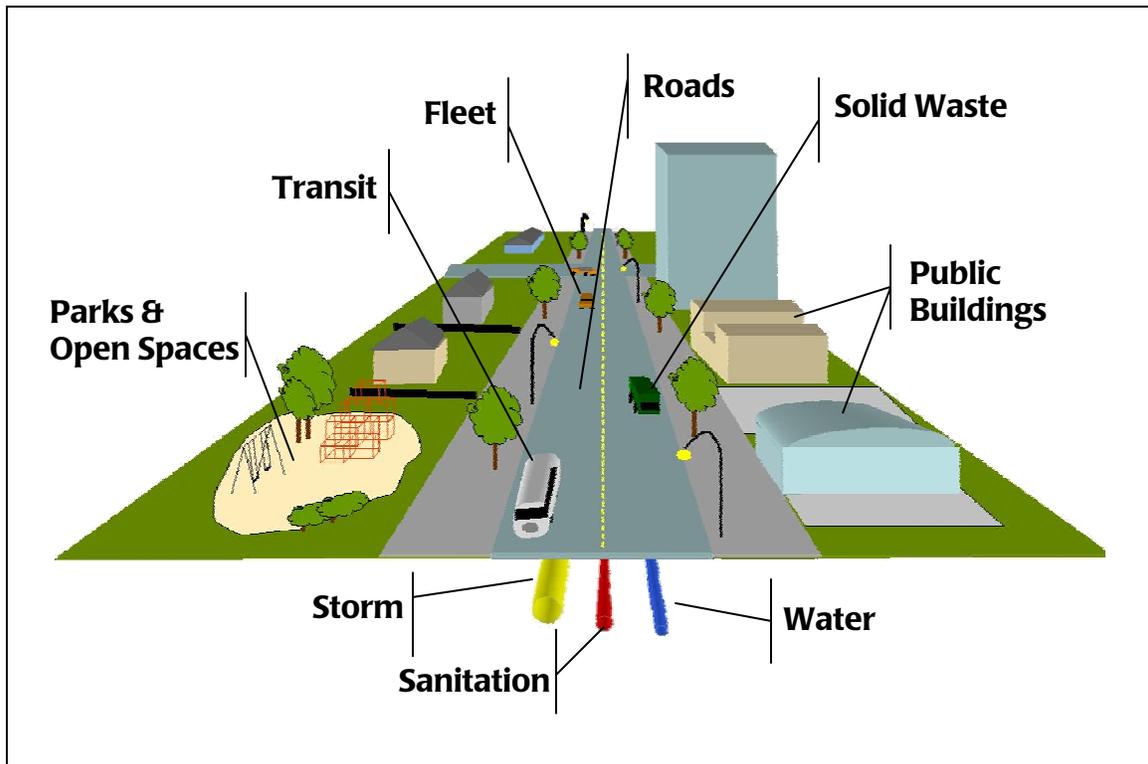
Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

CHAPTER 8	LOCAL GOVERNMENT REPORTING MODEL	71
1.0	CONCEPTUAL FRAMEWORK	71
2.0	KEY CONCEPTS	72
2.1	<i>Elements of Financial Statements</i>	72
2.2	<i>Key Indicators in Local Government Reporting Model</i>	72
2.2.1	Net debt/net financial asset position	73
2.2.2	Accumulated surplus/deficit	73
2.2.3	Annual surplus/deficit	73
2.2.4	Change in net debt	73
2.2.5	Cash flows	73
3.0	FINANCIAL STATEMENT PRESENTATION	74
3.1	<i>Statement of Financial Position</i>	74
3.2	<i>Statement of Operations</i>	74
3.3	<i>Statement of Change in Net Debt/Net Financial Assets</i>	74
3.4	<i>Statement of Cash Flow</i>	75
3.5	<i>Illustrative Example Financial Statements</i>	75
4.0	PRESENTATION OF BUDGET AMOUNTS	82
4.1	<i>Budget Scope and Accounting Basis</i>	82
4.2	<i>Budgets Prepared on Different Scope and Accounting Basis</i>	82
4.2.1	Scope different	83
4.2.2	Basis of accounting different	83
4.3	<i>Effect of Accrual Budgeting on Tax Rates and User Fees</i>	83
CHAPTER 9	FINANCIAL STATEMENT ISSUES – EXTERNAL AUDITS	84
1.0	PREPARING FOR THE EXTERNAL AUDIT	84
2.0	MANAGEMENT’S RESPONSIBILITY	84
3.0	OPENING BALANCES	85
4.0	FINANCIAL STATEMENT DISCLOSURES	86
5.0	COMMON PITFALLS	86
CHAPTER 10	LESSONS LEARNED – OTHERS	88
APPENDIX A		
	GENERIC IMPLEMENTATION PLAN	89
APPENDIX B		
	WORK FLOW IN RECOGNITION AND REPORTING OF TANGIBLE CAPITAL ASSETS	91
APPENDIX C		
	SAMPLE TANGIBLE CAPITAL ASSET POLICY	94
APPENDIX D		
	GLOSSARY OF TERMS	99

Chapter 1 Need for and Benefits of Reporting Tangible Capital Assets

1.0 Types of Capital Assets

Local governments are responsible for the management of a diverse range of capital assets. In addition to significant holdings of land, the following diagram illustrates some of the major classes of tangible capital assets (TCA) that support basic municipal services.



Source: City of Hamilton, 2005 Life-Cycle State of the Infrastructure Report On Public Works Assets.

Each of those major classes comprises numerous sub-systems and components that contribute to the overall operation of the asset class.

Asset System	Components
BUILDINGS AND EQUIPMENT	Administrative facilities, warehouses, libraries, museums, recreational centres, social housing and health related facilities, fire stations and fire trucks, police stations and vehicles, snow clearing vehicles.
ROADWAYS	Pavement, bridges, tunnels, embankments, slopes, avalanche and rock shelters, retaining walls, signal and lighting systems, maintenance facilities.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

MASS TRANSIT	Elevated track and station structures, bridges, tunnels, subway stations, platforms, rail power, overhead catenary, signal and control systems, rolling stock, and maintenance facilities.
WATER AND SEWER	Dams and diversion structures, pipelines, tunnels, aqueducts, canals, reservoirs, tanks, wells, pumps, mechanical and electrical equipment, buildings, electric power and emergency equipment.

Source: Research Report, *Accounting for Infrastructure in the Public Sector* (Toronto, Canadian Institute of Chartered Accountants, 2002).

2.0 The Need for Information

There is growing evidence that our communities are facing major challenges financing deferred maintenance, renewal and replacement of aging capital assets. This may be an indicator that decision makers have not received sufficient information to understand the financial effects of past funding decisions on the condition of existing capital assets and the cost of using them in service provision.

As the existing capital asset base ages and population grows, increased demands for new capital assets will place further pressures on the ability of a local government to sustain those services. Information about the existing stock, the cost of its use and the needs for its replacement must be at the forefront of decision making. To be useful, that information must be complete, reliable and unbiased and provided on a local government-wide basis.

This is not to say that local governments have not been maintaining information about their assets to properly manage them. Municipal engineers have developed asset management systems for work management, customer care and capital budgeting. But those systems exist largely independently of the core financial systems. They are often specialized in nature, incomplete and not comparable within a local government itself, nor with those of other local governments.

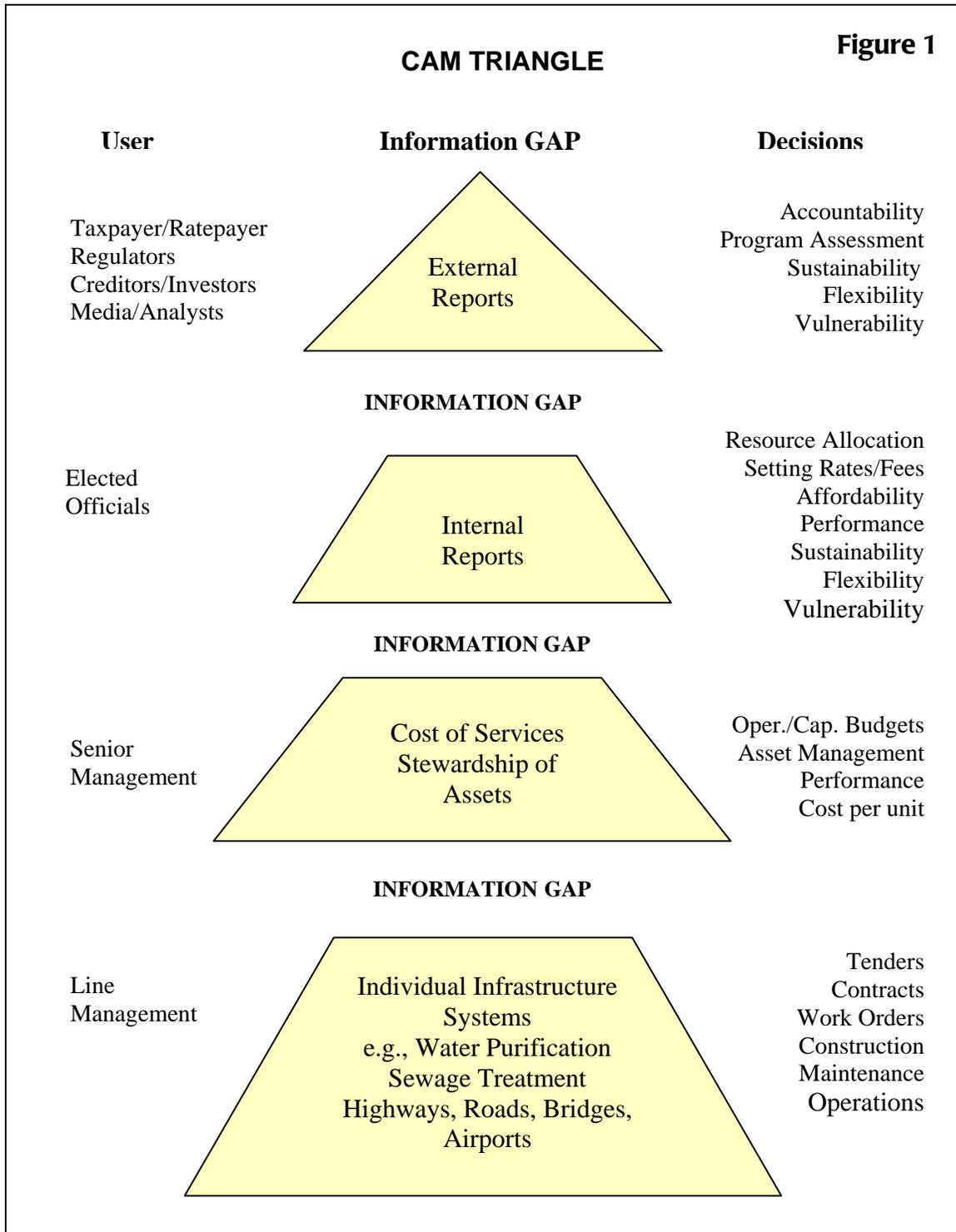
Figure 1 demonstrates the existing information gap and the need for better financial information about tangible capital assets.

3.0 The Role of Accounting Standards

The accounting standards on which financial statements are based play a vital role in bridging this gap by bringing capital asset information to the attention of the public and other users. A local government could choose to maintain only the data required for external financial reporting purposes, but it would be missing out on one of the main benefits of adopting accrual accounting – better information for management decision-making purposes.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook



Source: Accounting for Infrastructure in the Public Sector, op.cit.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

When a local government's accounting system maintains information on tangible capital assets and their amortization, that can provide valuable cost information as input for a variety of management decisions. A local government will derive the full benefit of accrual accounting, therefore, when its TCA information is developed, recorded and used at the departmental and/or program or activity levels. That information can then be used for assessing performance and for making resource allocations decisions. It also provides accounting control over the assets that the individual managers are responsible for and facilitates asset maintenance and replacement.

TCA information will benefit from current accounting standards because they create a common language understood by all those involved. They also assist with interpretations and analysis of information by promoting consistency in the TCA data. Standards help build credibility and confidence because the information provided can be relied on, is comparable across local governments and is verifiable. They remove any biases that influence decisions because there are common definitions and measurements.

Comparable and reliable data are essential for sound planning, good decision making and accountability. Unreliable, fragmented or incomplete information virtually guarantees uninformed decisions and all of the adverse consequences that follow.

4.0 Financial Versus Management Accounting

The purposes of accounting go beyond the presentation of information in financial statements (financial accounting) to also provide a basis for various management decisions (management accounting) such as buy or lease decisions or understanding the costs of a particular good or service and assessing the individual performance of departments and programs.

The information contained in the financial statements is based on generally accepted definitions, recognition and measurement rules (generally accepted accounting principles – GAAP). Those rules also serve to ensure that, to the extent possible, the information recorded in a local government's financial information system is represented to external users in a way that agrees with actual transactions and events.

For the purposes of management, the information needed to make decisions can be based on whatever rules and any other information, such as units produced or future-oriented information, management finds most useful for its own purposes.

The focus of GAAP and financial statements is on the measurement of an organization's consolidated financial position and annual results, not on cost allocation to various component entities, or making particular decisions about components, functions or purposes. One cannot rely on GAAP to measure full costs of individual components, functions or purposes because it is not specific enough to resolve many of detailed questions that can arise. For example, the full cost of a reporting entity's transportation services (direct and indirect) will be included in its summary financial statements somewhere but may not be allocated to the transportation service specifically.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

FINANCIAL ACCOUNTING	MANAGEMENT ACCOUNTING
Oriented to those external to the organization.	Oriented to those internal to the organization.
Reports governed by prescribed principles.	Reports and content are flexible.
Based on the needs of external users.	Based on the needs of management.
There is need for uniformity in reporting due to various user needs.	Management can specify the type and content of information needed.
Addresses all financial aspects of the local government as a whole for decision making.	Typically addresses certain aspects of the local government for decision making.
Focuses on financial position, annual results and cash-generating ability.	Focuses on issues such as determining prices to be charged, choices in product lines offered and product profitability.
Transaction and event based.	Includes transactions and events, future plans and any other required data.
Unified by the basic equation Assets – Liabilities = Net Assets.	Based on three principles: full, differential, ¹ and responsibility ² costing.
Mandatory.	Optional.

Nevertheless, financial accounting standards can benefit management by instilling a discipline in terms of definition, recognition and measurement throughout the financial information systems.

5.0 Management Benefits of Accounting for Tangible Capital Assets

From a management perspective, the key benefit to having local governments adopt tangible capital asset accounting is to obtain better information for decision making. While financial statements themselves will not necessarily provide detailed information about the stock, condition and costs of a local government's assets, "it is the underlying information, records and discipline that allows such to be reported that gives local government the information it needs to make informed decisions."³

The chart in Figure 2, adapted from *Accounting for Infrastructure in the Public Sector*, demonstrates how financial statement information about assets can be used throughout an organization.

¹ Differential cost is a cost that would be different if one alternative rather than another were selected.

² Responsibility cost is allocating costs to a particular unit. It is similar in nature to activity-based cost where costs are allocated to activities rather than responsibility centres.

³ *Accounting for Infrastructure in the Public Sector* (Toronto: Canadian Institute of Chartered Accountants, 2002), p. 2.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Accounting for Infrastructure in the Public Sector noted the following benefits of accounting for the stock of infrastructure assets:⁴

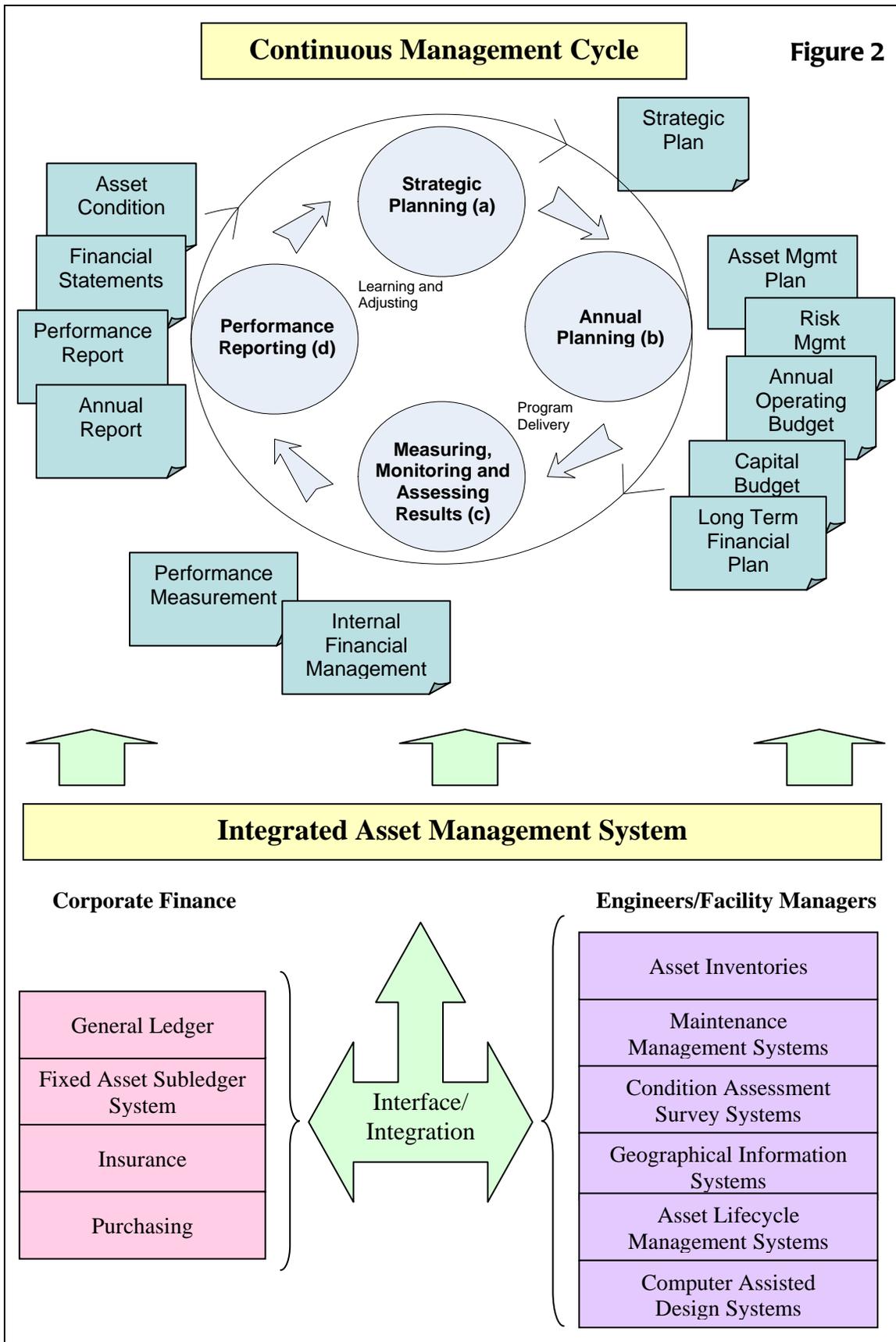
- Provides a proper context and inventory for debating maintenance, renewals, replacement, funding, financing and rate-setting decisions.
- Establishes a common basis of measurement, allowing for enhanced comparability.
- Provides a useful starting point and basis for evaluating the condition of infrastructure on a regular basis and for highlighting changes in its condition over time.
- Is useful in identifying a local government's flexibility in responding to a community's changing service demands.
- Helps decision makers assess the long-term sustainability of existing debt loads, current program costs and the need for future infrastructure replacement or improvements.
- Contributes to the evaluation of contingencies related to infrastructure by promoting an understanding of the type of infrastructure a local government has and, thus, identifying types of unexpected events that could befall that infrastructure.

In summary, this information facilitates better management of assets, development of appropriate maintenance and replacement policies, identification and disposal of surplus assets, and better management of risks such as loss due to theft or damage. Identifying assets and how they are amortized helps managers understand the impact of using capital assets in the delivery of services and encourages them to consider alternative ways of managing costs and delivering services. The full accrual basis of accounting provides information about the full costs of services, helping managers assess future revenue requirements, the performance and sustainability of existing programs and the likely cost and affordability of proposed future activities and services.

⁴ *Accounting for Infrastructure in the Public Sector* (Toronto: Canadian Institute of Chartered Accountants, 2002), p. 30.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook



Chapter 2 Understanding Accounting Standards

The objective of PS 3150 Tangible Capital Assets is to prescribe the accounting treatment for tangible capital assets of all levels of local government so that users of their summary financial statements can learn about a local government's investments in its tangible capital assets and the changes in those investments over time. The principal issues in accounting for tangible capital assets are the recognition of the assets, the determination of their carrying amounts and the recognition of any amortization charges and impairment losses. This section provides explanations and background information to promote understanding of the standards involved in TCA accounting.

1.0 Definition of an Asset

1.1 Accounting Standard

The *Public Sector Accounting Handbook* contains the following definitions:

Financial Statement Concepts, Section PS 1000:

Assets are economic resources controlled by a government as a result of past transactions or events and from which future economic benefits may be obtained. (PS 1000.35)

Non-financial assets are acquired, constructed or developed assets that do not normally provide resources to discharge existing liabilities, but instead:

- a) are normally employed to deliver government services;*
- b) may be consumed in the normal course of operations; and*
- c) are not for sale in the normal course of operations. (PS 1000.42)*

Tangible Capital Assets, Section PS 3150:

Tangible capital assets are non-financial assets having physical substance that:

- a) are held for use in the production or supply of goods and services, for rental to others, for administrative purposes or for the development, construction, maintenance or repair of other tangible capital assets;*
- b) have useful economic lives extending beyond an accounting period;*
- c) are used on a continuing basis; and*
- d) are not for resale in the ordinary course of operations. (PS 3150.05)*

1.2 Application of Standard PS 3150

Before an item is recognized as a tangible capital asset for financial reporting purposes, it must satisfy two criteria:

1. It must satisfy the definition of a tangible capital asset.
2. It must have a cost or other value that can be reliably measured.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Some of the key elements of the definition of tangible capital assets include:

- They are economic resources controlled by a local government.
- They result from past transactions or events.
- They embody future economic benefits that are expected⁵ to be realized.
- They are held for own use on a continuing basis and not for resale in the ordinary course of business.
- They have economic lives extending beyond the accounting period.

Finally, items whose value is not measurable or reasonably estimable cannot be recognized within the financial statement totals.

TIP – Capitalization Threshold

Theoretically, any item that meets the definition and recognition criteria would be accounted for as a tangible capital asset. In practical terms, most organizations will establish capitalization thresholds or minimum amounts that expenditures must exceed before they are capitalized as tangible capital assets. Items not meeting that threshold would be recorded as expenses in the period. (See “Recognition Thresholds,” Chapter 4, Section 4.0.)

1.3 Concept of Control

The concept of control of an asset’s economic benefit is a key issue in determining whether that asset should be reported in the financial statements of a local government. For example, in some provinces, local governments do not have title to the roads and highways within their jurisdiction. Ownership and control are not synonymous, however. An analogous situation is a capital lease. A local government may not have title to a particular asset, but the asset is recognized in its financial statements because the economic benefits substantially accrue to that local government. Other situations may involve public/private partnerships (e.g., build, own, operate partnerships). To determine whether a local government should be reporting an asset, it is necessary to look to the indicators of control:

- Is the local government the beneficiary of future economic benefits from the asset?
- Do the terms and conditions of legislation or a contract transfer substantially all benefits and risks incident to ownership to the local government?
- Is the local government responsible for the asset’s performance, availability and maintenance?
- Is the local government responsible for renewal and replacement of the asset?
- Does the local government bear all risk of obsolescence, environmental liability,

⁵ “Expected” is used with its usual general meaning and refers to what can reasonably be anticipated, contemplated or believed on the basis of available evidence or logic but is neither certain nor proved. It is not intended to accommodate the recognition of items that do not meet the definition of an asset. (See PS 1000.54 for further discussion.)

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

- uninsured damage or condemnation of the asset?
- Has the local government been using the asset on a continuing basis in the production or supply of goods and services?
- Have third parties made significant use of the asset but the local government is able to restrict such use?
- Is the local government responsible for the construction costs of the asset and the financial or other implications of cost and time overruns caused by events outside of its control during the construction period, or subsequent warranty repairs?

1.4 Computer Hardware and Software

The scope paragraph of PS 3150 classifies computer hardware and software as tangible capital assets. There may be a perception that software is an intangible capital asset as it lacks physical substance. Software is included as a tangible capital asset because it is what permits computer hardware to operate. Its cost is directly attributable to installing the hardware in the condition necessary for its intended use.

2.0 Works of Art and Historical Treasures

Works of art and historical treasures would not be recognized as tangible capital assets under PS 3150. It is not possible to estimate the future economic benefits associated with such property. It is normally the intention of local governments to maintain and preserve them indefinitely because of their unique historical and cultural attributes. In many cases, it is not even possible to put a value on these types of assets – they are priceless. While some art work and historical treasures can be duplicated, they can not be replaced. Duplicates would rarely have the same intrinsic value as the original.

The existence of such property should be disclosed in the notes to the financial statements. Expenditures for preservation, cleaning and restoration that are implicit with works of art and historical treasures should be expensed in the period incurred.

3.0 Measurement of Assets

3.1 Accounting Standard

PS 3150 requires that:

Tangible capital assets be recorded at cost. (PS 3500.09)

3.2 Why Historical Cost?

From a public sector perspective, many have indicated that using historical cost is meaningless, particularly given the long-lived nature of infrastructure assets. There are basically three arguments against using historic cost:

1. Conventional historical cost accounting does not produce meaningful performance measurements in times of changing prices and money values.
2. Because infrastructure needs to be replaced on an ongoing basis, the costs of using infrastructure should reflect its current cost, rather than an allocation based

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

on historic costs. Historic cost may not provide the most relevant information for decision makers.

3. Engineers would argue that what is meaningful is replacement cost as this is what should be budgeted to replace assets. It also acts as a gauge for measuring required expenditures for maintenance and renewals against actual expenditures.

One can argue that, at acquisition, the cost of an asset equals its current cost and fair value. Subsequent to acquisition, however, there are basically three measurement options for valuing tangible capital assets:

1. historical cost;
2. replacement cost (i.e., current cost); and
3. fair value (i.e., market value).

Different values are used to support different decisions. For example, fair value is generally used when selling an asset. Replacement value may be used for insurance purposes or in a budgeting exercise to estimate financing requirements. Historical cost is used for accountability and costing.

There are pros and cons to the various measurement bases.

Because accounting is "transaction based," the primary measurement for both assets and liabilities is the value at the time they were acquired, developed or constructed. Historical cost accounting is, therefore, objective and reliable because it is based on bargained transactions. It avoids the uncertainties of using another measurement basis.

A replacement cost basis measures the value of a tangible capital asset at the current cost of replacing the asset. Such costs would reflect alternative uses for assets and are the current economic costs of obtaining similar service potential. The advantage claimed for accounting on a replacement cost basis is that it provides a realistic and understandable value for reported assets. This would be particularly true for long-lived tangible capital assets as the related charge to operations for amortization would have a current value corresponding to the values of other items (such as revenues) in the operating statement. Some view it as particularly useful for setting funding aside for the eventual replacement of the asset.

Fair value is the value of an asset based on the price that would be agreed on in an open and unrestricted market between fully informed, knowledgeable and willing parties dealing at arms length without constraint. The benefits of using fair values for assets are the same as using replacement value. There may not be an active market for certain tangible capital assets, however, making the application of fair value difficult. Without an active market, surrogate methods to determine fair values increases the extent of judgment required in preparing financial statements.

While there may be merit in using some other basis for the purposes of funding the replacement of a tangible capital asset, the continued use of historical cost accounting is appropriate. It is reliable in that the information agrees to the actual transaction and events to which it relates, can be independently verified and is reasonably free from error or bias. It also provides a consistent, verifiable foundation for management to make estimates of future replacement costs or market value. Historical cost has been generally

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

accepted by standard setters around the world, its application is well understood and it is still the preferred method of accounting for tangible capital assets.

3.3 Measurement of Cost

Cost is the gross amount of consideration given up to acquire, construct or develop a tangible capital asset. Gross cost includes all costs “directly attributable” to the acquisition, construction or development of the tangible capital asset. This includes installing the asset at the location and in the condition necessary for its intended use. Examples of directly attributable costs are:

- costs of site preparation;
- initial delivery and handling costs;
- installation and assembly costs;
- costs of testing that the asset is functioning properly prior to or during installation; and
- professional fees.

The term “directly attributable” is the key to determining whether a cost can be allocated to a tangible capital asset. For example, the salary, wages and benefits of the staff of a design department that are directly related to completing engineering drawings for a constructed asset could be allocated to the gross cost of that asset. Allocation of a portion of fixed costs (e.g., occupancy costs or general administrative overheads associated with a City Engineer’s office, etc) is not generally considered a directly attributable cost.

If two or more assets are acquired for a single purchase price, it is necessary to allocate the purchase price to the various assets acquired based on the fair value of the assets at the time of acquisition. The most common example would be the purchase of land and improvements. If the fair value of the components is not readily available, other proxies may be used, such as assessed values for property tax purposes, values of similar properties or estimated reproduction/replacement costs. One could also look at market values of similar components, such as the sale price of vacant land.

A local government may acquire a property, parts of which it does not intend to use. For example, there may be buildings on land acquired for park purposes that will be demolished. In this case, the total purchase price, plus any costs net of proceeds of demolition, would be allocated to the land. Similarly, a local government may acquire a property knowing that it may require expenditures to bring it to a condition where it is ready for use (e.g., environmental remediation). The cost of the asset would include any subsequent expenditures provided they do not exceed the fair value of the asset.

Spare parts and servicing equipment are usually carried as inventory and recognized as an expense as consumed. Major spare parts and standby equipment may, however, qualify as tangible capital assets when a local government expects to use them during more than one period. Similarly, if the spare parts and servicing equipment can be used only 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 period not exceeding the useful life of the related asset.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

3.4 Grants and Donations

Local government often receive grants from senior level local governments or donations toward the acquisition cost of an asset. The arrangements may provide total or partial reimbursement of that cost. For example, a local government may receive a provincial grant and donations from community groups toward the cost of constructing a community centre.

The definition of cost precludes the netting of capital grants or donations against the cost of the asset. In fact, Standard PS 3150 specifically states that grants are not netted against the cost of the tangible capital asset.

3.5 Capitalization of Interest Costs

Interest expense may be attributed to the gross cost of an asset when a local government's policy is to capitalize interest costs. The local government's policy must be consistently applied across all asset categories, for example, to building, sewer and water construction projects alike.

A number of restrictions have been placed on capitalizing carrying costs. Carrying costs incurred while land acquired for building purposes is held without any associated construction or development activity do not qualify for capitalization. Capitalization of carrying costs also ceases 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 intended acquisition, construction or development is substantially complete. Determining when a tangible capital asset, or a portion of it, is ready for productive use requires consideration of the circumstances in which it is to be operated. Normally, a local government would look at factors such as productive capacity, occupancy level or the passage of time to make such a determination.

4.0 Donated or Contributed Assets

Local governments may receive contributions of tangible capital assets. For example, tangible capital assets may be transferred from senior levels of government at no or nominal cost. Frequently, development agreements require developers to provide tangible capital assets such as roads, sidewalks and street lighting.

Donated or contributed assets meet the criteria for recognition as tangible capital assets because they embody an expected future economic benefit that a local government will control. The past transaction or event that allows the local government control of the economic benefit is the transfer of the asset. As with a purchased asset, the cost of using a contributed asset over time should be reported in the financial statements. Recording donated or contributed assets will provide complete information about the cost of services and enhance comparability of financial results both within and among local governments and ensure taxpayers understand the full cost of services being provided.

The difficulty with donated or contributed assets is determining the appropriate value at which to record them. PS 3150 states that the cost of a donated or contributed asset is considered equal to its fair value at the date of contribution. Fair value is the amount of

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

the consideration that would be agreed on in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act. Given the nature of some tangible capital assets, there may not be an active market for them. PS 3150 states that fair value of a contributed tangible capital asset may be estimated using market or appraisal values. In some circumstances, cost may be determined by an estimate of replacement cost. In unusual circumstances, where it is impossible to estimate its fair value, the tangible capital asset would be recognized at nominal value.

Where a contribution involves “bundled” assets, a cost must be allocated to each individual asset. For example, the roadways, curbs and gutters, street lighting and sidewalks contributed by a developer may include land. It is important that the land component be identified and accounted for because it is typically not subject to amortization.

5.0 Single Asset or Component Approach

Many tangible capital assets, particularly complex network systems such as those for water and sewage treatment, consist of a number of components. For example, a water system includes water mains, distribution lines, reservoirs, pumping stations, filtration and treatment plants and service connections.

PS 3150 gives local government the option of accounting for such systems as a single asset or to treat each component as an individual asset. Whether a local government decides to record and account for each component as a separate asset will be determined by the usefulness of the resulting information to the local government and the cost versus the benefit of collecting and maintaining it.

5.1 Single Asset Approach

Under the single asset approach, the entire water system would be accounted for as one asset. As its components are replaced, they are simply expensed as repair and maintenance. Estimates of expected life and amortization are averaged for the entire system. The major advantage to the single asset approach is that it is less expensive and simpler since it does not require detailed records and estimates of expected useful lives of each of the components.

5.2 Component Approach

Under the component approach, the water system is broken down into major components. The component approach does not mean that each and every item of the water system is separately identified. A component can comprise assets of similar useful lives and consumption patterns. The major components are accounted for as separate assets. For example, it may be appropriate to group the pumps related to a certain treatment facility.

6.0 Capitalizing Upgrades and Improvements – “Betterments”

The cost of an asset will also include subsequent expenditures for “betterments.” Betterment is a cost incurred to enhance the service potential of a tangible capital asset. In general, for tangible capital assets service potential is enhanced:

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

- 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.

Any other expenditure would be considered a repair or maintenance and expensed in the period.

For complex, long-lived network systems, it is more difficult to distinguish between maintenance and betterment. It is not always practical to determine whether an expenditure will or will not extend an asset's useful life. The following basic distinctions can be used:

- 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.
- Betterments increase service potential (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.

Whether a local government accounts on a single asset or component basis can also have an impact on the treatment of a subsequent expenditure. For example, if a local government accounts on a single asset basis for road systems, expenditures to widen the roads or add to the number of lanes expand the capacity of the road system and are clearly betterments. Expenditures on annual resurfacing programs or crack filling incurred to maintain the originally anticipated service potential of a road, or its estimated useful life, are more in the nature of maintenance (e.g., resurfacing). On the other hand, if the road system is accounted for on a component basis, where the pavement is a separate component, the expenditures on resurfacing would be treated as a betterment and the replaced pavement would be accounted for as a disposal and removed from the asset register.

7.0 Disposal

7.1 Accounting Standard

PS 3150 requires that:

The difference between the net proceeds on disposal of a tangible capital asset and the net book value of the asset should be accounted for as a revenue or expense in the statement of operations. (PS 3150.38)

7.2 Application of Standard

Disposals of tangible capital assets in the accounting period may occur by sale, trade-in, destruction, loss or abandonment. Such disposals represent a reduction in a local government's investment in tangible capital assets.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

When a tangible capital asset is disposed of, the cost and accumulated amortization are removed from the accounts. Any difference between net proceeds and the carrying amount of the asset is accounted for as a revenue or expense in the statement of operations. The value given for a trade-in is the net proceeds on disposal.

When a component of a complex network is replaced, the removal from service of the old asset is treated as a disposal. For example, if a section of a road is resurfaced, the cost and accumulated amortization of the old pavement is removed from the accounts. The difference between the salvage value and the carrying amount, if any, is reported as revenue or expense.

TIP – Deemed Disposals

Some local governments have adopted a deemed disposition policy for certain capital assets, where asset replacement may occur on a regular basis (e.g., culverts) but the administrative costs to separately track and account for each acquisition and disposal transaction would be prohibitive. In these situations, the total additions are recorded and amortized over the applicable estimated useful life. The asset is assumed or deemed to have been disposed of in the last year of its estimated useful life. At the deemed disposition, the full cost of the addition and the related accumulated amortization is removed from the accounting records.

8.0 Amortization

8.1 Accounting Standard

PS 3150 requires that:

The cost, less any residual value, of a tangible capital asset with a limited life should be amortized over its useful life in a rational and systematic manner appropriate to its nature and use by the government. (PS 3150.22)

The amortization of the costs of tangible capital assets should be accounted for as expenses in the statement of operations. (PS 3150.23)

The amortization method and estimate of the useful life of the remaining unamortized portion of a tangible capital asset should be reviewed on a regular basis and revised when the appropriateness of a change can be clearly demonstrated. (PS 3150.29)

A local government consumes an asset's economic benefit or service potential principally through the use of that asset. The amortization method should reflect the pattern in which the government consumes the tangible capital asset's economic benefits or service potential in the provision of services. Other factors, such as technical obsolescence, may also decrease an asset's economic benefit or service potential and affect its amortization rate. An amortization expense is made even if the value of the asset exceeds its carrying amount.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

8.2 Estimated Useful Life

As a general rule, expected useful life is normally the shortest of the asset's physical, technological, commercial and legal life. An asset's useful life is based on its use by the local government.

PS 3150 does not provide specific guidance in this regard as it is not possible to authoritatively predetermine the useful lives of assets. In determining an asset's estimated useful life, a local government should consider its present condition, intended use, construction type and maintenance policy. It should also consider how long the asset is expected to meet service and technology demands. Useful lives should be based on the local government's own experience and plans for the assets.

For example, a local government may pave a vacant property to provide surface parking to the downtown core. The parking lot and equipment may physically be capable of providing service for 10 years but the local government expects to redevelop the property in five years to provide affordable housing to citizens. In this case, the expected future usage of the parking lot is five years. Therefore the cost, less any residual value, should be amortized over the five years.

Other factors to be considered in estimating the useful life of a tangible capital asset include:

- expected future usage;
- effects of technological obsolescence;
- expected wear and tear from use or the passage of time;
- the maintenance program;
- geological conditions;
- capacity versus actual usage
- studies of similar items retired;
- changes in demand for services; and
- condition of existing comparable items.

The deferral of maintenance can shorten an asset's estimated useful life. For example, deferral of annual pavement crack filing programs could allow water to infiltrate the road bed, causing deterioration and shortening of the life of the road. (See 8.4 below for more discussion on the impact of maintenance and renewal programs on estimated useful life.)

Many long-lived assets, such as water mains and pipes, often need replacing well within their physical life due to road repairs, corrosion and basic weather conditions. All of these factors need to be considered when determining the estimated useful life of infrastructure.

8.3 Revising Amortization Method and Estimated Useful Life

PS 3150 requires that the method of asset amortization and estimated useful life be reviewed on a regular basis. This review is event driven. As well, before any changes are made to the amortization method or the estimate of the asset's remaining useful life, it must be clearly demonstrated that those changes are justified. PS 3150 identifies some

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

significant events that may indicate a need to revise the amortization method or the estimate of the remaining useful life of a tangible capital asset:

- a change in the extent to which the tangible capital asset is used;
- a change in the manner in which the tangible capital asset is used;
- removal of the tangible capital asset from service for an extended period of time;
- physical damage;
- significant technological developments;
- a change in the demand for the services provided through use of the tangible capital asset;
- a change in the law or environment affecting the period of time over which the tangible capital asset can be used.

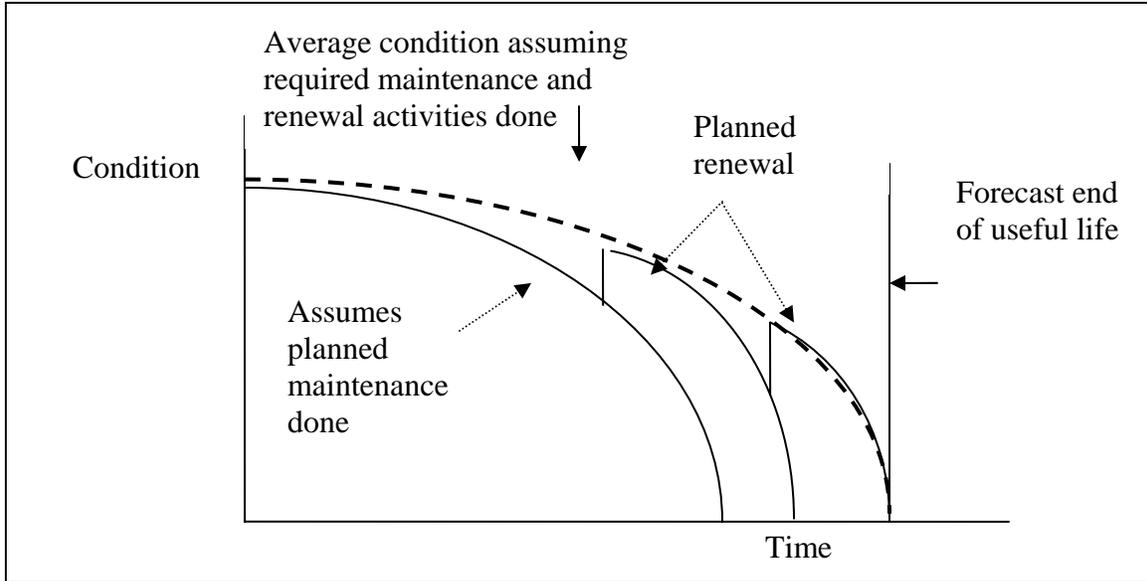
A change in an asset's amortization rate as a result of a revision of its estimated life is treated as change in the accounting estimates rather than a change in accounting policy. Under PS 2120 Accounting Changes, paragraph 27, a change in an estimate is not given retroactive effect since it arises from new information or developments. The effect of a change in the estimated useful life of a tangible capital asset and its associated effect on amortization expense are allocated to the period of revision and applicable future periods.

8.4 Accounting for Deferred Maintenance and Renewal Expenditures

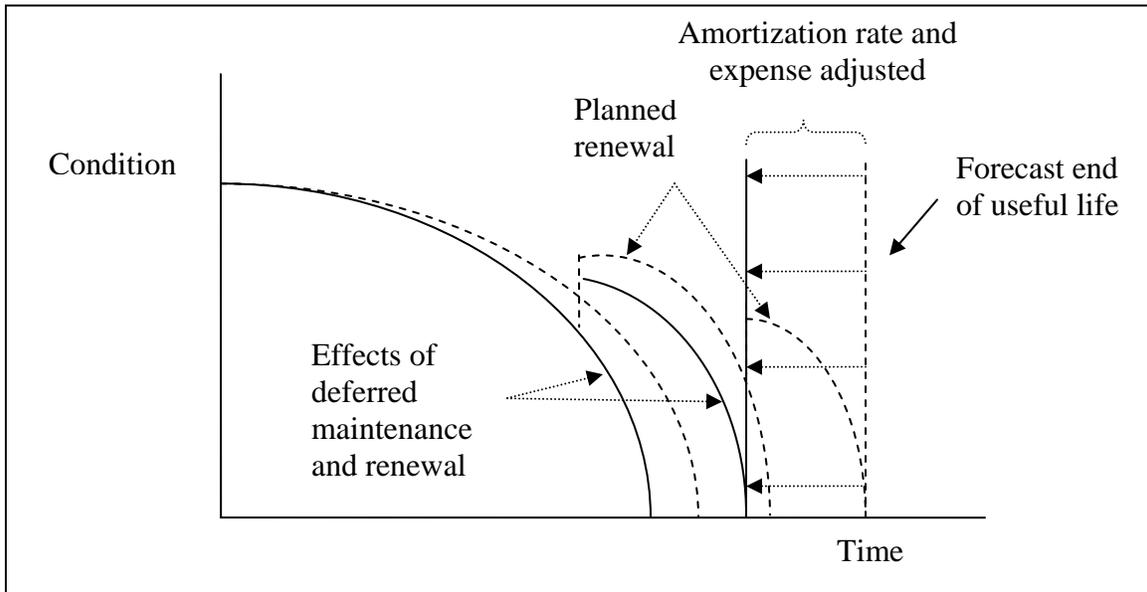
PS 3150 states that planned maintenance and renewal expenditures must be taken into account when estimating the useful life of an asset. This means that a local government's repair and maintenance policy can affect the useful life of an asset. Some assets may be poorly maintained or maintenance may be deferred indefinitely because of budgetary constraints. The following series of charts illustrates how accounting deals with deferral of maintenance and renewal expenditures. To last its estimated useful life, a tangible capital asset, particularly a long-lived asset such as a road, can require ongoing maintenance and periodic minor and major renewal expenditures. The following chart illustrates the typical life cycle of a long-lived asset. In this case, it is assumed that a single asset basis is used to record the asset for illustrative purposes. The effects would be similar if a component approach were used.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook



Deferral of maintenance and renewal expenditures may result in a decrease in service levels and can affect the life expectancy of the asset. In most cases, both are affected. Significant deferral of planned expenditures could require a review of amortization rates and the asset's estimated useful life. If it is determined that the estimated useful life of the asset has been reduced, the amortization rate would be increased so that the cost is expensed over the remaining useful life. The following chart illustrates how current accounting standards deal with deferred maintenance and renewal affecting the estimated useful life of an asset.



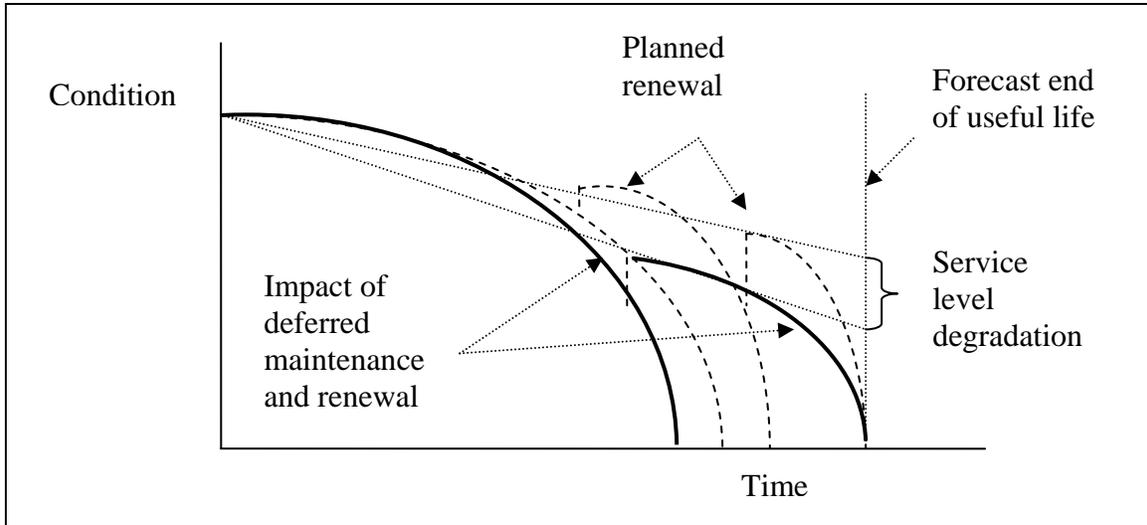
The accounting reflects deferred maintenance and required renewals that shorten the estimated useful life of the asset, therefore affecting the cost of using the asset in service delivery. PS 3150 states that the effects of deferred maintenance and renewal expenditures on estimated useful life would not be reported until it can be clearly demonstrated that an adjustment is warranted. While it may eventually result in a

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

permanent impairment, deferred maintenance and renewal do not necessarily represent a permanent decline in the asset's ability to provide services.

From a practical perspective, there are many instances where deferral of maintenance and renewal expenditures will not affect the estimated useful life of an asset. A policy decision to defer maintenance and renewal may result only in a degradation of service levels. For example, a local government may accept a degradation in the road condition (i.e., more potholes and grade separations), knowing that the road will continue to provide service. The following chart illustrates this situation.



Accounting does not deal with this situation. It would not be appropriate to adjust the estimated useful life and amortization.

9.0 Disclosure Requirements and Identifying Asset Categories

9.1 Accounting Standard

PS 3150 requires that:

The financial statements should disclose, for each major category of tangible capital assets and in total:

- a) *cost at the beginning and end of the period;*
- b) *additions in the period;*
- c) *disposals in the period;*
- d) *the amount of any write-downs in the period;*
- e) *the amount of amortization of the costs of tangible capital assets for the period;*
- f) *accumulated amortization at the beginning and end of the period; and*
- g) *net carrying amount at the beginning and end of the period. (PS 3150.40)*

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Financial statements should also disclose the following information about tangible capital assets:

- a) the amortization method used, including the amortization period or rate for each major category of tangible capital asset;*
- b) the net book value of tangible capital assets not being amortized because they are under construction or development or have been removed from service;*
- c) the nature and amount of contributed tangible capital assets received in the period and recognized in the financial statements;*
- d) the nature and use of tangible capital assets recognized at nominal value;*
- e) the nature of the works of art and historical treasures held by the government; and*
- f) the amount of interest capitalized in the period. (PS 3150.42)*

9.2 Application of Standard

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.

PS 3150 does not prescribe specific asset categories. Although that might improve comparability and consistency, there are simply too many variations inherent in prescribing and establishing definitions of capital asset categories.

Selection of asset categories will be specific to the nature and objectives of a particular local government. Because all local governments are not the same, neither will be their categories of capital assets. Consider the differences between a lower tier local government and an upper tier or regional local government. The types of capital assets these two levels of local government use vary considerably. Categories should be based on the best representation of a local government's capital assets. One local government may have a category for its water system that would not be appropriate for one that purchases clean water from a local government agency. In this case, the better description might be "water distribution system."

The following list, although not comprehensive or prescribed, may be a useful starting point in the identification of categories of tangible capital assets:

- land;
- buildings;
- equipment;
- roads;
- water, sewer and other utility systems;
- bridges;
- electricity transmission networks;
- communication networks;
- motor vehicles; and
- furniture and fixtures.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

In addition, a local government may decide to recognize a separate category for assets under construction or development, assets removed from service, surplus assets and assets subject to a capital lease.

10.0 Impairment of Assets

10.1 Accounting Standard

PS 3150 requires that:

When conditions indicate that a tangible capital asset no longer contributes to a government's ability to provide goods and services, or that the value of future economic benefits associated with the tangible capital asset is less than its net book value, the cost of the tangible capital asset should be reduced to reflect the decline in the asset's value. (PS 3150.31)

The net write-downs of tangible capital assets should be accounted for as expenses in the statement of operations. (PS 3150.32)

A write-down should not be reversed. (PS 3150.33)

10.2 Application of Standard

Two conditions could lead to a write-down of an asset.

10.2.1 Impairment of service potential

A write-down could be appropriate when a tangible capital asset no longer contributes to the provision of goods and services. It would also be required when a local government has no intention of continuing to use an asset in its current capacity and there is no alternative use for that asset. This could happen when an asset is taken out of service because it has been damaged, is technically obsolete or can not meet environmental standards. It would be written down to the asset's residual value, if any. A write-down may also be appropriate where the demand for services changes. For example, if less people use a community centre because a newer facility has been built, that may warrant a write-down of the asset.

When a local government can (a) objectively estimate a reduction in the value of a tangible capital asset's service potential and (b) has persuasive evidence that the reduction is expected to be permanent, the cost of the asset would be written down to the revised estimate of the value of the asset's remaining service potential. Where either of these conditions is not met, the asset is not written down.

Estimating the future service potential of a tangible capital asset can be challenging. International Public Sector Accounting Standard 21 Impairment of Non-cash Generating Assets gives some guidance. It states that an asset's "value in use" may determine its recoverable service amount. It defines value in use of a non-cash-generating asset as the present value of the asset's remaining service potential. The standard suggests several value-in-use methods for measuring future economic benefits:

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

- Depreciated replacement cost could be used to measure the present value of the remaining service potential of a non-cash generating asset. Estimated replacement cost is based on an asset with similar service potential to that currently provided by the existing asset.
- Subtracting the estimated restoration cost of the asset from the current cost of replacing its remaining service potential before impairment (usually the depreciated replacement cost). Restoration cost is the cost of restoring the service potential of an asset to its pre-impaired level.
- Reducing the current cost (usually the depreciated replacement cost) of the asset's remaining service potential before impairment to conform to the reduced number of service units expected from the asset in its impaired state.

10.2.2 Impairment of future economic benefits

A write-down could be appropriate when a tangible capital asset's carrying amount exceeds the value of its future economic benefits. There are a number of ways of estimating future economic benefits, including:

- Where the asset generates cash, use the estimated amount of the sum of the undiscounted cash flows (cash inflows less associated cash outflows) expected to result from its use and eventual disposition.
- Where there is an active market for the asset, use fair value less costs of disposition.

10.3 Testing for Impairment

The requirement to test assets for impairment is typically event driven. Only when conditions indicate that an asset may be impaired is it necessary to consider whether a write-down is warranted. Conditions that may indicate a write-down include:

- A change in the extent to which the tangible capital asset is used.
- A change in the way a tangible capital asset is used.
- Significant technological developments.
- Physical damage.
- Removal of the tangible capital asset from service.
- A decline or cessation of the need for the services provided by the tangible capital asset.
- A decision to halt construction of the tangible capital asset before it is complete or in usable or saleable condition.
- A change in the law or environment affecting how the tangible capital asset can be used.

10.4 Accounting for Asset Impairment

A write-down is an adjustment to the cost of an asset. A corresponding adjustment is made to the accumulated depreciation and the net adjustment is reported as an expense in the statement of operations. This new cost should be amortized over the remaining useful life of the asset.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

The following example shows how to measure and record the impairment loss resulting from a decline in the need for a tangible asset's service.

Facts: A municipality's manufacturing plant has closed, and many residents have lost their jobs. Since the closure of the plant, the community's population has dropped by 50%, from 30,000 to 15,000. This change is probably permanent. The town has a water system that originally cost \$10 million. The system was designed to service 20,000 water connections (single family households and commercial) as well as the manufacturing plant. The system had an expected useful life of 40 years and has been operated for 20 years. The municipality has used the straight-line amortization method to expense the cost of the system over its estimated useful life. The net book value of the water system is \$5.0 million. The value in use of its future service potential has been determined to be \$4.0 million.

Accounting: The write down-would be calculated as follows:

Original cost of water system		\$10,000,000
Accumulated amortization	$\$10,000,000/40*20$	\$ 5,000,000
Net book value		\$ 5,000,000
New cost of the water system*		\$ 4,000,000
Net asset impairment write-down	$\$5,000,000 - \$4,000,000$	\$ 1,000,000

* The value in use has been based on the depreciated replacement cost of an asset that could provide water services to 10,000 residential and commercial customers.

Estimated replacement cost	\$8,000,000
Accumulated amortization ($\$8,000,000/40\text{yrs}*20\text{yrs}$)	<u>\$4,000,000</u>
Estimated future economic benefits	<u>\$4,000,000</u>

The cost of the water system would be written down by \$6.0 million to \$4.0 million. The accumulated amortization would be reduced by \$5.0 million and a write-down expense of \$1.0 million would be reported in the statement of operations. The new cost of the water system would be \$4.0 million, and this amount would be amortized over its remaining useful life.

11.0 Leased Assets

11.1 Accounting for Capital Leases

Leases are classified as either capital leases or operating leases. The differentiation between the two types is critical to the appropriate accounting treatment. PSG 2 Leased Tangible Capital Assets contains the following definition for distinguishing between the two types of leases:

“A leased tangible capital asset is a non-financial asset that has physical substance and a useful life extending beyond an accounting period, and is held under lease by a government for use, on a continuing basis, in the production or supply of goods and services. Under the terms and conditions of the lease, substantially all of the benefits and risks incident to ownership are, in substance, transferred to the government without necessarily transferring legal ownership.” (PSG 2, paragraph 3)

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

For substantially all of the benefits and risks of ownership to be transferred to the lessee, one or more of the following conditions must be met:

- There is reasonable assurance that the local government will obtain ownership of the leased property by the end of the lease term.
- During the term of the lease, the local government will receive substantially all of the economic benefits expected to be derived from the use of the leased property over its life span.
- The lessor would be assured of recovering the investment in the leased property and of earning a return on the investment as a result of the lease agreement.

PSG 2 paragraph 6 provides further guidance on applying these conditions.

Even without those conditions, a lease may still be classified as a capital lease. It is not appropriate to focus on one factor in isolation. Each factor should be considered in terms of its relative significance to a particular lease. Other factors to consider include:

- The leased property is used to provide an essential service (e.g., jails, roads and highways, utilities systems) and the asset is so specialized that there is no alternative asset readily available; it is likely that the local government will have the use of the property throughout its economic life.
- The local government contributes significant financial assistance (land, loan guarantees, transfers, etc.) toward the cost of acquiring or constructing the property that it will lease; the local government would bear certain costs and risks associated with the leased property that would normally be associated with ownership of property.
- The local government has a significant degree of control over the idle capacity of the leased property (e.g., although there is a potential for third-party use of the asset, the local government is able to restrict such use, whether or not it pays for that capacity).
- The local government bears residual risk or benefit of asset ownership (e.g., the local government owns or retains control of the land on which the leased property is located, and the asset cannot be easily moved; the local government is obliged to either find a sub-lessee or pay significant costs to the lessor to end the agreement before its term is up; the lessor has the option, at the end of the lease, to transfer the leased property and any related obligation, to the local government; the local government shares in the residual loss or gain on the leased property).
- The local government is responsible for performance, availability and/or maintenance of the property.
- The local government bears the business risk associated with the leased property (e.g., lease payments that fluctuate with specific indices such as interest rates or the CPI).
- The local government assumes responsibility for construction risk (e.g., pays for cost overruns or does not have use of the asset by the agreed date).
- The local government is obliged to pay for the output or capacity, whether or not it is needed (e.g., guaranteed payment for a minimum number of users in recreational complex).
- The local government is responsible for other potential risks of asset ownership

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

including obsolescence, environmental liability and uninsured damage or condemnation of the asset.

If the local government is on the hook for these or any other significant risks, that may be additional evidence that it has a leased tangible capital asset.

11.2 Recognition of Leased Assets

Property that meets the definition of a leased tangible capital asset is accounted for as both a tangible capital asset and a liability. The value of the leased tangible capital asset and the amount of the lease liability, recorded at the beginning of the lease term, would be the present value of the minimum lease payments, excluding the portion relating to executory costs.⁶

At inception of the lease, the estimate of the discount rate used should be reviewed together with:

- the present value of the minimum lease payments;
- the assumed fair value of the property; and
- the assumed residual value, to ensure that all figures are reasonable and internally consistent.

The discount rate for determining the present value of the minimum lease payments would be the lower of the local government's rate for incremental borrowing and the interest rate implicit in the lease. The maximum value recorded for the asset may not, however, exceed the leased property's fair value.

A leased tangible capital asset would be amortized over the period of its expected use, on a basis consistent with the local government's amortization policy for similar tangible capital assets. If the lease contains terms that allow ownership to pass to the local government, or a bargain purchase option, the period of amortization would be the economic life of the property. Otherwise, the property would be amortized over the lease term. Lease payments would be allocated between repayments of the liability, interest expense and any related executory costs. The total minimum lease payments, less the initial liability recorded, represents the total interest cost of the lease. The interest expenditure/expense would be calculated based on the same discount rate used in computing the present value of the minimum lease payments applied to the outstanding lease liability at the beginning of the lease payment period.

11.3 Sale-Leaseback Transactions

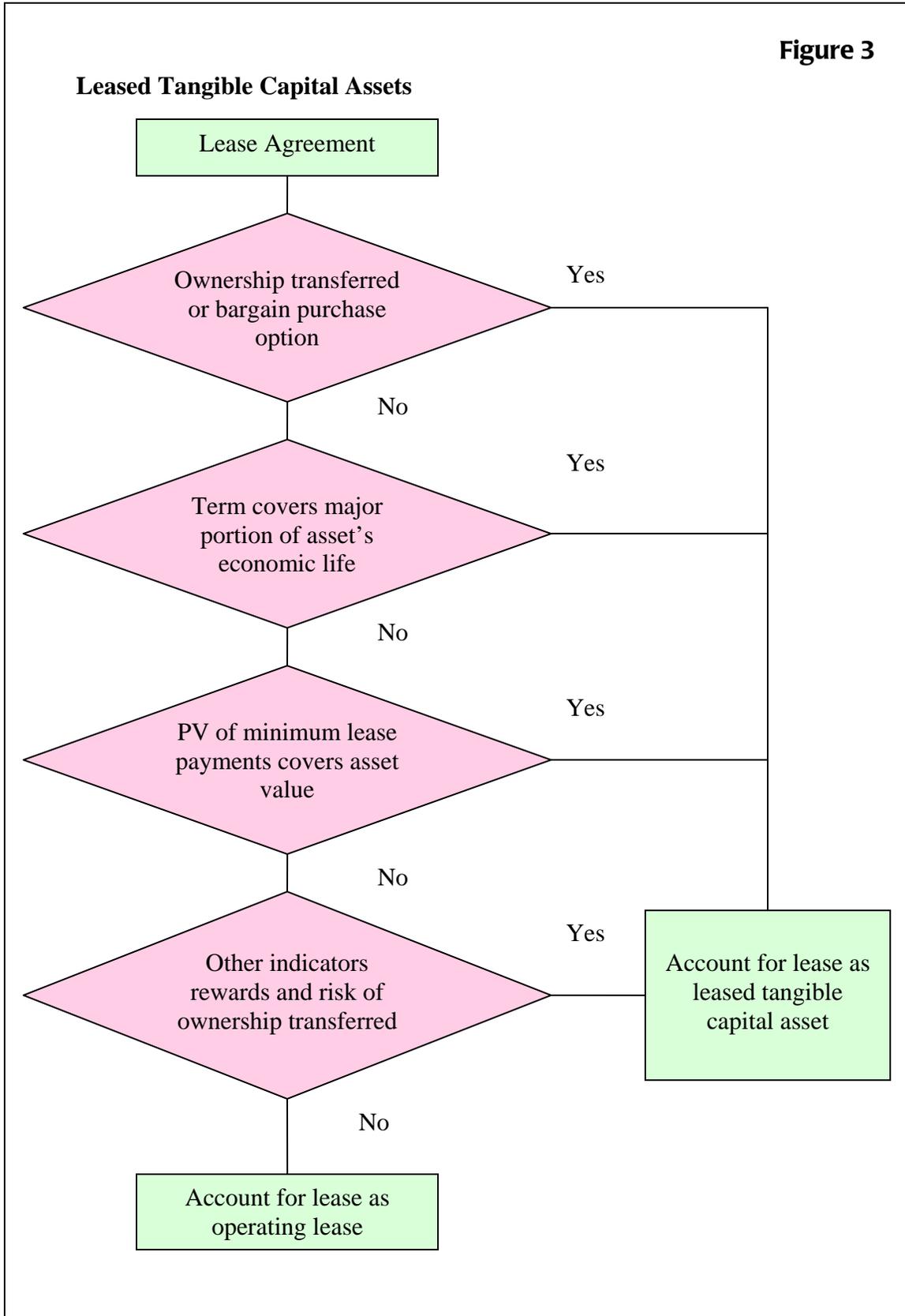
A sale-leaseback transaction would have a local government sell a property and then lease it, or a part of it, back. The transaction may be done through a series of concurrent sale transactions involving more than one external party or organization within the local government reporting entity, with the end result being that the local government retains the use of the property, or a part of it. The *Public Sector Accounting Handbook* provides guidance on appropriate accounting for sale-leaseback transactions.

⁶ Executory costs are costs related to the operation of a leased tangible capital asset (e.g., insurance, maintenance cost and property taxes).

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Figure 3



Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

The lease component of the transaction would be classified according to whether it transfers the benefits and risks of ownership to the local government. If the local government retains the right to substantially all of the property, it is treated as a leased tangible capital property. When the local government retains the right to more than a minor portion but less than substantially all of the property, it has to determine whether the leaseback portion of the transaction should be classified as a leased tangible capital asset in accordance with PSG-2.

12.0 Valuation Transitional Provisions

PS 3150 requires that all tangible capital assets in existence at the effective date be recorded in a local government's accounting system. The transitional provisions of PS 3150 allow local governments to recognize tangible capital assets at the actual or estimated original cost as well as related estimated accumulated amortization. A local government should apply a consistent method of valuing any tangible capital assets for which it does not have historical cost records, except where it can demonstrate that a different method would provide a more accurate estimate of the cost of a particular group or class of tangible capital asset.

The information recorded would include the actual or estimated original cost of the tangible capital assets, their estimated useful lives and the related estimated accumulated amortization. (Appendix B illustrates the work flow process in initiating tangible capital asset accounting and reporting.)

TIP – Establish a Threshold Limit for Initial Recognition

When establishing initial values, it is important to keep in mind that accounting standards are not intended to apply to immaterial or insignificant items. It will be important to establish a threshold limit to manage the administrative effort in inventorying and valuing assets.

13.0 Retroactive Application of the New Accounting Standard

13.1 Accounting Standard

PS 2120 Accounting Changes states that:

The Recommendations in this Section do not override any specific provisions as to prospective or retroactive application contained in other Public Sector Accounting Recommendations (PS 2120.11)

When a change in an accounting policy is made to conform to new Public Sector Accounting Standards or to adopt Public Sector Accounting Recommendations for the first time, the new Standards may be applied retroactively or prospectively” (PS 2120.13)

When a change in an accounting policy is applied retroactively, the financial

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

statements of all prior periods presented for comparative purposes should be restated to give effect to the new accounting policy, except in those circumstances when the effect of the new accounting policy is not reasonably determinable for individual prior periods. In such circumstances, an adjustment should be made to the opening balance of the accumulated surplus/deficit of the current period, or such earlier period as is appropriate, to reflect the cumulative effect of the change on prior periods. (PS 2120.17)

For each change in an accounting policy in the current period, the following information should be disclosed:

- a) a description of the change;*
- b) the effect of the change on the financial statements of the current period;*
and
- c) the reason for the change. (PS 2120.18)*

When a change in an accounting policy has been applied retroactively and prior periods have been restated, the fact that the financial statements of prior periods that are presented have been restated and the effect of the change on those prior periods should be disclosed. (PS 2120.19)

When a change in an accounting policy has been applied retroactively but prior periods have not been restated, the fact that the financial statements of prior periods that are presented have not been restated should be disclosed. The cumulative adjustment to the opening balance of the accumulated surplus/deficit of the current period should also be disclosed. (PS 2120.19)

13.2 Application of Standard

Although PS 2120.13 permits prospective application of the new accounting standards, PS 3150.44 overrides this when it states: “This section applies to all tangible capital assets.” Local governments must present information about the complete stock of their tangible capital assets and amortization in the summary financial statements regardless of when acquired.

It is expected that most local governments will adopt the new accounting standards in PS 3150 retroactively, with a corresponding restatement of all prior periods presented for comparative purposes. Retroactive application with restatement provides consistency in accounting policies from one period to another. It assists in interpreting trends in a local government's performance and other analytical data that are based on comparisons.

When the effect of the new accounting policy is not reasonably determinable for individual prior periods, local governments are allowed to make an adjustment to the opening balance of the accumulated surplus/deficit of the current period, or such earlier period as is appropriate, to reflect the cumulative effect of the adoption of the accounting standards under PS 3150.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

14.0 Transitional Implementation Guidance

14.1 Accounting Standard

PS 3150 states that:

When, during the period of transition, a local government has information on some but not all categories of its tangible capital assets, the local government would disclose information in accordance with PUBLIC SECTOR GUIDELINE PSG-7, Tangible Capital Assets of Local Governments. (PS 3150.45)

14.2 Application of Standard

Local governments are **not** allowed to implement the new accounting standards on a piece-meal basis. Until a local government has complete information about all categories of tangible capital assets, it is not permitted to recognize them in the financial statements. If a local government is able to report complete information on all categories as required by PS 3150, it may adopt the new standards and reporting model earlier than the January 1, 2009 implementation date. This is to avoid the confusion that would be caused by a local government reporting both on an expenditure and expense basis.

PSG-7 Tangible Capital Assets of Local Government, effective for fiscal years commencing on or after January 1, 2007, provides transitional guidance on reporting information about a local government's physical assets. PSG-7 provides that reporting of information about tangible capital assets may occur in stages. When a local government has information that must be disclosed under PS 3150 on some but not all categories of its tangible capital assets, it would disclose that information. In addition, it would disclose which categories of tangible capital assets it does not have complete information for.

The disclosure would occur in notes to the financial statements until January 1, 2009. Disclosure requirements are generally the same as those set out in PS 3150.

Chapter 3 Implementation Planning

1.0 Managing the Process

The transition to tangible capital asset accounting is a major project for most local governments. Like any large-scale project, it requires careful planning and management. Transition is likely to be smoother and faster when the implementation plan features the following:

- a clear mandate;
- political commitment;
- the commitment of central departments and organizations and key officials;
- adequate resources (human and financial);
- an effective project management and coordination structure; and
- adequate technological capacity and information systems.

2.0 Implementation Plan

To prepare an implementation plan for accounting and reporting tangible capital assets, a local government needs to have some idea of the scope of the tasks involved and the likely amount of resources that these tasks will take. The amount of work required to recognize tangible capital assets depends on the extent to which a local government already has information available on those assets. General steps in the recognition of assets include:

- define and recognize tangible capital assets;
- establish information systems requirements;
- prepare accounting policies for each category, including valuation and recognition thresholds;
- compile accurate opening balances for each category (identification, application of definition of asset, and measurement).

Six Critical Questions

- **What do you have?**
- **Where is it?**
- **When did you get it?**
- **What did it cost?**
- **What is its condition?**
- **What is its expected remaining service life?**

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

The detailed implementation plan should identify the following:

- the person/position responsible for each task;
- the person/position responsible for management of this aspect of the plan;
- project milestones and deadlines;
- dependent items within the asset recognition plan and between asset recognition and other parts of the wider project; and
- process and timeframe for resolution of issues.

A generic detailed work plan outline is included as Appendix A.

3.0 Involving the External Auditor

Although it is essential that auditors maintain their independence, there are many benefits to establishing a collaborative working relationship with the auditor at the beginning of the transition process. This could include formally consulting with the external auditor on proposed transition paths. It would be unlikely that an auditor would be able to give an absolute assurance that a particular system or process would meet audit requirements. The auditor may, however, provide helpful advice on the criteria that would be used in assessing the system or process.

Chapter 4 Tangible Capital Asset Accounting Policy

1.0 Development of Tangible Capital Asset Accounting Policies

One of the first steps in the implementation process will be establishing and getting agreement on asset accounting policies. The following is a checklist of the broad issues to deal with in the capital asset policy:

- authority, purpose and scope;
- asset definition;
- asset categories;
- single asset versus component approach (segmentation);
- asset valuation (cost, contributed or donated assets, grants or donations, etc.);
- capitalization policies (buildings, library books, computer software, land and land improvements);
- recognition thresholds;
- capitalization of carrying costs;
- betterments versus maintenance;
- amortization methodology and rates;
- reviews of estimated useful life and write-down for impairment;
- capital leases;
- asset ledgers (content, maintenance, periodic inventories);
- control (asset inventory, maintaining records and documentation);
- construction-in-progress (when to start amortizing);
- surplus assets;
- asset disposal (sale, abandonment, demolition, trade-in);
- risk management, health and safety issues and environmental issues.

Much of the content of a capital accounting policy can be developed by reference to the chapter on “Understanding Accounting Standards.” A few items have been chosen for further discussion.

The bibliography contains some suggested sources and Appendix C contains a sample policy template.

2.0 Single Asset or Component Approach

Determining whether to use a single asset versus component approach should be based on what it costs to compile the information versus the value it has to management. The approach taken does not have to be consistent across all categories of assets. Different approaches may be taken for each category. Judgment and the usefulness of the information will govern the selection of the approach and the level of detail maintained.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

2.1 Analysis of Advantages and Disadvantage

Single Asset Approach	
Advantages	Disadvantages
Less expensive and simpler to maintain because it does not require detailed records and estimates of useful lives of the components of assets.	<p>There is no control over the stock and no information about its cost, location or physical attributes.</p> <p>Provides only summarized information for asset management plans and financial planning.</p> <p>Can skew the cost information of programs and services. For example, if an entire water system were to be amortized over its average expected life of, say 75 years, the costs of components having expected lives of less than 75 years may well be understated in period costs and overstated in periods where major replacements are required. Estimating the useful life of an asset is more difficult and, for long-lived infrastructure assets, is likely to be arbitrary. For example, pipes in water systems could last 100 years or more based on physical attributes. Other factors, such as capacity, actual usage, deferred repair and maintenance, effects of idle time, geological conditions, technical obsolescence and changes in demand must be factored into the estimate of useful life. The influences of these factors are easier to estimate on a component basis than over an entire system.</p>

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Component Approach	
Advantages	Disadvantages
<p>Complex network systems have major components with significantly different expected useful lives and that require replacement at different intervals throughout the life of the system. Accounting for components provides better information on asset condition, location and physical attributes.</p> <p>Information required for asset management plans and financial planning is readily available and can be compiled on local government-wide basis.</p> <p>The information about the cost of providing programs and services is more accurate since the costs of major components are amortized and expensed over their individual lives. This may improve pricing decisions.</p> <p>Improves comparability of period cost information and removes “lumpiness” in period costs since each component is accounted for individually and amortized over its estimated useful life. Each replacement is capitalized.</p> <p>Improves accuracy of estimates of useful lives and costs. It is easier factor in effects of physical attributes, capacity, actual usage, deferred repair and maintenance, idle time, geological conditions, technical obsolescence, and changes in demand for individual components.</p>	<p>Requires the creation and maintenance of detailed records and estimates of useful lives of individual components. Accounting for components does not, however, require recording each individual item. Components having similar useful lives and consumption patterns can be grouped. For example, a water system could be broken down into treatment facilities, pumping stations, water mains and distribution lines. Further, pumping stations could be broken down into pumps, pipes, facilities, etc.</p>

2.2 Component Approach Implementation Issues

As part of accounting for network or system assets on a component basis, a local government may need to:

- Construct an asset management database.
- Identify appropriate components of the system or network.
- Ascertain the age and condition of the components.
- Assess the remaining useful life of existing asset components.
- Identify features of the component, for example type of surface or method of construction for a road.
- Identify the levels of use for particular parts of a system or network.
- Establish a method for distinguishing between maintenance and upgrades or improvements for that component.
- Determine the valuation of assets for inclusion in the financial records.
- Calculate the amount of decline in service potential (amortization) for the financial period.
- Plan for a cycle of inspection to check accuracy of records against actual conditions.
- Link the underlying data to asset management plans, and link asset management plan information to the financial records and financial statements (that is, reconcile to general ledger information).

2.3 Asset Segmentation

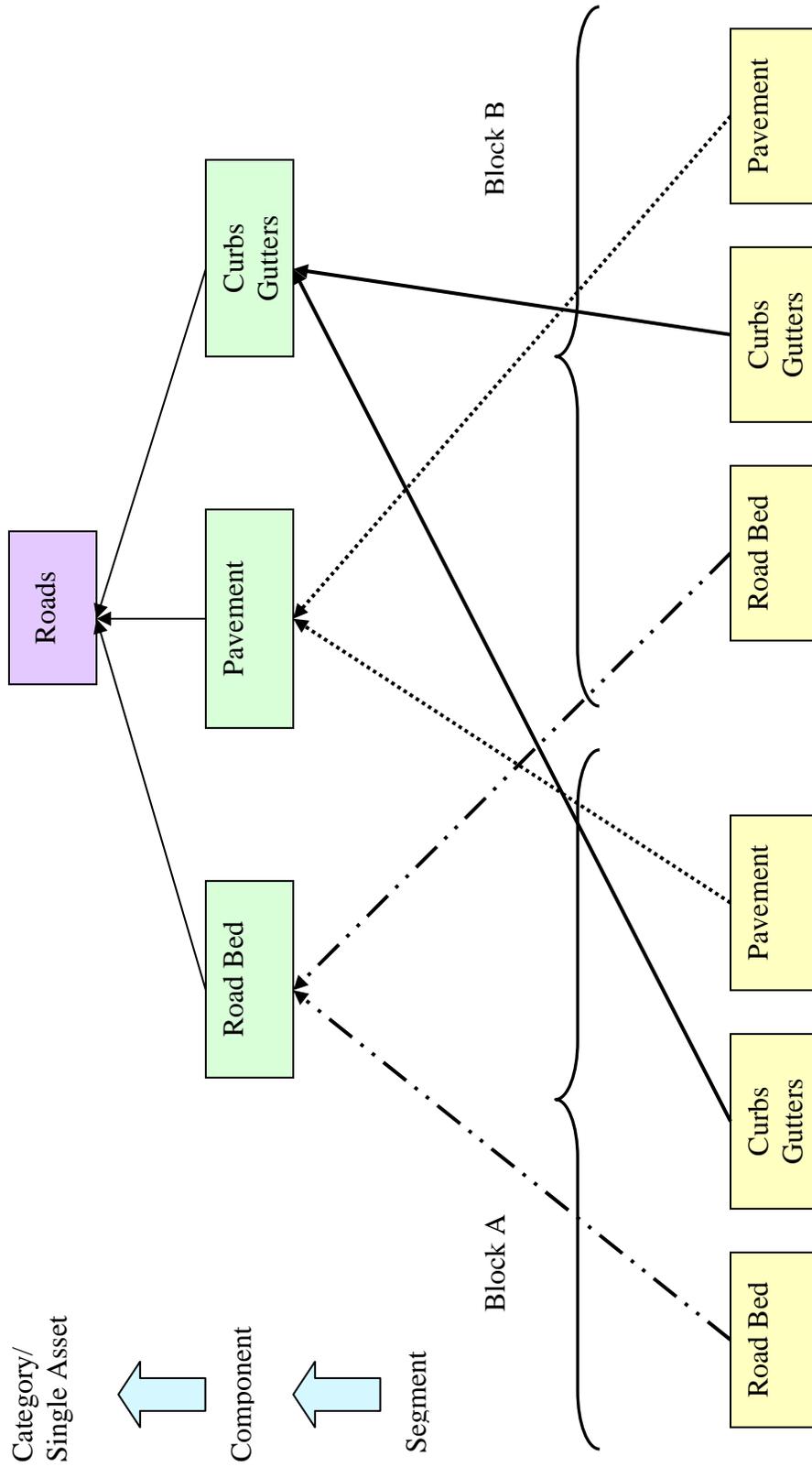
Linear assets (complex network systems such as roads, water systems and sewer systems) are usually defined in terms of details such as length, unit of measure and geographic reference (e.g., start and end points). For linear assets, it may be appropriate to break down assets into corresponding segments. For example, when work is performed at a specific point in a linear asset – such as replacing a portion of a water main or roadway – the cost and work involved is attributed to that portion of the asset rather than the entire asset.

Segmentation may make the accounting and reporting of assets easier. It allows more accurate tracking of an asset by age, type, use and other attributes used in estimating an asset's useful life. It may allow for more accurate tracking of betterments and maintenance. For example, if a segment of water main is replaced, the costs of the replacement can be capitalized and amortized over its useful life and the old water main written off.

Many infrastructure management systems track infrastructure assets on this basis. It may be possible to utilize existing infrastructure management systems as the asset register and interface the systems with the accounting records for accounting and reporting purposes.

Figure 4

ILLUSTRATION OF SEGMENTATION



Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Linear coordinates can also be used to identify other related assets. For example, street lights, traffic signals, sidewalks and fire hydrants can all be related to a coordinate of a road segment. This improves asset tracking and management. (See also Chapter 6, “Asset Registers,” Section 4.0, “Integration of Asset Registers with the General Ledger.”)

3.0 Assessment of Useful Lives

One of the key challenges of tangible capital asset accounting is estimating the useful service lives of assets.

Relevant sources of information for determining asset lives include:

- Discussions with the people responsible for the use and maintenance of assets.
- Useful lives used by other entities and jurisdictions for similar assets (the useful lives of major classes of assets are disclosed in annual reports).
- General guidelines from professional or industry organizations (e.g., professional engineering associations).
- Past records of asset acquisition and disposal.
- Useful lives implicit in the capital allowance rates approved by taxation authorities for income determination. (Although these figures are established for the purpose of determining taxable income for private sector business activities, they may provide a useful starting point or point of comparison.)

It is important to adapt such general information to a local government’s specific circumstances.

Factors to consider in estimating the useful life of tangible capital assets include:

- Similar assets may differ substantially in quality and, hence, in their useful lives, because of differences in materials, design and workmanship. For example, an asphalt road will not have the same useful life as a concrete road. Likewise, the depth of the material used for paving purposes, as well as the quality of the underlying base, will also affect the useful life of a road.
- The useful life of a given type of capital asset may vary significantly depending on its intended use. Thus, the life of a motor vehicle used in the public safety function may differ from the life of the same type of vehicle used in the parks and recreation function.
- Climatic differences among geographic locations can have an important impact on the useful lives of capital assets. For instance, the useful life of a road subject to extremes in temperature is likely to be different from that of a similar road located in a more temperate climate.
- Regulatory obsolescence may shorten the service life of some capital assets used in highly regulated activities (e.g., utilities).

In determining the estimated useful life of an existing asset, a local government must also consider the asset’s present condition and how long it is expected to meet service demands. For example, a water main may have to be replaced well within its physical life because community growth is stressing its capacity. A bridge may have to be replaced because it can no longer service the increase in traffic volume.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Useful lives need to be reviewed periodically to monitor the accuracy of estimates. For example, if a local government is still using assets that have already been completely written down, that may indicate the estimates of useful lives are too short. Alternatively, it might indicate that the local government is accumulating a backlog of required replacements.

4.0 Recognition Thresholds

4.1 Capitalization/Reporting Threshold

Each local government needs to determine the value above which assets are capitalized and reported in the financial statements. Assets below the relevant threshold are expensed in the period of purchase and those above the threshold are recognized as assets in the Statement of Financial Position. The use of capitalization thresholds reduces the cost of gathering data because it decreases the total number of tangible capital assets to be recorded and tracked. This saving to the local government must be considered in relation to the significance of the data to users of the financial statements. See Figure 5 for a summary of the decision tree for application of capitalization thresholds to asset purchases.

4.2 Selecting the Capitalization/Reporting Threshold

Different thresholds will be appropriate for different local governments and different local government organizations within a reporting entity – although, for consolidation purposes, the controlling local government will establish a level above which assets must be capitalized. Although consistency makes it easier to report, there may be a different capitalization/reporting threshold for management and financial reporting purposes. The threshold could vary by asset category. For example, a local government may choose to record and report all land, regardless of whether its recorded value is below the capitalization threshold for other asset categories. It may choose a higher threshold for complex network assets than for moveable equipment.

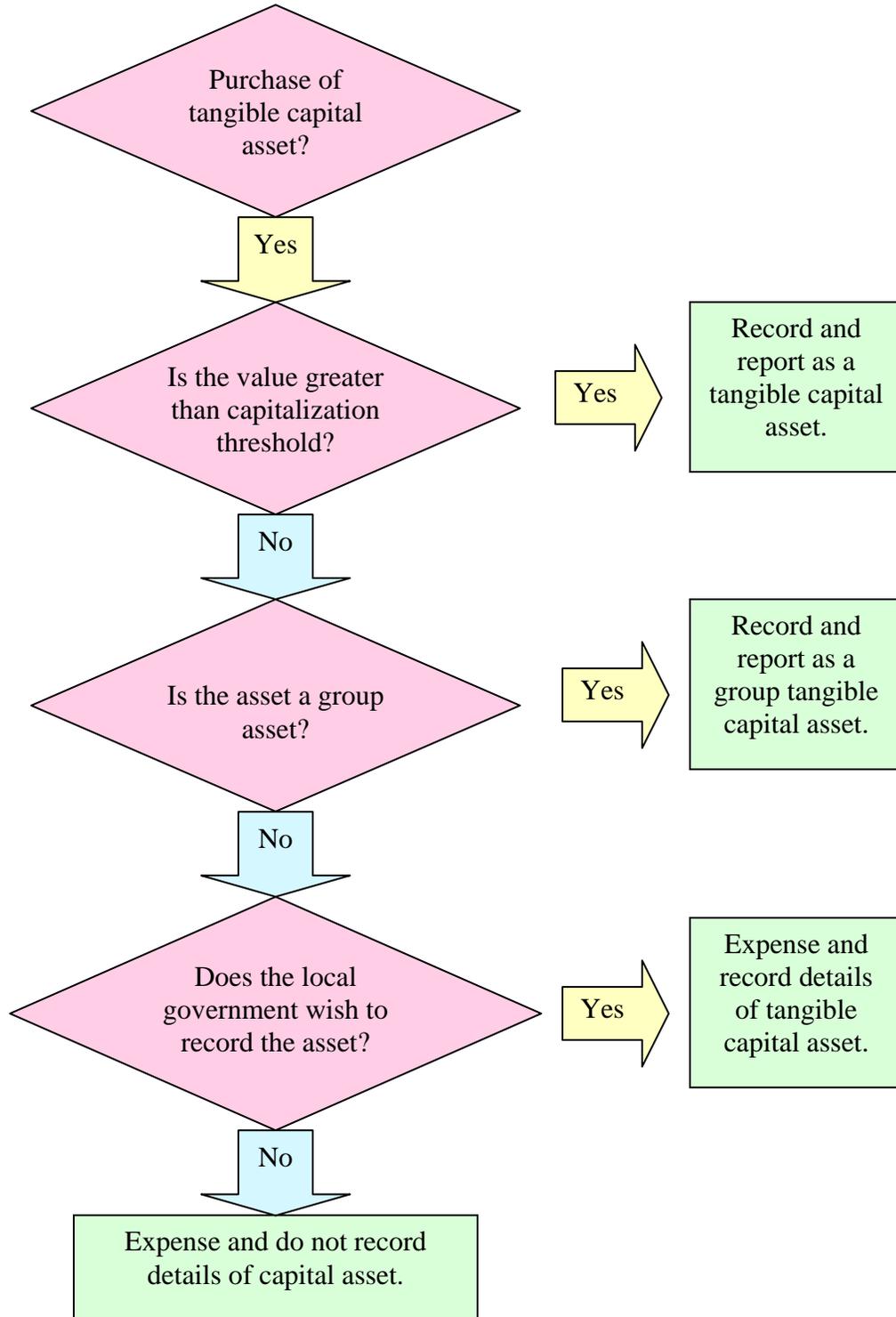
It is common to express thresholds in terms of an absolute dollar amount, for example, \$10,000. Any acquisition below this amount would be expensed in the period. The choice of the dollar amount of the threshold would be influenced by the size of the local government and the level of information required for management purposes.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Recording Threshold

Figure 5



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Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Another alternative for setting an initial capitalization threshold (sometimes referred to as the “de minimis level”) requires that a certain percentage (for example, at least 95%) of estimated total assets by value are reported in the financial statements. This method, which requires a local government to make a reasonable estimate of total assets, may be appropriate when dealing with linear assets such as water mains and roads.

4.3 Capitalization of Assets Below Capitalization/Reporting Threshold

Assets that have a lower value, per unit, than the capitalization threshold, may be material when grouped. Such assets are generally recorded as a single group asset, with one combined value. Examples where this may be appropriate include:

- computer networks;
- furniture and fittings;
- certain types of moveable equipment; and
- library contents.

Even though such items may be recorded as a single asset in the financial systems, a local government is still able to monitor or control their use and maintenance via a subsidiary asset ledger system. For example, each personal computer may be recorded as a component of the computer network.

4.4 Recording “Portable” Assets

A local government may choose to record certain items that fall below the capitalization/reporting threshold for control and security reasons. These items are sometimes referred to as “portable” items. In accordance with the capitalization policy, these items would be expensed when purchased. A description of the items and their location may still be recorded in the subsidiary asset ledgers. For example, these items may be bar-coded and recorded in a separate asset register. This type of recording is appropriate for items such as video recorders, scanners, fax machines, mobile telephones, mobile computing and communication equipment and certain tools. Regular checks of such items, as part of the annual inventory, can assist in better management of the items and reduce the risk of theft.

4.5 Recording Threshold for Betterments

A monetary (or other) threshold may also be applied to betterments (note: this threshold does not have to be the same as the one used for the initial capitalization of the relevant asset). For example, a local government may decide to recognize any modification or enhancement that increases capacity or efficiency by more than 10%.

Any assets replaced as part of betterment need to be removed from the asset register and any other relevant records. Any residual carrying value for such assets would need to be written off at that point. (See also Chapter 2, “Understanding Accounting Standards,” Section 7.0, “Disposals.”)

A local government may need to develop guidelines and include examples as part of the capital asset accounting policy (and provide training) for managers with asset

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

responsibility, illustrating the types of transactions that would normally be capitalized or expensed.

The diagram in Figure 6 summarizes a decision tree for capitalization of spending subsequent to the purchase and the application of capitalization thresholds.

4.6 Accounting for Replacements under Component Approach

Provided the recognition criteria in PS 3150 are satisfied, replacement or renewal of a component is accounted for as the acquisition of a separate asset and the replaced asset is written off. The recognition of components will be influenced by factors such as:

- the recognition threshold;
- whether the component performs a separate function; and

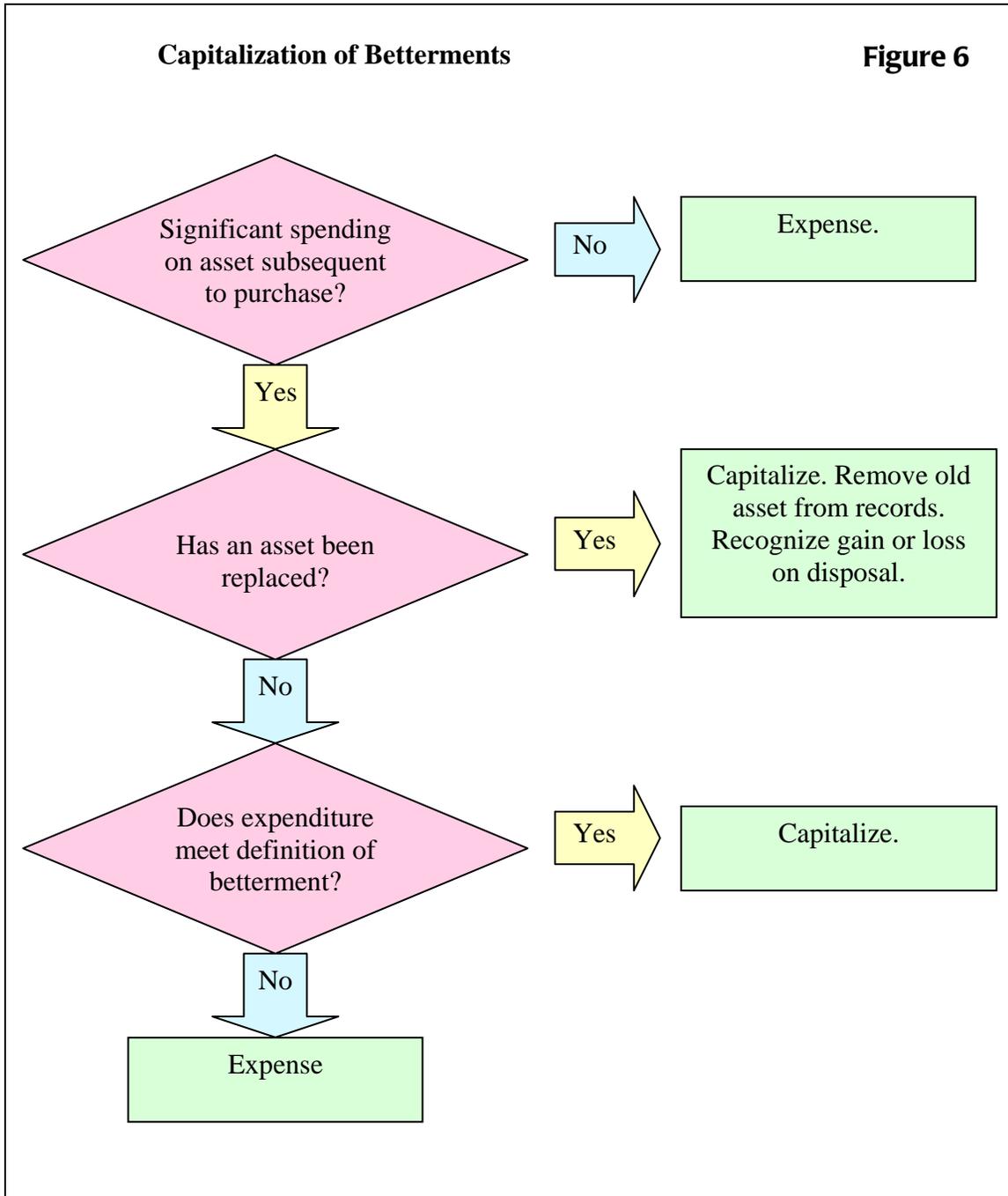
whether the component's useful life differs from that of other components.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Capitalization of Betterments

Figure 6



Chapter 5 Asset Management Practices

1.0 Strategic Asset Management Plans

While accounting for and reporting information provides a useful starting point, it does not report sufficient information for:

- Understanding the condition of tangible capital assets.
- Assessing the performance of tangible capital assets.
- Anticipating the needs for replacements in the short and long term.
- Assessing the cost and sustainability of existing programs.

Tangible capital asset management and condition assessment is an ongoing, long-term process. Maintenance and replacement policies must focus on the long-term, system-wide requirements.

Long-term strategic plans must be developed not only to address the current issues of deferred maintenance and renewal, but also to plan for the ongoing maintenance and replacement needs of the existing stock of tangible capital assets and for future growth.

2.0 Responsibility for Asset Management

A key factor in the development of asset management policies and procedures is the answer to: “Who will be responsible for the condition, use and performance of assets?” For example, some classes of assets may be centrally managed and individual operational managers may require little information about those assets. In other cases, responsibility for assets may be delegated to operational managers. In this case, each person with responsibility for asset management needs to know exactly what the responsibility entails and who has the authority to make changes to the accounting records.

3.0 Asset Operating Policies and Procedures

Ideally, a local government will have asset policies and procedures that cover all aspects of asset management, including:

- general accounting procedures (refer below for examples);
- planning (for example, the development of policies on the provision of operational facilities and other staff amenities such as canteens and gyms);
- acquisition;
- operation (refer below for examples); and
- disposal.

General accounting procedures for tangible capital assets include:

- recording assets in fixed asset registers with an identifiable audit trail (for example, a bar-coded sticker on each asset and unique reference numbers);
- regular reconciliation of the asset register to general ledger balances;
- annual management checks for existence, continuing use, remaining life, obsolescence;

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

- annual reviews for impairment;
- regular reviews of useful lives;
- proper purchasing procedures to ensure that all additions are identified and recorded; and
- proper sales or write-off procedures to ensure all disposals are managed and recorded.

Operating procedures for assets could include:

- establishing performance indicators (for example, levels of under-used space);
- developing operation and maintenance plans (including maintenance priorities highlighting essential and urgent work);
- procedures for monitoring the condition and use of assets;
- developing maintenance plans;
- tracking assets that are off-site, for example, transfers, loans and off-site repairs; and
- safeguarding and protection of assets.

Not all of these policies and procedures need to be in place at the beginning of the transition to tangible capital asset accounting. Some of them will evolve as managers become more familiar with the impact of assets on financial reporting, and asset management issues. These policies and procedures do, however, have an impact on the type of asset management systems required and, in particular, on the structure and content of the asset register (refer to next section). It is helpful if they are considered (even if not developed) at an early stage of the transition.

The type of operating policies required also depends on the extent of a local government's responsibility for asset management. Where procurement, maintenance and disposal functions are centrally managed, a department will be responsible for following the procedures established by central entities rather than developing its own procedures.

Adequate asset management plans or other appropriate information systems are necessary to reliably estimate the decline in service potential (amortization) and to ensure reliable reporting of the carrying value of those assets.

In the absence of an asset management plan, the following problems can occur:

- poor use of assets;
- failure to rationalize surplus assets;
- significant variation in operating costs between locations;
- inadequate management information;
- deteriorating physical condition of stock; and/or
- continuing maintenance of uneconomic assets.

4.0 Asset Condition Assessments

The CICA's *Accounting for Infrastructure in the Public Sector*, cited earlier, concluded that because the condition and performance of infrastructure tangible capital assets⁷ can be directly affected by a number of different factors, such as a local government's maintenance and replacement policies, population changes, past and existing use of the infrastructure, hydro-geological considerations, weather, political cycles, and regulations in general, that there was a need to complete condition assessment surveys on a regular basis. This would allow local governments to determine the ability of infrastructure tangible capital assets to continue to perform and provide services into the future. Regardless of the accounting methodology followed for infrastructure, asset condition assessments are important to the overall process of infrastructure management.

Conducting condition assessments requires the following steps:

- Identify and quantify all of the infrastructure involved.
- Gather information about the infrastructure's age, physical location, material.
- Establish the condition of the infrastructure at acquisition.
- Develop a standard of condition at which infrastructure must be maintained.
- Determine future renewal and replacement profiles, based on life-cycle costs.
- Develop systems to collate the information.
- Integrate the information with other information systems.

While condition assessments are generally an engineering function, a local government can also establish basic performance and benchmarking indicators that will assist in the process. For example:

- Keeping historical information on sewer failure could be used to predict when replacements might be needed.
- Analyzing the amount of water treated compared to the amount of water used can provide a useful indicator of condition, as can:
 - driving on roads and over bridges doing visual inspections and counting potholes and grade separations; and
 - reviewing life-cycle costs and comparing them to the actual amounts spent on infrastructure maintenance and replacement.

Condition assessments are useful, not just from an accounting point of view, but also from a service, financing and risk assessment point of view. If a local government does not understand the condition of its existing stock of infrastructure, bridges might collapse, sewer failure might destroy roadways, agricultural and commercial property might be flooded, and failing energy control centres could cause power shortages.

As a starting point in gaining the necessary understanding, a rating scale such as the one in the following tables could be developed for each class or type of infrastructure.

⁷ Although the study group only dealt with infrastructure tangible capital assets, many of the concepts of asset management are equally applicable to all categories/classes of tangible capital assets.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Condition Rating for Water Pipes	
Rating	Description
Excellent	No failures. Complies with engineering standards.
Good	Few failures. Few areas not complying with engineering standards.
Fair	Failures beginning to occur. Significant areas not complying with engineering standards.
Poor	Regular failures occurring and significant corrosion. Increases operating costs resulting. Many must be replaced.
Failing	Significant failures and should be substantially reconstructed.

Condition Rating for Roads	
Rating	Description
Excellent	No potholes. No crack filling required. Complies with engineering standards.
Good	Some potholes. Minimal crack filing required. Complies with engineering standards.
Fair	Evidence of deterioration. Has numerous potholes and regular crack filling requirements.
Poor	Pavement deteriorating. Extensive potholes and cracks. Joint failures. Needs resurfacing.
Failing	Road bed and surface needs replacing.

The rating scale could be applied to various types of infrastructure, such as the size of pipe, or type of road or geographical location (e.g., segment). The ratings could also be disclosed with information about any deferred maintenance. The following table is illustrative.

Condition Assessment of Roads				
Category	Method	Overall Condition Rating	Deferred Maintenance	Critical
Highways 100 kilometers	Condition Survey	Good	\$0	\$0
Arterial Roads 400 kilometers	Condition Survey	Fair	\$1,000,000	\$250,000
Collectors 50 kilometers	Condition Survey	Excellent	\$0	\$0
Paved 4 Lane 300 Kilometers	Condition Survey	Poor	\$5,000,000	\$3,000,000
Paved 2 Lane 800 kilometers	Visual Inspection	Poor	\$5,000,000	\$3,000,000
Unpaved Rural 100 kilometers	Visual Inspection	Poor	\$1,000,000	\$500,000

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

These ratings could be compared from period to period and supplemented with information about future maintenance and replacement costs. It would be necessary to conduct asset condition surveys on a cyclical basis to ensure that, say, every three years, an asset type or class is reviewed.

The study group working on that research report concluded that information about infrastructure condition would offer the following benefits:

- Financial information alone cannot provide the necessary information to help users understand the condition of the stock of a local government's infrastructure. The information contained in the financial statements must be supplemented by other non-financial information. That information could be described in terms of the categories and types of assets, the methods used for performing condition assessments, an overall rating for each class of asset, amounts needed to return assets to an acceptable condition and amounts needed for future reconstruction.
- The information is useful for interpreting any performance and benchmarking information.
- Infrastructure condition information, supplementing the financial information, will provide those not directly involved in local government operations with a source of information that may otherwise not be publicly available.

The study group also concluded that information on deferred maintenance should be provided as part of the infrastructure condition information, offering the following benefits:

- Deferred maintenance is a significant issue for many local governments in Canada. Information about the effect of deferred maintenance and how it relates to the existing condition of infrastructure is crucial for managing the infrastructure deficit. The study group acknowledged that deferred maintenance is only one aspect of understanding infrastructure deficits and the condition of infrastructure.
- Deferred maintenance should be accounted for as an expense when it results in impairment or a required revision in an asset's useful life. Until then, disclosure of information about deferred maintenance is useful for highlighting the ongoing maintenance and replacement needs of infrastructure.
- Disclosing information about deferred maintenance contributes to understanding and assessing the future revenue requirements of a local government's infrastructure.

5.0 Establishing a Planning and Investment Framework

Accounting for Infrastructure in the Public Sector concluded that a clear and consistent framework is needed for infrastructure planning and investment, determining ongoing operational needs and assessing its condition over time.

Such a framework must include:

- a local government strategy that sets out the overall objective for infrastructure;
- the organizational structure of the local government;

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

- an extensive inventory of the infrastructure;
- life-cycle needs and costs;
- preventative strategies;
- various condition assessment models, to address the various types of infrastructure; and
- appropriate economic valuation tools.

The central feature to developing these plans is having an inventory of infrastructure.

Overall, infrastructure management plans reflect:

- strategic plans setting out the directions to be taken, based on factors such as needs assessments and growth expectations;
- tactical plans, given the existing deployment of resources;
- long-term financing needs, including determining whether additional resources are needed;
- operational planning, which would include life-cycle costing together with estimates of useful life, required maintenance and timing of major repair and replacements; and
- condition assessments for identifying performance, funding requirements and any business risk associated with deteriorating infrastructure condition.

All of these functions must be integrated into a decision-useful system that provides decision makers with the information they need to plan, coordinate and assess the stock and use of infrastructure. An integrated infrastructure management system is crucial for:

- managing infrastructure in high-growth, high-density areas and areas with a declining tax base or changing demands;
- assessing the risk associated with and the sustainability of infrastructure;
- addressing the needs of accumulating infrastructure deficits;
- operating and capital budgeting;
- controlling the costs of using infrastructure;
- financial planning;
- assessing performance;
- evaluating whether objectives are being met; and
- nurturing an interdisciplinary approach to the management of such a system.

Effective infrastructure management represents one of the main considerations in the reduction of various risks (such as financial risk, environmental risk and condition risk) that are particularly relevant for long-lived infrastructure systems. Infrastructure requires sustainable management and a clear understanding of the costs of maintenance, renewal and incremental operating costs.

The implementation of infrastructure management plans is fundamental for:

- safeguarding significant public infrastructure;
- protecting taxpayers' and ratepayers' interests; and
- developing related financial and risk management plans.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Infrastructure management plans lead to:

- a much better understanding of the characteristics and behaviour of infrastructure;
- greater confidence in the assumptions and underlying information;
- better understanding of the level of service desired by the public; and
- focusing attention on the risks associated with managing infrastructure by identifying the critical elements within the systems.

6.0 Guidelines for Infrastructure Management Plans

An infrastructure management plan (IMP) should be developed and made available for each major network of infrastructure. Where an overall network comprises various major sub-systems, for example, different service areas for a water treatment and distribution system, it may be appropriate to have a single IMP for the entire system. If service levels differ significantly from area to area, each service area should be clearly defined, the level of service described and the accounting information segregated by each major sub-system. An inventory of the system and its components must be completed on a regular basis. The IMP should include any assumptions about the condition of the system, the performance of the system and any demand/growth forecasts.

The IMP should define the system's required service levels and performance in terms of quality, quantity, reliability, responsiveness, environmental impact, geological conditions, expected useful life and costs. The IMP should adequately describe the physical attributes of the system in terms of location, construction materials and the year built. Financial information should include the system's original cost, replacement cost, estimates of residual life and depreciated replacement cost. Financial forecast information should be included in the IMP describing planned maintenance and replacement requirements and providing a clear linkage to a local government's overall long-term financial strategy.

The plan should provide sufficient information to permit identification of declines in service capacity by describing the output capacity of the system determined by the quantity and quality of service and estimated useful life. The IMP should define and state the expected outcome of maintenance, renewals and restoration requirements, identifying estimates of the effects of not performing these activities on a regular basis.

The IMP should also include an outline of the necessary improvements required in terms of areas, location and condition of sub-performing systems, the time frame over which repairs will be completed and estimates of the human and financial resources required to complete the work. The IMP must be reviewed on a regular basis, as significant changes occur within a community. Growth, changes in demand for the types of service and catastrophic events, such as flooding, can all contribute to the need to revise a local government's IMP on a timely basis.

The study group concluded that a local government's infrastructure should provide information about its management plan, citing the following reasons:

- Given the significance of infrastructure, both in terms of the original investment and the costs associated with operating and maintaining it, a local government

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

should provide information about its infrastructure management plans. Information should include basic strategies adopted, types and classes of infrastructure, indicators used to assess performance and any assumptions about growth.

- Supplementary information provides an indication of how a local government is addressing the issues related to infrastructure management. This information is useful in understanding how infrastructure affects a local government's financial position and results.

Chapter 6 Asset Registers

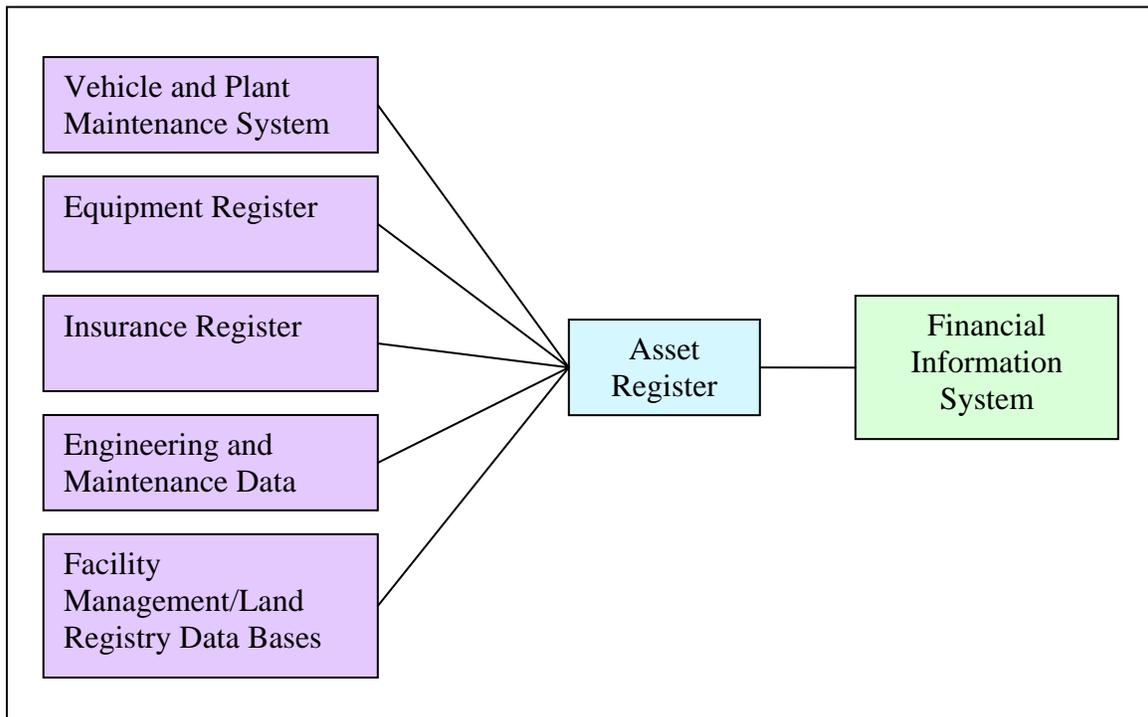
1.0 Description and Purpose

An asset register is a complete and accurate list of the assets a local government owns that is regularly updated and validated. It records the opening and closing balances of classes of tangible capital assets and is used to support the figures reported in the financial statements. The compilation of an asset register is one of the major steps in the adoption of the full accrual basis of accounting. It is a critical part of an asset management information system and will normally contain information beyond that required for financial reporting.

The size and complexity of an asset register will depend on:

- the number and type of assets an organization has; and
- the volume of purchases, transfers and disposals.

In its simplest form, an asset register may be a manual document or a spreadsheet. Alternatively, it can be a computerized system that interfaces directly with the general ledger (most computerized accounting systems have this facility). An asset register does not have to be a single computerized system or document. It can also be a series of sub-systems with linkages and a common directory. The design of an asset register will, to a large extent, be influenced by the content of existing asset management systems and databases. The following diagram illustrates how a number of systems can be linked to form an asset register.



2.0 Design and Development

Key issues in the design and development of an asset register are:

- what information does it need to contain; and
- should it be integrated with the general ledger/other systems?

For each asset, an effective asset register needs to contain the following details (where applicable):

- name of asset;
- physical description;
- serial number;
- date of acquisition (purchase, creation, donation, forfeiture);
- location;
- person/position responsible for custody and maintenance of asset;
- due date for replacement;
- expected useful life:
 - original life;
 - expired life; and
 - remaining life;
 - date asset life last reviewed;
 - any evidence of impairment;
- historic cost or initial valuation if historical cost is not known;
- amortization method, rate and amount;
- book value; and
- date of disposal.

An asset register could also contain (or be linked to) other relevant information such as insurance details and planned maintenance. Features of a good asset register include:

- asset information is updated as transactions and events occur;
- the information is regularly reconciled with acquisition data, any subsidiary systems and the general ledger;
- the information is readily available to asset managers, at the level of detail they require, preferably “on-line”; and
- the information is structured to allow the distinction of the different classifications of assets.

3.0 Information Sources

Possible sources of information for asset registers include:

- existing asset lists and systems (details of vehicles and computer equipment are often available);
- insurance lists;
- lists of properties where the local government pays property taxes, electricity, water or other utilities; and

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Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

- information on land and buildings held by local government entities responsible for cleaning or maintenance.

These records can often be the starting point for the compilation of an asset register. These sources may be used as the primary data or used to reconcile information held on assets within different systems. It is essential, however, that these records be checked for accuracy and completeness. Such records will not generally have been an integral part of the accounting system, and they may have been updated periodically rather than as transactions occurred.

In compiling the initial list of assets, it is often helpful to reconcile information in various systems with each other and with financial records. Where the information in a fixed asset register is drawn from a number of different systems, it is essential that the underlying records for all items be reliable. To permit reliance on the information in existing systems, details of additions and disposals must have been correctly recorded in preceding years. Errors identified in existing systems need to be resolved and corrected. If the accuracy and completeness of existing systems is in doubt, complete or partial physical inventory will be required. Poorly performed physical inventories do not provide reliable information. It is important to get this step right or, to get reliable information and a clean audit opinion, it will need to be done again.

Once full accrual accounting has been adopted, it will be necessary to conduct regular inventories. Cyclical coverage of assets can vary between types of assets depending on their risk profiles and degree of physical security.

Ownership of assets, especially land, needs to be checked and resolved. Items that may need special attention include:

- land requisitioned for a particular purpose but never returned to the original owners;
- forfeited assets (which may or may not belong to the local government); and
- donated assets and assets held in trust (which may include assets owned by the local government but required to be used for a particular purpose).

Where data do not appear to be accurate (for example, quantity, location, age), or ownership cannot be immediately resolved, options include:

- loading the data into the asset register (together with information on the issues to be resolved) and clearly flagging the issue; and
- noting the discrepancies and referring the issue to more specialized staff (for example, legal advisers) for resolution.

When a local government begins to collect information for its asset register, ideally, that information would be collected in a form compatible with the software and systems to be used to account for the tangible capital assets. That software may, however, not be in place yet. Nevertheless, it is still possible to compile the basic data required for the asset register. At some point, asset register information may need to be transferred from one format to another. The benefits of making early progress on the asset register need to be compared to the costs and likely time required to transfer information into a different system.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

An asset register may be compiled in stages. The first stage may consist of compiling a list of all tangible capital assets controlled by a reporting entity. This information can be collected prior to the finalization of accounting policies, as valuation and measurement issues can be resolved at the second stage. In addition, where information on particular classes of assets is difficult to obtain, or determining control is a problem, the information on such assets can be collected separately. Alternatively, identification and valuation can proceed on a class-by-class basis.

4.0 Integration of Asset Registers with the General Ledger

Asset registers may be separate systems or they may be integrated with the general ledger and other systems. If they are separate, information from the asset register needs to be periodically transferred (using a manual or computerized interface) into the general ledger for the preparation of the financial statements. If the asset register is integrated with the general ledger, the opening and closing balance information can automatically flow through into the general ledger, also creating automatic journal entries for depreciation.

Integration of the asset register with other systems has clear advantages. For example, integration of the asset register with the purchasing, capital planning, preventative maintenance, accounts payable (to capture acquisitions) and general ledger systems:

- minimizes manual intervention;
- reduces the possibility of corruption of data, or error;
- reduces the number of reconciliations required;
- prevents duplicate data entry and processing; and
- allows journals for depreciation and asset revaluations to be automatically generated.

An asset register may also be integrated with the human resource management information system. This allows the tracking of employee possession of attractive and portable items.

During the initial stages of implementation, a local government may be constrained by the nature of existing systems and the time and cost to re-design or replace those systems. Manual or computer interfaces between existing systems and the general ledger will be required. Such interfaces are a potential source of errors, not least the possibility that not all data on assets may be transferred. Careful design, training and testing are required to avoid such interface problems.

5.0 Validation of Asset Registers

Validation of asset registers involves verification to show that the information in the registers is complete and accurate as at a certain date. Compilation of a register can take one to two years and, during that time, assets will have been acquired, enhanced and disposed of. Validation of figures to be used for opening balances is, therefore, required. Lists of additions, enhancements and disposals should be generated and centrally reviewed for reasonableness. Validation is also required on an ongoing basis.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

In most cases, there will be some asset movements (additions, enhancements and disposals) between the original valuation and loading of information into the asset register and the reporting date.

Methods of validating figures for opening balances include:

- for land and buildings – documenting the source of information and procedures followed to establish the completeness of the records; and
- for other tangible capital assets – circulating information in the asset register to the employees responsible for physical custody of assets and asking them to confirm the accuracy and completeness of the records.

Good validation procedures include:

- assigning responsibility for validation of information on each class of assets to one person/position;
- ensuring that physical existence checks are conducted by staff independent of those responsible for custody of the assets;
- requiring written confirmation of any amendments;
- requiring written statements confirming the accuracy of asset register information (taking into account any amendments);
- retaining records of any adjustments made to the asset register following receipt of proposed amendments; and
- keeping records of which parts of the register have been validated and the dates on which the data were validated.

If it is not possible to conduct all verifications at the reporting date, it would be prudent to confirm the acceptability of a phased program of verification with the external auditor.

A local government may initially omit some immaterial categories from the asset register. Subsequently, these assets will need to be identified (by component), valued, entered into the asset register and recognized in the financial statements. The subsequent recognition of such assets will generally lead to both an increase in assets and net assets/equity.

6.0 Summary

The following key points will be useful for developing an asset register:

- If preparing for conversion to full accrual accounting, start collecting basic information on assets immediately, even if this information is simply collected on a spreadsheet.
- Make sure physical inventory instructions are clear and thoroughly explained to those conducting the physical inventory.
- Start small – it is better to create a simple but workable asset register that has the minimum data required for all assets than to attempt and never finish a more complex register.
- Assign clear roles and responsibility for maintenance of asset registers.
- Establish clear procedures for updating of asset registers.
- Communicate with users to make sure registers are usable and used.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

- Provide training for users of asset accounting/management systems and asset registers – a slow take up by users requires follow-up action.
- Allow sufficient time for researching proof of ownership, including reconciling historical documents of ownership to more recent records – this task can be very time consuming.
- Establish a process for dealing with assets where ownership is disputed or cannot be resolved prior to reporting date.
- Remember to develop systems to track assets (such as major components/spare parts) that the local government owns but are held by contractors for repair, overhaul or modification.
- Properties identified for disposal must be checked to ensure that they are valued in accordance with the policy on valuation of properties for disposal.
- Do not spend more to obtain information than the information is worth.

Chapter 7 Initial Recognition of Tangible Capital Assets

1.0 Establishing Opening Values without Historical Cost Records

When a local government does not have historical cost accounting records for its tangible capital assets, it will need to use other methods to estimate the cost and accumulated amortization of those assets. It may be possible to derive information for recording tangible capital assets from records of local government departments that manage those assets.

Alternatively, the initial valuation could be based on:

- **Reproduction cost**, which is based on the attributes of the assets a local government currently owns. It is the cost of reproducing an asset in substantially identical form. It does not attempt to take into account impacts on costs such as changes in technology or construction methods.
- **Replacement cost**, adjusted to take into account any major differences between an actual asset and a replacement asset. That is, the current replacement cost is the amount of cash or other consideration that would be needed to acquire an asset having equivalent service potential to that of the asset presently owned. It would take into account changes in technology. It would be based on the estimated present cost of constructing the existing asset or component of the asset by the same or (similar method) of construction using the same or similar materials. Replacement cost may be established by reference to the price of a similar asset in an active and liquid market.
- **Market value**, where there is an open market for an asset. May be available for many types of assets such as buildings or unoccupied land. May rely upon appraisals.
- **Fair value**, where there may not be an active market for an asset, but a valuator, applying different valuation approaches and by referencing market data and reasoning, can arrive at a value.

In all cases, the estimated current value is adjusted by a deflation factor to estimate the original historical cost of the asset when acquired, constructed or developed. Deflation can be accomplished using appropriate specific price indexes such as a construction index available through Statistics Canada. If the exact date of acquisition is unknown, a reasonable estimate is acceptable. The resultant estimated historical cost less salvage value is amortized from the date of acquisition to the current date to reflect the remaining useful life of the asset.

There is a general preference for use of the reproduction cost model for the following reasons:

- Replacement cost is based on the cost of an asset not yet owned. Replacement cost to provide the same level of service may be more or less than original cost. Recognizing cost increases or efficiencies could skew the reported costs of services in the statement of operations.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

- Reproduction cost is based on the existing qualities of the assets currently owned and does not introduce amounts for new and improved infrastructure.

The terms replacement cost or net current replacement cost should not be confused with the term depreciated replacement cost (DRC). DRC refers specifically to a method used by professional valuers to arrive at a surrogate for market value. The method is commonly applied to the valuation of a specialized asset having no readily available or otherwise dependable market data to analyze in developing a market value estimate. In this context, valuers use the term depreciation to refer to any loss in value from the estimate of total replacement or reproduction cost attributable to physical deterioration, functional (technical) obsolescence or economic (external) obsolescence. It is not the same as the accounting concept of depreciation (see Figure 7).

2.0 Asset Acquired at No or Nominal Cost

Where an asset is acquired at no or nominal cost, its cost is its fair value at the date of contribution or acquisition. Fair value is defined as the amount of consideration that would be agreed on in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act. Fair value may be determined using market value or appraisal values. Costs could be estimated based on the costs of similar acquired or constructed assets or engineering estimates of the cost of replacing the various components. It is important to recognize a cost to ensure that the stock of tangible capital assets is complete. In unusual circumstances, where it's not possible to estimate fair value, the tangible capital asset would be recognized at nominal value. For recognition purposes, nominal value is an estimate of what the asset may have cost.

3.0 Fully Amortized Assets

Some local government tangible capital assets still in use may not have any unamortized cost remaining because of their age and the amortization period set for that type of tangible capital asset. A record of such tangible capital assets would, however, be required for asset control purposes. If a local government has the information to estimate the historical cost and accumulated amortization of such fully amortized assets, that information would be recorded in the accounting records. Where a local government does not have this detailed information, it would record them at an initial value equal to their residual value, where the residual value is material and estimable, or at nominal value.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Figure 7

Illustration of Difference between Accounting and Valuation Techniques for Specialized Assets (limited or non-market assets)

Description	Valuation	PSAB
Objective	Estimation fair value today	Estimation of original historical cost and accumulated amortization
Methodology	Estimated depreciated replacement cost: - depreciation is a valuation allowance for any loss in value from the estimate of total replacement or reproduction cost attributable to physical deterioration, functional (technical) obsolescence, or economic (external) obsolescence of existing asset.	Deflated reproduction or replacement cost: - estimate of historical cost of existing or similar asset - amortization is an accounting estimate for consumption of the asset over its useful life to date attributable to physical deterioration, functional (technical) obsolescence, or economic (external) obsolescence.
Illustration		
Facts: Local government has specialized asset with an estimated useful life of 10 years. The asset is 5 years old.		
Reproduction Cost	Valuation \$100,000	PSAB \$100,000
Deflated Cost	N/A	\$ 87,000
Depreciation/Amortization	<u>\$ 50,000</u>	<u>\$ 43,500</u>
Depreciated Replacement Cost/ Net Book Value	<u>\$ 50,000</u>	<u>\$ 43,500</u>

4.0 Pre and Post-Adoption Asset Classes

Although a local government may wish to adopt a component approach to accounting for certain complex tangible capital assets to meet the requirements of the new accounting standard, it may be concerned about trying to allocate historical costs of existing assets to their components. A local government may have two different asset classes within an asset category: one for its pre-adoption assets and one for its post-adoption assets. Component accounting could be used for post-adoption assets acquired, constructed or developed.

5.0 Completing the Valuation

5.1 Asset Valuers

Once the asset inventory is complete, the next step will be to assign a value to the assets. Valuers could be corporate accounting staff, asset managers, temporary staff, experts or a combination. Regardless, they will need to be familiar with the process.

Steps in valuing assets include:

- develop valuation policies, including the valuation method, for each class of asset;
- decide whether assets within those classes are to be valued;
- prepare instructions for valuers;
- collate information required by valuers;
- select valuers; and
- perform management review of valuations.

5.2 Valuation Policies

The following example of an accounting policy illustrates the use of valuations in the determination of opening balances.

Example: Accounting Policy – Initial Recognition of Tangible Capital Assets

In some cases, an asset's original cost may be available but it may have had major improvements since that date. For example, a community centre may have incurred significant capitalized development costs. If original contract details for this work are not available, estimations of development costs can be used to determine opening balances.

5.3 Full Population or Sample

It is possible to use stratified sampling when establishing the value of assets.

For example, assume that, in 2008, a local government has 65 lane-kilometres of roads in a secondary road subsystem. If the current construction cost of similar roads is \$1 million per lane-kilometre, the estimated total current replacement cost of the secondary road subsystem is \$65 million ($\$1 \text{ million} \times 65$). If the roads have an estimated weighted-average age of 15 years, 1993 is considered to be the acquisition year. Based on the available construction price indices, the cost of constructing a secondary road in 1993

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

would be 69% of today's cost. The estimated historical cost of the secondary road subsystem, therefore, is \$44.9 million ($\$65 \text{ million} \times 0.69$). This local government would report the subsystem in its financial statements at that amount, less accumulated depreciation.

It may be possible to develop a computer based model that will provide an estimate of historic cost for real property and infrastructure assets. In other cases, it may be appropriate to apply actuarial methods.

It may be impractical to require capitalization of all existing tangible capital assets, such as infrastructure, because of their age. For example, many local governments have infrastructure that was put into use 50 or 100 years ago, or more. Capitalizing an estimate of costs incurred for some aged infrastructure assets is not likely to significantly change the cost of services, operating results and financial position of most local governments after transition to the new standard. When deciding whether to capitalize the costs of these assets, consideration should be given to the cost to develop information versus the benefits derived from more accurate information on cost of services, operating results and financial position.

5.4 Instructions for Valuers

Valuers require detailed instructions on the valuation policies and specific details of assets to be valued. An example of the considerations to take into account when compiling such instructions is found in the United Kingdom National Audit Office's *Resource Accounts: Preparing for Audit* (London: United Kingdom National Audit Office, November 1997). In particular, it is important to be aware that the effectiveness of a valuation exercise will largely depend on the quality of the instructions.

Suggestions for developing instructions for valuers include:

- Requiring valuers to establish the completeness of the list of assets at a given site.
- Requiring valuers to provide a value and an estimated useful life for each asset.
- Using a relatively low capitalization threshold for valuations and applying this threshold to gross values (as opposed to net values). The threshold used in the asset register can be higher than this, but sufficient data is required to make an informed judgment.
- Being explicit about whether valuations are to include or exclude relevant taxes or duties.
- Stating which set of professional valuation guidelines is applicable.

5.5 Information Required by Valuators

The data required by valuers for land is likely to include:

- area;
- ownership and title;
- planning consents and agreements;
- restrictive covenants, easements and rights of way;
- use(s); and
- access.

The data required by valuers for buildings is likely to include:

- type of building, roof and heating system;
- year of construction;
- gross external area;
- net internal area;
- number of stories;
- estimated replacement cost for insurance purposes;
- condition surveys; and
- maintenance records and expenditures.

5.6 Selection of Valuers

Qualified external valuers generally provide reliable and independent valuations. The cost of obtaining valuations may, however, dictate the use of some internal staff to value some assets. This may be more appropriate where computer-based models, price indices and catalogues can provide approximations of historic cost or current value. Where internal staff perform valuations, it is important that the valuations are in full accordance with the best practice followed by professional valuers and that sound audit trails (including references to price indices and catalogues used) are established.

5.7 Management Review of Valuation

Management is still responsible for the accuracy of valuations, even when they are performed by external valuers. Before valuations are entered into asset registers, management needs to review them for completeness and reasonableness. Management should document that this review has occurred, any issues identified and subsequent action taken. Some of the problems that can arise include:

- assets not owned by a local government being included in its records;
- assets owned by a local government not being included; and
- assets identified as being held for disposal being valued on a continuing use basis.

Reconciliations between management records, the asset register and valuations are useful checks to ensure that all assets owned have been valued and that all assets valued are indeed owned. Such reconciliations provide important audit evidence.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

After the valuation data have been entered into the asset register, only the transactions that took place after the valuation date should be reflected in that register. Copies of valuation reports form supporting documentation for opening balances.

5.8 Check for Asset Impairment

When recording the initial value of a tangible capital asset, consideration would be given to whether the asset's estimated net book value exceeds the future economic benefits expected from its use and, therefore, whether a write-down is required to establish a more appropriate cost and accumulated amortization amount for the asset.

Chapter 8 Local Government Reporting Model

1.0 Conceptual Framework

A research study commissioned by the CICA in 1980 found “financial statements of Canadian governments are now so complex and varied in presentation and terminology that even persons familiar with government accounting have difficulty in appreciating the significance of information conveyed.”⁸ In 1980, senior Canadian governments faced significant fiscal challenges and users found financial statements issued by those governments lacking in consistency and transparency. PSAB’s origin dates back to this research study.

Over the last 25 years, PSAB has brought a significant level of consistency to government financial reporting. Considerable effort was invested in developing consensus on accounting and reporting standards for governments and, as a result, they are now based largely on codification of existing practices and compromises. In October 2002, PSAB approved a conceptual framework intended to add consistency and robustness to the standard-setting process.

The conceptual framework establishes the:

- Fundamental nature and purpose of what information should be provided in the summary financial statements.
- Objectives of summary financial statements.
- Qualitative characteristics of information provided.
- Definition of the elements of summary financial statements.
- Concepts for recognition, measurement and display.

The conceptual framework provides the guidelines or boundaries against which accounting issues being considered can be evaluated to ensure the most appropriate method of reporting is recommended. It ensures internal consistency within the *PSA Handbook* and ensures transparency in Board decisions. Stakeholders can understand the rationale behind the decisions made.

It is equally important that stakeholders understand how the conceptual framework is applied to developing financial reporting standards. This will help them interpret the information in the financial statements. It will also help preparers and auditors address financial reporting issues when no specific guidance is available.

With the implementation of tangible capital asset accounting, local governments must adopt the full accrual basis of accounting and the government reporting model.

The following sections deal with some of the key concepts. Have a look at PS 1000 through PS 1200 to learn more about the conceptual framework.

⁸ *Financial Reporting by Local governments*, Research Study (Toronto: The Canadian Institute of Chartered Accountants, 1980), p. 2.

2.0 Key Concepts

2.1 Elements of Financial Statements

Under the conceptual framework, financial statements are based on an economic resources model. The model attempts to measure the net economic resources of a government at a particular point in time.

There are two types of elements of financial statements: those that describe the economic resources, obligations and accumulated surplus or deficit of a government at a point in time, and those that describe changes in economic resources, obligations and accumulated surplus or deficit over a period of time. Notes to financial statements, which are useful for clarifying or further explaining the items in financial statements, while an integral part of the statements, are not considered to be an element.

The elements of government financial statements include: assets (both financial and non-financial), liabilities, revenues, and expenses. Revenues and expenses and, therefore, operating results for an accounting period, result only from changes in assets and liabilities. Only items that meet the definition of an asset or liability are reported on the statement of financial position. That is why the definitions of assets and liabilities are critical and the underpinning of the conceptual framework.

Assets are economic resources controlled by a government as a result of past transactions or events and from which future economic benefits may be obtained. Liabilities are present obligations of a government to others arising from past transactions or events, the settlement of which is expected to result in the future sacrifice of economic benefits.

Assets and liabilities are the key concepts in the conceptual framework. No revenues or gains can occur unless an asset increases or a liability decreases, and no expense or loss can occur unless an asset decreases or a liability increases. As a result, earnings reflect an increase in net assets and losses a decrease in net assets.

The difference between assets and liabilities is the accumulated surplus or deficit. The net year-over-year change in assets and liabilities is the operating surplus or deficit.

2.2 Key Indicators in Local Government Reporting Model

Financial statements need to provide information on a government's financial position in terms of its assets and liabilities, its net debt, its accumulated surplus or deficit and its tangible capital assets and other non-financial assets at the end of the accounting period. Financial statements also need to provide a meaningful summary of the sources, allocation and consumption of the government's economic resources in the accounting period, how the activities of the period have affected the government's net debt, how the government financed its activities in the period and how it met its cash requirements. Each indicator gives readers messages about the state of a government's finances:

2.2.1 Net debt/net financial asset position

Net debt/financial asset position is calculated as the difference between financial assets and liabilities. Net debt position is often called the government's "future revenue requirements" because this indicator provides a measure of the future revenues required to pay for past transactions and events. It provides an indication of the affordability of additional spending. Conversely, net financial asset position is an indicator of the financial resources a government has available to finance future operations.

2.2.2 Accumulated surplus⁹/deficit

The accumulated surplus/deficit position represents a government's net economic resources. An accumulated surplus is that amount by which all assets (financial and non-financial) exceed all liabilities. An accumulated surplus indicates that a government has net resources (financial and physical) that can be used to provide future services. An accumulated deficit means that liabilities are greater than assets and that the government has been financing annual operating deficits by borrowing. The extent of a government's accumulated surplus/deficit is an indication of its ability to provide future services.

2.2.3 Annual surplus/deficit

The annual surplus/deficit measures, in money terms, whether a government has maintained its net assets in a year. For example, if a local government's revenues equal its expenses in the year, so that its annual results are \$0, the government is said to have maintained its net assets in the year. The annual surplus or deficit shows whether the revenues raised in the year were sufficient to cover the year's costs. The costs of the year include the cost of using existing and new capital assets to provide services.

2.2.4 Change in net debt

The change in net debt in the year is a measure of whether the revenues raised were sufficient to cover government spending. The spending in the year would include any capital expenditures to acquire new capital assets. An increase in net debt means that more future revenues will be needed to pay for past transactions and events. And, if a government is spending on capital assets, the statement of change in net debt will highlight the actual level of capital spending in the year and compare it to planned capital spending.

2.2.5 Cash flows

Cash flows are reported on the statement of cash flow, which shows the change in cash in the year as well as highlights the sources and uses of cash. That is, this statement highlights capital activities, including the use of cash to acquire capital assets. A local government may report cash flows from operating activities using either the direct method or the indirect method. The difference between the two formats relates solely to how the cash flows from operating activities are presented – directly, or indirectly by reconciling from the annual surplus or deficit.

⁹The term net assets could be used to describe net accumulated surplus.

3.0 Financial Statement Presentation

Financial statements should include a statement of financial position, a statement of operations, a statement of change in net debt and a statement of cash flow. These statements are mandatory. The government may provide additional supplementary information in schedules and notes to the financial statements.

3.1 Statement of Financial Position

The statement of financial position highlights four key figures that describe the financial position of the government at the reporting date.

- a) The cash resources of the government.
- b) The net debt position of the government (difference between its liabilities and financial assets).
- c) The non-financial assets of the government (tangible capital assets, inventories of supplies and prepaid expenses, etc).
- d) The accumulated surplus or deficit of the government (sum of the net debt of the local government and its non-financial assets). This indicator represents the net assets of the government.

Each of the three remaining government financial statements illustrates the change in one of the four key figures in the government's financial position.

3.2 Statement of Operations

The statement of operations reports the surplus or deficit from operations in the accounting period. The statement displays the cost, including the consumption of non-financial assets, of government services provided in the period, the revenues recognized in the period and the difference between them. It measures, in monetary terms, the extent to which a government has maintained its net assets in the period.

3.3 Statement of Change in Net Debt/Net Financial Assets

The statement of change in net debt/net financial position reports the extent to which the expenditures, including investment in capital assets and changes in other non-financial assets, of the accounting period are offset by the revenues recognized in the period. This measure is displayed by reporting the items that explain the difference between the surplus or deficit from operations and the change in net debt for the period. This statement is a reconciliation of the annual surplus or deficit and the change in net debt.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

3.4 Statement of Cash Flow

The statement of cash flow reports the change in cash and cash equivalents in the accounting period, and how a government financed its activities in the period and met its cash requirements.

3.5 Illustrative Example Financial Statements

The following are examples of the new financial statement for governments.

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

STATEMENT 1

CITY OF ANYWHERE CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT DECEMBER 31, 20X9

	20X9	20X8
	(in \$000's)	
Financial assets		
Cash and cash equivalents	1,577	1,366
Accounts receivable	1,864	1,708
Portfolio investments	7,031	6,932
Business enterprise equity	331	207
Inventories for resale	109	135
	<u>10,912</u>	<u>10,348</u>
Liabilities		
Accounts payable and accrued liabilities	2,383	2,644
Debt	9,363	9,796
Pensions and other employee benefits	4,813	4,890
Other accrued liabilities	1,703	1,841
	<u>18,262</u>	<u>19,171</u>
Net debt	<u>(7,350)</u>	<u>(8,823)</u>
Non-financial assets		
Tangible capital assets	87,218	97,215
Inventories of supplies	112	222
Prepaid expenses	30	20
	<u>87,360</u>	<u>97,457</u>
Accumulated surplus	<u>80,010</u>	<u>88,634</u>

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

STATEMENT 2

CITY OF ANYWHERE CONSOLIDATED STATEMENT OF OPERATIONS for the year ended December 31, 20X9

	<u>20X9</u> <u>Budget</u>	<u>20X9</u> <u>Actual</u>	<u>20X8</u> <u>Actual</u>
		(in \$000's)	
Revenue			
Property taxes	8,034	8,628	9,503
User fees	3,381	3,746	3,788
Local government transfers	1,722	1,820	1,648
Fees, permits, licenses and fines	581	651	669
Investment income	409	610	747
Income from enterprises	50	525	97
Miscellaneous revenues	100	342	402
Total revenues	<u>14,277</u>	<u>16,322</u>	<u>16,854</u>
Expenses			
Protection to persons and property	4,329	4,061	3,938
Water and sewerage	8,541	8,626	8,457
Roadways and transportation	7,360	7,557	7,449
Recreation and culture	3,094	3,310	3,269
General local government	832	899	777
Other	93	493	413
Total expenses	<u>24,249</u>	<u>24,946</u>	<u>24,303</u>
Annual deficit	(9,972)	(8,624)	(7,449)
Accumulated surplus, beginning of year	<u>88,634</u>	<u>88,634</u>	<u>96,083</u>
Accumulated surplus, end of year	<u>78,662</u>	<u>80,010</u>	<u>88,634</u>

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

STATEMENT 3

CITY OF ANYWHERE CONSOLIDATED STATEMENT OF CHANGE IN NET DEBT for the year ended December 31, 20X9

	<u>20X9</u> <u>Budget</u>	<u>20X9</u> <u>Actual</u>	<u>20X8</u> <u>Actual</u>
		(in \$000's)	
Annual deficit	(9,972)	(8,624)	(7,449)
Acquisition of tangible capital assets	(294)	(294)	(250)
Amortization of tangible capital assets	10,226	10,226	10,230
(Gain)/loss on sale to tangible capital assets		(5)	(19)
Proceeds on sale of tangible capital assets		46	72
Write-downs of tangible capital assets		24	44
	<u>(40)</u>	<u>1,373</u>	<u>2,628</u>
Acquisition of supplies inventories			(324)
Acquisition of prepaid expenses		(30)	(20)
Consumption of supplies inventories		110	102
Use of prepaid expense		20	
	<u>0</u>	<u>100</u>	<u>(242)</u>
(Increase)/decrease in net financial assets/net debt	(40)	1,473	2,386
Net financial assets (net debt), beginning of year	(8,823)	(8,823)	(11,209)
Net financial assets (net debt), end of year	(8,863)	(7,350)	(8,823)

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

STATEMENT 4

CITY OF ANYWHERE CONSOLIDATED STATEMENT OF CASH FLOW (indirect method) for the year ended December 31, 20X9

	20X9	20X8
	Actual	Actual
	(in \$000's)	
Operating transactions		
Annual deficit	(8,624)	(7,449)
Non-cash items including amortization	10,504	10,522
Prepaid expenses	(30)	(20)
Change in deferred revenue	(23)	16
Other	(819)	77
Cash provided by operating transactions	<u>1,008</u>	<u>3,146</u>
Capital transactions		
Proceeds on sale of tangible capital assets	46	72
Cash used to acquire tangible capital assets	(294)	(250)
Cash applied to capital transactions	<u>(248)</u>	<u>(178)</u>
Investing transactions		
Proceeds from portfolio investments	1,030	4,126
Portfolio investments	(1,129)	(4,369)
Other	(17)	(15)
Cash provided by (applied to) investing transactions	<u>(116)</u>	<u>(258)</u>
Financing transactions		
Proceeds from debt issues	13,970	3,694
Debt repayment	(14,403)	(6,175)
Cash applied to financing transactions	<u>(433)</u>	<u>(2,481)</u>
Increase in cash and cash equivalents	211	229
Cash and cash equivalents, beginning of year	<u>1,366</u>	<u>1,137</u>
Cash and cash equivalents, end of year	<u><u>1,577</u></u>	<u><u>1,366</u></u>

Guide to Accounting for and Reporting Tangible Capital Assets

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

STATEMENT 4

CITY OF ANYWHERE CONSOLIDATED STATEMENT OF CASH FLOW (direct method) for the year ended December 31, 20X9

	20X9	20X8
	Actual	Actual
	(in \$000's)	
Operating transactions		
Cash received from:		
Taxes	9,239	8,267
Transfers	1,541	1,943
User fess	3,618	4,808
Fees, permits, licenses and fines	581	791
Enterprises	1,401	983
Investments	564	675
Other	1,176	1,016
	<u>18,120</u>	<u>18,483</u>
Cash paid for:		
Salaries, wages, employment contracts and benefits	7,345	7,276
Material and supplies	7,192	5,936
Contracted services	2,074	1,290
Financing charges	501	835
	<u>17,112</u>	<u>15,337</u>
Cash provided by operating transactions	<u>1,008</u>	<u>3,146</u>
Capital transactions		
Proceeds on sale of tangible capital assets	46	72
Cash used to acquire tangible capital assets	(294)	(250)
Cash applied to capital transactions	(248)	(178)
Investing transactions		
Proceeds from portfolio investments	1,030	4,126
Portfolio investments	(1,129)	(4,369)
Other	(17)	(15)
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GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

SCHEDULE

CITY OF ANYWHERE CONSOLIDATED SCHEDULE OF TANGIBLE CAPITAL ASSETS AS AT DECEMBER 31, 20X9 (in \$000's)

	Opening Balance	Additions	Disposals	Write- downs	Balance End of Year	Accumulated Amortization Beginning of Year	Deletions	Net Carrying Amount Beginning of Year	Amortization	Acc- umulated Amort'n End of Year	Net Carrying Amount End of Year
Land	3,015		25		2,990		3,015			0	2,990
Buildings	4,251	10		24	4,237	981	3,270		355	1,336	2,901
Roads	47,033	92			47,124	17,637	29,395		3,191	20,828	26,296
Sanitary and storm sewers	60,337	118			60,454	22,626	37,710		4,094	26,720	33,734
Parks and recreation	12,657	30			12,687	2,921	9,736		1,057	3,978	8,710
Traffic control and lighting	3,258	8			3,266	652	2,606		283	934	2,331
Transit	5,735	15			5,750	956	4,780		519	1,475	4,276
Fleet	4,561	12	45		4,528	760	3,801	29	413	1,144	3,384
Waste management facilities	1,335				1,335	445	890		97	542	793
Technology equipment	752	8			760	251	502		54	305	455
Other	2,264	1			2,266	755	1,510		164	919	1,347
	145,199	294	70	24	145,399	47,984	97,215	29	10,226	58,181	87,218

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

4.0 Presentation of Budget Amounts

One further essential feature of the government reporting model is the requirement to report both budget and actual numbers on the statements of operations and change in net debt/net financial assets. Consistency between financial plans and reporting of actual results is considered an essential part of accountability reporting.

Presentation of budgeted amounts in the financial statements provides important accountability information users can access to assess how the actual results of activities of the period compare with those originally planned and judge whether public economic resources were managed in accordance with the plan. Providing budget information makes it possible to identify variances, compute trends and analyze operations.

4.1 Budget Scope and Accounting Basis

Budgeted amounts should be presented for the same scope of activities and on a basis consistent with that used in each statement for actual amounts.

For the statement of operations, this means budgeted amounts are presented on a full accrual basis. In both cases, budgeted amounts are presented on the same basis of consolidation as actual results. That is, the statement would include budgeted amounts for all local government organizations in a local government's reporting entity.

4.2 Budgets Prepared on Different Scope and Accounting Basis

A recent survey of senior level government budgeting practices found that, "for the fiscal year ended March 31, 2004, the budgets, estimates and the summary financial statements for almost all local government jurisdictions are on the accrual basis."¹⁰ Local governments have resisted adopting the full accrual basis for budgeting. Many argue that cash-based budgeting ensures a rigorous tracking of cash flows and recognizes the short-term effects of policies on the cash position of the local government. Cash-based budgeting allows elected officials the greatest control over spending. Today's balanced budget legislation may force local governments to prematurely raise taxes to finance amortization and other items such as employee future benefits. They may then have to reduce programs and services to balance budgets and keep property taxes at politically acceptable levels.

If a local government's budgets are prepared on a different basis or for a different scope than the actual amounts reported in the financial statements, PSAB requires them to provide a link to the financial statements so that its council understands how the actual results compare to the results planned.

¹⁰ Paul-Emile Roy, "Accounting bases used in Canadian local government budgeting," *CA Magazine* (Jan/Feb2005), pp.18-20.

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

4.2.1 Scope different

When the scope of financial activity reported in the fiscal plan is not the same as that reported in the financial statements, it may be necessary to restrict the comparison of actual and budgeted results on the statements of operations and changes in net debt to the scope of financial activity reported in the budget or main estimates of expenditures. A comparison of the budget and actual results based on the same scope would be included in a note to the financial statements or in a supporting schedule. To ensure that this disclosure is reconcilable to the information reported in the financial statements, a local government would highlight the differences between the reporting entity used for the financial statements and that used for the fiscal plan.

4.2.2 Basis of accounting different

When a local government's fiscal plan is not prepared on a basis consistent with that used to report the actual results, planned results should be reported on the same basis as that used to report the results of the current period. In these circumstances, budgeted amounts would be restated to reflect the same basis of accounting as used for actual amounts. It would be necessary to provide a reconciliation of the restated information with that originally presented in the fiscal plan.

4.3 Effect of Accrual Budgeting on Tax Rates and User Fees

The setting of rates should be viewed as a pricing exercise. Local governments do not have to determine rates according to an accrual-based budget. They can continue to set rates based on the existing cash basis. That is, local governments must set rates based on cash requirements to meet obligations coming due in the period, and other financing requirements for future operations considering operating expenditures, reserves and reserve funds, capital expenditures to be financed from current revenues, etc.

Traditional budgeting has not been concerned about managing a local government's net debt and net asset position. Yet, managing its financial position is a critical component of a local government's responsibility. The annual operating surplus or deficit is only one component of the accountability equation.

Since full accrual-based accounting and reporting will display the effects of policy decisions on budget rate setting, a local government should consider preparing pro-forma statements based on the accrual-based budget. This will demonstrate how the budget and rate decisions will affect the key indicators of its financial position.

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Chapter 9 Financial Statement Issues – External Audits

1.0 Preparing for the External Audit

This section considers how a local government can prepare for an external audit after the implementation of tangible capital asset accounting. The main objective of this section is to ensure that external auditors can complete an efficient audit and issue an unqualified opinion on the summary financial statements. To help local governments reap the benefits of the work they have put into the transition, this section discusses a selection of management responsibilities related to the accounting for, and reporting of, tangible capital assets. This section is not comprehensive. It is intended to provide examples of the types of planning and preparation that may be required to attain the goal of an unqualified audit opinion.

Management and staff can help the audit go smoothly and minimize the risk of a qualified audit report by:

- understanding management’s responsibility;
- maintaining audit trails;
- having supporting information and schedules ready; and
- being aware of common pitfalls and taking steps to avoid their occurrence.

2.0 Management’s Responsibility

The preparation of financial statements is the responsibility of management. Management is responsible for the assertions made in the financial statements. Management is also responsible for a local government’s systems, controls, validations and reviews that provide assurance regarding:

- completeness – there are no unrecorded assets, events or other undisclosed items relating to assets;
- accuracy – the cost and other information related to the assets is accurate;
- existence – the asset exists at a given date;
- rights and obligations – the asset properly pertains to the local government at a given date;
- valuation – the asset is recorded at an appropriate carrying value; and
- presentation and disclosure – an item is disclosed, classified and described in accordance with the applicable accounting standards/regulations.

Management should document audit trails that link each transaction or balance from source to account and back. It is the ability to track from the financial statements back through the prime accounting records to the underlying transactions and events (and back again) that permits the auditor to substantiate the individual account figures. Audit trails include the original source documentation to support transactions.

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Some of the supporting schedules that may be required for the preparation and audit of the financial statements include:

- a copy of the asset register by asset category;
- a reconciliation of opening and closing balances of each class of asset;
- a copy of the inventory procedures and the inventory report;
- a reconciliation of the inventory report to the asset register;
- a list of write-offs/write-downs;
- a schedule of spending subsequent to purchase showing which spending has been capitalized in accordance with the policy on capitalization;
- a schedule of any revenue or expense to be recognized in the statement resulting from the sale of assets; and
- valuation reports, where applicable, including the basis, date and name and qualifications of the valuator.

Management should consult with the auditor on specific documentation requirements during the implementation planning.

3.0 Opening Balances

Evidence to support opening balances of assets can be provided by the following documents and procedures:

- a reconciliation of the initial asset register totals to valuation reports;
- copies of confirmations from asset holders that asset registers are accurate and complete;
- a record of adjustments made to the asset register following review by asset holders;
- lists of fixed asset additions, enhancements and disposals, with documentation of validation procedures performed on them; and
- reasonableness checks on amortization and revaluation (to include comparisons with any prior period figures available).

Opening balances need to:

- be recognized and valued according to the chosen accounting policies;
- be accurately entered into the accounting system;
- be consistent with any figures brought forward from the cash-based accounts, for example, suspense accounts;
- have clearly identifiable, documented sources;
- show evidence of management review for ownership, accuracy and completeness; and
- show evidence of physical verification, where appropriate.

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

4.0 Financial Statement Disclosures

A local government will need to ensure that its financial systems and records can provide the information required to meet the disclosure requirements of accounting standards, to monitor and assess potential financial risks associated with assets (for example, environmental clean up costs) and to provide data for voluntary disclosures.

Examples of disclosures required by accounting standards include:

- any class of tangible capital assets not recognized under the transitional provisions in PS 3150 and PSG 7;
- the existence and amounts of restrictions on title for tangible capital assets pledged as securities for liabilities;
- the amount of expenditures on tangible capital assets in the course of construction (work-in-progress); and
- the amount of commitments for the acquisition of tangible capital assets.

5.0 Common Pitfalls

Common pitfalls include:

- physical inventories not being performed according to instructions (including breach of internal control by using staff with responsibility for assets to perform the inventory);
- deficiencies in inventory procedures and unresolved discrepancies;
- missed expenditures on betterments subsequent to initial acquisition, particularly where the component basis is used – this can lead to the age and condition of components being misstated as the components may have been upgraded or replaced since initial recognition of the assets;
- poor implementation of asset systems (missing data, errors in initial data capture, poor conversion programs, etc.);
- lack of integration of asset registers to financial systems or other systems resulting in redundancy and duplicate data entry;
- tags/stickers used for recording asset register references on assets such as furniture and equipment being incorrect or not visible;
- policies, procedures and training not being in place to ensure the sustainability of the asset register (or components of it);
- assets being recorded at incorrect locations;
- depreciation rates and useful lives not reviewed regularly (leading to large numbers of assets fully depreciated despite having future value);
- acquisitions and disposals not recorded in a timely manner in asset registers or not processed in the general ledger;
- missing disposal documentation;
- lack of documentation to support the figures in the asset register;
- figures presented for audit not subjected to any prior management review;
- incomplete data on dates of acquisition (required for amortization calculations);

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

- errors in estimating useful life of assets;
- asset registers not regularly reconciled to subsidiary records;
- asset registers not regularly reconciled to the general ledger;
- not obtaining credible valuation reports.

Avoiding such pitfalls may help to avoid a reservation in the audit report.

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Chapter 10 Lessons Learned – Others

General lessons learned regarding the recognition of assets from other jurisdictions that have done the implementation include the following:

- Start early – sufficient lead time is critical.
- Obtain support from all concerned.
- Work very closely with external auditors.
- Be prepared to make some mistakes.
- Be pragmatic.
- The process is evolutionary.
- Phased recognition of classes of assets has both advantages and disadvantages.
- Integrated systems avoid a number of audit issues arising from interfaces.
- Ensure there is a good audit trail, including documentation for estimates and assumptions.

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

APPENDIX A

Generic Implementation Plan

Project Initiation

- Document project and obtain project approval
- Establish the steering committee
- Prepare detailed project plan(s)
- Establish project team
 - Project sponsor
 - Project manager
 - Project team (team leader/director and other staff)
- Identify required resources
- Obtain required resources

Detailed Scoping and Planning

- Document existing processes, procedures and legislative requirements (including existing accounting policies and systems)
- Identify proposed changes or areas of change (including proposed accounting policies and systems)
- Systems planning
- Identify structure/ownership of proposed systems
- Identify system requirements (existing and new systems)
- Identify control requirements
- Identify interfaces required
- Develop the chart of accounts
- Develop interfaces (if applicable)
- Develop new reporting requirements
- Audit
- Liaise with external auditor to assess impact of changes on audit process
- Identify role of internal audit during the change process
- Develop communications plan
- Prepare training strategies (for example, project team, accrual accounting and computer literacy)
- Develop change management strategy

Implementation Phase

- Initiate project management responsibilities and reporting structures
- Implement new systems/system changes
- Implement interfaces
- Develop detailed accounting policies
- Develop/amend supporting financial management policies and procedures

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

- Implement roles and responsibilities
- Deliver training
- Obtain approval to switch to new systems
- Implement other phased projects (for example, the recognition of specific categories of assets or liabilities may be phased)

Reporting

- Develop improved external and internal reporting
- Develop financial and non-financial performance measures
- Review controls and procedures that support the integrity of financial and non-financial information

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

APPENDIX B

Work Flow In Recognition and Reporting of Tangible Capital Assets

- Step 1 Develop policies:
- develop familiarity with authoritative standards including definitions and recognition criteria
 - identify asset classifications, components and segments (if applicable)
 - establish capitalization thresholds for each classification/component
 - establish measurement policies for each classification/component
 - develop policies for differentiating between betterment and expense for subsequent expenditures on tangible capital assets
 - develop depreciation policies and select depreciation methods for each classification/component
 - develop asset impairment policies
- Step 2 Information requirements:
- identify information requirements for each policy
 - identify information requirements for asset management purposes
 - plan timeframes for collection and verification of data
 - plan timeframes for development and implementation of systems
- Step 3 Development of asset register:
- review current systems and asset management practices
 - decide whether to retain/modify existing asset records/systems or develop new systems
 - decide whether an existing/new asset register is to be integrated with the general ledger
 - design and implement systems
 - identify responsible asset managers within the local government
 - identify and classify assets (see note 1 below)
 - validate data (ongoing) and resolve issues
 - review/develop asset management practices
- Step 4 Determine opening balances:
- develop methods for obtaining historic cost or estimated historic cost information
 - obtain historic cost (note 2)
 - estimate historic cost using alternative valuation methods (note 3)
- Ongoing Ongoing reporting matters:
- maintenance of record of all asset movements within the period and other information required for additional disclosure (note 4)
 - calculation of amortization
 - perform regular reviews of asset condition, estimates of useful life and amortization rates
 - Perform regular reviews for asset impairment

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Note 1:

To complete an asset register, a local government will have to:

- ensure complete identification of all potential assets applying:
 - definitions of tangible capital assets;
 - recognition criteria;
 - capitalization thresholds;
- collect data on existing assets:
 - description of asset;
 - identification of asset classification and components;
 - verification of ownership where necessary;
 - identification of restrictions/covenants over ownership;
 - year of acquisition;
 - expected useful life at time of acquisition;
 - assessment of condition and remaining useful life;
 - establish service hours, production or mileage to date, if applicable;
 - identify significant improvements made to the asset (date and estimated useful life of improvement);
 - estimated residual value.

Note 2:

Collation of historic cost data includes the identification of all costs to make an asset operational and betterments since acquisition.

Note 3:

Estimation of historical cost involves the valuation of any assets using one of the acceptable valuation methodologies (deflated reproduction cost, deflated replacement cost, etc.). The valuation of assets includes:

- deciding whether to value all assets or whether to use a sampling approach;
- identifying appropriate valuers for each class of asset;
- preparing instructions for valuers;
- collecting information required by valuers; and
- management review of estimated valuations.

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Note 4:

The identification of opening balances for tangible capital assets is merely the first step in the process of accounting for and reporting for tangible capital assets. Other steps are the:

- identification of closing balances;
- identification of all movements during the period;
- calculation of amortization;
- identification of audit issues and the development of plans to resolve these issues;
- development and testing of interfaces between the asset register and general ledger; and
- identification and collection of other asset information required to be disclosed in the financial statements.

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

APPENDIX C

Sample Tangible Capital Asset Policy

Disclaimer:

This policy is not intended to be comprehensive. It is intended to provide examples of the types of items that may be covered in a typical tangible capital asset policy. It should be used only as a guide in the preparation of a local government's policy. Actual contents and policies will be affected by the size of the local government; particular objectives of the local government in accounting for tangible capital assets; particular circumstances of the local government, etc.

City of Anywhere**SUBJECT: Accounting for Tangible Capital Assets****TYPE: Administrative****POLICY NUMBER: XXXXXX-06****AUTHORITY: City Treasurer****PURPOSE:**

The objective of this policy is to prescribe the accounting treatment for tangible capital assets so that users of the financial report can discern information about the investment in property, plant and equipment and the changes in such investment. The principal issues in accounting for tangible capital assets are the recognition of the assets, the determination of their carrying amounts and amortization charges and the recognition of any related impairment losses.

In addition the policy covers policy and procedures to:

- a) Protect and control the use of all tangible capital assets.
- b) Provide accountability over tangible capital assets.
- c) Gather and maintain information needed to prepare financial statements.

SCOPE:

This policy applies to all City departments, boards and commissions, agencies and other organizations falling within the reporting entity of the City.

DEFINITIONS:**Tangible Capital Assets:**

Assets having physical substance that;

- a) Are used on a continuing basis in the City's operations.
- b) Have useful lives extending beyond one year.
- c) Are not held for re-sale in the ordinary course of operations.

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Betterments:

Subsequent expenditures on tangible capital assets that:

- increase previously assessed physical output or service capacity;
- lower associated operating costs;
- extend the useful life of the asset; or
- improve the quality of the output.

Any other expenditure would be considered a repair or maintenance and expensed in the period.

Group Assets:

Assets that have a unit value below the capitalization threshold but have a material value as a group. Normally recorded a single asset with one combined value. Although recorded in the financial systems as a single asset, each unit may be recorded in the asset sub-ledger for monitoring and control of its use and maintenance. Examples could include personal computers, furniture and fixtures, small moveable equipment, etc.

Fair Value:

Fair value is the amount of consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.

Capital Lease:

A capital lease is a lease with contractual terms that transfer substantially all the benefits and risks inherent in ownership of property to the City. For substantially all of the benefits and risks of ownership to be transferred to the lessee, one or more of the following conditions must be met;

- a) There is reasonable assurance that the City will obtain ownership of the leased property by the end of the lease term.
- b) The lease term is of such a duration that the City will receive substantially all of the economic benefits expected to be derived from the use of the leased property over its life span.
- c) The lessor would be assured of recovering the investment in the leased property and of earning a return on the investment as a result of the lease agreement.

POLICY STATEMENTS:

Capitalization

Tangible capital assets should be capitalized (recorded in the fixed asset sub-ledger) according to the following thresholds:

- a) all land;
- b) all buildings;

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

- c) civil infrastructure systems (built assets such as roads, bridges, sewers, water, transit, parks, etc.) with unit cost of \$25,000 or greater;
- d) all others with unit cost of \$5,000 or greater.

Different thresholds may be used for group assets. Capitalize betterments to existing assets when unit costs exceed the threshold.

Categories

A category of assets is a grouping of assets of a similar nature or function in the City's operations. The following list of categories shall be used:

- land;
- buildings;
- equipment;
- roads;
- water;
- sewer;
- bridges;
- communication networks;
- motor vehicles;
- furniture and fixtures;
- computer systems (hardware and software).

Valuation

Tangible capital assets should be recorded at cost plus all ancillary charges necessary to place the asset in its intended location and condition for use.

1.1 Purchased assets

Cost is the gross amount of consideration paid to acquire the asset. It includes all non-refundable taxes and duties, freight and delivery charges, installation and site preparation costs, etc. It is net of any trade discounts or rebates.

Cost of land includes purchase price plus legal fees, land registration fees, transfer taxes, etc. Costs would include any costs to make the land suitable for intended use, such as pollution mitigation, demolition and site improvements that become part of the land.

When two or more assets are acquired for a single purchase price, it is necessary to allocate the purchase price to the various assets acquired. Allocation should be based on the fair value of each asset at the time of acquisition or some other reasonable basis if fair value is not readily determinable.

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

1.2 Acquired, Constructed or Developed assets

Cost includes all costs directly attributable (e.g., construction, architectural and other professional fees) to the acquisition, construction or development of the asset. Carrying costs such as internal design, inspection, administrative and other similar costs may be capitalized. Capitalization of general administrative overheads is not allowed.

Capitalization of carrying costs ceases when no construction or development is taking place or when the tangible capital asset is ready for use.

1.3 Capitalization of Interest Costs

Borrowing costs incurred by the acquisition, construction and production of an asset that takes a substantial period of time to get ready for its intended use should be capitalized as part of the cost of that asset.

Capitalization of interest costs should commence when expenditures are being incurred, borrowing costs are being incurred and activities that are necessary to prepare the asset for its intended use are in progress. Capitalization should be suspended during periods in which active development is interrupted. Capitalization should cease when substantially all of the activities necessary to prepare the asset for its intended use are complete. If only minor modifications are outstanding, this indicates that substantially all of the activities are complete.

1.4 Donated or Contributed Assets

The cost of donated or contributed assets that meet the criteria for recognition is equal to the fair value at the date of construction or contribution. Fair value may be determined using market or appraisal values. Cost may be determined by an estimate of replacement cost. Ancillary costs should be capitalized.

Componentization

Tangible capital assets may be accounted for using either the single asset or component approach. Whether the component approach is to be used will be determined by the usefulness of the information versus the cost of collecting and maintaining information at the component level.

Factors to consider when determining whether to use a component approach include:

- a) Major components have significantly different useful lives and consumption patterns than the related tangible capital asset.
- b) Value of components in relation to the related tangible capital asset.

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Civil infrastructure systems should use the component approach. Major components should be grouped when the assets have similar characteristics and estimated useful lives or consumption rates.

Amortization

The cost, less any residual value, of a tangible capital asset with a limited life should be amortized over its useful life in a rational and systematic manner appropriate to its nature and use. The amortization method and estimate of useful life of the remaining unamortized portion should be reviewed on a regular basis and revised when the appropriateness of a change can be clearly demonstrated.

Useful life is normally the shortest of the asset's physical, technological, commercial or legal life.

Generally, the City uses a straight-line method for calculating the annual amortization. A comprehensive list of estimated useful lives of assets and amortization rates is attached. *(Local government should develop a schedule of appropriate amortization methods and rates for each asset category/class that takes into account their unique nature and use.)* City departments, boards and commissions, agencies and other organizations are responsible for establishing and utilizing an appropriate amortization methodology and rate for assets acquired. City departments, boards and commissions, agencies and other organizations are responsible for establishing and utilizing an appropriate estimated useful life for assets acquired.

Disposal

Disposal of tangible capital assets that are moveable personal property is the responsibility of the Manager of Purchasing Services unless delegated to operating departments. Department heads should notify the Manager when assets become surplus to operations.

Disposal of real property will be the responsibility of facilities services.

When other constructed tangible capital assets are taken out of service, destroyed or replaced due to obsolescence, scrapping or dismantling, the department head or designate must notify corporate services of the asset description and effective date. The corporate services department is responsible for adjusting the asset registers and accounting records recording a loss/gain on disposal.

Capital Leases

Account for a capital lease as acquiring a capital asset and incurring a liability. Account for a lease as an operating lease when the net present value of the future minimum lease payments or fair value, which ever is less, is less than \$10,000.

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

APPENDIX D

Glossary of Terms

Amortization is the accounting process of allocating the cost less the residual value of a tangible capital asset to operating periods as an expense over its useful life in a rational and systematic manner appropriate to its nature and use. Amortization expense is an important part of the cost associated with providing local government services, regardless of how the acquisition of tangible capital assets is funded. Depreciation accounting is another commonly used term to describe the amortization of tangible capital assets.

Assets are economic resources controlled by a local government as a result of past transactions or events and from which future economic benefits may be obtained. Assets have three essential characteristics:

- a) they embody a future benefit that involves a capacity, singly or in combination with other assets, to provide future net cash flows, or to provide goods and services;
- b) the local government can control access to the benefit; and
- c) the transaction or event giving rise to the local government's control of the benefit has already occurred.

Asset impairment occurs when conditions indicate that a tangible capital asset no longer contributes to a local government's ability to provide goods and services, or that the value of future economic benefits associated with the tangible capital asset is less than its net book value.

Betterment is a cost incurred to enhance the service potential of a tangible capital asset. Betterments increase service potential (and may or may not increase the remaining useful life of the tangible capital asset). Such expenditures would be included in the tangible capital asset's cost.

Capitalization threshold (recognition threshold) is the value above which assets are capitalized and reported in the financial statements.

Carrying amount is the amount at which a tangible capital asset is recognized after deducting any accumulated amortization and accumulated impairment losses.

Carrying costs are costs directly attributable to an asset's acquisition, construction or development activity where, due to the nature of the asset, it takes a long period of time to get it ready for its intended use. Typical carrying costs could include:

- technical and administrative work prior to commencement of and during construction;
- overhead charges directly attributable to construction or development; and
- interest.

Component is a part of an asset with a cost that is significant in relation to the total cost of that asset. Component accounting recognizes that each part might have a different

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

useful life and requires separate accounting for each component that has a different useful life than the whole asset does.

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 the asset's acquisition, construction, development or betterment, including installing the asset at the location and in the condition necessary for its intended use. 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. Capital grants would not be netted against the cost of the related tangible capital asset. The cost of a leased tangible capital asset is determined in accordance with Public Sector Guideline PSG-2 Leased Tangible Capital Assets.

Depreciation is the expense in an accounting period arising from the application of depreciation accounting.

Depreciation accounting is the accounting procedure in which the cost or other recorded value of a fixed asset less any estimated value on disposal is distributed over its useful life in a systematic and rational manner. It is a process of allocation, not valuation.

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. Refer also to the definitions of 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.

Expenses, including losses, are decreases in economic resources, either by way of outflows or reductions of assets or incurrence of liabilities, resulting from the operations, transactions and events of the accounting period. Expenses include transfer payments due where no value is received directly in return. Expenses include the cost of economic resources consumed in, and identifiable with, the operations of the accounting period. For example, the cost of tangible capital assets is amortized to expenses as the assets are used in delivering local government programs. Expenses do not include debt repayments or transfers to other local governmental units in a local government reporting entity.

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Fair value is defined in accounting standards as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction who are under no compulsion to act.

Financial assets are assets that could be used to discharge existing liabilities or finance future operations and are not for consumption in the normal course of operations. Financial assets include cash, investments, accounts receivable, inventory held for resale, etc.

Full accrual basis of accounting recognizes the financial effects of transactions in the period(s) in which they occur irrespective of when the cash has been received or paid. It requires that tangible capital assets be reported on the balance sheet (statement of financial position) at historical cost and expensed (amortized) in the annual results of operations over their estimated useful lives.

Gains can arise from peripheral or incidental transactions and events affecting a local government. Such transactions and events include the disposition of assets purchased for use and not for resale, and the liquidation or refinancing of debt.

Group assets are homogenous in terms of their physical characteristics, use and expected useful life. Group assets are amortized using a composite amortization rate based on the average useful life of the different assets in a group.

Local government reporting model describes the set of rules, parameters and content requirements that prescribe what must be presented in the summary financial statements. It prescribes the number, type and format of the financial statements, what information those financial statements should report, when it should be reported and how, as well as the notes required to explain what has been reported in the financial statements. It dictates the basis of accounting used in compiling a local government's accounting records.

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.

Liabilities are present obligations of a local government to others arising from past transactions or events, the settlement of which is expected to result in the future sacrifice of economic benefits. Liabilities have three essential characteristics:

- a) they embody a duty or responsibility to others, leaving a local government little or no discretion to avoid settlement of the obligation;
- b) the duty or responsibility to others entails settlement by future transfer or use of assets, provision of goods or services, or other form of economic settlement at a specified or determinable date, on occurrence of a specified event, or on demand; and
- c) the transactions or events obligating the local government have already occurred.

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Losses can arise from peripheral or incidental transactions and events affecting a local government. Such transactions and events include the disposition of assets purchased for use and not for resale, and the liquidation or refinancing of debt.

Market value is defined as the estimated amount for which a property would be exchanged on the date of valuation between a willing buyer and a willing seller in an arm's length transaction wherein the parties had each acted knowledgeably, prudently and without compulsion.

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.

Net book value of a tangible capital asset is its cost, less accumulated amortization and the amount of any write-downs.

Non-financial assets include tangible capital assets and other assets such as prepaid expenses and inventories of supplies. Non-financial assets are acquired, constructed or developed assets that are normally employed to deliver local government services, may be consumed in the normal course of operations and are not for sale in the normal course of operations.

Prospective application: A new accounting policy is applied only to events and transactions occurring after the date of the change and to any outstanding related balances existing at the date of the change. No cumulative catch-up adjustment is made to such balances.

Recognition threshold (capitalization threshold) is the value above which assets are capitalized and reported in the financial statements.

Residual value is the estimated net realizable value of a tangible capital asset at the end of its useful life to a local government.

Responsibility cost is allocating costs to a particular unit. It is similar in nature to activity-based cost where costs are allocated to activities rather than responsibility centres.

Retroactive application with no restatement of prior periods. A new accounting policy is applied to events and transactions from the date of origin of such items and a cumulative adjustment representing the effect of the change in an accounting policy on prior periods is made in the period in which the change is made. Two different treatments of the cumulative adjustment have been followed: an item reflected in annual results or an adjustment of the opening balance of the accumulated surplus/deficit.

Retroactive application with restatement of prior periods. The new accounting policy is applied to events and transactions from the date of origin of such items. The financial statements for each prior period presented for comparative purposes are restated to reflect the new policy. The balance of the accumulated surplus/deficit at the beginning

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

of the earliest period presented is restated to reflect the cumulative effect of the change on periods prior to that date.

Revenues, including gains, can arise from: taxation; the sale of goods; the rendering of services; the use by others of local government economic resources yielding rent, interest, royalties or dividends; or receipt of contributions such as grants, donations and bequests. Revenues do not include borrowings, such as proceeds from debt issues or transfers from other local governmental units in a local government reporting entity.

Tangible capital assets are non-financial assets having physical substance that:

- are held for use in the production or supply of goods and services, for rental to others, for administrative purposes or for the development, construction, maintenance or repair of other tangible capital assets;
- have useful economic lives extending beyond an accounting period;
- are to be used on a continuing basis; and
- are not for sale in the ordinary course of operations.

Service potential is tangible capital asset's output or service capacity, normally determined by reference to attributes such as physical output capacity, quality of output, associated operating costs and useful life.

Straight-line amortization allocates the cost less estimated residual value of a capital asset equally over each year of its estimated useful life.

Useful life is the estimate of either the period over which a local government expects to use a tangible capital asset, or the number of production or similar units that it can obtain from the tangible capital asset. The life of a tangible capital asset may extend beyond its useful life. The life of a tangible capital asset, other than land, is finite, and is normally the shortest of the physical, technological, commercial and legal life.

Write-down is a reduction in the cost of a tangible capital asset to reflect the decline in the asset's value due to a permanent impairment.

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

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International Federation of Accountants. International Public Sector Accounting Standards Board. IPSAS 17 Property, Plant and Equipment. (Paid subscription required.) <http://www.ifac.org/PublicSector/#Guidance>.

— Study 14. *Transition to the Accrual basis of Accounting: Guidance for Local governments and Local government Entities*. 2nd. Ed. Chapter 6. (Free download available at <http://www.ifac.org/Store/Details.tml?SID=102026702640546>)

GUIDE TO ACCOUNTING AND REPORTING FOR TANGIBLE CAPITAL ASSETS

Guidance for Local Governments and Local Government Entities that Apply the Public Sector Handbook

Province of Saskatchewan. Financial Administration Manual.

<http://www.gov.sk.ca/finance/FAM/manual.html>.

Other Useful Information

Price indices: <http://www.fhwa.dot.gov/programadmin/pt2006q1.cfm>

Estimating useful life of assets: <http://www.imtausa.org/polGASBusefulLife.doc>

Sample policies:

<http://policy.ciu10.com/article.php?story=20040514120229415>

<http://mainegov-images.informe.org/osc/pdf/saammanual/ch30capitalassets.pdf>

Municipal associations :

Ontario Association of Municipal Clerks and Treasurers

<http://www.amcto.com/db/assetmgmt.asp>

Ontario Municipal CAO's Benchmarking Initiative

<http://www.ombi.ca/accounting.asp>