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## Tangible Capital Assets – Time to Get Ready

The CICA's Public Sector Accounting Board (PSAB) has recently issued a number of new standards which will significantly alter financial reporting for local governments. These new standards include:

- PS 1000 – *Financial Statement Concepts*
- PS 1100 – *Financial Statement Objectives*
- PS 1200 – *Financial Statement Presentation*
- PS 3150 – *Tangible Capital Assets*

A summary of the requirements of each of these new standards can be found in the BDO Dunwoody LLP publication – *Accounting Update 2006*. The end result of these new sections is that local governments will be subject to the same reporting model as the senior levels of government. This reporting model is based on full accrual accounting.

All of these sections are applicable for fiscal years beginning on or after January 1, 2009 (December 31, 2009 year ends). In addition, PSG-7 – *Tangible Capital Assets of Local Governments* requires disclosure for fiscal years beginning on or after January 1, 2007 (December 31, 2007 year ends).

Each of these new sections is significant in its own right; however the work effort required to implement PS 3150 – *Tangible Capital Assets* warrants immediate attention. This publication provides details on the requirements of PS 3150 and the steps a local government should take to properly implement this new section.

### Introduction to Tangible Capital Assets

Currently local governments use the modified accrual basis of accounting; therefore, tangible capital assets are recorded as expenditures in the year of acquisition. Beginning in 2009, local governments must recognize all tangible capital assets as assets on the statement of financial position. The assets will then be amortized over their useful lives, with the related depreciation expense recorded as an expense on the statement of operations. This will ultimately impact the surplus or deficit of the local government.

This change will bring accounting for local governments in line with the senior levels of government. As well, the treatment is similar to accounting used by private sector companies.

When implementing Section PS 3150, governments should approach it as a project and manage it as such by establishing a Tangible Capital Assets project plan. Governments should also look beyond PSAB compliance.

The tangible capital asset inventories that will be built to comply with Section PS 3150 could be used to develop asset management plans and financing plans which integrate asset needs with financing strategies.

The main steps in the initial implementation of Section PS 3150 include:

1. Creating a Tangible Capital Asset Inventory
2. Valuing the Tangible Capital Assets
3. Depreciating the Tangible Capital Assets

## **Creating a Tangible Capital Asset Inventory**

### ***Definition of Tangible Capital Asset***

Before you can begin to create your inventory, you must understand the definition of a tangible capital asset. PS 3150 defines tangible capital assets as non-financial assets having physical substance that:

- (i) 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;
- (ii) have useful economic lives extending beyond an accounting period;
- (iii) are to be used on a continuing basis; and
- (iv) are not for sale in the ordinary course of operations.

Based on this definition, tangible capital assets would include items such as:

- Land and buildings
- Vehicles and machinery
- Water and sewage systems
- Roadways, bridges, sidewalks, traffic lights and street lighting
- Landfill sites
- Furniture and office equipment
- Information technology

Works of art and historical treasures are not recognized as tangible capital assets because a reasonable estimate of the future benefits associated with such property cannot be made. Nevertheless, the existence of such property should be disclosed. In addition, intangible assets, natural resources and Crown lands that have not been purchased by the government are specifically scoped out of PS 3150 and are therefore not recognized as assets on the statement of financial position.

### ***Tangible Asset Classification***

To begin the inventory process, the government should develop asset classifications. For example, a local government may define its major asset categories as follows:

- Land
- Buildings
- Infrastructure
- Vehicles & machinery
- Furniture, computers & office equipment

These major categories would then be broken down into subcategories. For example, vehicles and machinery may be broken down as licensed cars and light trucks, fire trucks, transit buses, and heavy equipment.

**Segmentation of Tangible Capital Assets**

The government must also decide if it wants to segment assets into separate components. This decision is particularly important for complex networks, such as a water system, but it should be considered for any asset which has component parts with useful lives which are different from the asset as a whole. For example, if component accounting is used for a building, the roof, elevator and HVAC systems would likely be segmented from the rest of the building.

The decision to use component accounting or not has a significant impact on depreciation and whether or not future capital expenditures are accounted for as betterments or repairs and maintenance expense (see sections below on Valuation and Depreciation for a description of the impact). When deciding on the approach to use, you should consider how the inventory will be linked to the asset management system. A single asset approach does not provide the necessary information for an asset management plan.

**Capitalization Thresholds**

It is also important to create threshold values prior to beginning the inventory process. PS 3150 does not provide any guidance on minimum dollar thresholds to determine what you will include as a capital asset. U.S. Governmental Accounting Standards, in GASB Statement 34, does provide guidance on minimum dollar thresholds:

Asset category	Revenues less than \$10 million	Revenues \$10million - \$100 million	Revenues exceeding \$100 million
Land	Always Capitalize	Always Capitalize	Always Capitalize
Land improvements	\$12,500	\$25,000	\$50,000
Buildings	\$25,000	\$50,000	\$100,000
Construction in progress	Always Capitalize	Always Capitalize	Always Capitalize
Machinery & equipment	\$2,500	\$5,000	\$5,000
Vehicles	\$2,500	\$5,000	\$5,000
Infrastructure	\$100,000	\$250,000	\$3,000,000??

GASB 34 should only be used as a guide and the ultimate decision should be based on each government’s specific factors and striking the right balance between costs and financial reporting accuracy. For example if the threshold is set too high, the cost of services may swing radically from year to year as major expenditures will be expensed in the year incurred; however, if it is set too low, costs to maintain the tangible capital assets inventory could be too costly. When deciding on this threshold, it is important that the government consult with its auditors and consider the impact of financial statement materiality on the capitalization thresholds.

**Compiling the Tangible Asset Inventory**

Once decisions have been made on classification, segmentation and capitalization thresholds, you can begin compiling the tangible capital asset inventory. In many cases, inventory information already exists. In the case of vehicle fleets, each vehicle is usually tracked and information such as description, age and milage for each vehicle likely exists. For networked systems, such as water systems, maps exist displaying where the assets are, what they are, their composition and length. Buildings should be relatively easy to inventory; however in the case of the contents of buildings (i.e. office furniture), site visits and inventory counts will have to be performed.

It is also important to note that when creating the inventory, you will also have to consider leased tangible capital assets. If, based on the substance of the lease, it is determined that substantially all the benefits and risks of ownership of the asset have been transferred to the government, PSG-2 – *Leased Tangible Capital Assets* require the leased asset to be recognized on the government’s statement of financial position.

When completing the inventory, the following information is needed for each tangible capital asset:

- Description of the asset
- Year of acquisition
- Expected useful life at the time of acquisition
- Significant improvements made to the asset from the time of acquisition to the inventory date and the date of the improvement and the estimated useful life of the improvement
- Service hours, production or mileage to date (if applicable)
- Estimated residual value, if any, on disposal

This information will be important in determining the value and the depreciation of the asset.

When completing the tangible capital asset inventory, governments should consider the capabilities of their information systems. In many cases, because local governments were not previously required to account for tangible capital assets, they did not use or did not purchase the capital asset modules of their accounting packages. A capital asset module should capture key financial and physical data about all of an organization's capital assets.

## Valuing the Tangible Capital Assets

### ***Determining Cost***

Tangible capital assets are required to be recorded at cost. Cost includes the purchase price of the asset and other acquisition costs such as installation costs, design and engineering fees, legal fees, survey costs, site preparation costs, freight charges, transportation insurance costs, and duties. Cost also includes carrying costs directly attributable to the acquisition, construction or development activity, such as interest costs when the government's policy is to capitalize interest costs. It is also important to note, that the cost to be recognized in the statement of financial position is the gross cost - capital grants would not be netted against the cost of the related tangible capital asset.

Although PS 3150 requires tangible capital assets to be recorded at historical cost, the transitional provisions allow for the fact that historical cost accounting records may not exist for all assets. PS 3150 only says a government should apply a consistent method of estimating the cost of the tangible capital assets for which it does not have historical cost records; it does not provide guidance on what other measurement bases should be used.

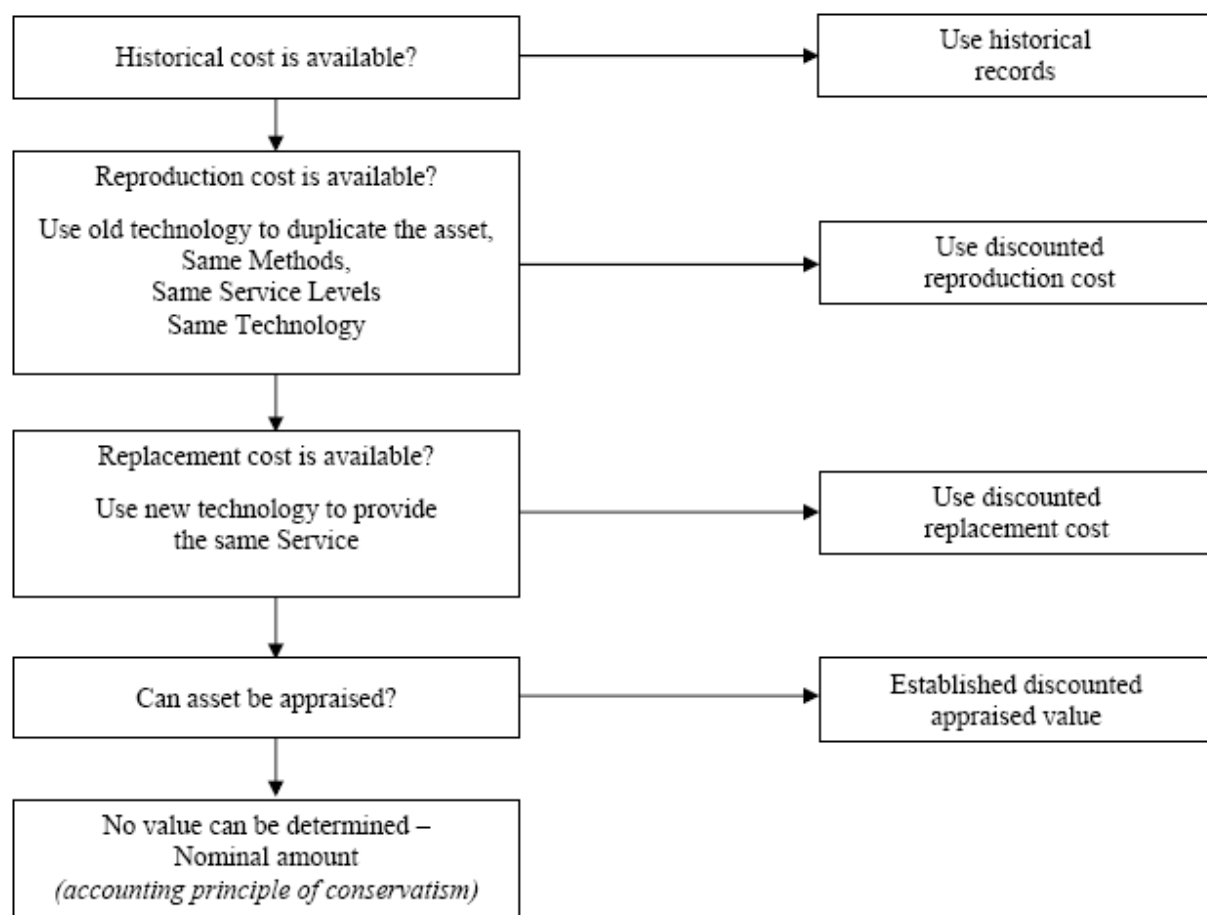
The Ontario Municipal Benchmarking Initiative (OMBI) suggests three methods to approximate the historical cost of a tangible capital asset:

*Discounted Reproduction Cost* – The current cost of reproducing the asset in the same physical form is discounted to the cost at the time of acquisition using an inflation index. The inflation index used should be consistent with the asset being valued. For example, if the asset was a building, a construction index should be used. If no relevant measure exists, the cost should be discounted using the general inflation rate.

*Discounted Replacement Cost* – The current cost of replacing the asset in a different physical form but with the same productive capacity is discounted to the cost at the time of acquisition using an appropriate inflation index. This method should be used in instances where, due to technological change, it does not make sense to replace an asset in similar physical form.

*Appraisal* – A professional assessment of what an asset is worth based on its current age and condition. This value is then discounted to the cost at the time of acquisition using an appropriate inflation index.

The OMBI has created the following valuation decision tree:



It is important to note that the values determined will become part of the government's financial records and are therefore subject to audit. Therefore it is important that the values are reasonable and that adequate documentation is maintained to facilitate the audit. The auditing of the tangible capital assets will also increase the extent of work required by the auditor and the auditor may need to use specialists in the completion of their audit work. Accordingly, audit fees should be expected to rise.

### **Contributed Tangible Capital Assets**

Governments may receive contributions of tangible capital assets. The cost of a contributed asset is considered equal to its fair value at the date of contribution. Fair value of a contributed tangible capital asset may be estimated using market or appraisal values. Contributed capital assets include tangible capital assets received in lieu of a developer charge. In the case of developer charges, it may be easy to obtain information about fair market value, as agreements with developers often specify what is to be installed for water and sewer services and the estimated cost.

### **Betterments**

When valuing the assets, you must also consider if there have been any betterments since the asset was originally acquired or constructed. Costs of betterments are considered to be part of the cost of a tangible capital asset and would be added to the cost of the related asset. A betterment is a cost incurred to enhance the service potential of a tangible capital asset. In general, service potential may be enhanced 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. For example, expenditures incurred to add additional lanes to a road system expands the capacity of the road system and are accounted for as a betterment.

The decision to use component accounting will have a significant impact on whether an item is a betterment or not, especially with networks. If a single asset approach is used, the replacement of individual parts will usually not increase the service capacity of the network as a whole, therefore they are recorded as an expense. However, the replacement of a part could increase the service capacity of a component and therefore would be accounted for as a betterment.

When recording a betterment, the cost of the betterment should not simply be added to the original cost of the asset. In some cases, a partial disposal of the existing asset that was improved occurs. For example, if the exterior of building is replaced and that results in increasing the useful life of the building, the cost of the replaced exterior should be removed from the cost of the building and the cost of the new exterior should be added to the cost. The accumulated depreciation related to the old exterior should also be removed.

There are also transitional provisions for older assets that are still in use but do not have any unamortized cost remaining because of their age and the amortization period set for that type of tangible capital asset. In these cases, if historical cost information is not available, the government would record them at an initial value equal to their residual value, where material and previously known. Otherwise, it would disclose them at a nominal value. Before recording these assets at their residual value or at a nominal value, don't forget to consider if there have been any betterments that should be capitalized.

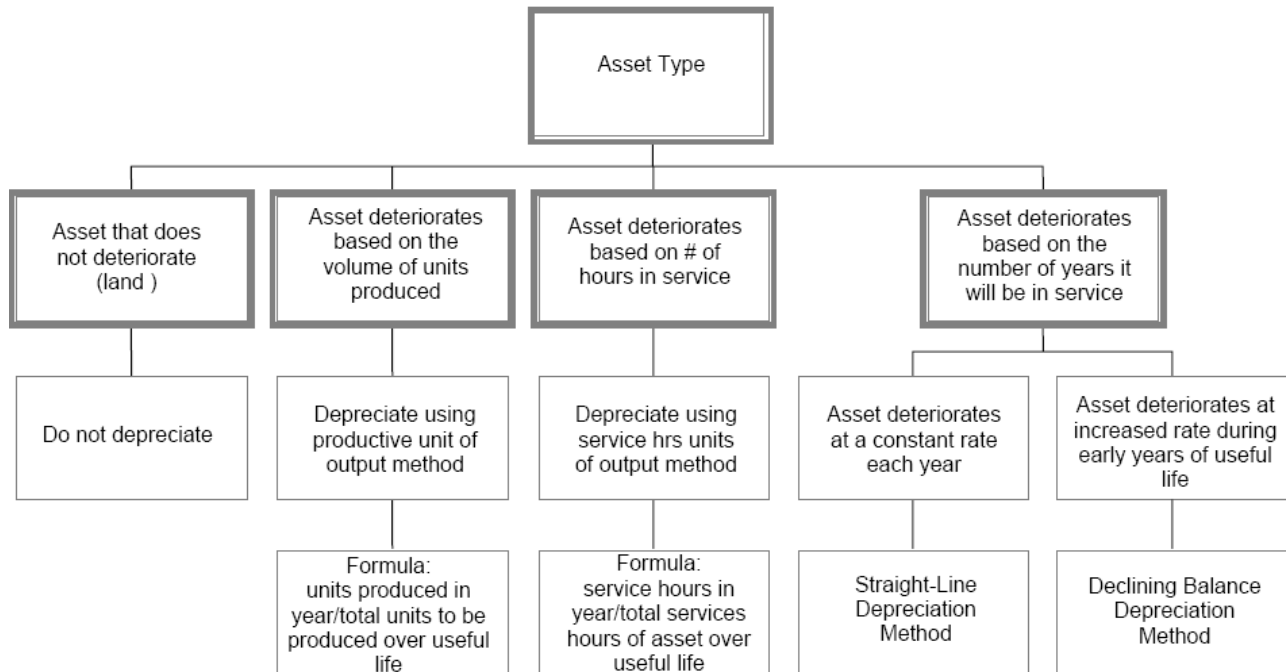
## **Depreciating the Tangible Capital Assets**

Now that all the tangible capital assets have been inventoried and valued, they must be depreciated. PS 3150 requires the cost, less any residual value, to be amortized over its useful life in a rational and systematic manner appropriate to its nature and use. Upon implementation of this new standard, the goal is to determine the accumulated amortization to the date of implementation. This will ultimately impact the amount of depreciation expense recorded in future years.

The amount of depreciation for any given asset depends on three factors: the method of depreciation, the useful life and the residual value.

### ***Depreciation Method***

There are a number of depreciation methods available; however, PSAB does not provide any specific guidance on which method should be used other than that the method must be appropriate given the asset's nature and use. The OMBI has developed the following decision tree to assist in determining the most appropriate method of depreciation:



### **Useful Life**

The useful life of a tangible capital asset depends on its expected use by the government. 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
- studies of similar items retired
- the condition of existing comparable items

Land is normally the only asset that has an infinite useful life and therefore is not subject to amortization.

### **Residual Value**

The last factor to consider in determining the amount of depreciation to be recorded is the residual value. The residual value is the value expected to be received on disposal of the asset. This amount is to be deducted from the initial cost in the determination of the annual depreciation.

### **Calculating Depreciation**

The following example will illustrate the calculation of the accumulated depreciation of an asset up to January 1, 2009, the implementation date.

A municipality purchases a tangible capital asset on January 1, 2006 for \$35,000. The municipality replaces this type of asset every five years. At the date of purchase, the residual value was determined to be \$10,000. The declining balance method of depreciation is used.

Depreciation rate =  $2 \times (1/\text{useful life}) = 2 \times (1/5) = 40\%$

Annual Depreciation =  $(\text{cost} - \text{residual value} - \text{opening accumulated depreciation}) \times \text{depreciation rate}$

2006 Depreciation =  $(35,000 - 10,000 - 0) \times 40\% = 10,000$

2007 Depreciation =  $(35,000 - 10,000 - 10,000) \times 40\% = 6,000$

2008 Depreciation =  $(35,000 - 10,000 - 16,000) \times 40\% = 3,600$

Accumulated depreciation at January 1, 2009 = 10,000 + 6,000 + 3,600 = 19,600  
2009 Depreciation = (35,000 – 10,000 – 19,600) x 40% = 2,160

Therefore at January 1, 2009, the municipality will have record an asset with a value of \$35,000 and related accumulated depreciation of \$19,600. The related depreciation expense to be recorded for the year ended December 31, 2009 will be \$2,160.

The decision to use component accounting for assets with significant components will have an impact on the depreciation calculations. With a single asset approach, you would determine the useful life of the entire network and depreciate the asset over that period. Using a component approach, a network such as a water system would be divided into its components (pumps, plants, pipes) and each component would be depreciated over its useful life. The useful life of each component is likely less than the network as a whole, therefore increasing depreciation expense.

Once the accumulated depreciation has been determined, the net book value can be calculated as the initial cost less accumulated depreciation. At this time, consideration should be given to whether the net book value of the tangible capital asset is in excess of the future economic benefits expected from its use and, therefore, whether a write-down is required to establish more appropriate cost and accumulated amortization amounts for the asset.

## Required Disclosures

Although the actual recording of tangible capital assets on the statement of financial position will not begin until 2009, disclosure requirements begin as early as 2007. *PSG-7 - Tangible Capital Assets of Local Governments* requires the following disclosure for fiscal years beginning on or after January 1, 2007 for each major category of tangible capital assets and in total:

- cost at the beginning and end of the period
- additions in the period
- disposals in the period
- the amount of any write-downs in the period
- the amount of amortization for the period
- accumulated amortization at the beginning and end of the period
- net carrying amount at the beginning and end of the period
- the method used for determining the cost of each major category of tangible capital assets
- the amortization method used, including the amortization period or rate for each major category of tangible capital assets
- the net book value of tangible capital assets not being amortized because they are under construction or development or have been removed from service
- the nature and amount of contributed tangible capital assets received in the period
- the nature and use of tangible capital assets disclosed at nominal value
- the nature of the works of art and historical treasures held by the government
- the amount of interest included in cost in the period

The required disclosures are extensive; however, it is not expected that this information be available for all tangible capital assets at December 31, 2007. This disclosure is only required for categories of assets for which this information is available. However the government must disclose categories of tangible capital assets excluded from that disclosure until the relevant information about the complete stock of tangible capital assets can be provided.

Once PS 3150 becomes effective in 2009, the above disclosure would be required for all categories of tangible capital assets.

## Conclusion

The first step to implementing PS 3150 is to gain knowledge of the requirements and educate those that will be involved in this project. In addition to this publication, information could be found from various sources, such as the following websites:

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

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

At this point in time, we feel that creating the initial tangible capital asset inventory, completing the initial valuation and calculating the initial accumulated depreciation will be the most time consuming tasks and therefore should be made a priority. As such, this publication only addressed those topics. Other issues which must be considered include the impact on budgeting and the ongoing management and accounting of tangible capital assets subsequent to January 1, 2009.

If you require further information, please contact your local BDO Dunwoody LLP office.