

# It's All in The Details: Capital Assets, Fund Balance, and Net Position

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# Capital Assets

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## Part 1

# Definition of a *capital asset*

- Two criteria
  - Used in operations
    - Not assets acquired for sale or investment
      - Foreclosure properties
      - Real estate held by an endowment
  - Initial life of more than one year
- Governmental funds
  - Capital assets that will be sold cannot be reclassified as fund assets

# Application of materiality

- Capitalization threshold
  - GFOA recommendation
    - \$5,000 minimum
    - Apply to individual items
      - Exception – numerous individual items under limit (library books)
  - Different thresholds for different types of assets
  - More effective means of maintaining managerial control over smaller assets
    - Nonfinancial information
    - Maintained at departmental level

# Who should report?

- The same asset cannot be reported by more than one government
  - Decisive criterion for reporting = ownership
    - Ultimate control over “use and enjoyment”
      - Normally evidenced by title
      - Not affected by reversionary interest
    - Capital asset vs. right to use a capital asset
- Surrogate if ownership cannot be determined = responsibility for maintenance
  - Maintenance vs. responsibility to replace
- Undivided interest vs. joint venture asset

# Major asset classes

- Display or disclosure
- Define so that depreciating/amortizing assets are never in the same class as assets that are not being depreciated/amortized
  - Thus intangibles normally is not an appropriate major asset class

# Land

- Always capitalized separately from related asset (e.g., infrastructure)
- Include cost of preparation with indefinite useful life
  - Excavation, fill, removal of power lines
- Includes related rights, unless acquired separately
- Normally indefinite useful life (exceptions)

# Buildings

- Permanent (= non-moveable) structures
- Subclasses based on type of construction
  - Concrete, steel, masonry, heavy timber, wood
- Include improvements
- Components with shorter lives may be reported as separate capital assets (e.g., HVAC)



# Improvements other than buildings

- Improvements to land with a limited useful life (hence not included as part of *land*)
  - Fences
  - Retaining walls
  - Parking lots
  - Most landscaping

# Furnishings and equipment

- Moveable items
  - Landscaping for picnic area = improvements other than buildings
  - Picnic tables = furnishings and equipment
- Sometimes reported as machinery and equipment

# Infrastructure

- ...long-lived capital assets that normally are stationary in nature and normally can be preserved for a significantly greater number of years than most capital assets.
  - Roads, bridges, tunnels
  - Drainage systems, water and sewer systems, dams
  - Lighting systems

# Infrastructure (cont.)

- Level of reporting
  - Networks or
  - Subsystems
- Exclude
  - Associated land
  - Buildings
    - Exception – buildings that are purely ancillary
      - Rest stops on state highway

# Construction/development in progress

- Construction-in-progress
  - Tangible
- Development-in-progress
  - Intangible

# Other capital assets

- Two categories may be required if a significant portion subject to depreciation/ amortization

# Capitalizable costs

- Cost of purchasing/constructing
- “...ancillary charges necessary to place the asset into its intended location and condition for use.”

# Acquisition costs

- Requirement for capitalization = evidence of future service utility *at time cost incurred*
  - Exclude cost of feasibility study



# Training cost

- *Not* an ancillary cost
  - Training readies the *user* rather than the *asset*

# Application of internal resources

- Direct project costs
  - Capitalize
- Indirect project costs
  - Capitalize proportionate share of costs clearly related to the construction, development, or improvement of capital assets as a group

# Specific guidance for the cost of developing intangible assets

- The specific objective of the project has been determined
- The nature of the service capacity to be provided has been determined
- The feasibility of successfully completing the project has been demonstrated; and
- The government has demonstrated that it 1) intends, 2) is able to, and 3) is making an effort to develop and complete the project.

# Computer software

Stage	Related activities	Capitalize?
Preliminary project stage	Conceptual formulation and evaluation of alternatives; Determination of the existence of needed technology; and Final selection of alternatives for development	NO
Application development stage	Design of the chosen path, including software configuration and software interfaces; Coding; Installation to hardware; Minimum data conversion necessary to make the software operational; and Testing, including the parallel processing phase	YES (but only if incurred after completion of the preliminary project stage)
Post-implementation/operation stage	Application training; Data conversion beyond what is strictly necessary to make the software operational; and Software maintenance.	NO

# Interest incurred during acquisition/construction

- Theory – match revenues and related expense
  - Enterprise funds
  - Business-type activities
- How much to capitalize depends on source of funding
  - Tax-exempt debt
  - Grants
  - Other sources
- Often all three applicable to a single project

# Funding from tax-exempt debt

- Capitalize difference between
  - Interest expense
  - Earnings on related investments

# Funding from grants

- Interest not capitalized

# Funding from other sources

- Interest rate x expenditures
- May be applicable even if debt not issued
  - Existing debt in the same fund



# Improvements vs. repairs

- Repair (expense of period)
  - Any outlay that does no more than return a capital asset to its original condition, regardless of amount
- Improvement (capitalized)
  - Increase utility (through increased capacity or serviceability)
  - Extend total estimated useful life
    - Not applicable under modified approach
- May be necessary to separate for a single project

# Donated assets

- Estimated acquisition cost (entry price)
- Substance over form
  - Nominal cost (e.g., \$1) = donation

# Capital asset impairments

- Clarifications

- Scope

- Readily known (media/governing body)
    - Permanent
    - Unexpected (at acquisition)
    - Distinct from a change in demand or use

# Insurance recoveries

- Only recognize when realized or realizable
- Net against loss (if same period)
- Restoration and replacement are separate transactions
- FEMA  $\neq$  insurance

# Transfers between funds

- Difference in measurement focus?
  - Capital contribution
  - Loss on disposal

# Sales within reporting entity

- No change in carrying value
- Difference
  - Within primary government
    - Transfer
  - Between primary government and discretely presented component units
    - Revenue/expense

# Net position

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## Part 2

# Net position

- Private sector
  - Focus on capital maintenance
    - Owner investment
    - Retained earnings
- Public sector
  - Focus on availability of resources
    - Net\* investment in capital assets
    - Restricted (by major restriction)
      - Nonexpendable vs. expendable
      - By major category of restriction
    - Unrestricted



# Capital assets

- Include all capital assets
  - Even if intangible
  - Even if acquired without borrowing
- Exclude
  - Resources not yet expended
  - Equity interest joint venture capital asset

# Capital-related borrowings

- Proceeds used to
  - Construct a capital asset of the government
  - Acquire a capital asset of the government
  - Improve a capital asset of the government
- Exclude
  - Borrowings within the primary government
    - Other than with blended component unit
  - Borrowing related to capital assets of another government

# During construction

- Amount of borrowing considered to be capital-related:
  - Amount actually spent for capital purposes
    - Including certain costs that ultimately may not be capitalized (e.g., furnishings)

# Upon completion of construction

- Amount of borrowing considered to be capital-related:
  - Net carrying value of the outstanding borrowing
    - Exception for proceeds applied to a noncapital purpose
      - Debt service “reserve fund”
      - Issuance costs

# Example

- Assumptions
  - \$20,000 bonds issued
    - \$500 used to fund debt service reserve account and issuance costs
  - Spending through completion of project

	<u>Capitalized</u>	<u>Not Capitalized</u>	<u>Total</u>
Year 1	\$7,500	\$100	\$7,600
Year 2	9,800	50	9,850
Year 3	<u>2,000</u>	<u>50</u>	<u>2,050</u>
	<u>\$19,300</u>	<u>\$200</u>	<u>\$19,500</u>

# Calculation

Year 1:

Capitalized project spending –current year	\$7,500
Noncapitalized project spending (if not significant)	
- current year	<u>100</u>
Total capital-related debt	\$7,600

Year 2:

Amount recognized previously	\$7,600
Capitalized project spending – current year	\$9,800
Noncapitalized project spending (if not significant)	
- current year	<u>50</u>
Total capital-related debt	\$17,450

Year 3:

Amount recognized previously	\$17,450
Capitalized project spending – current year	\$2,000
Noncapitalized project spending (if not significant)	<u>50</u>
Total capital-related debt	\$19,500

# Recap

Recap:

Net carrying value of debt	\$20,000
Less: amount applied to noncapital purposes	<u>(500)</u>
Total capital-related debt	\$19,500

# Restricted net position

- Restricted assets net of related liabilities
  - Legally restricted assets
    - Parties outside the government
    - Constitutional provisions
    - Enabling legislation
  - Related liabilities
    - Amounts to be paid from restricted assets
    - Source of restricted assets
    - Exclude capital-related debt
- Restrictions must be substantive
- Need for a flow assumption



# Fund balance

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## Part 3

# Fund balance

- Basis for categorization
  - Constraints on how existing resources of the fund can be spent
  - The sources of those constraints
- Applicable to spending on *existing* resources
  - Fund balance policy irrelevant

# Presentation of components

- Most constraining  $\Rightarrow$  least constraining
  1. Nonspendable
  2. Restricted
  3. Committed
  4. Assigned
  5. Unassigned

# 1. Nonspendable fund balance

- A. Not spendable in form
- B. Not spendable because of legal requirement to maintain intact
  - Endowment principal
  - Corpus of loan fund

## A. Nonspendable in form

- Assets than never can be spent
  - Supplies inventories and prepaid items
- Assets that currently cannot be spent
  - Assuming no limitation on the use of the resources once received
    - Not applicable to funds other than the general fund
  - Examples
    - Long-term portion of loans receivable
    - Nonfinancial assets held for resale
    - Inventories held for sale

## 2. Restricted fund balance

- Externally enforceable limitations
  - Creditors, grantors, contributors, laws and regulations of other governments
  - Constitutional provisions
  - Enabling legislation
- Stabilization arrangements
  - If limitation on use is externally enforceable *and*
  - Circumstances that trigger spending are both specific and nonroutine

### 3. Committed fund balance

- Self-imposed legal limitation
  - Highest level of decision-making authority
  - Formal action
    - If multiple levels of action (ordinances, resolutions, “other” actions), only action at the highest level
  - Remains in force unless formally rescinded
  - In place by the end of the reporting period
- Stabilization arrangements
- Unaffected by budget
  - Lapse
  - Authorization to spend resources vs. limitation

## 4. Assigned fund balance

- Earmarking of resources
- Contrast with committed fund balance
  - Level at which limitation imposed
    - Highest level (committed)
    - Power may be delegated to a group or individual (assigned)
  - Type of action
    - Formal (committed)
    - Less formal (assigned)
  - Timing
    - No later than the end of the reporting period (committed)
    - Later date (assigned)



# Clarifications

- Encumbrances
  - Assigned fund balance unless payable from restricted or committed resources
- Appropriated fund balance
- Not allowed for stabilization arrangements
- Cannot create a deficit balance in unassigned fund balance

## 5. Unassigned fund balance

- All remaining fund balance
- Positive balance only in the general fund
- Not appropriate for encumbrances
  - Unless insufficient amount available in assigned fund balance
- Unassigned fund balance of general fund of blended component unit
  - Special revenue fund
    - Assigned, committed, or restricted

# Flow assumptions

- Two
  - Use of restricted resources v. unrestricted resources (committed and assigned)
  - Use of committed resources v. assigned resources
- Formal policy or assumed policy
  - Assumed policy = 1) committed, 2) assigned, 3) unassigned