CAPITAL CONFUSION

12 Misunderstandings about Accounting for Capital Assets

BY STEPHEN J. GAUTHIER

Many accounting and financial reporting issues affect some governments, but not others. Virtually all state and local governments, however, must confront the ongoing challenge of accounting for capital assets. To help governments meet this challenge, the Government Finance Officers Association (GFOA) recently released a new book, *Accounting for Capital Assets: A Guide for State and Local Governments*, that comprehensively addresses accounting and financial reporting for capital assets (the contents are listed in Exhibit 1). This article will focus on 12 common misunderstandings that the new publication should help eliminate.

Misunderstanding No. 1

If it's a parcel of land with a building on top, it must be a capital asset.

If asked to provide the quintessential example of a capital asset, most probably would reply "land" or "buildings." Yet not every parcel of land or building necessarily qualifies as a capital asset. Some assets are acquired for use in operations (e.g., fire truck), while others are acquired with the intent of resale (e.g., foreclosure properties). By definition, only the former qualify as capital assets.[1] That is, the crucial factor in determining whether a given item should be classified as a capital asset is not the form of the asset, but its intended use. Thus, a parcel of land acquired to serve as the site of a new school would properly be classified as a capital asset, but not an identical parcel of land acquired for eventual resale to a private-sector business as part of a redevelopment program.

Virtually all state and local governments must confront the ongoing challenge of accounting for capital assets.

The distinction between *capital* and *noncapital* is more than a question of terminology. Governmental funds (e.g., general fund) do not report capital assets; they do, however, report items acquired for the purpose of resale, including items that resemble capital assets. Also, capital assets are unaffected by changes in fair value, whereas items held for resale cannot be reported at more than their net realizable value.

Misunderstanding No. 2

Capital assets and "fixed assets" are really one and the same thing.

In the private sector, capital assets are commonly described as *property*, *plant*, and *equipment*. For many years, the equivalent term in the public sector was *fixed assets*. In both cases, the language suggests an asset that is both tangible and immovable. Neither quality, however, is an essential characteristic of a capital asset. Rather, the essential features of a capital asset are that it will be *used in operations* and that it has a useful life *extending beyond a single reporting period*. Thus, *intangible* items such a legal rights (e.g., easements) and internally developed computer software typically qualify as capital assets. Unfortunately, because intangible assets do not "look like" other capital assets, financial statement preparers often overlook them when calculating the portion of *net assets* classified as *invested in capital assets, net of related debt*.

Misunderstanding No. 3

A capital asset should always be reported as an asset of the government that maintains it.

In the public sector, it is not uncommon for a higher level of government (e.g., county) to acquire or construct a capital asset for a lower level of government (e.g., township), with the latter assuming responsibility for maintenance. Under generally accepted accounting principles (GAAP), the same item cannot be reported as a capital asset of two different governments.[2]

When two or more governments are involved with the same capital asset, it is the government that owns it that should report it. If ownership of a capital asset is difficult to establish (e.g., sidewalks), it is the government responsible for managing the asset (e.g., maintenance) that normally would report it.[3] This last provision has led some to erroneously conclude that responsibility for managing a capital asset is the normal criterion for determining which government should report a capital asset. To the contrary, *responsibility for maintenance is only a factor if ownership cannot be determined*. Put differently, ownership always "trumps" management for this purpose.

Misunderstanding No. 4

An infrastructure asset includes the land it is built on.

Infrastructure assets (e.g., roads and sewer lines) typically are built on land that the government controls through ownership or easement. Since infrastructure is unimaginable without the underlying land, it is tempting to view the cost of the land or easement as an integral part of the cost of the infrastructure. Authoritative accounting standards, however, require that land and easements associated with infrastructure be treated as separate capital assets in their own right.[4]

Exhibit 1: Accounting for Capital Assets: A Guide for State and Local Governments

Chapters
1. Capital Assets: Definition, Accounting Function, Types, and Basic Information Requirements
2. Basic Accounting
3. Major Asset Classes
4. Capitalizable Costs
5. Valuation of Capital Assets for Financial Reporting Purposes
6. Impairments
7. Depreciation
8. Financial Statement Presentation and Disclosure
9. System Design and Policies
10. Inventorying

Appendices
A. Answers to Exercises
B. Sample Journal Entries
C. GFOA Recommended Practices

Glossary and Index

Misunderstanding No. 5
The cost of a capital asset should include the cost of an associated feasibility study.

Governments often undertake a feasibility study prior to the acquisition or construction of a capital asset. Accountants presume that cost should be recognized as expense when incurred, unless they have demonstrable future value at that time. It is hard to argue that cost has demonstrable future value before the feasibility of a project has been established. Therefore, the cost of a feasibility study associated with the acquisition or construction of a capital asset should not be included as part of the cost of the asset thus acquired.[5]

Misunderstanding No. 6
If you don't issue debt for a project you will have no interest to capitalize.

For enterprise funds and business-type activities, interest incurred during the acquisition or construction of a capital asset must be included as part of the cost of that asset. It would be understandable to conclude that there would be no interest to capitalize if the government did not issue debt to finance a given project. However, GAAP often require that interest be capitalized even in situations where no new debt is issued.

In theory, if a given enterprise fund or business-type activity had both available resources and outstanding debt, it could apply those resources to liquidate the debt. If this were done, of course, the resources would no longer be available to finance acquisition or construction, thus necessitating a new borrowing. Consequently, GAAP take the position that if there is any outstanding debt in a given enterprise fund or business-type activity, *even though that debt may relate to a different project of a prior period*, the government's decision not to pay off the debt is equivalent to a new borrowing, and the related interest should be capitalized during acquisition or construction as part of the cost of the capital asset.[6]

Misunderstanding No. 7
The fair value of something is what you can sell it for.

GAAP require that donated capital assets be recorded at their *fair value* as of the date of donation. For this purpose, fair value should be understood as referring to what it would have cost the government to acquire the asset, not the amount for which it could resell the asset.

Assume, for example, that a developer donated the right-of-way for a road. There is little market for the land under a road, so the right-of-way would have little or no resale value. Conversely, the cost of acquiring the land for the right-of-way could have been substantial. Some have reasoned in similar cases that the minimal anticipated resale value of the donated land justified its being reported at some nominal value (e.g., $1 per acre). GAAP, however, would require that the right-of-way be reported at the cost the government would have had to incur to acquire it.[7]

Misunderstanding No. 8
Capital outlays and capitalized expenditures are one and the same thing.

Most state and local governments report a separate line item for *capital outlays* in their governmental fund financial statements. Many presume that this line item represents total expenditures for capital assets acquired or constructed during the period. In fact, the amount reported as *capital outlays* normally excludes some significant capitalized expenditures, while at the same time incorporating certain other expenditures that were not, in fact, capitalized.

Specifically, most governments report a line item labeled *capital outlays* in the governmental fund financial statements but restrict its use to capital projects funds. Outlays for capital acquisition or construction in the general fund typically are reported by function (e.g., public safety or parks and recre-

ation) rather than as *capital outlays*. Conversely, the amount reported as *capital outlays* in the capital projects funds often includes project-related costs that were not, in fact, capitalized (e.g., furnishings). Thus, the amount reported as *capital outlays* should not be understood as a measure of capital spending in governmental funds.

Misunderstanding No. 9
Land is never depreciated.

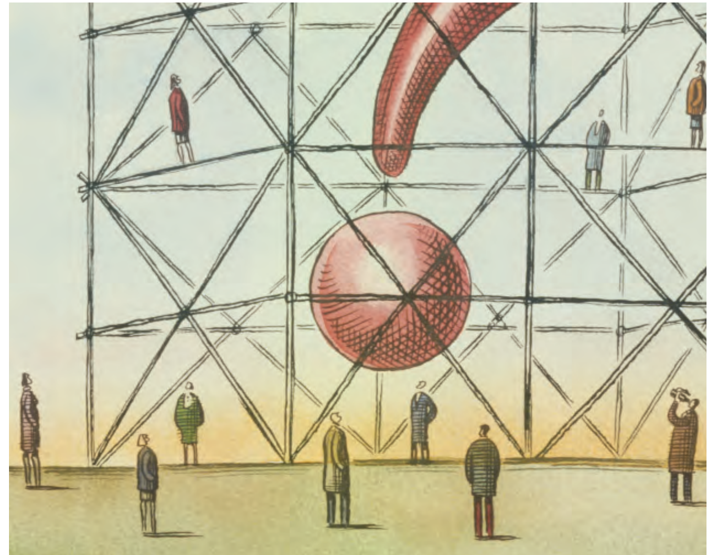
Capital assets that are exhausted through use must be depreciated over their estimated useful life. Since land *normally* retains its economic value indefinitely, it *normally* is not depreciated. Indeed, it is almost an axiom among accountants that "land is never depreciated." However, in certain cases, the economic value of land may, in fact, be depleted through use (e.g., land used as a site for toxic waste or as a source of gravel or ore). In such circumstances, the land would need to be depreciated to reflect this depletion.[8]

Misunderstanding No. 10
Capitalization is essential to ensure control over walk aways.

There is no dispute that governments have a duty to maintain control over all of their assets, including smaller and less expensive items easily converted to personal use ("walk aways") such as laptop computers and printers. Some have argued that this responsibility requires that governments set their capitalization threshold low enough to encompass such items. As a practical matter, however, there are far more effective and efficient means of maintaining control over walk aways than capitalization.[9] Accordingly, governments should set their capitalization thresholds for capital assets solely from the perspective of the requirements of sound financial reporting (i.e., would the exclusion of items below the threshold be material to the financial statement presentation?).[10]

Misunderstanding No. 11
For groups of similar items, the capitalization threshold should be applied to the group.

As already discussed, the sole consideration in setting a capitalization threshold ought to be the requirements of sound financial reporting. For groups of similar items (e.g., desktop computers), most often the dollar value of the entire group will still not be significant for financial reporting purposes. Accordingly, governments normally should apply their capitalization threshold to individual items in such groups rather than to the group as a whole. The one exception would be those rare cases where application of the capitalization threshold to individual items in a group would result in the



elimination of a significant portion of total capital assets (e.g., the book collection of a library district).

Misunderstanding No. 12
It's better to start from scratch than to rely on deficient inventory records.

Governments sometimes have the option of following a comprehensive basis of accounting other than GAAP (e.g., cash basis accounting). When such governments wish to convert to GAAP, they often discover that their capital asset records are insufficient to support GAAP financial statements and must undertake a major inventory effort to establish beginning balances for capital assets. Intuitively, it might appear easier to simply start over rather than to attempt to build upon defective capital asset records. Experience, however, indicates that normally it is more efficient to start from existing records, even when they are deficient.

CONCLUSION

In summary, financial statement preparers can easily avoid some of the most common misunderstandings involving accounting for capital assets by remembering the following:

1. Items acquired for resale should *not* be treated as capital assets.
2. Remember to include intangible capital assets in the calculation of *net assets invested in capital assets, net of related debt*.
3. If one government owns a capital asset, but another is responsible for its management, it is the government that owns the asset that should report it.

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4. Land or easements related to infrastructure should be reported as separate assets in their own right.

5. The cost of feasibility studies should *not* be capitalized.

6. Interest capitalization is required if debt is outstanding in an enterprise fund or business-type activity, even if the debt is unrelated to the capital asset being acquired or constructed.

7. The fair value of a donated asset is what it would cost the government to acquire it.

8. The line item *capital outlays* excludes some expenditures that are capitalized, while including others that are not.

9. Land must be depreciated if it loses economic value through use.

10. "Walk aways" should *not* be capitalized.

11. A capitalization threshold normally should be applied to individual items in a group of similar items, rather than to the group as a whole.

12. When establishing an initial capital assets inventory, it normally is better to build upon existing records than to start over from scratch.

Notes

1. Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements — and Management's Discussion and Analysis — for State and Local Governments*, paragraph 19: "The term *capital assets* includes land, improvements to land, easements, buildings, building improvements, vehicles, machinery, equipment, works of art and historical treasures, infrastructure, and all other tangible or intangible assets that are used in operations and that have initial useful lives extending beyond a single reporting period." [emphasis added]
2. GASB Concepts Statement No. 4, *Elements of Financial Statements*, paragraph 14: "The same specific resource cannot simultaneously be an asset of more than one entity…"
3. GASB Statement No. 34, footnote 67.
4. GASB *Comprehensive Implementation Guide*, Question 7.12.16.
5. GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, paragraph 8.
6. Financial Accounting Standards Board (FASB) Statement No. 34, *Capitalization of Interest Cost*, paragraph 12.
7. GASB Comprehensive Implementation Guide, Question 7.12.6.
8. FASB Statement No. 93, *Recognition of Depreciation for Not-for-Profit Organizations*, paragraph 34.
9. Government Finance Officers Association (GFOA), *Ensuring Control over Noncapitalized Items* (Recommended Practice).
10. GFOA, *Establishing Appropriate Capitalization Thresholds for Capital Assets* (Recommended Practice).

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