

# Australian Infrastructure Financial Management Guidelines

## POSITION PAPER 5

# Capitalisation Policies

TOC Sections 2.3.3

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### 1. SCOPE

This position paper explores issues relating to capitalisation policies for recognition of a capital asset.

### 2. ISSUES

Capitalisation policies were generally adopted with the implementation of AAS27 in Australia some ten years ago. A capitalisation policy sets the threshold for recognising capital expenditure. Expenditure below the capital threshold is expensed in the period in which it is incurred.

Capitalisation policies are necessary to ensure that there is a distinction made between expenditure on long-lived assets and expenditure on goods and services for immediate consumption. This becomes critically important in determining the cost of providing services. The inclusion of the full cost of a capital item in one year's costs will skew the calculation. It is also important in ensuring that intergenerational equity is maintained and that the expense of capital acquisitions is spread over their life, through the mechanism of depreciation, so that those who have the benefit of the assets can be charged, through taxation or fees and charges, for their use.

Most capitalisation policies were prepared in the mid 1990's using past history of recognising non-infrastructure assets such as plant and equipment. An example of such an asset management policy is shown below.

*"Capital Expenditure are amounts expended to acquire future service potential or economic benefits. Such expenditure will be recognized where it can be clearly identified that:*

1. *Services or benefits will be received in future periods; and*
2. *The expenditure represents a single purchase or acquisition in excess of*
  - a. *\$1,000 for asset types:*
    - *Plant and equipment*
    - *Office equipment and furniture and fittings*
  - b. *\$3,000 for replacement of building fixtures and fittings (eg hot water systems, air-conditioning, flooring, curtains, light fittings, heating, cooking stoves, etc)*
  - c. *\$5,000 for all other asset types excepting network assets (see guidelines)."*<sup>1</sup>

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<sup>1</sup> City of Salisbury, quoted by Jeff Roorda & Associates and Skilmar Systems, 2006, p1

Some councils are reviewing their asset capitalisation policies based on experience of recognising assets over the past ten years. This position paper is prepared from work done by the City of Salisbury, SA in review of capitalisation policies. The permission of Salisbury City Council to use their report is acknowledged with thanks.

### 3. ACCOUNTING STANDARDS

Guidance in recognising and reporting on assets is provided by Australian Accounting Standards. Relevant definitions and commentary are shown below.

#### 3.1 Definition of an asset

The definition of an asset is contained in the Framework for the Preparation and Presentation of Financial Statements, published by the Australian Accounting Standards Board in 2004. This framework superseded Statements of Accounting Concepts 3 and 4 on January 1, 2005.

The definition is outlined at paragraph 49(a):

*“An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.”*

There are three specific elements that define an asset:

- Future economic benefits – in the case of public sector entities, future economic benefits (or service potential) are the goods and services to be provided by the asset, whether or not the entity receives a net cash inflow for their provision.
- Control by the entity - control means the ability of the entity to benefit from the future economic benefits or to restrict the access of others to those benefits.
- Occurrence of past event – the asset must be in existence. A contract to purchase an asset does not give rise to an asset, nor does the intent to acquire an asset. The asset must have been purchased, acquired or transferred to the control of the entity prior to the date of the financial report.

#### 3.2 Recognition of an Asset

The criteria for recognising an asset is outlined at paragraph 89 of the *Framework for the Preparation and Presentation of Financial Statements*:

*“An asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.”*

The two essential components of recognition:

- Probable future economic benefits – probable means that it is more likely than less likely that the benefits will be realized.
- Reliably measured – reliability means the faithful representation of the underlying transactions or events, without bias or error. Essentially, a third party would come to a similar value if presented with the information relating to the transactions or events.

#### 3.3 Measurement at Recognition

The basis for measurement of the value of an asset is its cost. *AASB 116 – Property Plant and Equipment* outlines this at paragraph 15:

*“An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost.*

*Aus15.1 Notwithstanding paragraph 15, in respect of not-for-profit entities, where an asset is acquired at no cost, or for a nominal cost, the cost is its fair value as at the date of acquisition.”*

Note: AASB 116 defines *fair value* as "...the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction."

AASB 116 paragraph 13 provides guidance on recognising parts of assets.

*"13. Parts of some items of property, plant and equipment may require replacement at regular intervals. For example, a furnace may require relining after a specified number of hours of use, or aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe. Items of property, plant and equipment may also be acquired to make a less frequently recurring replacement, such as replacing the interior walls of a building, or to make a non-recurring replacement. Under the recognition principle in paragraph 7, an entity recognises in the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met. The carrying amount of those parts that are replaced is derecognised in accordance with the derecognition provisions of this Standard (see paragraphs 67-72)."*

### 3.4 Depreciation of Assets

Two definitions in *AASB 116 – Property Plant and Equipment* are useful to understand the concept of depreciation. They are:

*"Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.*

*Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value."*

Depreciation provides two key information sets for public sector entities:

- The rate at which the entity's asset base is used up; and
- Information for the pricing of services.

In the context of asset capitalisation, depreciation is an important determinant of the current fair value of an asset. Paragraphs 43 to 47 of *AASB 116 – Property Plant and Equipment* provide guidance in applying the concept of depreciation to parts of assets.

*"Depreciation*

- 43. Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.*
- 44. An entity allocates the amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciates separately each part. For example, it may be appropriate to depreciate separately the airframe and engines of aircraft, whether owned or subject to a finance lease.*
- 45. A significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.*
- 46. To the extent that an entity depreciates separately some parts of an item of property, plant and equipment, it also depreciates separately the remainder of the item. The remainder consists of the parts of the item that are individually not significant. If an entity has varying expectations for these parts, approximation techniques may be necessary to depreciate the remainder in a manner that faithfully represents the consumption pattern and/or useful lives of its parts.*

47. *An entity may choose to depreciate separately the parts of an item that do not have a cost that is significant in relation to the total cost of the item.*<sup>2</sup>

### 3.5 The Concept of Materiality

The relevance of information is affected by its nature and materiality. Information is material if its omission or misstatement could influence the decisions of users or assessments made on the basis of the financial statements. Materiality depends on the nature or size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

AASB 1031 – Materiality sets out the requirements for applying the concept of materiality to information in financial statements.

Fundamentally, the concept of materiality leads to the recognition that, in the case of non-current assets, it is not necessary to recognise each and every non-current asset in the balance sheet. For example, a small calculator may have a useful life greater than twelve months, but its \$15 cost in the context of millions of dollars worth of office equipment suggest that it is simpler to expense it. Similarly, the minor refurbishment of a non-current asset, which may increase the future economic benefits of the asset, but which is a very small portion of the value of the asset, need not be recorded as an increase in the value of the asset if the change in value is not material.

The purpose of setting a threshold level or levels is to minimise the expense and effort associated with maintaining records. This must be balanced with the need to ‘expense’ items, through depreciation, against more than one financial year so that revenues and expenses are matched and the need to present financial information fairly.

Care needs to be taken to ensure that assets which may be under the threshold, but which form part of a network or asset group, such as laptop and desktop PC’s, office furniture and the like, are treated as a group. The assets need not be identified individually (each group or sub-group can be an individual entry in the asset database), but the group needs to include ‘ons’ and ‘offs’ and record total numbers and values. Sub-groups may also be used to capture information and values for homogenous assets – e.g. different types of laptops, chairs etc.

AASB 1031 provides guidance on the quantitative measure that may be used to determine whether an item is material, as follows:

*“15. Quantitative thresholds used as guidance for determining the materiality of the amount of an item or an aggregate of items shall, of necessity, be drawn at arbitrary levels. Materiality is a matter of professional judgement influenced by the characteristics of the entity and the perceptions as to who are, or are likely to be, the users of the financial report, and their information needs. Materiality judgements can only be properly made by those who have the facts. In this context, the following quantitative thresholds may be used as guidance in considering the materiality of the amount of items included in the comparisons referred to in paragraph 13 of this Standard:*

- (a) an amount which is equal to or greater than 10 per cent of the appropriate base amount may be presumed to be material unless there is evidence or convincing argument to the contrary; and*
- (b) an amount which is equal to or less than 5 per cent of the appropriate base amount may be presumed not to be material unless there is evidence, or convincing argument, to the contrary.”*

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<sup>2</sup> AASB 116, 43-47, p 22

## 4. LEGISLATIVE FRAMEWORK

Generally, legislators across Australia have not included specific provisions or guidance to local governments on aspects of asset capitalisation in Local Government Acts or Regulations, except to provide that local governments should follow accounting standards. The only exception is Queensland. The Queensland Local Government Finance Standard 2005 requires local governments to set a threshold below which non-current assets will be treated as an expense. The requirement is:

*“43 Setting amount for treating non-current asset as an expense*

- (1) A local government must, by resolution, set an amount (the set amount) below which the value of a non-current asset must be treated as an expense.*
- (2) The set amount must not be more than—*
  - (a) for land—\$1; or*
  - (b) for plant or equipment—\$5000; or*
  - (c) for another type of asset—\$10000.*
- (3) The set amount may be a different amount for different assets, even if the assets are the same type.*

*Example for subsection (3)—*

  - 1. For plant or equipment—the set amount for motor vehicles may be \$5000 while the set amount for computers may be \$1000.*
  - 2. For other types of assets—the set amount for a building may be \$5000 while the set amount for a pump station or other infrastructure may be \$10000.*
- (4) The set amount must be included in a note in the local government’s financial statements.”*

## 5. GUIDANCE FROM LOCAL GOVERNMENT OFFICES AND OTHER GOVERNMENT ENTITIES

### 5.1 Local Government Victoria

The Local Government Services Division of the Department for Victorian Communities’ *Accounting for non-current physical assets under AASB 116 ‘Property, plant and equipment’ - A guide 2006* discussed the concept of vertical and ‘horizontal’ separation into components and ‘vertical’ separation into segments.

#### *“1.3 ‘Horizontal’ separation into components*

*Almost all infrastructure assets can be separated into component parts. These assets are typically managed at the component level, because each major part has a different life and/or requires different approaches to repair, maintenance and renewal/replacement.*

*The financial reporting standards require that major parts (significant components) of assets be separately identified and depreciated. It is important therefore that the primary or subsidiary accounting records can distinguish between major parts. Ideally, the subsidiary accounting records will be integrated with asset management systems. The way that assets are separated into components and managed in the asset management system should be reflected in the accounting for these assets.*

*The issue of ‘horizontal’ componentisation is partially relevant to road networks.*

*For example, the separable parts of sealed road assets may include the following:*

- Land under roads (not presently required to be accounted for)*
- Road formation or earthworks*
- Road pavement (may be further separated into sub-grade and pavement)*
- Road seal*
- Kerb & channel*
- Traffic control devices (if material)”<sup>3</sup>*

<sup>3</sup> DVC, 2006, Sect 1.3, p7

#### 1.4 'Vertical' separation into segments

*Breaking assets into component parts may not itself be sufficient to adequately account for the assets. Networked assets including roads and drains will often be managed by further division into segments or sections.*

*Criteria used for sectioning networked assets may vary between local governments, but need to be applied consistently over time within a local government. The most common criteria for dividing network assets into sections will be differences arising from:*

- *Dates of initial construction*
- *Dates of renewal or replacement of components*
- *Nature and dimensions of materials uses (different drain diameters or composition)*
- *Construction methods (eg MacAdam roads)*
- *Physical separation (non-contiguous local roads)*

*The objective of this form of componentisation or segmentation is to achieve homogenous groupings of sections of an asset that have similar characteristics.”<sup>4</sup>*

#### Section 2.1.2 discussed capitalisation threshold

*”The cost of acquiring an asset is recorded in the balance sheet. This is called the asset’s initial ‘carrying’ value (sometimes called its “book” value).*

*However, not all assets acquired need to be recorded in the balance sheet. If an individual asset or component of an asset is not ‘material’ the cost of acquisition may be shown as an expense in the period it was incurred.*

*It is common practice to establish a dollar amount as a materiality or capitalisation threshold for each class of asset. Where the cost of an asset or a component of an asset falls below this threshold, it is expensed.*

*What is ‘material’ is detailed in AASB 1031.15 Materiality. It is a decision for each entity based on its own financial position and operating results. It is not appropriate therefore to specify a common threshold to apply to all local governments or even for one local government to use the same threshold each year without reconfirming its relevance and suitability.*

*The test to be applied is whether, for a given threshold, the application of a lower value would produce a materially different financial position or operating result. This can be determined accurately only by modelling different threshold amounts.*

*One way of approaching this issue is to establish a benchmark by modelling using a zero threshold (ie. capitalisation of all expenditure on assets). The results of this modelling should then be compared with increased thresholds.*

*When assessing the impact of different thresholds, particular attention should be given to effect on the annual depreciation expense and the operating result. For example, the threshold should be set so that the annual depreciation charge obtained from the ‘zero’ threshold does not decrease by more than say 10% using the planned threshold.”<sup>5</sup>*

#### Section 3.2 discusses expenditure after acquisition.

*“After an asset is acquired decisions need to be made on how to treat subsequent expenditure on the asset.*

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<sup>4</sup> DVC, 2006, Sect 1.4, p8

<sup>5</sup> DVC, 2006, Sec 2.1.2, p 10

*As previously discussed the acquisition cost of an asset is recognised in the balance sheet when it is acquired. The cost includes an estimate of any subsequent expenditure required to be spent after the planned date of retirement or disposal of the asset.*

*However, other anticipated or planned expenditure between the date of acquisition and the planned date of retirement or disposal of an asset cannot be included in its acquisition cost even if it is first recognised, even if it is known that it will be required.*

*Expenditure on an asset incurred after it comes into service and prior to, or on to its disposal, must either be accounted for as recurrent expenditure and expensed or as capital expenditure and added to the carrying amount of the asset when it is incurred. The decision as to whether the expenditure is expensed or capitalised depends on its relative size (materiality) and how long it is likely to continue to provide benefits. Small, immaterial expenditure and that with benefits unlikely to last for 12 months are expensed. Relatively large, material expenditure with benefits to last for more than 12 months are capitalised.*

### *3.2.1 Maintenance, repair and operating costs*

*The costs of maintenance, repairs and operations are generally expensed.*

*Maintenance is actions taken to ensure that the asset or component achieves its original intended useful life at its desired service levels standards.*

*Cleaning carpets; painting buildings and bridges; and clearing drains are examples of maintenance. The useful life of an asset is normally determined assuming appropriate levels of maintenance and appropriate intervals. A similar principle applies to minor repairs such as treating cracking in spray seals or repairing a lift.*

*Similarly the cost of operating an asset is not capitalised but expensed when it incurred. The cost of staff to run a facility; fuel and power; and the cost of routine inspections are examples of operating costs.*

### *3.2.2 Capital costs*

*Some costs incurred over the life of an asset may be deferred and recorded as part of the carrying value of the asset (refer 2.1.2). The criteria to be applied to determine whether costs should be capitalised is whether, compared to the original assets, the expenditure:*

- is material*
- extends the useful life of the asset, and/or*
- provide additional economic benefits or service potential.*

*The simplest example of a subsequent cost that may be capitalised is the replacement of a major component – for example, replacing the seal on a sealed road segment. The seal is designed to keep water out of the sub-grade or pavement. Water seriously reduces the load carrying capacity of the pavement and subgrade. If a seal is not replaced it will become brittle and crack allowing water ingress. This will seriously reduce the useful life of the road asset segment. Regularly replacing seals will extend the useful life of a pavement and such expenditure should therefore be capitalised where it satisfies the capital threshold criteria (materiality).*

*A similar principle applies to expenditure on other asset components such as gravel re-sheets and re-roofing.*

*Examples of added economic benefit include lane and shoulder widening, or additional lanes on roads or bridges.*

*The accounting standards (AASB 116.14) also clarify the situation in relation to major periodic inspections, particularly where these are an operating requirement - for example for safety reasons. If above the capitalisation threshold (ie material), the cost of such inspections is to be capitalised and depreciated. The full cost of the inspection will usually be fully depreciated (ie no residual value) over the period between the date of the inspection and the date of the next planned inspection.”<sup>6</sup>*

## 5.2 Queensland Audit Office

The Queensland Audit Office, which has been proactive in the area of asset management, produced, in 2003, *Better Practice Guidelines for Non-Current Assets*. The guidelines provide guidance on complex assets.

### *“Introduction*

*Complex assets are assets comprising a number of major components that have different useful lives and may be replaced during the useful life of the complex (or principal) asset. A component of an asset is not specifically defined by any of the prescribed requirements. However it can be deduced from the relevant standards that a major components is that part of the asset that –*

- *Requires substantial expenditure on a major overhaul, refurbishment or refit, or replacement or renewal during the life of the complex asset to which it relates; and*
- *Has a different useful life from the asset to the extent that the depreciation of the asset would be materially misstated if the component asset was not separately identified and depreciated.*

*The prescribed requirements also acknowledge that different components of a complex asset may not be readily identifiable.*

### *Prescribed requirements*

*There is no one specific accounting standard, legislative or regulatory replacement pertaining to complex assets as such, but complex assets (or the principles thereof) are referred to in the Australian Accounting Standards and in the Queensland Treasury non-Current Asset Accounting Guidelines as follows.*

#### *AAS 4/AASB 1021 Depreciation*

*Major components of some non-current assets may require replacement at regular intervals. For example, a furnace may require relining after a specified number of hours of usage or aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe. [Author’s comment – a sealed road will require resurfacing/resealing several times during the life of the road pavement] The components are accounted for as separate assets, and are depreciated separately, because they have useful lives different from those of the non-current asset to which they relate.*

*The breakdown of the asset into separate components enables the allocation of the depreciable amount of these assets over their useful lives in a manner that better reflects the pattern in which the assets’ future economic benefits are consumed or lost to the entity.*

#### *UIG 26 Accounting for Major Cyclic Maintenance*

*Complex assets such as service delivery networks, specialised buildings and major items of plant and equipment may be comprised of a number of major components that have different useful lives and may be replaced during the useful life of the complex asset. In order to allocate the*

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<sup>6</sup> DVC, 2006, pp 15-16

*depreciable amount of these assets over their useful lives in a manner which reflects the pattern in which the asset's future economic benefits are consumed or lost by the entity, it may be necessary for the entity to account for those components as separate assets when they have useful lives different from those of the non-current assets to which they relate.*

*Decisions about which components are accounted for separately usually reflect the systems put in place to ensure that the service delivery capabilities of infrastructure and other complex assets are monitored, managed and maintained on an appropriate basis.*

*The decision as to what constitutes a major component must be based on numerous factors. These include the nature of the asset, how it is maintained, the effect of different parts in other parts, materiality, industry standards and what information is used in strategic and operational asset management.*

*Certain assets may have significant components which are defined as those components that have different estimated useful lives from the asset to which they relate and failure to depreciate them separately would result in a material difference in depreciation expense charged each year.*

*Significant components must be depreciated separately from the main asset to which they belong. The useful life of significant components should be separately estimated in order to determine the appropriate depreciation expense.*

*Significant components should be assigned a value where they exceed the asset recognition threshold for the agency. If a component does not meet the asset recognition threshold, it is reasonable to assume that it would not be cost-effective to value and depreciate the asset separately.*

#### *Depreciation*

*The most important aspect of the accounting treatment of complex assets is the consequent effect on depreciation. The decision on the most appropriate course of action in the accounting for complex assets will be the calculation and comparison of depreciation expense under whole and separate component asset models.*

*This is of particular relevance to large assets such as buildings or infrastructure. The effect of the dissection of an asset into its separate components often has a material impact on the annual depreciation charge against the particular complex asset.”<sup>7</sup>*

QAO believes the following factors should be considered to ensure compliance with prescribed requirements.

- *“Where a major component has a different useful life from that of the complex asset of which it forms part and its depreciation expense is a material element of the total depreciation expense of the complex asset, the major component should be recorded as a separate asset within that class.*
- *In determining the appropriate level of dissection, material components of complex assets must be identified and accounted for. Not all components of the assets need be identified. It is necessary to consider the individual circumstances of the asset and the entity. One rule cannot apply to all situations or types of assets.*
- *By definition, it is unlikely that an asset would generally consist of more than five or six major components. It is unlikely that the identification of any additional components would have a material impact on the depreciation charge.*

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<sup>7</sup> QAO, 2003, pp 31-32

- *The diminishing effect of the impact of different useful lives should be considered. For example, if the life of a component is 25% of that of the total assets, and the component is 10% of the total asset the difference in depreciation will not be a direct impact of 25% but be mitigated by a factor equivalent to the percentage of the component, that is, the impact on depreciation will only be 2.5%.*
- *Entities should ensure that assets are recorded down to their component levels on initial recognition and recording in the asset register. Where assets are constructed by the entity, it is their responsibility to ensure that their costing systems are able to collect costs at the major asset component levels. Where assets are purchased, the entity should have negotiated with the supplier to ensure that sufficient detail is recorded on the supplier's invoice so that the asset components can be separately identified and priced.*
- *Agencies should as a minimum -*
  - *Examine their asset base and identify any complex assets;*
  - *Develop a methodology to account for the components of the complex assets;*
  - *Document their considerations and determinations in relation to any complex assets; and*
  - *Indicate their policy in relation to these requirements in the notes to their financial statements.”<sup>8</sup>*

## 6. OTHER CAPITALISATION POLICIES

### 6.1 Ipswich City Council (Qld)

Ipswich City Council's Annual Financial Statements for 2004-2005 includes part Note 1 to the Financial Statements – Summary of Significant Accounting Policies:

#### ***“(I) Non Current Assets***

*Council has formally adopted a Physical Non Current Asset Statement of Accounting Policy which conveys the accounting policies adopted by it in respect to the recording, valuing, disposing, transferring and depreciating of non current assets. This policy has been prepared in accordance with the requirements of the Local Government Finance Standard 1994. Physical non current assets include land held for development and sale, land and land improvements, buildings, plant and equipment, infrastructure assets, and other non-current assets comprised of artworks and portable and/or attractive items.*

##### *(i) Non Current Assets Threshold*

*In accordance with Section 35 (3) of the Local Government Finance Standard 1994, the Physical Non Current Assets Policy provides for an asset recognition threshold of \$100 for portable or attractive assets and \$5,000 for all other physical non current assets. Expenditure below these thresholds is accordingly treated as an expense.*

##### *(ii) Capital and Operating Expenditure*

*Wages and materials expenditure incurred for the acquisition or construction of assets are treated as capital expenditure. Routine operating maintenance, repair costs and minor renewals to maintain the operational capacity of the non-current asset is expensed as incurred, while expenditure that relates to replacement of a major component of an asset to maintain its service potential is capitalised.*

##### *(iii) Acquisition and Valuation*

*All physical non current assets acquired, over the asset recognition threshold, are initially recorded at their cost of acquisition where this cost is considered to be indicative of their fair value. Cost of acquisition is defined as the fair value of the non current asset plus costs incidental to acquisition. The cost of assets constructed by Council and capital works in progress include the cost of all materials used in construction, direct labour on the project and an appropriate*

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<sup>8</sup> QAO, 2003, p32

*proportion of variable and fixed overheads. Where loan borrowings have been obtained to fund specific capital projects and those projects have extended over a number of financial years, borrowing costs directly attributable to those projects have also been capitalized as part of the costs of construction in accordance with Australian Accounting Standard AAS 34 'Borrowing Costs'.*

*Physical non current assets received in the form of donations or contributions are recognised as both revenues and non current assets in the year in which Council obtains control over the asset. The cost equivalent of acquisition is determined by qualified council staff based on their current fair value.*

*Previously unrecognised non current assets have been brought to account at their written down current values and recognised direct to equity in accordance with Australian Accounting Standard AAS 36 'Statement of Financial Position'.*

*Land with an area under 100 square metres, access restriction strips and underground land are excluded from valuation as their value is not material and the cost of valuing these items would exceed any benefits to be obtained from their valuation.*

*In accordance with Section 36 (2) (a) and (b) of the Local Government Finance Standard 1994, assets with a carrying value up to \$50 000 or useful life of not more than 10 years are valued at historical cost. However during the current year, all asset categories with the exception of Plant & Equipment have been worked out by using the fair value basis to accurately represent the significant market fluctuations experienced in Queensland during the 2004-2005 financial year.*

*Other physical non-current assets are revalued as required by AASB 1041 Revaluation of Non Current Assets. Particulars relating to valuation of Property, Plant and Equipment, including the valuers' methodology, are included in Note 19(b) to the Financial Statements.*

*Amounts paid for identifiable assets (licences and computer software) are capitalised and then amortised on a straight line basis over the expected period of benefit (3 to 10 years). Written down balances and remaining useful lives are reviewed annually to ensure these reflect the probability of continuing future benefits.*

*(iv) Amortisation and Depreciation*

*Land is not depreciated as it has an unlimited useful life. Depreciation on property, plant and equipment is calculated on a straight-line basis so as to write-off the net cost or revalued amount of each depreciable asset, less its estimated residual value, progressively over its estimated useful life to the Council.*

*Assets are depreciated from the date of acquisition or, in respect of internally constructed assets, from the time an asset is completed and commissioned ready for use.*

*Where assets have separately identifiable components that are subject to regular replacement, these components are assigned useful lives distinct from the asset to which they relate. Any expenditure that increases the originally assessed capacity or service potential of an asset is capitalised and the new depreciable amount is depreciated over the remaining useful life of the asset to the Council.*

*Major spares purchased specifically for particular assets that are above the asset recognition threshold are capitalised and depreciated on the same basis as the asset to which they relate.*

*Separately identified components of assets are measured on the same basis as the assets to which they relate and are recognised as a separate asset. These items or components may be replaced during the life of the complex asset. Each component is depreciated over its individual life or the life of the complex asset if shorter.*

*The estimated useful lives of property, plant and equipment are reviewed annually."*

## 6.2 Devonport City Council (Tas)

Devonport City Council's Asset Management – Threshold Limits Policy defines threshold limits for recognition of assets in general purpose financial reports. The threshold limits are defined in physical terms for infrastructure assets. The policy is summarised below.

	Maintenance	Capital
All assets	<ul style="list-style-type: none"> <li>• &lt; \$1,000</li> <li>• \$1,000 - \$5,000 where Manager Technical authorises expensing as maintenance</li> </ul>	<ul style="list-style-type: none"> <li>• &gt; \$1,000</li> <li>• &gt; \$5,000</li> </ul>
Sealed Roads	<ul style="list-style-type: none"> <li>• Bitumen patching</li> <li>• Shoulder grading</li> <li>• Culvert clearing</li> <li>• Table drain clearing</li> <li>• Pavement marking</li> <li>• Signs &amp; guide post maintenance</li> <li>• Cleansing/sweeping</li> <li>• Scrub clearing</li> </ul>	<ul style="list-style-type: none"> <li>• Heavy patching &gt; 50 m2</li> <li>• Culvert construction</li> <li>• Re-profiling</li> <li>• Resurfacing(inc rehabilitation, structural overlay, non-structural overlay)</li> </ul>
Unsealed Roads	<ul style="list-style-type: none"> <li>• Grading</li> <li>• Culvert clearing</li> <li>• Table drain clearing</li> <li>• Signs &amp; guide post maintenance</li> <li>• Cleansing/sweeping</li> <li>• Scrub clearing</li> </ul>	<ul style="list-style-type: none"> <li>• Heavy patching &gt; 50 m2</li> <li>• Culvert construction</li> <li>• Regravelling &gt; 100 m2</li> </ul>
Footpaths	<ul style="list-style-type: none"> <li>• Concrete replacement &lt; 25 m2</li> <li>• Regravelling</li> <li>• Bitumen patching</li> <li>• Resetting segmented blocks</li> </ul>	<ul style="list-style-type: none"> <li>• Concrete replacement &gt; 25 m2</li> <li>• Forming new footpaths</li> <li>• New paved footpaths</li> <li>• Resealing bitumen footpaths</li> </ul>
Traffic Islands & Roundabouts	<ul style="list-style-type: none"> <li>• Repairs to existing islands</li> <li>• Replacing signs</li> <li>• Pavement markings</li> </ul>	<ul style="list-style-type: none"> <li>• New installation including furniture</li> </ul>
Kerb & Channel	<ul style="list-style-type: none"> <li>• Replacement &lt; 15 m length</li> </ul>	<ul style="list-style-type: none"> <li>• Replacement &gt; 15 m length</li> </ul>
Drainage Pits	<ul style="list-style-type: none"> <li>• Component replacement</li> <li>• Clearing/cleaning</li> </ul>	<ul style="list-style-type: none"> <li>• Total pit replacement</li> <li>• New installations</li> </ul>
Guide posts	<ul style="list-style-type: none"> <li>• Other new guide posts</li> <li>• Replacements</li> </ul>	<ul style="list-style-type: none"> <li>• Guide posts as part of new installation</li> </ul>
Signs: Street Name and Traffic	<ul style="list-style-type: none"> <li>• Other new signs</li> <li>• Replacement signs</li> <li>• Re-straightening</li> </ul>	<ul style="list-style-type: none"> <li>• Signs as part of new installation</li> </ul>
Drainage	<ul style="list-style-type: none"> <li>• Repair and refurbishment of existing asset components</li> </ul>	<ul style="list-style-type: none"> <li>• Installation of new or replacement of more than one standard length of main including associate structures (pit, access point, headwall, etc)</li> <li>• Installation of a new, complete access point or pit to introduce a new main into the reticulation system or to replace an existing assembly</li> </ul>

Buildings	<ul style="list-style-type: none"> <li>Replacing only part of a building component (walls, floors, roof, ceiling and windows)</li> <li>Repairs to building component or part component</li> </ul>	<ul style="list-style-type: none"> <li>New structures</li> <li>Replacing whole of a building</li> </ul>
Parks & Reserves	<ul style="list-style-type: none"> <li>All expenditure other than defined as capital</li> </ul>	<ul style="list-style-type: none"> <li>Establishment of new parks and extensions to existing parks &gt; 1,000 m<sup>2</sup></li> <li>Landscaping or other improvement &gt; \$1,000</li> </ul>
Plant & Equipment	<ul style="list-style-type: none"> <li>All expenditure other than defined as capital</li> </ul>	<ul style="list-style-type: none"> <li>Individual assets &gt; \$1,000</li> <li>Network asset groups with aggregate price &gt; \$1,000</li> </ul>

### 6.3 Salisbury City Council (SA)

Salisbury City Council conducted a review of its asset capitalisation policy in 2006. The existing policy prior to the review is shown below. The policy is supported by guidelines.

*“Capital Expenditure are amounts expended to acquire future service potential or economic benefits. Such expenditure will be recognized where it can be clearly identified that:*

1. *Services or benefits will be received in future periods; and*
2. *The expenditure represents a single purchase or acquisition in excess of*
  - (a) *\$1,000 for asset types:*
    - *Plant and equipment*
    - *Office equipment and furniture and fittings*
  - (b) *\$3,000 for replacement of building fixtures and fittings (eg hot water systems, air-conditioning, flooring, curtains, light fittings, heating, cooking stoves, etc)*
  - (c) *\$5,000 for all other asset types excepting network assets (see guidelines).<sup>9</sup>*

The policy review identified the work activities associated with providing services from the assets and classified them into operations, maintenance, renewal and upgrade. An example of the classification of work activities for building and road assets is shown below.

#### *“Asset Capitalisation Threshold – Building & Other Structures*

*Buildings assets are recognised at the following asset level (building item)*

- *Building item (useful life ~ 50-100 yrs)*
- *Other structures (useful life ~ 10-100 yrs)*

<i>Work Activity</i>			
<i>Operations</i>	<i>Maintenance and Repair</i>	<i>Capital Renewal</i>	<i>Capital New</i>
<ul style="list-style-type: none"> <li><i>Service delivery and property management including condition assessment, defect inspection and facility management systems operations</i></li> <li><i>Supervision</i></li> <li><i>Utility service costs</i></li> <li><i>Cleaning</i></li> </ul>	<ul style="list-style-type: none"> <li><i>Reactive maintenance and repair</i></li> <li><i>Programmed maintenance (painting, structural repairs, replacing windows, fencing, guttering, drains, etc)</i></li> <li><i>Component replacement (floors, roof, carpets, air/conditioning plant , etc) &lt; \$10,000</i></li> </ul>	<ul style="list-style-type: none"> <li><i>Replacement of building asset with same standard</i></li> <li><i>Component replacement &gt; \$10,000</i></li> </ul>	<ul style="list-style-type: none"> <li><i>New assets</i></li> <li><i>Fit out &gt; \$10,000</i></li> <li><i>Upgrade assets</i></li> </ul>

<sup>9</sup> Jeff Roorda & Associates & Skilmar Systems, 2006, p 1

- *Building renewal/rehabilitation/reconstruction (remove and replace) (complete asset) is recognised as a new asset and the old asset retired from the asset stock.*
- *Building component renewal (partial asset) is recognised by adding the component replacement cost to the existing asset value and reviewing the remaining/useful life of the renewed asset to recognise the restored economic benefits to the entity.”<sup>10</sup>*

*Asset Capitalisation Threshold – Road Assets*

*Road assets are recognised at the following asset level (Pavement Management System segments 50-600 m urban, 100-2000 m length rural)*

- *Sealed surfaces (useful life 13-25 yrs)*
- *Sealed pavements (useful life 40-80 yrs)*
- *Unsealed pavement are held at an average depreciated replacement cost and not depreciated*
- *Earthworks and formation are not recognised*

<i>Work Activity</i>			
<i>Operations</i>	<i>Maintenance and Repair</i>	<i>Capital Renewal</i>	<i>Capital New</i>
<ul style="list-style-type: none"> <li>• <i>Service delivery management including condition assessment, defect inspection and PMS operations</i></li> <li>• <i>Supervision</i></li> <li>• <i>Pavement markings</i></li> <li>• <i>Landscaping maintenance (inc. mowing, slashing, shrub clearing, etc.)</i></li> <li>• <i>Culvert and table drain clearing</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>Reactive maintenance and repair to road assets (pothole repair, guidepost replacement, signs repair and replacement)</i></li> <li>• <i>Programmed maintenance (sealed road resurfacing preparation/patching, unsealed road grading)</i></li> <li>• <i>Sealed pavement partial renewal/ rehabilitation (heavy patching)</i></li> <li>• <i>Unsealed road resheeting*</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>Pavement replacement/ renewal of main (whole) asset with same standard</i></li> <li>• <i>Resurfacing with same standard</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>New assets</i></li> <li>• <i>Pavement upgrade - renewal with higher standard (&gt; same standard)</i></li> <li>• <i>Resurfacing upgrade with higher standard (&gt; same standard)</i></li> <li>• <i>Land acquired for road works</i></li> </ul>

- *Resurfacings are recognised as a new asset and the old asset retired from the asset stock.*
- *Pavement renewal/rehabilitation/reconstruction (remove and replace) (complete asset) is recognised as a new asset and the old asset retired from the asset stock.*
- *Pavement low cost renewal (stabilisation, tyne/add rubble and seal, etc of complete asset) is recognised as a new asset with the old asset revalued to recognise its residual value.*
- *Land under roads acquired for roadworks is recognised as a new asset. When the Certificate of Title for the land no longer exists, the land value is excluded from land values.*

*Council’s current expenditure on road patching (including partial renewal) is \$800,000. Approx 1,000 m2 is treated each month with the majority of treatments less than 25 m2 in area.*

Note: \* Salisbury has a very low length of unsealed roads (< 5%) and considers resheeting expenditure below materiality limits.

The definition of capital thresholds in physical terms is similar to that adopted by Devonport City Council. This process allows the decision as to whether a work activity is maintenance or capital to be made when the work is planned and minimises time of finance staff in deciding whether a completed work action was maintenance or capital and making journal entries to capitalise or expense the work action expenditure.

<sup>10</sup> Op cit, Table 4, p 20

The process defined renewal as replacement of a complete building or component > \$10,000 and gives guidance in the estimation of remaining and useful life of the building.

The definitions included the documenting the definition of an asset and commentary on the business process for recognising capital renewal expenditure.

## 7. SUMMARY

This section summarises the research in Sections 3-6.

Accounting Standards require that parts of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item be depreciated separately.<sup>11</sup>

UIG 26 provides guidance for complex assets comprising a number of major components with different lives and advises that these components be identified as separate assets in order to allocate the depreciable amount of the asset over its useful life in a manner which reflects the pattern in which the asset's future economic benefits are consumed.

QAO<sup>12</sup> defined complex assets as assets comprising a number of major components that have different useful lives and may be replaced during the useful life of the complex (or principal asset).

Thus, components of complex assets, such as infrastructure assets should be identified as separate assets where:

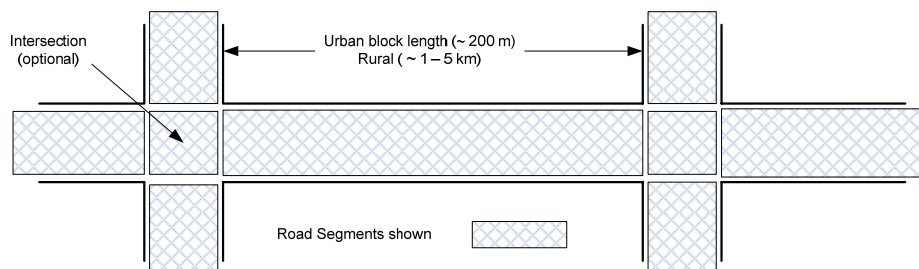
- they have a cost that is significant in relation to the total cost of the complex asset, and
- a component has a different useful life to the useful life of the complex asset.

The capitalisation policy should identify those components of complex assets whose cost is significant to the total cost of the complex asset and whose useful life is different to the useful life of the complex asset.

DVC<sup>13</sup> provides guidance on identifying components by the concept of horizontal separation into components and vertical separation into segments. This concept can be applied to a road network, with reversal of the terminology to suit the road management principles.

Roads are generally broken into segments that are used for operational and strategic management purposes. This includes planning maintenance and renewal, recording condition, recording work activities. An example of road segmentation is shown in Fig 1.

**Fig 1. Road Segmentation Example**



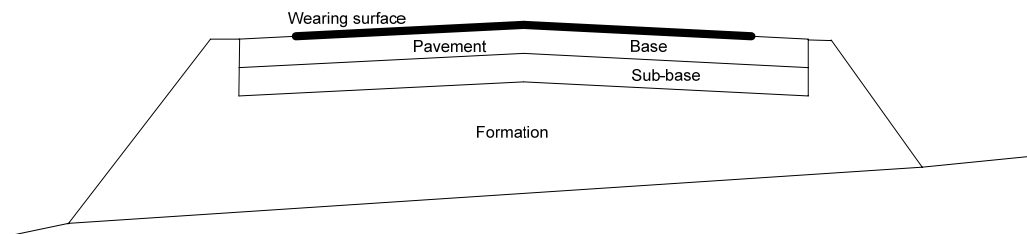
<sup>11</sup> AASB 166.43

<sup>12</sup> QAO, 2003

<sup>13</sup> DVC, 2006

Some items within a segment are further broken down into components reflecting the different life of these components. Fig 2 shows an example of road componentisation where the components are identified and recognised as assets.

**Fig 2. Rural Road Componentisation within Segments Example**



Components of a rural road with different useful lives can include the wearing surface (~ 10-20 years) pavement (~ 30–80 years) and formation (100 + years or may not be depreciated). The pavement may be split further into base and sub-base assets depending on the expected service life and renewal strategy adopted for the road.

Componentisation of buildings is undertaken in a similar manner depending on the size and cost of the building.

- A small building (eg toilet block) may be recorded as a single asset
- A medium building (eg water/sewer pump station) may be recorded as 3 or more assets, building structure, mechanical equipment and electrical equipment.
- A large building may be recorded as many assets, building structure, air conditioning plant, electrical switchboard, roof, floor coverings, fitout, electrical cabling, car park, landscaping, specialised equipment, etc.

The accounting concept of materiality is useful in assisting organisations to make sound judgements about the level of detail that needs to be recorded about the acquisition, maintenance and renewal costs of assets. There is a world of difference in keeping a record of attractive items (low value, but requiring effective control to ensure they are not mislaid or stolen) and classing those same items as assets and controlling them through the asset register, with its onerous requirements for depreciation and regular re-valuation, including all the necessary accounting transactions! It also allows a broader view of what is maintenance and what is renewal to be taken, using some financial limit as the test, which obviates the inadvertent classification of minor work on assets which does not extend their useful life as being capital expenditure. Again, this significantly reduces the accounting effort, without materially affecting the financial statements.

The identification of components as individual assets is the judgement of the entity. DVC suggest applying a materiality test and modelling different threshold amounts from a zero threshold where all expenditure is capitalised until the annual depreciation charge from the 'zero' threshold does not decrease by more than say 10% using the planned threshold.

It is a significant challenge for organisations to manage their assets. Good records about the assets are a key and necessary step to effective asset management, along with knowledge about asset values and asset lives. For complex assets, which can readily be broken down into major components, each of which will have different values and lives, the work of breaking down the assets and understanding the attributes of each major component will provide a better knowledge basis for managing the assets than treating them as single assets.

Like many activities, asset management is about balancing the needs for knowledge with the time available for effective management. Each organisation needs to exercise its own judgement about capitalisation thresholds and the recording of information about assets. The judgements made need to take account of the capacity of the organisation to manage its assets, the effort required to maintain asset records, the effectiveness of asset management plans and the legislative and accounting standard requirements.

The capitalisation policy defines the criteria used to distinguish which expenditure is to be capitalised and which is to be expensed.

The capitalisation criteria can be in dollar values or in work activity terms as used by Devonport and Salisbury City Councils.

## **8. RECOMMENDED POSITION**

1. Councils develop a capitalisation threshold policy to distinguish between expenditure on long-lived assets and expenditure on goods and services for immediate consumption.
2. Capitalisation policies determining capitalisation thresholds for each asset class be determined by each entity considering the following issues:
  - a. The entity's revenue base and asset stock,
  - b. The nature of work undertaken by the entity in creating and maintaining infrastructure assets,
  - c. The level of detail that is required for managing the assets and providing services from the assets,
  - d. The level of detail that is required for recognising, depreciating, revaluing and disposing of assets at the end of their life,
  - e. The control of attractive assets (low value but requiring effective control to ensure they are not mislaid or stolen) by methods other than through the asset register such as an attractive assets register,
  - f. Balancing the workload of recognising, depreciating, revaluing and disposing of assets against the materiality in financial reporting and asset knowledge for asset management,
  - g. The business systems required to implement capitalisation thresholds from work planning through to asset accounting.
3. Capitalisation policies distinguish between expenditure on long-lived assets and expenditure on goods and services for immediate consumption by identifying and classifying work activities into operations/maintenance and capital. An example of this methodology from the City of Salisbury is shown below.

Asset Capitalisation Threshold – Road Assets

Work Activity			
Operations	Maintenance and Repair	Capital Renewal	Capital New
<ul style="list-style-type: none"> <li>• Service delivery management including condition assessment, defect inspection and PMS operations</li> <li>• Supervision</li> <li>• Pavement markings</li> <li>• Landscaping maintenance (inc. mowing, slashing, shrub clearing, etc.)</li> <li>• Culvert and table drain clearing</li> </ul>	<ul style="list-style-type: none"> <li>• Reactive maintenance and repair to road assets (pothole repair, guidepost replacement, signs repair and replacement)</li> <li>• Programmed maintenance (sealed road resurfacing preparation/patching, unsealed road grading)</li> <li>• Sealed pavement partial renewal/ rehabilitation (heavy patching)</li> <li>• Unsealed road resheeting*</li> </ul>	<ul style="list-style-type: none"> <li>• Pavement replacement/ renewal of main (whole) asset with same standard</li> <li>• Resurfacing with same standard</li> </ul>	<ul style="list-style-type: none"> <li>• New assets</li> <li>• Pavement upgrade - renewal with higher standard (&gt; same standard)</li> <li>• Resurfacing upgrade with higher standard (&gt; same standard)</li> <li>• Land acquired for road works</li> </ul>

Note: \* Salisbury has a very low length of unsealed roads (< 5%) and considers resheeting expenditure below materiality limits.

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Note for footnotes; *ibid* – in the same place, *op cit* already cited.


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