To Capitalize, or Not to Capitalize — That is the Question

By Leonard J. Flood

In establishing a capitalization threshold, governments should ask themselves: What needs to be accounted for in our financial statements, and how can we capture the maximum value while accounting for the minimum number of assets?

In the world of capital assets, there is a vast difference between controlling and accounting for them. When determining what is more important in your jurisdiction, you must first look at the realities of budget and staff size, but you also need to consider the question from a practical perspective. What do we need to control and why? Will micromanaging our capital assets lead to more control or just more work? What needs to be accounted for in our financial statements, and how can we capture the maximum value while accounting for the minimum number of assets?

GFOA's recommended practice, "Establishing Appropriate Capitalization Thresholds for Tangible Capital Assets," helps answer some of these questions. ". . . a government's principal concern in establishing specific capitalization thresholds ought to be the anticipated information needs of the users of the government's external financial statements," it reads. GFOA recommends that tangible assets only be capitalized if they have an estimated useful life of at least two years, that infrastructure assets be treated separately from other capital assets for the purpose of establishing capitalization thresholds, that thresholds never fall below $5,000, and that governments establish procedures at the departmental level for controlling non-capitalized items.

COUNTING STAPLERS

A lot has changed both in terms of the control of and accounting for capital assets at the Village of Lombard, Illinois, since I joined the Finance Department in 1991. Lombard is a suburban community of more than 42,000 located just 20 miles west of downtown Chicago and the shore of Lake Michigan. In the early 1990s, the purchasing function was centralized in the Finance Department, where it was supervised by a purchasing clerk. Although the Village did not have a formal capital asset policy, control of capital assets was of primary importance. Almost any tangible item purchased was considered a "fixed asset." Even today, I can find evidence of this level of control in the form of staplers, in-boxes, and pencil sharpeners bearing a Village of Lombard inventory tag and number. While no one actually kept track of these items, our purchasing clerk was tireless in her efforts to see that everything was properly tagged—as if this practice would ensure that no items were misappropriated.

After settling into my position, I came to two conclusions. First, to go through the ritual of tagging without tracking was a waste of time, money, and valuable staff resources. Second, in our desire to know where all the Village's "stuff" was located, we really didn't have any idea what was important or why.

Knowing that changes come slowly to organizations, I took small steps to gain control of the process. Understanding that a small staff with ever-increasing demands in accounting and other areas of departmental operations could not continue to focus on capital assets to the extent that we had been, we introduced two changes in 1993. First, we eliminated the position of purchasing clerk and reallocated those resources elsewhere. While Finance still oversees purchasing, the process has been decentralized and entirely automated through our financial system.

Next, we developed a formal capital asset policy clearly identifying what constituted a capital asset and raising the capitalization threshold to $2,500. This was quite a move for an organization that counted staplers just a few years before. The policy also decentralized control of capital assets, shifting responsibility to the departments. After all, who better to keep track of assets than the departments that actually use them? The director of finance retained the authority to require departments to inventory assets under the capitalization threshold that, in the aggregate, comprise a substantial asset group (for example, guns in the Police Department). Departments track these assets using inventory spreadsheets that are subject to internal audit at any time. We stopped tagging assets, and no one has missed it since.

In 1998, we took another look at our capitalization threshold and decided to raise it to $5,000. At that time, we were in a better position to quantify exactly what such a change would mean. Implementing this increase would eliminate the accounting for more than 25 percent of the Village's capital assets, but would still allow us to capture for financial reporting purposes more than 95 percent of the value. Given the savings in staff time, we felt this was a good trade-off.

THE GASB 34 EFFECT

When GASB 34 came along in 2000, we were forced to take yet another look at the issue of capital assets. With the assistance of our auditors, we revised the capital asset policy to comply with GASB 34. The revised policy addressed four areas: infrastructure accounting, property control, capitalization threshold, and depreciation methods. The changes were sweeping.

We expanded the definition of infrastructure to capture roads, bridges, traffic lights, streetlights, and sidewalks. We limited capitalization of roads to cases in which they were torn down to the base and rebuilt, eliminating the need to worry about street repaving—a relatively minor expense compared to street reconstruction. Grind and overlay and street patching were considered a maintenance item.

The policy also clarified the capitalization process for the water and sewer system. Capitalization would occur "when the project constructs additional infrastructure or replaces infrastructure *and* meets the capitalization threshold." Repairs that did not materially extend the life of the asset and did not meet the capitalization threshold would not be capitalized. We recommended capitalizing all expenses relating to projects, including engineering and legal expenses.

Obviously, the capitalization threshold would be essential to determining the amount of work that would go into implementing this GASB 34 reporting requirement. We went back to the same thought process we used when we increased the threshold from $2,500 to $5,000. Our intent was to capture the maximum asset value from as few assets as possible, thereby streamlining the accounting for capital assets by reducing the number of assets we had to track.

We estimated that more than 90 percent of the Village's capital assets were in buildings and infrastructure. However, the greatest number of assets fell within the $5,000 to $50,000 range, most notably vehicles and equipment. Since the Village already maintains a comprehensive vehicle and equipment replacement schedule and the threat of someone walking off with one of our squad cars was minimal, we recommended the following capitalization thresholds:

- $50,000 on a per unit basis for machinery, equipment, and vehicles
- $100,000 for buildings and improvements
- $200,000 for land and infrastructure

Similar to the vehicle and equipment replacement schedules, the Village maintains an inventory and replacement schedule for computer equipment and other major pieces of equipment such as copiers. While the number of these items exceeds 1,000, few of them exceed the old $5,000 threshold. As such, moving the capitalization threshold to $50,000 seemed appropriate and practical.

Six months after the preliminary review of the revised capital asset policy with the Finance Committee—a six-member citizen committee that reviews all financial policies and recommends them to the Village Board for adoption—staff presented the final version of the policy to the members for review and approval. The Finance Committee unanimously approved the revised policy in May 2002, and the Village Board officially adopted it a month later. Since then, the number of assets capitalized has been reduced by 80 percent, while the total dollar amount of assets capitalized fell just 7.5 percent.

ISSUES TO CONSIDER

Lombard's experience may hold some lessons for other jurisdictions grappling with the question of where to set their capitalization thresholds or contemplating a new or revised capital asset policy. The following are just a few important issues to consider:

- Know what you want to control versus what you are required to account for under GASB 34.

- Determine whether your capital asset accounting system is the best way to control your assets.
- Consider your resources both in terms of staff time and costs of computer software and outside consulting. Limits on both these may guide you to an easier solution to the problem.
- In developing a capital asset policy, solicit the input and address the concerns of staff, auditors, committee members, and senior management. Make them aware of proposed changes and explain why the changes are necessary.
- Finally, ask yourself a question. What is easier: taking your time to implement a comprehensive, well-reasoned policy or tagging your staplers in 2004 and beyond? ∎

LEONARD J. FLOOD is director of finance and treasurer for the Village of Lombard, Illinois.