Managing and Accounting for Fixed Assets

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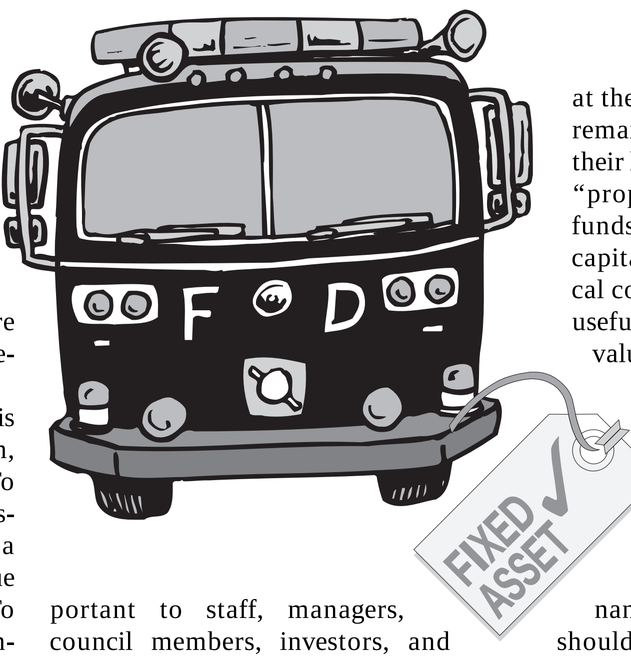
Fixed assets represent a significant investment of public dollars for local governments and public authorities. Items that constitute fixed assets are tangible in nature and normally have a useful life of at least two years. Commonly used classifications of fixed assets are land, buildings, equipment, and vehicles.

Maintaining control of fixed assets is a function of the entire organization, not just the accounting department. To maintain financial control of fixed assets from an accounting perspective, a locality must properly report their value on its annual financial statements. To maintain internal control from a management perspective (that is, to ensure use of the assets for authorized purposes and to prevent their misuse or theft), the locality must assign custodial responsibility for fixed assets to the department and division managers who employ them for service delivery. A fixed assets policy based on the recommended practices of the Government Finance Officers Association (GFOA) and the Local Government Commission (LGC) is essential to obtaining both types of control.

External auditors review fixed assets records and internal controls during the annual audit. They issue an "unqualified audit opinion" if the general-purpose financial statements present fairly, in all material respects, the financial position of the organization. This type of audit opinion is extremely im-



portant to staff, managers, council members, investors, and creditors. External auditors issue a "qualified audit opinion" if they find that the financial statements are inadequate in a material respect. Lack of control over fixed assets is one of the primary causes for receiving a qualified audit opinion. For localities that receive a qualified opinion concerning their accounting for fixed assets, the LGC will no longer authorize the issuance of long-term debt (bonds).[1]

The purpose of this article is to encourage localities to review their fixed assets policies and to establish capitalization thresholds based on criteria proposed by the GFOA and the LGC. A "capitalization threshold" is the dollar value at which assets are "capitalized" (carried on the general ledger) rather than "expensed" (shown on the general ledger as a decrease in cash and an increase in expenditures). Fixed assets purchased by "governmental funds" (public-purpose funds, such as public safety and public works) are capitalized at their original historical cost and remain at that value throughout their life. Fixed assets purchased by "proprietary funds" (business-like funds, such as public utilities) are capitalized at their original historical cost and depreciated over their useful life. Items of insignificant value are simply expensed in their year of purchase.

Localities tend to capitalize assets at dollar values much lower than needed, setting policy primarily to satisfy the internal control function rather than the financial reporting function.[2] They should set the dollar value for capitalization of assets with the objective of accurately reporting the value of fixed assets on their annual financial statements. Internal control of fixed assets should be addressed in the fixed assets policy by more effective means than the capitalization threshold.

Legal, Administrative, and GAAP Requirements

The North Carolina General Statutes (hereinafter G.S.) do not address the management of fixed assets in detail, providing flexibility for local governments. G.S. 159-26(a) states that "each local government or public authority shall establish and maintain an accounting system designed to show in detail its assets, liabilities, equities, revenues, and expenditures." Additionally, G.S. 159-26(b)(8) requires that an accounting system be designed to provide for "a ledger or group of accounts in which to record the details relating to

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the general fixed assets of the unit or public authority."

The North Carolina Department of State Treasurer *Policies Manual* expounds on G.S. 159-26(a) and G.S. 159-26(b)(8), providing detailed instructions on fixed assets management, including the capitalization threshold. It concludes that the dollar amount set for capitalizing assets is a policy decision of the governing board.

Three of the twelve generally accepted accounting principles (GAAP) deal directly with managing and accounting for fixed assets.[3] None of the principles, however, address what is a proper capitalization threshold, again leaving that to each locality to decide on the basis of its individual needs.

Fixed Assets Records and Audit Findings

Fixed assets records are used for a variety of reasons and should be accurate and complete. They are periodically reconciled with departments' actual fixed assets to ensure fulfillment of the departments' custodial responsibility. Risk management personnel use them to ensure that the organization is properly protected with insurance coverage.[4] Analysts often need fixed assets records when completing special assignments, and they are used to report the beginning value, additions, disposals, and ending value of an entity's fixed assets on the annual financial statements.

External auditors move toward a qualified audit opinion when fixed assets records do not materially reflect the value of fixed assets or when proper internal controls are not in place to safeguard the assets. Therefore, in developing a fixed assets policy, local officials should understand the audit process and likely sources of problems.

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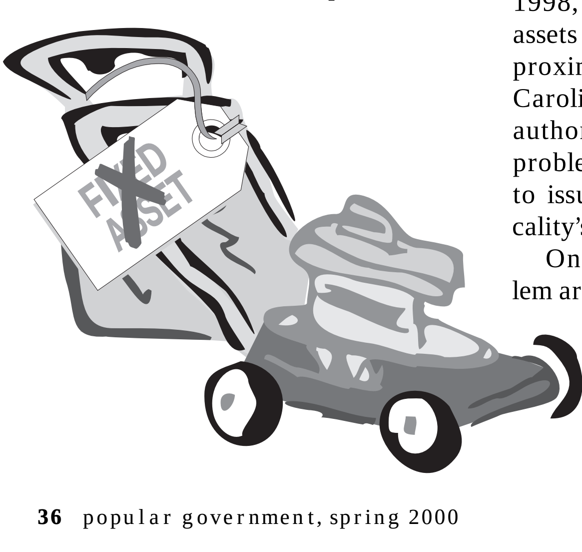


The external auditors begin with an examination of the organization's fixed assets policy and procedures. At this point the auditors are determining whether adequate controls are in place and whether the organization is following its policy and procedures. Auditors typically intensify their examination of fixed assets records when they uncover problems during this initial review. Problems tend to emanate primarily from one of the following areas:

1. Fixed assets already disposed of still appear on the fixed assets list. This is the most common source of audit problems.
2. Fixed assets recently purchased by the organization are not listed on the fixed assets list.
3. Fixed assets that appear on the fixed assets list are not valued correctly.

For audits at the end of fiscal year 1998, external auditors identified fixed assets weaknesses as problems for approximately 12.5 percent of North Carolina local governments and public authorities.[5] If not corrected, these problems can force an external auditor to issue a qualified opinion for a locality's financial statements.

One key to avoiding the major problem areas is to avoid basing a capitalization threshold solely on the internal control function. When concerns about internal control dictate the dollar value for capitalizing assets, the capitalization threshold is likely to be lower than needed, and fixed assets records become difficult to manage. The financial reporting goal is to record the necessary information accurately when a fixed asset is acquired, maintain the information during the life of the asset, and delete the information after disposal of the asset. Localities can decrease the probability of a qualified audit opinion by following the recommendations of the GFOA and the LGC.

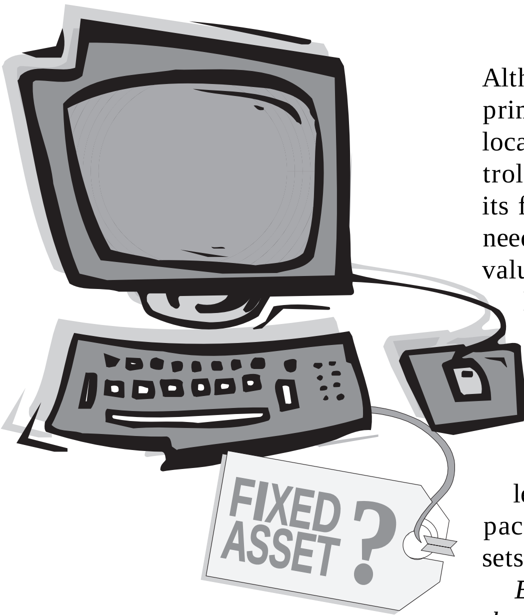
Capitalization Threshold

An effective fixed assets policy must be tailored to the individual needs of an organization. Therefore the organization must reconcile the recommendations offered by the GFOA and the LGC with its own demands.

Estimating the useful life of assets. A fixed assets policy should begin by stating its purpose and effective date. It then should define fixed assets. The LGC maintains that "fixed assets are tangible in nature and have a useful life longer than one year. They are classified as land, improvements other than buildings, buildings, operating plants, equipment, and construction in progress."[6] The GFOA promotes a similar definition but states that "fixed assets should be capitalized only if they have an estimated useful life of at least two years following the date of acquisition."[7] Normally a locality capitalizes assets with a useful life of at least two years unless special circumstances dictate otherwise.

Determining the threshold. The next step is to establish the capitalization threshold. In practice, land and buildings always are capitalized, so the capitalization threshold primarily applies to equipment and vehicles. The GFOA maintains that "as a general rule, capitalization thresholds should be designed to encompass approximately 80 percent of a government's total noninfrastructure assets"—that is, assets other than items like roads, bridges, and sidewalks.[8] In addition, the GFOA recommends that a government never use a capitalization threshold of less than $1,000 for any individual item.[9]

The LGC states that "equipment and vehicles costing $500 or more should be recorded as fixed assets."[10] To rec-



oncile the two recommendations, localities should begin by applying the 80 percent rule. As for the actual dollar threshold for individual assets, a manageable one would normally fall between $1,000 and $5,000 for larger localities.[11] Smaller localities may have to employ a threshold of less than $1,000 to reflect the value of fixed assets materially. Localities should be extremely cautious when adopting a capitalization threshold of less than $500. A lower threshold begins to compromise the accuracy of the fixed assets records because it results in the need to record and track a large number of items.

Applying the capitalization threshold. The fixed assets policy should address whether the capitalization threshold applies to individual assets or groups of assets. The GFOA recommends that capitalization thresholds apply to individual fixed assets only.[12] The LGC approaches this issue slightly differently, giving localities the needed flexibility to record groups of assets. For example, the value of individual desks in local schools may fall well below the capitalization threshold. However, together the desks represent a significant investment and may have a material impact on the overall value of fixed assets if they are not capitalized. If a locality is going to capitalize groups of assets, its fixed assets policy should specify what groups and why. The reason is to avoid ambiguity that may cause problems during the audit process.

Internal Control Function

Although the capitalization threshold is primarily a financial reporting issue, a locality should address the internal control function during the development of its fixed assets policy. Localities often need to track certain assets regardless of value—weapons purchased by the police department, for example. The LGC suggests that localities faced with this issue assign a value of one dollar to each asset and track it accordingly.[13] (Assigning a one-dollar value overcomes the problem that some accounting software packages will not let the user enter assets with a value of zero).

Establishing multiple capitalization thresholds. The GFOA maintains that a "government may establish a single capitalization threshold for all of its fixed assets or establish multiple capitalization thresholds for different classes of fixed assets."[14] Localities should consider multiple thresholds to control certain specialty items—for example, data processing equipment. Multiple capitalization thresholds sometimes are appropriate, but localities should be careful not to expand excessively the number of items that they must record as fixed assets.

Assigning custodial responsibility. The fixed assets policy should require department and division managers to establish procedures that address the control not only of fixed assets but of assets that fall below the capitalization threshold. With a threshold of $1,000, for example, most lawn-maintenance equipment, like mowers and shredders, would not be capitalized. However, department and division managers must tag and track these assets. This form of control can be more effective in preventing misuse than a control mechanism located in the accounting area. The organization therefore should assign custodial responsibility to individuals who can immediately detect problems associated with fixed assets. For an additional control measure, the finance department should maintain copies of all assets records.

Conducting periodic inventories. The GFOA recommends conducting periodic inventories of capitalized fixed assets and supports a physical count based on a rotating method to ensure that all fixed assets are accounted for at least once every five years.[15] The LGC recommends annual verification of the existence and the condition of all fixed assets.[16] The LGC recommendation is more realistic for adequate control but should be expanded to include certain assets that may fall below the capitalization threshold. For example, periodically, localities should physically verify the existence of weapons, computer equipment, and lawn-maintenance equipment that are not capitalized.

Reporting of a Change in the Capitalization Threshold

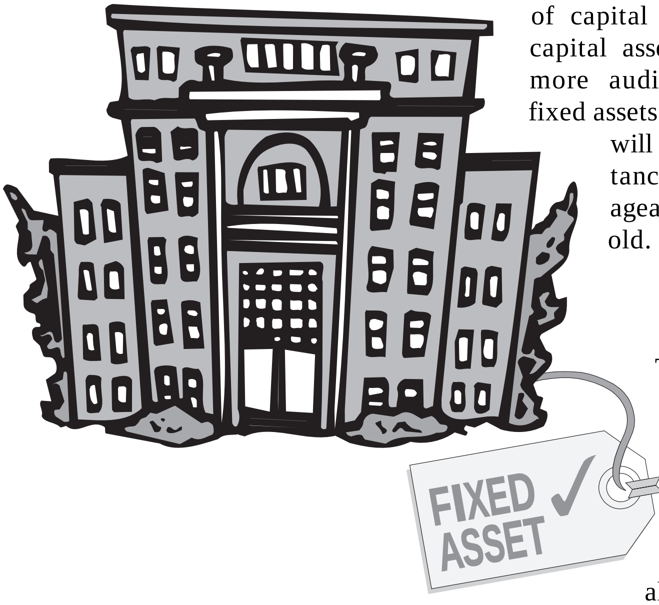
When a locality increases its capitalization threshold, it must delete from the fixed assets list the items that fall below the new dollar value. It also must adjust the notes to its financial statements[17] (see Table 1 for an illustration of how to show this change for general fixed assets).[18]

Reporting the actual dollar amount of the new capitalization threshold is

Table 1. General Fixed Assets

	June 30, 1999 $	Adjustments $	Additions $	Disposals $	June 30, 2000 $
Land and improvements	1,000,000	—	10,000	—	1,010,000
Buildings	14,000,000	—	—	—	14,000,000
Furniture and equipment	5,000,000	(1,500,000)	500,000	(400,000)	3,600,000
Vehicles	8,000,000	—	1,000,000	(1,000,000)	8,000,000
	28,000,000	(1,500,000)	1,510,000	(1,400,000)	26,610,000

Note: The $1,500,000 in adjustments reflects a change in the capitalization threshold.



optional. The purpose of the adjustments column is to avoid overstating the disposal of fixed assets and to let the reader know that a change has been made. In Table 1 the $1.5 million value decrease resulting from an increase in the capitalization threshold is relatively small compared with the overall total of approximately $26.6 million. The major impact of the change is the number of items that have been removed from the fixed assets list.

New Requirements for Recording Infrastructure and Depreciating Capital Assets

The Governmental Accounting Standards Board's recent passage of Statement No. 34 has heightened the importance of accurate fixed assets records.[19] The new pronouncement requires the recording and the tracking of infrastructure along with customary fixed assets. Further, because of its inclusion of infrastructure, the board has substituted the term "capital assets" for "fixed assets." The capitalization threshold will not be a major issue in determining whether to record infrastructure or not. Like land and buildings, infrastructure is almost always recorded as a capital asset. The issue is with a new depreciation requirement for governmental funds. After the implementation of Statement No. 34, capital assets, including equipment and vehicles, will have to be depreciated. This requirement will force external auditors to intensify their examination of capital assets records (because capital assets records will contain more auditable information than fixed assets records do). That in turn will place additional importance on establishing a manageable capitalization threshold.

Conclusion

The capitalization threshold and the internal control function are extremely important to a meaningful and manageable fixed assets policy. Localities also should address other areas when constructing a fixed assets policy, including the use of only capital accounts to purchase fixed assets and the offering of annual training in the management of fixed assets. Often overlooked, annual training is an excellent way to expose employees regularly to the idea that managing assets is a function of the entire organization, not just the accounting department.

Local governments tend to capitalize assets at overly low dollar values. When seen only in the context of control, this practice is explainable. Capitalization thresholds, however, are a function of financial reporting. The guidance presented by the GFOA and the LGC offers a logical approach for establishing a meaningful and manageable capitalization threshold. Based on the need for materially accurate financial statements, the guidelines are designed to reduce the possibility of a qualified opinion stemming from lack of control of fixed assets. Local government and public authority administrators, as well as council members, should be proactive in constructing a comprehensive fixed assets policy. Accountability, credit quality, and time are at stake.

Notes

1. North Carolina Department of State Treasurer, Policies Manual (Raleigh, N.C.: 1992).

2. Government Finance Officers Association, Recommended Practices for State and Local Governments (Chicago: GFOA, 1999).

3. Principle 5 requires a clear distinction between general fixed assets and fund fixed assets. Principle 6 requires the recording of all fixed assets at their historical cost or at their estimated historical cost if their actual cost cannot be determined. Principle 7 addresses the depreciation of fixed assets, requiring that depreciation be recorded in proprietary funds and certain trust funds. Depreciation is not recorded in governmental funds, but accumulated depreciation may be recorded in the General Fixed Assets Account Group (GFAAG), although few governments currently choose this option. *See* Governmental Accounting Standards Board, Governmental Accounting and Financial Reporting Standards (Norwalk, Conn.: GASB, 1995).

4. Robert J. Freeman & Craig D. Shoulders, Governmental Accounting & Financial Reporting (Lubbock: Center for Professional Development, Texas Tech University, 1996).

5. Telephone Interview with Cheryl J. Spivey, Assistant Director of Fiscal Management, N.C. Local Government Commission (Oct. 14, 1999).

6. Department of State Treasurer, Policies Manual at § 20, p. 4.

7. GFOA, Recommended Practices at 15.

8. GFOA, Recommended Practices at 15.

9. GFOA, Recommended Practices.

10. Department of State Treasurer, Policies Manual at § 20, p. 7.

11. Current federal requirements prevent the use of capitalization thresholds greater than $5,000 for purposes of grant reimbursement.

12. GFOA, Recommended Practices.

13. Department of State Treasurer, Policies Manual.

14. GFOA, Recommended Practices at 15.

15. GFOA, Recommended Practices.

16. Department of State Treasurer, Policies Manual.

17. Government Finance Officers Association, Governmental Accounting, Auditing and Financial Reporting (Chicago: GFOA, 1994).

18. The change in capitalization levels is a change in accounting policies. For proprietary funds, fixed assets and accumulated depreciation are adjusted for the amounts removed, and the difference between the two amounts is shown as an adjustment to beginning retained earnings.

19. Governmental Accounting Standards Board, Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments (Norwalk, Conn.: GASB, 1999).