CAPITALIZATION OF PROPERTY, PLANT, AND EQUIPMENT

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CAPITALIZATION OF PROPERTY, PLANT, AND EQUIPMENT

I. INTRODUCTION

Generally Accepted Accounting Principles (GAAP) requires the capitalization of costs associated with the acquisition or construction of property, plant, and equipment (PPE). This document provides the general framework for determining whether such costs should be capitalized as PPE.

II. DEFINITION

Property, plant, and equipment (PPE), also referred to as capital assets, include all tangible and intangible assets acquired, fabricated, or constructed for use in the operation of the institution, whose use or consumption will cover more than one year. It does not include assets acquired as investments or for sale. The University of California (UC) classifies its capital assets into the following categories for reporting purposes:

- Land
- Infrastructure
- Buildings and improvements (including fixed equipment)
- Equipment (including intangible assets and software)
- Libraries and collections
- Special collections
- Intangible assets (including computer software)
- Construction in progress

UC has also established the following threshold for capitalization:

Infrastructure and buildings:	$35,000
Equipment:	5,000

III. PRINCIPLES

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP) - CAPITALIZATION

The General Principles of the Governmental Accounting and Financial Reporting Standards established by the Governmental Accounting Standards Board (GASB) include the following requirements for the valuation and reporting of capital assets:

Section 1100: Summary Statement of Principles

.106 Valuation of Capital Assets: Capital assets should be reported at historical cost. The cost of a capital asset should include ancillary charges necessary to place the asset into its intended location and condition for use.

Section 1400 Reporting Capital Assets (Also repeated in GASB Statement 34, Para 18)

.102 Capital assets should be reported at historical cost. The cost of a capital asset should included ancillary charges necessary to place the asset into its intended location and condition for use. Ancillary charges include costs that are directly related to asset acquisition—such as freight and transportation charges, site preparation costs, and professional fees. Donated capital assets should be reported at their estimated fair value at the time of acquisition plus ancillary charges, if any.

The proper and consistent capitalization of expenditures is required to comply with the periodicity and matching principles of GAAP.

IV. BASIC CAPITALIZATION FRAMEWORK AT UC

A. ASSET ACQUIRED FOR OPERATIONS

To be considered for capitalization, the asset must be acquired (purchased, fabricated, constructed, or donated) for use by the University, and not for investment or for resale.

B. ESTIMATED USEFUL LIFE

To be considered for capitalization, the asset must also have an estimated useful life greater than one year.

IV. <u>BASIC CAPITALIZATION FRAMEWORK AT UC</u> (Cont.)

C. CAPITALIZATION THRESHOLD

Expenditures that meet the basic framework defined by this chapter must be capitalized; however, the University has also established the following threshold values for capitalization. Expenditures below the established threshold values should not be capitalized.

- Moveable equipment: $5,000
- Additions, replacements, major repairs and renovations to infrastructure and buildings: $35,000
- All costs of land, library collections and special collections are capitalized.

D. RECORDED AT COST OR FAIR VALUE

Capital assets are recorded at cost at the date of acquisition, or estimated fair value at the date of donation in the case of gifts. Capital leases are recorded at the present value of future minimum lease payments, which should be equal to the cash purchase price as of the inception date of the lease.

E. INCLUDED COSTS FOR CAPITALIZATION

The University shall capitalize the initial direct costs and incremental indirect costs related to the acquisition and placement of the capital asset in its intended location for use. Capitalized costs must meet both conditions described below:

1. <u>Initial acquisition and placement costs</u>

Costs associated with the initial acquisition, preparation, and placement of the asset for use should be capitalized. Subsequent expenditures related to capital asset (additions, replacements, major repairs, and renovations) should be expensed unless the expenditure exceeds $35,000 and increases the asset’s useful life, improves its productivity or capacity, or enhances the quality of output of the asset. Minor renovations are charged to operations.

2. <u>Direct costs and incremental indirect costs</u>

To be included as a capital cost, expenditures must be:

a. Directly related to the initial acquisition of the capital asset, or

b. Indirectly related and incrementally identifiable to the initial acquisition of the capital asset. A cost is incrementally identifiable if it can be adequately documented that the particular cost element was incurred related to the acquisition of the assets, and resulted in an increase in overall costs incurred by the University. An attributable fixed cost, allocable to the acquisition of a capital asset, should not be capitalized.

For example, the purchase price of the equipment, freight, or delivery charges, and the cost of their initial installation should be capitalized. The associated cost of the acquisition by the purchasing and accounts payable departments should be expensed unless they have been identified and documented as incremental costs associated with the acquisition of specific items or projects. Subsequent maintenance cost attributable to the capital asset should be expensed.

For construction projects, all direct construction costs should be capitalized. Internal labor costs incrementally identified to specific projects and appropriately tracked and documented may also be capitalized.

V.

TYPES OF COSTS TO BE INCLUDED OR EXCLUDED FROM CAPITALIZATION

A. INCLUDED COSTS

Listed below are examples of the type of costs that can be included in the capitalized value of the asset. All capitalized costs must meet the cost characteristics defined in Section IV above, regardless of whether they are listed below or not.

1. Purchase price
2. Appraisals
3. Professional services
4. Title insurance
5. Broker's fees
6. Closing costs
7. Razing and removal
8. Land improvements
9. Site improvements
10. Landscaping associated with new construction
11. Construction costs, including materials, labor and overhead
12. Transportation
13. Installation
14. Duty
15. In-transit insurance

B. EXCLUDED COSTS

Listed below are examples of costs that should not be capitalized. These costs must be expensed to appropriate operational funds.

1. Cost of project opening/completion ceremonies

2. Internal labor and associated costs that are:

   a. Non-incremental to the acquisition or construction of capital assets

   b. Not specifically tracked by time and relationship to the acquisition or construction of capital assets

3. Costs allocated or charged to projects for the purpose of accumulating a reserve are restricted by the FASB Statement of Financial Accounting Standards (FAS) No. 5 (see Section VI below). Contingency reserves may be accrued only if the contingent event is probable and the costs are

reasonably estimable and related to the current or a prior period. Contingency reserves accrued in compliance with FAS 5 may be capitalized if the accrued charges are specifically identifiable to the asset or project, and were accrued during the acquisition or construction period. Charges accrued after the acquisition or construction period should be expensed.

4. Costs allocated or charged to projects for employee termination benefits are restricted by GASB Statement No. 47 (see Section VII below). The statement requires the accrual of <u>involuntary</u> termination benefits as they are earned. The cost of <u>voluntary</u> termination benefits must be recognized at the time of acceptance of the benefit. Termination benefits recorded in compliance with GASB 47 may be capitalized if accrued and recorded during the acquisition or construction period. Termination benefit costs accrued or recorded after the acquisition or construction period should be expensed.

VI. <u>FAS NO. 5 - ACCRUAL OF LOSS CONTINGENCY</u>

An estimated loss from a loss contingency shall be accrued if <u>both</u> of the following conditions are met:

a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be *probable* that one or more future events will occur confirming the fact of the loss.

VI. FAS NO. 5 - ACCRUAL OF LOSS CONTINGENCY (Cont.)

b. The amount of loss can be *reasonably estimated*.

When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms probable, reasonably possible, and remote to identify three areas within that range, as follows:

a. *Probable*. The future event or events are likely to occur.

b. *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.

c. *Remote*. The chance of the future event or events occurring is slight.

If a loss contingency is probable, and information available indicates that the estimated amount of loss is within a range of amounts, it follows that some amount of loss has occurred and can be reasonably estimated. If the reasonable estimate of the loss is a range, an amount shall be accrued for the loss. When some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued.

Inability to make a reasonable estimate of the amount because of significant uncertainty about possible claims precludes accrual and, if the range of possible loss is wide, may raise a question about whether sufficient experience has been gained to permit a reasonable estimate of the obligation.

General or unspecified business risks, or matters that may be construed as "reserves for general contingencies" do not meet the conditions for accrual, and no accrual for loss shall be made.

VII. GASB STATEMENT NO. 47 - ACCRUAL OF TERMINATION BENEFIT COSTS

Termination benefits may be voluntary or involuntary.

Voluntary termination benefits are those provided to employees as a) an inducement to hasten the termination of services or b) as a result of a voluntary early termination plan. Such benefits include early-retirement incentives.

For voluntary termination benefits, a liability is recognized when *both* of the following have been completed:

- The employee(s) accepts the offer, *and*
- The amount of the liability can be estimated.

Involuntary termination benefits are those provided as a consequence of the involuntary termination of services.

For involuntary termination benefits, a liability is recognized when all of the following have been completed:

- A plan of termination has been approved by those with the authority to commit the University to the plan, and
- That plan has been communicated to the employees, and
- The amounts can be estimated (reference FASB Statement No. 5).

VIII. REFERENCES

FAS Statement No. 5, *Accrual of Loss Contingency*

GASB Statement No. 47, *Accounting for Termination Benefits*

Accounting Manual chapters

P-415-1 Plant Accounting: Capitalization of Expenditures Made from Current Funds

P-415-2 Plant Accounting: Costing and Reconciling Inventorial Equipment

VIII. REFERENCES (Cont.)

P-415-3 Plant Accounting: Investment in Plant - Capitalization and Elimination in Current Funds

P-196-80 Payroll: Termination Benefits

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End.