

South Australia Local Government Association

Information Paper

**COSTING FOR ASSETS
(including overheads)**

June 2008



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INTRODUCTION

The primary purpose of this paper is to provide a technical resource to assist councils in determining whether a “cost” should be –

- capitalised (and included in the Balance Sheet as an asset) or
- expensed (and recorded as an expense in the Profit and Loss Account)

In particular, it is also to provide additional practical guidance on the identification and accounting treatment for overheads.

This information paper deals with the topic of Costing of Infrastructure assets (including overheads). The objective of this paper is to provide a technical resource to supplement other publications such as the Australian Infrastructure Financial Management Guidelines (AIFMG) that are currently being developed by the Institute of Public Works Engineering Australia.

The paper has been divided into several sections. These include –

- Context
- Overview of Prescribed Requirements
- Considerations
- Key Aspects: Accounting Standards
- Application: Overview
- Application: Practical

CONTEXT

Objective

Whether a cost is “capitalised” or “expensed” is critical to the financial management and accountability framework of the council.

The objective of financial statements is *to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions.*¹

*Financial reports also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the entity or whether to reappoint or replace the management.*²

It is therefore critical that the financial statements of councils report a “true and fair view” based on the Accounting Standards so that users of the financial statements (such as the ratepayers and other interested parties) are able to make informed decisions about the performance of the council.

Materiality

Councils are responsible for the management of community assets funded through public monies. In order to ensure the preservation of “intergenerational equity” it is imperative that each generation pay their “fair share”. In order to achieve this, the council is required to develop a balanced budget so that the funds raised in revenue offset the cost to provide the services. As a result, the Profit and Loss Statement of a council should report a surplus and the size of the surplus should be small, except where the council can demonstrate that a large surplus is justified and equitable.

Due to the small size of the operating result and the large amount of funds expended each year on the acquisition, maintenance, renewal, replacement or disposal of assets it is critical that costs be correctly recorded in accordance with the prescribed requirements. Otherwise, there is high risk of material misstatement which in turn impinges the ability of a council to be accountable to the community.

¹ Framework for the Preparation and Presentation of Financial Statements Paragraph 12

² Framework for the Preparation and Presentation of Financial Statements Paragraph 14

OVERVIEW OF PRESCRIBED REQUIREMENTS

Framework for the Preparation and Presentation of Financial Statements

The Framework sets out the concepts that underlie the preparation and presentation of financial reports for external users. The purpose of the Framework is to:

- (a) assist the AASB in the development of future Australian Accounting Standards and in its review of existing Australian Accounting Standards, including evaluating proposed International Accounting Standards Board pronouncements;*
- (b) assist the AASB in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial reports by providing a basis for reducing the number of alternative accounting treatments permitted by Australian Accounting Standards;*
- (c) [Deleted by the AASB];*
- (d) assist preparers of financial reports in applying Australian Accounting Standards and in dealing with topics that have yet to form the subject of an Australian Accounting Standard;*
- (e) assist auditors in forming an opinion as to whether financial reports conform with Australian Accounting Standards;*
- (f) assist users of financial reports in interpreting the information contained in financial reports prepared in conformity with Australian Accounting Standards; and*
- (g) provide those who are interested in the work of the AASB with information about its approach to the formulation of Australian Accounting Standards.³*

The Framework deals with:

- (a) the objective of financial reports;*
- (b) the qualitative characteristics that determine the usefulness of information in financial reports;*
- (c) the definition, recognition and measurement of the elements from which financial statements are constructed; and*
- (d) concepts of capital and capital maintenance.⁴*

The main aspects of the Framework that relate to this paper are the definition of asset and expense. A cost determined to be an "expense" will reduce the potential surplus of a council (thereby affecting decisions relating to the equitable charging of fees for services or rates) whereas costs deemed to be "assets" will be charged directly to the Balance Sheet. In turn, these costs will be charged to the Profit and Loss Account (to the extent that their service potential is consumed) as Depreciation Expense.

³ Framework for the Preparation and Presentation of Financial Statements Paragraph 1

⁴ Framework for the Preparation and Presentation of Financial Statements Paragraph 5

In relation to Assets, the Framework states –

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.⁵

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.⁶

An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the entity beyond the current accounting period. Instead, such a transaction results in the recognition of an expense in the income statement.⁷

In terms of Expenses - they are recognised in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets (for example, the accrual of employee entitlements or the depreciation of equipment).⁸

AASB 116 “Property Plant and Equipment”

The concepts of what is an asset (to be capitalised) and what is an expense (to be charged to the Profit and Loss Account) is also incorporated into AASB 116 “Property Plant and Equipment”.

AASB 116 requires that *the cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:*

- (a) it is probable that future economic benefits associated with the item will flow to the entity; and*
- (b) the cost of the item can be measured reliably.⁹*

“Cost” is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in

⁵ Framework for the Preparation and Presentation of Financial Statements Paragraph 49

⁶ Framework for the Preparation and Presentation of Financial Statements Paragraph 89

⁷ Framework for the Preparation and Presentation of Financial Statements Paragraph 90

⁸ Framework for the Preparation and Presentation of Financial Statements Paragraph 94

⁹ AASB 116 Paragraph 7

accordance with the specific requirements of other Australian Accounting Standards, for example, AASB 2 Share-based Payment.¹⁰

Essentially this means that any costs that result in acquisition of future economic benefits that last greater than 12 months should be capitalised. Any other costs should be expensed.

Capital costs are costs of significant value that are expected to generate benefits over a period longer than a year. They are shown as assets in a balance sheet. Buildings, plant and equipment are common classes of Local Government assets but usually infrastructure assets such as roads are far more significant in total value.

Operating costs are typically day to day expenses. Generally the benefits from the expenditure are used in the short-term (e.g. fuel or electricity) to support either ongoing activity or one-off initiatives that do not generate measurable long-lived benefits. Costs of maintaining an asset (e.g. servicing a vehicle or fixing a pothole) are also operating expenses because they do not extend the expected life of an asset but are necessary to preserve the value of the asset and its expected service life.¹¹

¹⁰ AASB 116 Paragraph 6

¹¹ LGA South Australia Information Paper 17: Depreciation and Related Matters June 2008

CONSIDERATIONS

Auditing Standards

Since 1 July 2006 the audits of all local governments are required to be conducted in accordance with the requirements of the Australian Auditing Standards (ASA). There are two major differences between the new Australian Auditing Standards (ASA) and its predecessor the Auditing Practice Statements (AUP). They are –

- The ASAs now carry “force of law” whereas the AUPs were only a professional obligation and not a legally enforceable requirement.
- In the main, the word “should” has been replaced with the word “shall”. This removes significant flexibility for the auditor to disregard or to choose not to perform certain audit procedures. The auditors are now compelled to complete all procedures as detailed in the Auditing Standards.

There are a number of Auditing Standards that have a direct impact in relation to infrastructure assets. These are –

- ASA 500 Audit Evidence
- ASA 540 Audit of Accounting Estimates
- ASA 580 Management Representations
- ASA 620 Using the Work of an Expert
- ASA 545 Auditing Fair Value Measurements & Disclosures

The Auditing Standards are based upon the concept of the auditor satisfying a number of audit assertions. These include –

- (a) *Assertions about classes of transactions and events for the period under audit:*
 - (i) *Occurrence - transactions and events that have been recorded have occurred and pertain to the entity.*
 - (ii) *Completeness - all transactions and events that should have been recorded have been recorded.*
 - (iii) *Accuracy - amounts and other data relating to recorded transactions and events have been recorded appropriately.*
 - (iv) *Cut-off - transactions and events have been recorded in the correct accounting period.*
 - (v) *Classification - transactions and events have been recorded in the proper accounts.*
- (b) *Assertions about account balances at the period end:*
 - (i) *Existence - assets, liabilities, and equity interests exist.*
 - (ii) *Rights and obligations - the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.*
 - (iii) *Completeness - all assets, liabilities and equity interests that should have been recorded have been recorded.* ¹²

¹² Australian Auditing Standard ASA500 “Audit Evidence”

In essence, and in relation to infrastructure assets, they require the auditor to

- obtain sufficient and appropriate evidence over the completeness and accuracy of the asset register
- assess the appropriateness and logic of the valuation and depreciation methodologies
- ensure that the methodologies fully comply with the Australian Accounting Standards. In particular AASB116 "Property Plant and Equipment"
- assess the competence, experience and objectivity of any experts used within the valuation and depreciation exercise
- obtain representations from management over a range of issues
- obtain sufficient and appropriate evidence to support the critical assumptions used within the methodology.

Capitalisation Thresholds

While the definition of what is an "asset" and what should be "expensed" is relatively easy as a concept, consideration also needs to be given to "materiality" and the relationship between the cost of collecting data and the level of detail to be captured.

Councils should set a "Capitalisation Threshold" that provides an automatic trigger to "expense" even if it technically satisfies the definition of an asset. This threshold should be set at a level that saves the council from the unnecessary cost of data and asset management whilst not leading to material misstatement of the financial statements or impinging upon its ability to effectively manage the asset portfolio.

Typically, thresholds are set for different asset classes (based on materiality) and range depending upon the size of the entity.

As an example, the prescribed requirements for local governments in Queensland require that –

- (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.¹³*

¹³ Queensland Local Government Finance Standard 1993 section 43

Guidance is also provided in Information Paper 17 -

A small value purchase like a \$2.95 calculator may last a long time and provide ongoing benefits but its modest cost is unlikely to warrant its capitalisation and subsequent depreciation over future accounting periods. Instead it would be expensed. Its value is low and the impact on the income statement of fully expensing it in one year, rather than over several, will be immaterial.

Where minor works are carried out e.g. pothole repairs to, or patrol grading of, a road such outlays should be expensed. They do not extend the life of an asset. Instead they are a cost that is required to maintain the asset so that its existing embedded service potential is realised.

On the other hand the cost of resealing a road should be capitalised.¹⁴

Types of Costs

There are a whole range of costs that may be incurred in relation to the acquisition or operation of assets. They include (but are not limited to) –

- preliminary studies, survey and designs
- investigations and community consultation
- planning approval process
- payments to external suppliers for assets, parts or supplies
- hire of equipment
- salaries and wages of internal staff
- contractors / consultants fees
- interest on finance facilities used to acquire assets
- costs associated with internal administration and other overheads
- internal charges for work completed by other sections of council
- compensation payments or payments to third parties
- licence fees and royalties
- salaries and wages of staff operating the asset
- costs of maintaining and operating the asset
- legal obligations to rehabilitate a site after the asset is decommissioned
- testing and handover

The Australian Infrastructure Financial Management Guidelines provide a number of classifications for the various types of expenditures. These classifications are consistent with

¹⁴ LGA South Australia Information Paper 17: Depreciation and Related Matters June 2008

those used in the Victorian STEP program which provides guidance on the appropriate accounting treatment. They are -

Maintenance: Regular ongoing day-to-day work necessary to keep assets operating, e.g. road patching

Operations: Regular activities to provide public health, safety and amenity, e.g. street sweeping, grass mowing, street lighting

Renewal/Refurbishment: Restores, rehabilitates, replaces existing asset to its original capacity, e.g. gravel resheets

Upgrade/Improvements: Enhances existing asset to provide higher levels of service, e.g. widen seal

New: Creation of an new asset to meet additional service level requirements, e.g. new building¹⁵

Recurrent Expenditure		Capital Expenditure	
Operational Costs	Maintenance Costs	Asset Management	Upgrade & New Projects
Operating	Maintenance (Routine & Specific)	Refurbishment / Renewal	Upgrade, New/ Expansion
- Street lighting - Grass Mowing - Cleaning drains - Streetsweeping - Facilities cleaning	- Pothole patching - Playground Equip - Wate Main Valve - Build (window rep) - Bridge pile mtce	- Reseals - Gravel Resheets - Oval refurbishment - Roof replacement - Pump replacement	- Pavement widening - New kerb / footpath - New Com building - Waste Water additional pumps
Non-discretionary Funding	Non-discretionary Funding	Non-discretionary Funding	Discretionary Funding

While these classifications provide a high level overview of how various expenditures are to be treated, reference needs to be made to AASB 116 when deciding whether to “capitalise” or “expense” particular items. For example – AASB 116 prohibits the capitalisation of some costs which are associated with the acquisition of assets.

¹⁵ Municipal Association of Victoria (Asset Management Conference 2007) – slide by John Hennessey

¹⁶ Municipal Association of Victoria (Asset Management Conference 2007) – slide by John Hennessey

KEY ASPECTS: ACCOUNTING STANDARDS

Elements of Cost

AASB 116 states that the "Cost" of an asset is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other Australian Accounting Standards, for example, AASB 2 Share-based Payment.¹⁷

To be recognised as a "cost" it must be –

- its purchase price
- a cost directly attributable to getting it in a position to deliver service potential or
- an obligation that must be met when the asset is decommissioned.

The standard states that -

The cost of an item of property, plant and equipment comprises:

- (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates;*
- (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management; and*
- (c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.¹⁸*

Examples of "directly attributable costs" are given as –

- (a) costs of employee benefits (as defined in AASB 119 Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;*
- (b) costs of site preparation;*
- (c) initial delivery and handling costs;*
- (d) installation and assembly costs;*
- (e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and*
- (f) professional fees.¹⁹*

¹⁷ AASB 116 Paragraph 6

¹⁸ AASB 116 Paragraph 16

¹⁹ AASB 116 Paragraph 17

However, a number of examples are also provided of costs which are not considered to meet the definition of a "cost" of the asset. These include –

- (a) *costs of opening a new facility;*
- (b) *costs of introducing a new product or service (including costs of advertising and promotional activities);*
- (c) *costs of conducting business in a new location or with a new class of customer (including costs of staff training); and*
- (d) *administration and other general overhead costs.*²⁰

Local Governments often construct their own assets. The standard provides specific instruction for these assets –

*The cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale (see AASB 102). Therefore, any internal profits are eliminated in arriving at such costs. Similarly, the cost of abnormal amounts of wasted material, labour, or other resources incurred in self-constructing an asset is not included in the cost of the asset. AASB 123 Borrowing Costs establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of property, plant and equipment.*²¹

Recognition Criteria

Even if a cost meets satisfies the definition of being a "cost" of the asset, it must also satisfy the recognition criteria. This is possibly the most difficult aspect of the decision process as it involves consideration of subjective criteria and each scenario can be slightly different possibly leading to a different outcome.

For example, if council has committed to a project and approved the budget, providing the design is undertaken after the approval to proceed is given, these costs can be incorporated as a "cost" of the asset. However, if the design is completed prior to the approval being given, the design costs cannot be included.

The recognition criteria are that *the cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:*

- (a) *it is probable that future economic benefits associated with the item will flow to the entity; and*

²⁰ AASB 116 Paragraph 18

²¹ AASB 116 Paragraph 22

(b) *the cost of the item can be measured reliably.*²²

If there is any doubt that the asset will not produce future economic benefit or will proceed, such costs fail the recognition threshold. Common examples include initial survey and planning costs, community consultation and planning process costs.

Likewise, costs that cannot be measured reliably or identified as being “directly attributable” to the asset also fail to satisfy the recognition criteria. Common examples include various forms of overhead costs.

It is also important to note that the assessment against the recognition criteria must be performed at the time the cost is incurred. It cannot be reassessed at a later date such as after the project is approved to proceed. The standard states –

*An entity evaluates under this recognition principle all its property, plant and equipment costs at the time they are incurred. These costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it.*²³

Initial Costs

Providing the cost satisfies the recognition criteria, any costs initially incurred in acquiring the asset are to be capitalised. This includes expenditure on items that may not produce any impact in terms of output but are required due to new or changing requirements.

*For example - Items of property, plant and equipment may be acquired for safety or environmental reasons. The acquisition of such property, plant and equipment, although not directly increasing the future economic benefits of any particular existing item of property, plant and equipment, may be necessary for an entity to obtain the future economic benefits from its other assets. Such items of property, plant and equipment qualify for recognition as assets because they enable an entity to derive future economic benefits from related assets in excess of what could be derived had it not been acquired. For example, a chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals; related plant enhancements are recognised as an asset because, without them, the entity is unable to manufacture and sell chemicals. However, the resulting carrying amount of such an asset and related assets is reviewed for impairment in accordance with AASB 136 Impairment of Assets.*²⁴

²² AASB 116 Paragraph 7

²³ AASB 116 Paragraph 10

²⁴ AASB 116 Paragraph 11

Subsequent Costs

Typically with local governments the useful life of infrastructure assets is extended through a combination of maintenance and renewal. Using a road as an example – this would include pothole repairs, grading gravel roads, patch repairing, re-seals, painting of new lines, major rehabilitation.

Cyclical Maintenance assets differ from other assets in that their total life is extended over time via ongoing maintenance and renewal. As a consequence, an assets total lifecycle cost can differ as a resulting of changing –

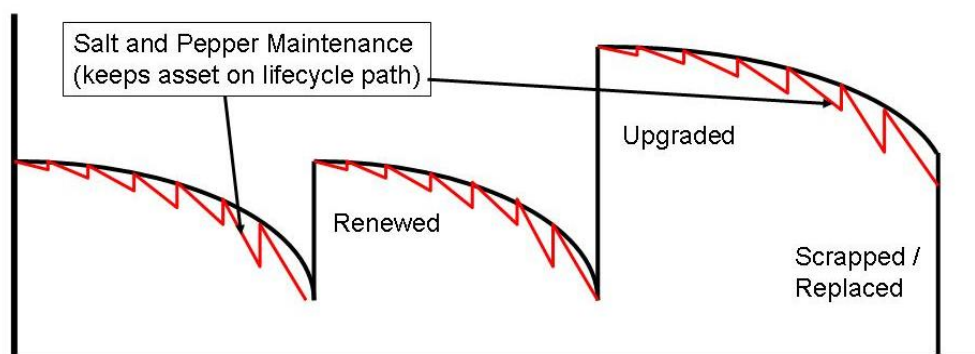
- *Maintenance Costs*
- *Renewal Treatments*
- *Levels of Service*

The assets are generally maintained via “salt and pepper” maintenance at a level that satisfies the community’s expectation or at a defined Level of Service. This maintenance does not restore the consumed Future Economic Benefit but simply keeps the asset on its lifecycle path. It may however have a significant impact on the time to next intervention.

When the asset is unable to meet the community’s needs there are a number of possible outcomes –

- *Restore the Future Economic Benefit through renewal or upgrade*
- *Replace the asset with an alternative asset*
- *Change the community’s expectations (reduced Level of Service).*

The following diagram represents typical lifecycle outcomes.



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AASB 116 recognises the difference between the impact of “salt and pepper” maintenance verses asset renewal. Proving the expenditure satisfies the recognition criteria (and it is material) it is to be capitalised.

²⁵ Prabhu-Edgerton Asset Management Consumption Model (www.apv.net/downloads)

In other words, any costs incurred subsequent to the initial recognition of the asset are to be capitalised if –

- They are material (greater than capitalisation threshold)
- The impact will lead to “future economic benefits”. For example – extending the life of the asset or increasing its service potential.
- It can be reliably measured.

AASB 116 states -

Under the recognition principle in paragraph 7, an entity does not recognise in the carrying amount of an item of property, plant and equipment the costs of the day-to-day servicing of the item. Rather, these costs are recognised in profit or loss as incurred. Costs of day-to-day servicing are primarily the costs of labour and consumables, and may include the cost of small parts. The purpose of these expenditures is often described as for the "repairs and maintenance" of the item of property, plant and equipment.

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.²⁶

Each decision needs to be made at the time the expenditure incurred and the impact of the expenditure considered in light of what it will achieve. For example an asset may have a “design life” of 60 years based on a standard asset maintenance program. If the maintenance program is not implemented fully you would expect the useful life of the asset to be less than the design life. In year 40 a maintenance treatment is applied. If the treatment was not applied the RUL of the asset would be 15 years. However, as a consequence of applying the treatment the RUL would be 20 years (as per the original planned design life given the maintenance program). As a result, the impact of the treatment is to extend the life of the asset by 5 years and therefore is to be capitalised.

Borrowing Costs

Due to the high acquisition cost of infrastructure assets, many are funded by way of loan with interest and redemption payments made by the council until such time as the loan is repaid.

The amount of Interest can be capitalised as part of the “cost” of the asset to the extent that the borrowing costs can be attributed to the acquisition of the asset.

²⁶ AASB 116 Paragraphs 12 & 13

In relation to borrowings made specifically to purchase an asset, if the funds are drawn down and invested prior to use, any interest earned on the funds is to be "offset" against the borrowing costs

The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognised as interest over the period of credit unless such interest is recognised in the carrying amount of the asset in accordance with the allowed alternative treatment in AASB 123.²⁷

The alternative treatment under AASB 123 "Borrowing Costs" provides *Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset shall be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation shall be determined in accordance with this Standard.²⁸*

The relevant sections from AASB 123 are -

13. *The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. When an entity borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.*
14. *It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. Such a difficulty occurs, for example, when the financing activity of an entity is co-ordinated centrally. Difficulties also arise when a group uses a range of debt instruments to borrow funds at varying rates of interest, and lends those funds on various bases to other entities in the group. Other complications arise through the use of loans denominated in or linked to foreign currencies, when the group operates in highly inflationary economies and from fluctuations in exchange rates. As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset is difficult and the exercise of judgement is required.*
15. *To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset shall be determined as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.*
16. *The financing arrangements for a qualifying asset may result in an entity obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditures on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing*

²⁷ AASB 116 Paragraph 23

²⁸ AASB 123 Paragraph 11

- costs eligible for capitalisation during a period, any investment income earned on such funds is deducted from the borrowing costs incurred.*
23. *To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation shall be determined by applying a capitalisation rate to the expenditures on that asset. The capitalisation rate shall be the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period shall not exceed the amount of borrowing costs incurred during that period.*
18. *In some circumstances, it is appropriate to include all borrowings of the parent and its subsidiaries when computing a weighted average of the borrowing costs; in other circumstances, it is appropriate for each subsidiary to use a weighted average of the borrowing costs applicable to its own borrowings.²⁹*

Contributed Assets

Local governments received a significant number of assets as “contributions”. Typically these are assets constructed by developers and “handed over” to the local government.

AASB 116 requires that such assets be recognised at an acquisition cost equivalent to the “Fair Value” of the asset. The standard states -

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. Aus15.2 In respect of not-for-profit entities, an item of property, plant and equipment may be gifted or contributed to the entity. For example, land may be contributed to a local government by a developer at no or nominal consideration to enable the local government to develop parks, roads and paths in the development. An asset may also be acquired for no or nominal consideration through the exercise of powers of sequestration. Under these circumstances the cost of the item is its fair value as at the date it is acquired.³⁰

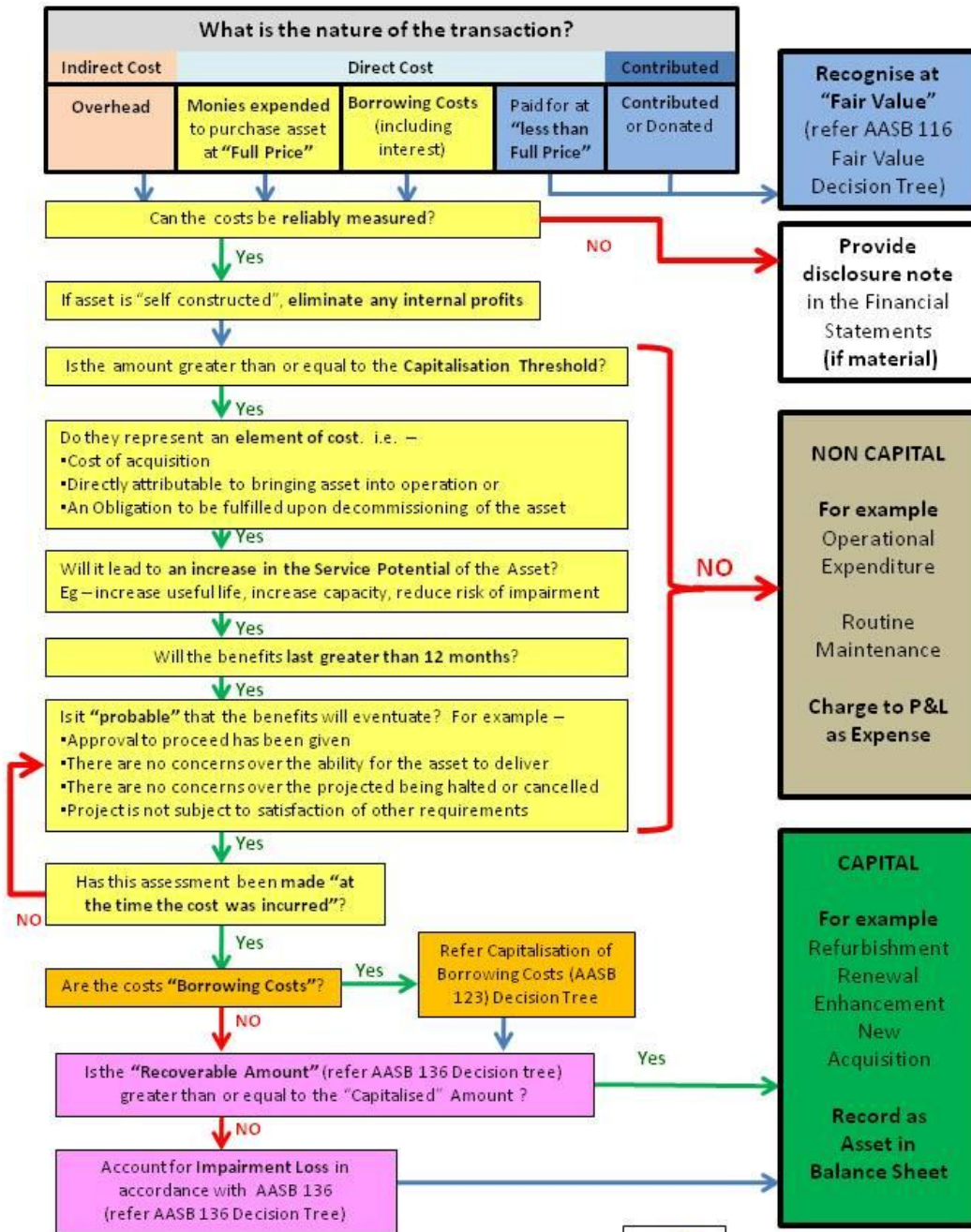
²⁹ AASB 123 “Borrowings”

³⁰ AASB 116 Paragraph 15.1

APPLICATION: OVERVIEW

Decision Tree & Notes

Costing of Assets (AASB 116) Decision Tree

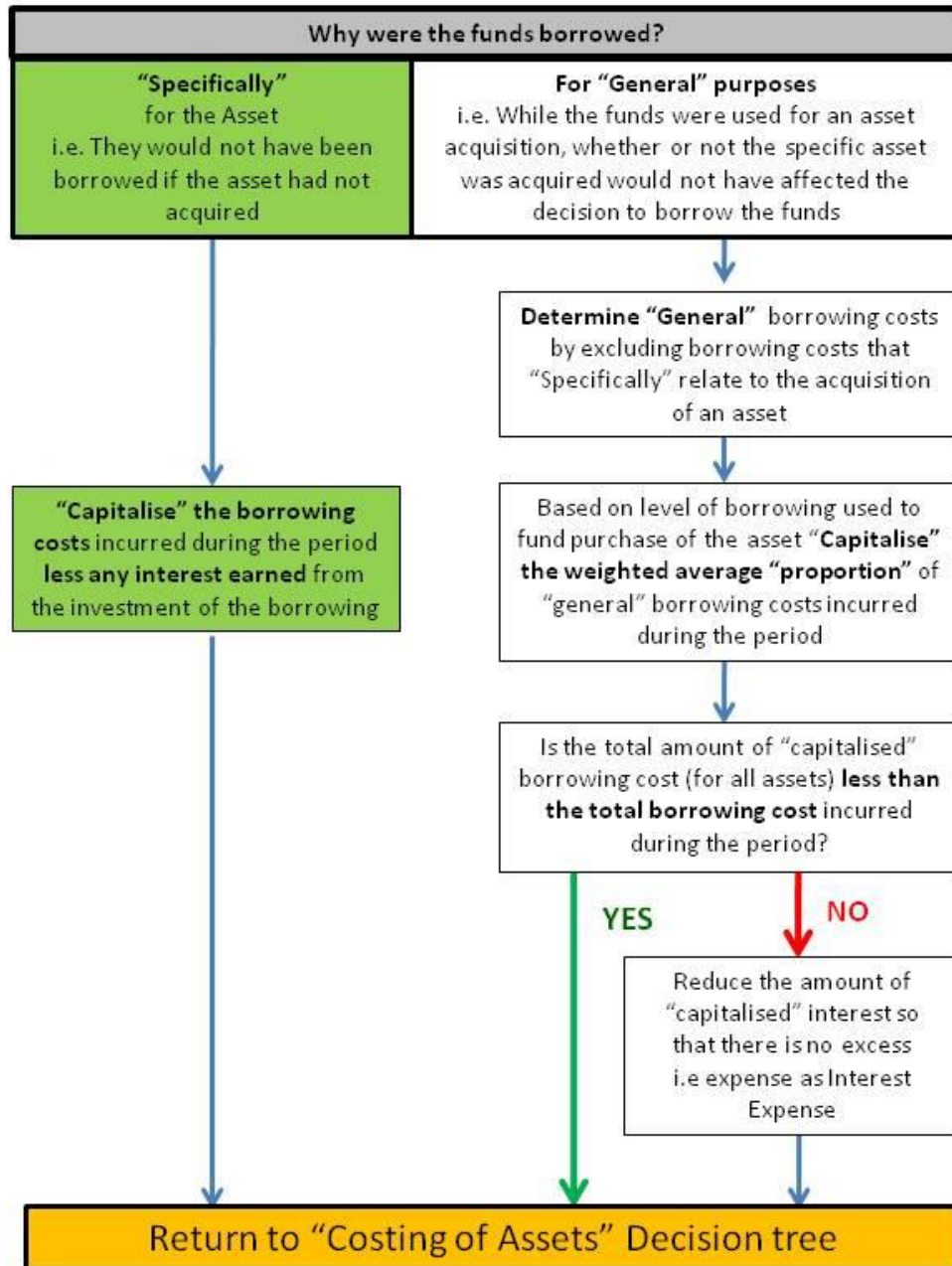


Contact: David Edgerton (07) 3221 3499
 Email: David@apv.net



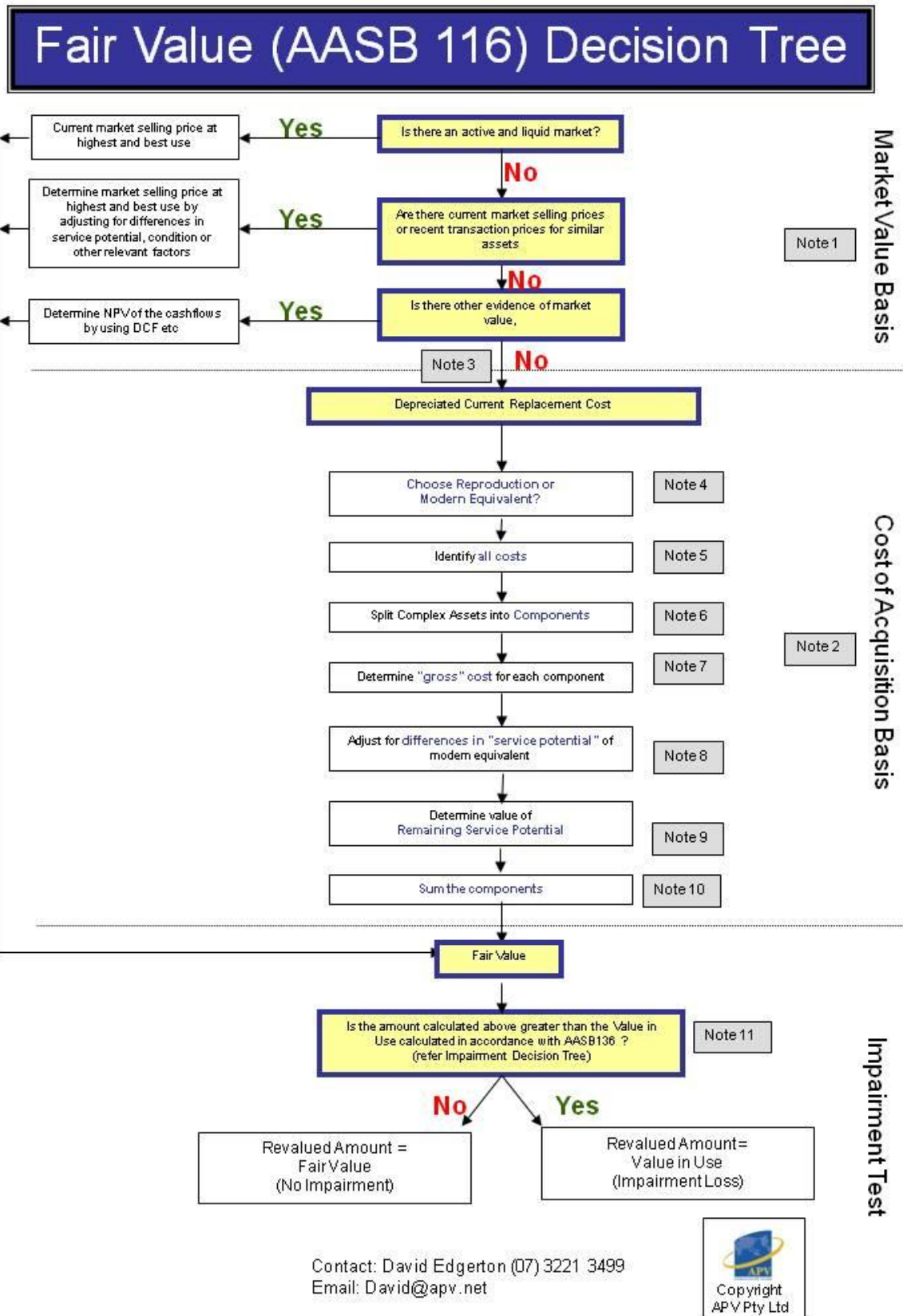
³¹ APV Valuers and Asset Management (Edgerton) 2008 (www.apv.net/downloads)

Capitalisation of Borrowing Costs (AASB 123) Decision Tree



Contact: David Edgerton (07) 3221 3499
 Email: David@apv.net





Specific Issues

Overheads

The cost of delivering a service using an asset includes both Direct and Indirect costs. These costs are incurred throughout the entire asset lifecycle including Acquisition, Operation, Maintenance, Renewal, Upgrade or Disposal

“Overheads” is a general term often used to describe “Indirect Costs”. *“Indirect Costs in entities providing services from infrastructure include technical overheads for program and project management, survey, investigation, design and construction supervision and corporate overheads for general management, procurement, financial services, information technology, human resource management, etc.”*³⁴

Overheads are no different to any other asset cost in that they must be “an element of cost” in order to be capitalised. Most importantly that the cost is *“directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management”*³⁵

Overheads are commonly categorised into the following types -

Type	Examples	Common Approaches
Labour	Amount paid in addition to direct wages (e.g. leave loading) Amounts paid to others for direct benefit of employees (e.g. superannuation) Unproductive Time (e.g. annual and long service leave, sick leave)	Based on percentage of wages. Normally supported by time sheets and other wages records linking specific employees back to project.
Materials	Cost of receiving, storing and issuing materials through a store Delivery and transport costs	Based on total cost of store as percentage of total value of stores issued. Normally supported by materials list used on project linked back to stores records
Technical	e.g. engineering management, investigation, survey, design and supervision.	Based on “total cost of the expenditure for which the technical service is responsible for” as percentage of total cost of providing the technical service. Normally linked to timesheets and/or internal charge records showing linkage back to specific projects
Corporate	General management and services such as financial services, purchasing, human resources, information technology, WH&S	Not normally allocated unless can show direct link to specific project.
Plant & Equipment	Cost of operation, maintenance and replacement of plant and equipment	Normally charged “directly” to projects as Internal Plant Hire. However, under AASB 116 <i>any internal profits are eliminated in arriving at such costs</i> ³⁶

³⁴ Australian Infrastructure Management Guidelines Section 12.9

³⁵ AASB 116 Paragraph 16

³⁶ AASB 116 Paragraph 22

Compensation and 3rd Party Costs

The standards require all costs to be included in the valuation. This may include a range of costs that may not be immediately apparent.

AASB116 states that total cost includes –

- Purchase price including duties & taxes after deducting trade discounts and rebates
- Any costs directly attributable to bringing it to operation
- Initial estimates of dismantling or rehabilitation where an obligation exists

Examples include –

- Sunk Costs (originally incurred but never to be repeated. E.g. making a cutting in the side of a mountain)
- Reacquisition or Reconstruction Costs (based on likely method used to reconstruct or acquire asset)
- Third Party Costs (compensation or reconstruction of assets controlled by third party. E.g. relocation of a third parties infrastructure to construct a dam, reconstruction of road belonging to a third party so you can replace pipes running underneath)

For example, the cost of building a new road may include costs in relation to forced resumption of land and relocation or reconstruction of assets held by third parties affected by the project. In this case, the costs “directly attributable to bringing the asset into operation” include –

- Purchase of land (usually market value plus premium for compensation)
- Relocation/reconstruction of assets held by other parties (even though assets replaced are not controlled by our council)

APPLICATION: PRACTICAL

The following case study is provided as an example to demonstrate the application of the various accounting standards in determining whether or not to "capitalise" (including overheads) various types of costs as part of a major project.

It is important that when using this example that due regard is provided to the circumstances surrounding each assumption. There are no "hard and fast" rules that can be applied. Ultimately, each scenario needs to be assessed in light of the particular circumstances.

ASSUMPTIONS - GENERAL

Council is involved in the constructing a major infrastructure project (Big Asset) worth \$25,000,000
This included \$5,000,000 for land acquisitions, relocation of assets and compensation

Business Units

Because of the size of the project council set up a Business Unit to deal exclusively with the project (Big Asset Project Bus Unit)
Extensive use will also be made of the existing business unit "Technical Services".
Costs for each Business Unit are collected separately within the General Ledger.

Total Costs of Council were analysed for consideration of capitalisation against the project.

Total Costs of the Council were summarised as follows -

Type	General Council Funds	Business Units		Whole of Council	
		Technical Services BU	Big Asset Project BU		
			Direct Costs	Other Costs	
Construction			10,000,000	1,500,000	11,500,000
Plant Hire	250,000		1,000,000	300,000	1,550,000
Land Acquisitions (all for project)	3,000,000				3,000,000
Relocation of assets (all for project)	1,000,000				1,000,000
Compensation (all for project)	1,000,000				1,000,000
Internal Governance (reports to council, etc)	100,000				100,000
Project Management Fees	500,000		1,110,000	230,000	1,840,000
Professional Fees	1,300,000		940,000	300,000	2,540,000
Feasibility Study			200,000	15,000	215,000
Initial design and planning			750,000	200,000	950,000
Misc Salaries & Wages	8,000,000	1,100,000		350,000	9,450,000
Materials and Services	30,000	50,000	1,000,000	200,000	1,280,000
Depreciation	3,500,000	50,000		100,000	3,650,000
Internal Charges (billed by Tech Serv)				1,000,000	1,000,000
Borrowing Costs	6,605,000				6,605,000
Other costs -					-
Motor Vehicle Lease	700,000	100,000		325,000	1,125,000
Photocopying & Printing	120,000	60,000		200,000	380,000
Building Lease	700,000	15,000		30,000	745,000
Information Technology	500,000	20,000		50,000	570,000
Miscellaneous	5,695,000	605,000		200,000	6,500,000
TOTAL	33,000,000	2,000,000	15,000,000	5,000,000	55,000,000

The total project cost is estimated as -

Land Acquisitions (all for project)	3,000,000
Relocation of assets (all for project)	1,000,000
Compensation (all for project)	1,000,000
Big Asset Project Business Unit	
Direct	15,000,000
Other	5,000,000
	<u>25,000,000</u>

ASSUMPTIONS - BORROWINGS

The project was funded via -

Federal Government Grant	5,000,000
Internal Cash Reserves	7,000,000
Special Purpose Loan for Project	10,000,000
General Borrowings	3,000,000
	<u>25,000,000</u>

Councils total borrowings are -

	Balance	Interest	Average Rate	Other Fees
This project (specific purpose)	10,000,000	1,000,000	10.00%	200,000
Other specific project borrowings	35,000,000	3,600,000	10.29%	55,000
Short Term Facility	1,000,000	123,000	12.30%	30,000
Long Term Debt Pool	8,000,000	845,000	10.56%	47,000
Infrastructure Renewal Facility	4,000,000	425,000	10.63%	25,000
Miscellaneous Non-specific loans	2,000,000	220,000	11.00%	35,000
	<u>60,000,000</u>	<u>6,213,000</u>	<u>10.36%</u>	<u>392,000</u>

Other fees includes application and establishment fees.

While the project was proceeding, the loan funds drawn-down specifically for the project were invested in the short-term money market and realised Investment Income of -

Total Borrowing Costs capitalised (for all other projects, i.e. excluding this 4,300,000

The first step is to identify potential costs that could be capitalised. These will include Direct Costs, Borrowing Costs and Overheads.

INITIAL ASSESSMENT OF TYPE OF COST & WHETHER CAN BE CAPITALISED AS PART OF PROJECT -

- Direct (DC)
- Borrowing Cost (BC)
- Possible Overhead (OH)
- Not Applicable (N/A)

Type	General Council Funds		Business Units							
			Technical Services BU		Big Asset Project BU					
			Assess	Amount	Assess	Amount	Assess	Amount	Assess	Amount
Construction		-		-	DC	10,000,000	DC	1,500,000		
Plant Hire	DC	250,000		-	DC	1,000,000	DC	300,000		
Land Acquisitions (all for project)	DC	3,000,000		-		-		-		
Relocation of assets (all for project)	DC	1,000,000		-		-		-		
Compensation (all for project)	DC	1,000,000		-		-		-		
Internal Governance (reports to council, etc)	OH	100,000		-		-		-		
Project Management Fees	DC	500,000		-	DC	1,110,000	DC	230,000		
Professional Fees	DC	1,300,000		-	DC	940,000	DC	300,000		
Feasibility Study		-		-	DC	200,000	DC	15,000		
Initial design and planning		-		-	DC	750,000	DC	200,000		
Misc Salaries & Wages	OH	8,000,000	OH	1,100,000		-	DC	350,000		
Materials and Services	OH	30,000	OH	50,000	DC	1,000,000	DC	200,000		
Depreciation	N/A	3,500,000	OH	50,000		-	DC	100,000		
Internal Charges (billed by Tech Serv)		-		-		-	DC	1,000,000		
Borrowing Costs	BC	6,605,000		-		-		-		
Other costs -		-		-		-		-		
Motor Vehicle Lease	OH	700,000	OH	100,000		-	DC	325,000		
Photocopying & Printing	OH	120,000	OH	60,000		-	DC	200,000		
Building Lease	OH	700,000	OH	15,000		-	DC	30,000		
Information Technology	OH	500,000	OH	20,000		-	DC	50,000		
Miscellaneous	N/A	5,695,000	OH	605,000		-	DC	200,000		
TOTAL		33,000,000		2,000,000		15,000,000		5,000,000		

Having identified the potential "Direct Costs" they need to be assessed for compliance with the Accounting Standards. If any criteria are not satisfied the costs need to be "expensed".

ANALYSIS OF DIRECT COSTS

Big Asset Project Business Unit

Cost	Big Asset Project BU		Reliably Measured	Eliminate Internal Profits	Cap Threshold	Element of Cost	Inc. Serv Potential	> 12 months	Probable	Comments	To Capitalise
	Assess	Amount									
Construction	DC	10,000,000	DC	1,500,000	✓	✓	✓	✓	✓		11,500,000
Plant Hire	DC	1,000,000	DC	300,000	✓	✓	✓	✓	✓		1,300,000
Project Management Fees	DC	1,110,000	DC	230,000	✓	✓	✓	✓	✓		1,340,000
Professional Fees	DC	940,000	DC	300,000	✓	✓	✓	✓	✓		1,240,000
Feasibility Study	DC	200,000	DC	15,000	✓	✓	✓	✓	✓	No #1	
Initial design and planning	DC	750,000	DC	200,000	✓	✓	✓	✓	✓	No #1	
Misc Salaries & Wages		-	DC	350,000	✓	✓	✓	✓	✓		350,000
Materials and Services	DC	1,000,000	DC	200,000	✓	✓	✓	✓	✓		1,200,000
Depreciation		-	DC	100,000	✓	✓	✓	✓	✓		100,000
Internal Charges (billed by Tech Serv)		-	DC	1,000,000	✓	No	✓	✓	✓	#2	800,000
Motor Vehicle Lease		-	DC	325,000	✓	✓	✓	✓	✓		325,000
Photocopying & Printing		-	DC	200,000	✓	✓	✓	✓	✓		200,000
Building Lease		-	DC	30,000	✓	✓	✓	✓	✓		30,000
Information Technology		-	DC	50,000	✓	✓	✓	✓	✓		50,000
Miscellaneous		-	DC	200,000	✓	✓	✓	✓	✓		200,000
		15,000,000		5,000,000							18,635,000

The Business Unit was set up exclusively for the construction of the asset. Therefore all costs satisfied the criteria of being "directly attributable" to the acquisition of the asset.

- #1 While the cost of the feasibility study and initial design and planning relate specifically to the project they were incurred prior to when approval to proceed with the project was given. The costs were initially coded to a general council code and once the Business Unit had been established the costs were transferred to the Business Unit.
- #2 The costs of professional services provided by the Technical Services Business Unit related directly to the project. However, they were recorded at the amount "invoiced" by Technical Services. As this is a self-constructed asset any internal profits need to be eliminated. The financial results of the Technical Services Business Unit revealed a net operating surplus of 20% so the amount of cost to be capitalised has been reduced by this percentage in order to eliminate internal profits.

General Council Funds

Type	General Council Funds		Reliably Measured	Eliminate Internal Profits	Cap Threshold	Element of Cost	Inc. Serv Potential	> 12 months	Probable	Comments	To Capitalise
	Assess	Amount									
Plant Hire	DC	250,000	✓	✓	✓	No	✓	✓	✓	#3	
Land Acquisitions (all for project)	DC	3,000,000	✓	✓	✓	✓	✓	✓	✓	#4	3,000,000
Relocation of assets (all for project)	DC	1,000,000	✓	✓	✓	✓	✓	✓	✓	#4	1,000,000
Compensation (all for project)	DC	1,000,000	✓	✓	✓	✓	✓	✓	✓	#4	1,000,000
Project Management Fees	DC	500,000	✓	✓	✓	Y/N	✓	✓	✓	#5	100,000
Professional Fees	DC	1,300,000	✓	✓	✓	Y/N	✓	✓	✓	#5	250,000
											5,350,000

- #3 While it is possible that some of these costs may have related to the construction of the asset - there was no record (such a Work Order) that linked the cost back to the project. Therefore, it was not proved that the cost was "directly attributable" to the asset
- #4 While these costs were charged to "general council" costs, they related directly to the acquisition of the asset.
- #5 A review of invoices disclosed some that related specifically to the project but had been coded to general council costs as they covered a range of projects and general issues. These totalled \$100,000 for Proj Mngt and \$250,000 for Prof Fees.

Borrowing Costs then need to be assessed with reference to AASB 123 "Borrowing Costs".

ANALYSIS OF BORROWING COSTS

Specifically for Project	Balance	Interest	Average Rate	Other Fees	Total Borrowing Costs
Loan	10,000,000	1,000,000	10.00%	200,000	1,200,000
less Investment Income earned					
Total Specific Purpose Borrowing Costs to be capitalised					<u><u>1,200,000</u></u>

General Borrowings	Balance	Interest	Average Rate	Other Fees	Total Borrowing Costs
Total Borrowings	60,000,000	6,213,000	10.36%	392,000	6,605,000
less Specific Projects					
this project	(10,000,000)	(1,000,000)	10.00%	(200,000)	(1,200,000)
other specific projects	(35,000,000)	(3,600,000)	10.29%	(55,000)	(3,655,000)
Total General Borrowings	<u>15,000,000</u>	<u>1,613,000</u>	<u>10.75%</u>	<u>137,000</u>	<u>1,750,000</u>

Proportion Borrowed					
Amount of General Borrowings Used for Big Asset Project	3,000,000		Total Base "General"		1,750,000
Percentage Proportion	20.0%				<u>20.00%</u>
Total General Borrowing Costs to be capitalised					<u><u>350,000</u></u>

Final Check

Total "Capitalised" Borrowing Costs				Total "Borrowing Costs"	
This project - specific		1,200,000		Whole of Council	6,605,000
This project - General		350,000			
Other projects		<u>4,300,000</u>			
		<u><u>5,850,000</u></u>			<u><u>6,605,000</u></u>

Total "Capitalised Cost" < "Borrowing Costs"					
Therefore, for this project capitalise					
Specific Purpose		1,200,000			
General Purpose		<u>350,000</u>			
		<u><u>1,550,000</u></u>			

Finally, an assessment needs to be done of whether there are any "overheads" which can be identified and capitalised. This step should also be considered in light of the cost/benefit to be obtained and the level of detail involved in the analysis.

ANALYSIS OF OVERHEADS

Technical Services Business Unit

Type	Business Units		Note	To Capitalise
	Assess	Amount		
Misc Salaries & Wages	OH	1,100,000		
Materials and Services	OH	50,000		
Depreciation	OH	50,000		
Motor Vehicle Lease	OH	100,000		
Photocopying & Printing	OH	60,000		
Building Lease	OH	15,000		
Information Technology	OH	20,000		
		<u>1,395,000</u>	#1	<u>0</u>

#1 Technical Services Business Unit provides professional services across council. All staff complete time sheets and all work is "billed" to the other sections of council on a professional fee for service basis.

As these costs were "billed" to the Big Asset Project Business Unit they have already been included as a "Direct Cost" after eliminating internal profits.

If however they had not been billed, they could have been allocated as an overhead with the amount most likely allocated on total hours billed to the project as a percentage of total hours billed for all work.

General Council Funds

Type	General Council Funds		Note	To Capitalise
	Assess	Amount		
Internal Governance (reports to council, etc)	OH	100,000	#1	
Misc Salaries & Wages	OH	8,000,000	#1	
Materials and Services	OH	30,000	#1	
Motor Vehicle Lease	OH	700,000	#1	
Photocopying & Printing	OH	120,000	#1	
Building Lease	OH	700,000	#2	175,000
Information Technology	OH	500,000	#1	
				<u>175,000</u>

#1 While it is possible that some of these costs may have related to the construction of the asset - there was no record (such a timesheet) that linked the cost back to the project. Therefore, it was not proved that the cost was "directly attributable" to the project.

#2 In addition to some lease costs billed to each Business Unit, the rent of the main admin building is coded to General Council costs. The Big Asset Proj BU occupies 25% of the floor area and therefore OH has been allocated at this rate.

Finally all the various types of costs are brought together and capitalised as appropriate. It is imperative that any assumptions that are made are well documented and "sufficient and appropriate" evidence is gathered to support the figures and critical assumptions.

SUMMARY OF COSTS TO CAPITALISE

	General Council Funds	Business Units		Whole of Council
		Technical Services	Big Asset Project	
Direct Costs	5,350,000		18,635,000	23,985,000
Borrowing Costs	1,550,000			1,550,000
Overheads	175,000	-		175,000
				<u>25,710,000</u>

Note -

If Technical Services not been billed for their work, part of the costs could have been allocated as an overhead with the amount most likely allocated on total hours billed to the project as a percentage of total hours billed for all work.