POLICY

LOGAN CITY COUNCIL

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Policy title: **CAPITALISED EXPENDITURE**

Directorate: ORGANISATIONAL SERVICES

Branch: FINANCE

Policy objective: To develop a system of accounting for capitalised expenditure that will comply with the requirements of the *Local Government Act 2009*, the Local Government Regulation 2012, and Australian Accounting Standards. This policy represents minimum standards.

Policy scope:

This policy applies to all Council officers responsible for the capture of asset-related expenditures and provides a basis for allocation of expenditures between those that create future benefit (capital expenditures) and those that are of an ongoing recurrent nature (operational expenditures).

Definitions:

TERM	DEFINITION
Accrual accounting	Means that the effects of transactions and other events are recognised when they occur (and not when cash or cash equivalents are received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.
Asset	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.
Capital work in progress	Means the activities to produce assets purchased or constructed over a period of time that cannot be put to use until such time as the item is in the location and condition necessary for it to be capable of operating in the manner intended by management.
Class of assets	Means a category of assets with similar properties, nature or function in operations which for the purpose of accounting is reported as a single item without further dissection.
Depreciation	Means the systematic allocation of the depreciable amount of an asset over its useful life.
Expenses	Means consumption or losses of future economic benefits in the form of reduction in assets or increase in liabilities of the Council.
Liability	Means a future sacrifice of economic benefits that the Council is presently required to make to other organisations as a result of a past transaction or event.
Non current asset	Means assets where the future economic benefits are not expected to expire within twelve months after the current reporting period.

TERM	DEFINITION
Recognition	Means reported on the face of the financial statements.
Useful life	Means the period over which an asset is expected to be available for use by an entity.

Policy statement:

The following procedure is to be undertaken for this policy:

1. Standards

   - Local Government Regulation 2012
   - Australian Accounting Standard; AASB116 Property, Plant and Equipment.

2. Preamble

   The Australian Accounting Standards Conceptual Framework provides a definition of an asset and details of when expenditure is not recognised as capital expenditure leading to the creation of an asset, but rather as an operational expense in the income statement. The recognition of expenditure as capital or operational expenditure requires management determination according to the criteria provided in the accounting standards. This policy provides management with a framework based on the accounting standards with which to determine whether expenditure is of a capital or operational nature.

3. Essential characteristics of expenses (operational expenditure)

   (a) Operational expenses represent a consumption or losses of future economic benefits that result from transactions undertaken by, and other events affecting, the Council during the reporting period. Consumption or loss of future economic benefits occurs in the form of reductions in assets (e.g. a payment of cash), or increases in liabilities (invoices processed through Accounts Payable).

   (b) For a transaction to be classed as an operational expense it must give rise to a reduction in the Council's equity. A purchase of an asset (e.g. a building) for example does not reduce the equity of the Council, but merely represents the conversion of one asset (cash) for another (the building). As a further example, salaries to employees (except for labour used to construct an asset) is an operational expense to the Council, as the reduction of cash to pay wages, is not retained by the organisation as an asset.

4. Criteria for recognition of operational expenses

   (a) For an expense to be recognised in the Council's operating statement for a reporting period, it must be demonstrated that:

      (i) it is probable that the consumption or loss of future economic benefits resulting in a reduction in assets and/or an increase in liabilities has occurred

      (ii) the consumption or loss of future economic benefits can be measured reliably.

   (b) Most of the Council's expenses result from the production or delivery of goods and services during an accounting period and these involve little or no uncertainty that future economic benefits have been consumed. In instances such as legal expenses due to a court case, there may be doubt over whether the Council will incur the expenditure, and, as the expense is contingent on a future event (e.g. the outcome of a court case), it should not be recognised until such time as it is probable that the Council will incur the expenditure (once the contingency has been satisfied).

   (c) In most cases the Council's consumption or loss of future economic benefit will be clearly evident and capable of being measured with a high degree of reliability (e.g. in the payment of wages). Again in the example of a potential loss of future economic benefits due to litigation, the amount of loss may not be reliably measured until such time as the judgement has been released, and the expense should then not be recognised until such time as it may be reliably measured or a reasonable estimate is possible.

(d) Where the economic benefits are consumed soon after acquisition (e.g. a vehicle has been serviced or goods have been received, but the service or goods have not yet been paid for), the expense will be recognised in the period that the economic benefit is consumed (i.e. on completion of the service or on receipt of the goods). The recognition of expenses when incurred rather than when paid is known as "accrual accounting".

(e) Where the reduction in future economic benefits occurs progressively over more than one reporting period, such as depreciation of machinery, maintenance contracts that span a longer period, insurance payments etc, the expense should be allocated systematically to the reporting periods during which the economic benefits are expected to be consumed.

5. <u>Characteristics of an asset (capital expenditure)</u>

(a) Essential characteristics

(i) Assets are future economic benefits that:

a. are controlled by the Council

b. result from a past transaction or event.

(ii) The most difficult of the above characteristics to define is control. Control relates primarily, but not exclusively, to legal ownership (for example when ownership passes on the purchase of land). Other factors to consider to determine whether Council has control of an asset include whether:

a. Council has the ability to control the benefits that may flow from a particular asset

b. Council has the ability to use the asset to achieve the Council's objectives (e.g. Council would recognise as an asset an item provided under a financial lease as Council is able to control the use of that asset over it's useful life)

c. Council has the ability to deny or control the access of others to the future economic benefits.

(b) Other characteristics of assets

(i) Acquisition at cost

Assets are normally acquired at a cost incurred by the Council, whether directly or indirectly in a production activity which transforms other assets acquired at a cost. This is not an intrinsic characteristic of an asset, as for example, the Council has assets donated by developers, which have a value but are of no cost to the Council.

(ii) Tangibility

a. An asset need not be tangible. Examples of intangible assets are receivables, prepayments, patents, trademarks and goodwill, all of which embody future economic benefits.

b. Objects that are tangible may not necessarily meet the definition of an asset. For example, the purchase of consumable parts for a machine does not meet the definition of an asset.

c. The Council will recognise and report intangible non-current assets separately to tangible non current assets.

(iii) Exchangeability

This means that the asset is severable from the Council, and has a separate disposal value. Although exchangeability is not an essential characteristic of an asset, the existence of a disposal value is evidence of the existence of a future economic benefit.

(iv) Legal enforceability

The ability to control an asset often stems from the existence of legally enforceable rights held by the Council. However the absence of legal ownership (for example a Deed of Title), does not mean that an asset will fail the control criteria. The idea of control is that of substance (the future economic benefits) rather than form (legal ownership).

6. Criteria for recognition of assets

(a) For an asset to be recognised in the Council's financial statements for a reporting period, it must be demonstrated that:

(i) it is probable that the future economic benefits associated with the item will flow to the entity

(ii) the cost of the item can be measured reliably.

(b) Assessments of the degree of certainty attached to the future economic benefits should be made on the basis of available evidence and logic.

(c) Unless the value of an asset can be measured reliably, expenditure incurred to produce future economic benefits cannot be treated as an asset (for example, the future economic benefits of vegetation and landscaping cannot be reliably measured, and hence would not be capitalised). An asset donated to the Council, such as a sewerage network from a developer, although it has no cost, has a value (replacement value), and must be recorded in the Council's financial statements.

7. Elements of assets

(a) Useful life

(i) Where it has been determined that expenditure meets the criteria for the recognition of assets, it is necessary to determine the period of time (life) over which the utility (economic benefits) arising from the expenditure will expire.

(ii) The life of an asset will be dependant on both internal and external measures, such as management decisions, legal undertakings, production capacity, technical and commercial obsolescence.

(iii) Where the life of an asset is greater than twelve (12) months (that is it will not expire before the end of the next financial year after its purchase), the asset should be classified as a non-current asset, otherwise the asset should be classified as a current asset.

(b) Categorisation

For the purpose of financial reporting, assets and other capitalised expenditure fall into the following broad categories:

(i) cash

(ii) receivables

(iii) prepayments

(iv) inventories

(v) investment (current and non-current)

(vi) non-current assets (greater than Council's asset acquisition threshold):

a. infrastructure

b. land and buildings

c. plant and equipment

d. intangibles

e. capital works in progress.

8. <u>Repairs and maintenance (operational) expenditure</u>

Repairs and/or maintenance expenditures are any costs associated with the day to day maintenance of an asset. These items are generally incurred in an attempt to maintain service levels and to ensure that the estimated life of the asset will be reached (that is, that there is no reduction in the utility of the asset). Expenditure on repairs and/or maintenance does not generally change the functionality of an asset, nor does it extend the life of the asset beyond that which the asset could reasonably be expected to be of service for.

The allocation of expenditure as repairs and maintenance requires careful consideration of the nature and expected outcomes associated with the expenditure. When the expenditure is considered to be of a sustaining rather than an enhancing or expanding nature, then it is likely to be operational expenditure. When the expenditure results in increased capacity (e.g. a widening of a road during resurfacing), at least part of the expenditure may be of a capital nature.

(a) Repairs and maintenance expenditure on an asset in poor condition

(i) Where an asset has been assessed as being in need of repair, and is in a worse condition than that reflected by the life recorded in the asset register, and repairs are undertaken, the costs incurred are an expense, as the asset is being returned to the condition it would be in if it had not deteriorated faster than the expected useful life.

(ii) Where the expected life of the asset has been reduced due to its condition or a lower service potential, and expenditure is undertaken to increase condition or service potential back to normal, the amounts expended are recorded as an operational expenses, and the useful life of the asset is adjusted in the asset register.

9. <u>Capital expenditure</u>

(a) Capital expenditure on an existing asset generally means expenditure that increases service potential or extends the life of an asset by a material amount. Capital expenditures incurred on existing assets are capitalised as either an increase to the existing asset carrying value, a new component of the existing asset, or an asset in its own right.

(b) Where an asset is an integral part of the existing asset, or has no inherent value were the Council to dispose of the original asset (e.g. software specific to the operation of a computer), then the asset is to be capitalised as a cost adjustment to the original asset and depreciated over the remaining life of the original asset.

(c) Where an asset is not an integral part of the existing asset (e.g. application software such as the Finance 1 package), or has an inherent value were the Council to dispose of the original asset, then the asset is to be capitalised as an asset in its own right, and depreciated over its own estimated useful life.

(d) Where an item of expenditure increases the life of an asset, this will generally form an integral part of the asset, be cost-adjusted to the original asset, and depreciated over the remaining life of the asset.

10. <u>Works in progress (project expenditure)</u>

(a) The use of phrases "works in progress", or "capital works", or any other wording used to describe a project, does not make the project capital by nature. Project expenditure captured by using "job costing" is a method of pooling different costs to create an item of expenditure, which may be either of an operational or capital nature.

(b) When a project is completed, the costs captured by the project must be analysed to ensure that items that can be classified as repairs and maintenance are not capitalised. Where costs captured in a work in progress are identified as being expenses, they are to be recognised as operational expenditure in the Council's operating statement. This can apply for an entire project or a proportion of a project, as the use of the word project does not make the costs incurred in the project capital in nature.

(c) Where the costs of a project are deemed to be capital in nature, then they are to be capitalised in accordance with section 7 above.

Related policies/legislation/other documents:

DOC ID	DOCUMENT TYPE	DOCUMENT NAME
-	Legislation	*Local Government Act 2009*
-	Legislation	Local Government Regulation 2012
-	Standards	Australian Accounting Standards