MADEIRA BEACH BOARD OF COMMISSIONERS

September 13, 2016 – Agenda Report

FROM: Vincent M. Tenaglia, Assistant City Manager

SUBJECT: **AUTHORIZATION TO REDEFINE CAPITALIZATION THRESHOLD FOR CAPITAL ASSETS**

BACKGROUND: As of September 30, 2015, capital assets of the City of Madeira Beach totaled a net value of $28,800,441. These assets include land, construction in progress, City facilities, improvements, vehicles, and equipment. The City's current capitalization policy defines capital assets as "items with an individual cost of $1,000 or more and an estimated useful life of one year or more." This definition is inconsistent with best practices recommended by the Government Finance Officers Association.

Industry research indicates that capitalization policies which incorporate relatively lower thresholds (i.e., $1,000) are often costly to maintain and operate, without improving management's control over the organization's assets. Finance is therefore requesting to redefine capital assets as "assets valued at $5,000 or more, used in operations, with an initial life of two or more years." The effects of implementing a higher capitalization threshold include more appropriate accounting of improvements and equipment, and less burdensome reporting requirements by Finance staff. Rather than frequently adding and deleting relatively inconsequential assets, the City's Statement of Net Position will include a more accurate depiction of long-term useful assets. As is the case with similar financial policies recently adopted by the Board of Commissioners, this requested change is consistent with best practices and will modernize the City's financial operation.

Finance is requesting to implement this change retroactively, effective October 1, 2015, so that the upcoming annual financial report will reflect this change.

BUDGETARY IMPACT: N/A

RECOMMENDED BY STAFF: Finance recommends approval of authorization to redefine the City's capital asset capitalization threshold.

ATTACHMENT(S): GFOA Best Practice: Establishing Capitalization Thresholds for Capital Assets

Agenda Item: J-2

Government Finance Officers Association

BEST PRACTICE

Establishing Capitalization Thresholds for Capital Assets

BACKGROUND:

The term *capital assets* is used to describe assets that are used in operations and that have initial lives extending beyond a single reporting period. Capital assets may be either intangible (e.g., easements, water (rights) or tangible (e.g., land, buildings, building improvements, vehicles, machinery, equipment and infrastructure). It is incumbent upon public-sector managers to maintain adequate control over all of a governments resources, including capital assets, to minimize the risk of loss or misuse.

As a practical application of the materiality principle, not all tangible capital-type items with useful lives extending beyond a single reporting period are required to be reported in a governments statement of position. Items with extremely short useful lives (e.g., less than 2 years) or of small monetary value are properly reported as an "expense" or "expenditure" in the period in which they are acquired.

When outlays for capital-type items are, in fact, reported on the statement of position, they are said to be *capitalized*. The monetary criterion used to determine whether a given capital asset should be reported on the balance sheet is known as the *capitalization threshold*. A government may establish a single capitalization threshold for all of its capital assets, or it may establish different capitalization thresholds for different classes of capital assets.

Capitalization is, of its nature, primarily a financial reporting issue. That is, a governments principal concern in establishing specific capitalization thresholds ought to be the anticipated information needs of the users of the governments external financial reports. While it is essential to maintain control over all potentially capitalizable items, there exist much more efficient means than capitalization for accomplishing this objective in the case of a governments smaller tangible capital-type items.[1] Furthermore, practice has demonstrated that capital asset management systems that attempt to incorporate data on numerous smaller items are often costly and difficult to maintain and operate.

RECOMMENDATION:

GFOA recommends that state and local governments consider the following guidelines in establishing capitalization thresholds:

- Potentially capitalizable items should only be capitalized only if they have an estimated useful life of at least two years following the date of acquisition;
- Capitalization thresholds are best applied to individual items rather than to groups of similar items (e.g., desks and tables), unless the effect of doing so would be to eliminate a

significant portion of total capital assets (e.g., books of a library district);

- In no case should a government establish a capitalization threshold of less than $5,000 for any individual item;
- In establishing capitalization thresholds, governments that are recipients of federal awards should be aware of federal requirements that prevent the use of capitalization thresholds in excess of certain specified maximum amounts (i.e., currently $5,000) for purposes of federal reimbursement; and
- Governments should exercise control over potentially capitalizable items that fall under the operative capitalization threshold.[2]

References:

[1] See GFOAs best practice on Maintaining Control over Items that Are Not Capitalized (2006).

[2] See GFOAs best practice on Maintaining Control over Items that Are Not Capitalized (2006).