CITY OF MADISON – FISCAL SERVICES

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Prepared by: Date:	Reviewed by: Date:

Capitalization, Depreciation & Amortization Policy

Purpose: To establish and implement controls necessary to protect the assets of the city, record assets in compliance with federal, state, and municipal rules and regulations, and generally accepted accounting principles (GAAP).

To provide guidelines and parameters necessary to allow the enforcement and implementation of the city's capital policies; and to provide a sound basis for accurately valuing the city's assets.

Policy: A capital asset is property, such as land, land improvements, easements, buildings, equipment, vehicles works of art and historical treasures, computer software and infrastructure with an estimated useful life greater than one year. Capital assets are acquired for use in the normal course of business and are not for resale. All purchases of capital assets that exceed $10,000, renovations or building improvements greater than $25,000 and any purchases and/or construction of infrastructure that exceeds $50,000 and/or extends the useful life will be capitalized. These assets may be subject to depreciation (see Depreciation/Amortization) based on the estimated useful life of the asset. A schedule of asset useful life, by asset class, has been defined by Finance Department staff. Assets valued under $10,000, or that are consumed, used-up, habitually lost, or worn-out in one year or less are to be expensed and not recorded for financial reporting purposes.

According to GAAP, capital assets should be recorded at historical cost or estimated historical cost. This would include: purchase price, construction cost, and any/all additional costs associated with placing the asset in its intended location and condition for use. Examples of additional costs might include, but are not limited to:

- land-preparation and demolition costs
- legal and title fees
- architect, engineering, design or project management fees
- appraisal and negotiation fees
- closing costs
- surveying and permit fees
- transportation charges
- utility usage exclusive to project

Finance Department staff is responsible for maintaining a permanent, detailed master record of capital assets owned by the city (excluded Transit and Water Utilities). The safeguard and use of assets assigned to each City agency is the responsibility of the division (agency) head. Changes in asset status such as relocation or disposal (due to sale, trade or damage) must be reported to the Finance Department by agency staff so City master records may be updated.

<u>Asset Classes and Definition</u>

1. Land and Land Improvements
2. Construction/Infrastructure in Progress
3. Infrastructure
4. Buildings and Building Improvements
5. Machinery and Other Equipment
6. Art, Historical Treasures and Library Collections
7. Vehicles
8. Computer Hardware
9. Intangibles

Land
Costs to be capitalized include all costs associated with the acquisition of the land. These costs include, but are not limited to, purchase costs, closing costs, demolition of existing structures, or any costs incurred to prepare the land for its intended purpose (excavation, fill, grading, remediation). Land is recorded at historical cost but not depreciated.

Land Improvements
Costs to be capitalized include, but are not limited to, excavation, driveways, sidewalks, flagpoles, landscaping, lighting, fences and parking lots that make the land ready for its intended purpose and which exceed $50,000. Land improvements can be further categorized as non-exhaustible and exhaustible. Landfill remediation costs are expensed.

> <u>Non-Exhaustible-</u> Improvements that do not require maintenance or replacement, expenditures to bring land into condition and that do not deteriorate with use or passage of time is generally not exhaustible and therefore not depreciable.
>
> <u>Exhaustible-</u> Other improvements that are part of a site; such as parking lots, landscaping, fencing, are usually exhaustible and are therefore depreciable.

Construction/Infrastructure in Progress
Construction projects meeting the city's capitalization policy should be capitalized and recorded within a fixed asset system. It should be reported with land and other non-depreciating assets until completion and/or substantial completion (infrastructure) of the project. Once the asset is ready for its intended use, re-classify construction/infrastructure in progress as one of the other major classes of capital assets (e.g., Buildings) and depreciate. In the case of Water, Sewer and Storm Utility infrastructure, assets are deemed ready for use and transferred from *construction in progress* once a certificate of completion is issued and the warranty period begins (see Engineering's General Conditions 105.15 and 105.16).

Infrastructure
Are generally defined as assets that are normally stationary in nature and can be preserved for a significantly greater number of years than most other capital assets. Can be classified into categories such as networks, subsystems, and components.

> <u>Network-</u> Composed of all assets that provide a particular type of service. Examples: Streets, Bridges, Bike Paths, Traffic Signals, and Street Lights
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>> Streets: Will include surface segments, curb & gutter, sidewalks, signage, pavement markings and terrace trees for newly constructed projects maintained by Engineering. New streets constructed by private developers will be capitalized in two pieces; streets excluding the final surface will be capitalized separately from the final surface upon acceptance of each by the Common Council. Fully reconstructed street segments will be fully disposed while resurfacing pulverizing (original street segment) will not be disposed of and will continue to depreciate until it reaches its salvage value. The new resurfacing pulverizing street segments will be capitalized and depreciated over 20 years without salvage value (the salvage value remains with the "older original street segment"). Traffic Signals and Street Lights will be separate stand-alone networks maintained by Traffic Engineering. Maintenance including resurfacing grinding, seal coating, and replacements will be expensed unless considered to extend the life (10% past the original useful life) and/or serviceability of the assets.
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>> Bike Paths: Will be capitalized if greater than or equal to the $50,000 capitalization threshold. Maintenance and preservation costs will be expensed.
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>> Bridges: Including Pedestrian will be capitalized if greater than or equal to the $50,000 capitalization threshold. Maintenance and preservation costs will be expensed.
>>
>> Street Lights: Will contain four types of costs (1) Roadway lights, (2) Pedestrian lights, (3) Residential lights (URD), and (4) Utility Wood Pole lights. All types of lights are 100% owned by the City of Madison, except for the Utility Wood Pole lights which the City of

Madison owns 100% of the arm and fixture only. Via contract the cost of maintenance that the City of Madison provides for Utility owned streetlights, is recovered through a monthly rate from the Madison Utility.

Traffic Signals: Excluding the underground interconnect costs will be capitalized during new street construction. Routine replacement and maintenance will be expensed.

Buildings
Buildings are recorded at either their acquisition or construction cost. Cost should include all charges necessary to place the building or structure into an operational state. Permanently attached fixtures to the building (i.e. heating and ventilation systems, roofs, plumbing, carpet, and electrical systems) should be included in the cost of the building.

Building Improvements
Expenses are sometimes incurred to restore or improve buildings. These costs should extend the building's useful life (See Renovations/Improvements). Care must be taken to distinguish between maintenance and renovation/improvement costs.

Machinery and Other Equipment
Should be capitalized and are depreciable tangible personal property (e.g., snow plows, dump trucks, busses, furniture). Costs include purchases, delivery, transportation, insurance while in transit, and installation costs.

Art and Historical Treasures
Should be capitalized and depreciable when exhaustible, at their historical cost or fair value at the date of donation whether they are held as individual items or in a collection. To capitalize a collection it must meet the following:

- Held for public exhibition, education, or research in furtherance of public service, rather than financial gain
- Protected, kept unencumbered, cared for and preserved
- Subject to an organizational policy that requires the proceeds from sales of collection items to be used to acquire other items for collections

Library Collections
Library collections are considered to be capital assets if they have a useful life of greater than one year and a cumulative cost of $10,000 or more. These assets should be capitalized and are therefore depreciable using the group or composite methods of depreciation.

Periodicals or subscription services that are replaced every year are deemed to have a useful life of less than one year and would not be capitalized.

Vehicles
Should be capitalized and are therefore depreciable if they meet capitalization threshold levels.
Examples: cars, light trucks, golf carts and squads.

Computer Hardware
May be capitalized and are depreciable if they meet capitalization threshold levels.

Intangibles (GASB 51 effective 12/31/2010)
Intangible assets should be capitalized according to the following thresholds:

$1,000,000 – Internally generated computer software (application development costs only)
$50,000 – Purchased or licensed computer software
$10,000 – Easements, Air Rights, Patents, Copyrights and Trademarks

Intangible assets with a cost equal to or greater than the threshold and a useful life of two or more years should be capitalized. Assets costing below the threshold should be expensed. When an internally generated computer project spans more than one year, the total application development costs of the project should be considered when applying the capitalization threshold, not the outlays incurred in individual years (Note: a project would include a modification to existing software).

Example: An internally generated computer project in two years. The application development outlays were $700,000 and $600,000 in year one and year two, respectively. The agency should capitalize these outlays, beginning in year one, since the total application development costs exceed the threshold. At the end of year two, the agency should have capitalized $1,300,000 as computer software in development.

Example: An internally generated computer software program that was placed into service in 2006. The program had total application development costs of $2.5 million. The program was not capitalized since retroactive application was not required. In 2010, the agency modified the program to increase its functionality. The application development outlays of the modification were $600,000. The agency should not capitalize the modification since it is below the threshold (Note: if the outlays were $1.1 million, the agency would capitalize the modification).

Before an intangible asset can be recognized in the financial statements, it must meet one or both of the following criteria:

- The asset is separable, that is, the asset is capable of being separated or divided from the government and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, asset, or liability.
- The asset arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

If the types of intangible assets reported by a government differ in nature and usage, then they should not be reported collectively as a single major class of capital assets (e.g., intangible assets). For example, the nature and usage of patents differs from that of right-of-way easements such that they should not be aggregated in the same major class of capital assets.

<u>Internally Generated Intangible Assets</u>
Intangible assets are considered internally generated if they are created or produced by the government or an entity contracted by the government, or if they are acquired from a third party but require more than minimal incremental effort on the part of the government to begin to achieve their expected level of service capacity.

Capitalization of internally generated capital assets can only occur after ALL of the following conditions have been met:

- Determination of the specific objective of the project and the nature of the service capacity that is expected to be provided by the intangible asset upon the completion of the project,
- Demonstration of the technical or technological feasibility for completing the project so that the intangible asset will provide its expected service capacity, and
- Demonstration of the current intention, ability, and presence of effort to complete or, in the case of a multiyear project, continue development of the intangible asset.
- Only outlays incurred subsequent to meeting the above criteria should be capitalized. Outlays incurred prior to meeting those criteria should be expensed as incurred.

Specific Application to Computer Software
Computer software is a common type of intangible asset that is often internally generated. Computer software should be considered internally generated if it is developed in-house by the government's personnel or by a third-party contractor on behalf of the government. Commercially available software that is purchased or licensed by the government and modified using more than minimal incremental effort before being put into operation also should be considered internally generated. Any of the following activities would satisfy the "*modified using more than minimal incremental effort*" criterion: changing code, changing fields, adding special reporting capabilities, and testing any changes.

The activities involved in developing and installing internally generated computer software can be grouped into the following stages:

- *Preliminary Project Stage*. Activities in this stage include the conceptual formulation and evaluation of alternatives, the determination of the existence of needed technology, and the final selection of alternatives for the development of the software.
- *Application Development Stage*. Activities in this stage include the design of the chosen path, including software configuration and software interfaces, coding, installation to hardware, testing, including the parallel processing phase, and data conversion needed to make the software operational.
- *Post-Implementation/Operation Stage*. Activities in this stage include application training, data conversion that is beyond what is strictly necessary to make the software operational, and software maintenance.

All outlays associated with activities in the preliminary project stage should be expensed as incurred.

All outlays related to activities in the application development stage should be capitalized, provided the following conditions are met: 1) the outlays were incurred subsequent to the completion of the preliminary project stage and 2) management authorizes and commits to funding (either implicitly or explicitly), at least through the current period. For commercially available software that will be modified to the point that it is considered internally generated, these two conditions generally are met at the time a government makes the commitment to purchase or license the computer software. Capitalization of such outlays should cease once the software is substantially complete and operational (i.e., ready for use). All outlays associated with activities in the post-implementation/operation stage should be expensed as incurred.

The activities within the three stages of development may occur in a different sequence. The recognition guidance for outlays associated with internally generated computer software should be applied based on the nature of the activity, not the timing of its occurrence. For example, outlays associated with application training activities that occur during the application development stage should be expensed as incurred.

If an agency is developing an enterprise resource planning (ERP) system with multiple modules, the guidance for reporting outlays based on the stages of software development should be applied for each individual module of the system rather than the system as a whole.

An improvement to existing computer software must increase at least one of the following to qualify for capitalization:

- functionality,
- efficiency
- estimated useful life.

If the modification does not result in any of the above outcomes, the modification should be considered maintenance, and the associated outlays should be expensed as incurred. If a maintenance contract covers all required maintenance and any unspecified upgrades issued during the year by the vendor, the unspecified upgrades should be considered maintenance.

An intangible asset should be considered to have an indefinite useful life if there are no legal, contractual, regulatory, technological, or other factors that limit the useful life of the asset (e.g., permanent right-of-way easement). Intangible assets with indefinite useful lives should not be amortized.

Intangible assets with limited useful lives (e.g., by legal or contractual provisions) should be amortized over their estimated useful lives. Amortization of computer software should begin when the program is placed into service.

Impairment Indicator
A common indicator of impairment for internally generated intangible assets is development stoppage, such as stoppage of development of computer software due to a change in the priorities of management. Internally generated intangible assets impaired from development stoppage should be reported at the lower of carrying value or fair value, assuming the stoppage was considered to be permanent (see GASB Statement 42).

Common Types of Intangible Assets

- Computer software
  - Purchased or licensed
  - Internally generated
- Websites
- Easements *Note: these will be recorded by their primary use. In service date shall be the date of execution of the instrument granting the easement: In its absence, the recording date shall be used.*
- Land use rights (e.g., water, timber, and mineral rights) *Note: land use rights associated with property already owned by an agency should not be reported as intangible assets separate from the property*
- Patents, copyrights, and trademarks

Retroactive Reporting
Retroactive reporting is required for intangible assets, except as follows. Retroactive reporting is not required for 1) internally generated intangible assets, including those in development as of the effective date of this policy and 2) intangible assets with an indefinite estimated useful life as of the effective date of this policy.

Accounting Guidance:
Intangible assets should be classified as capital assets, except if acquired or created primarily for the purpose of directly obtaining income or profit. Existing authoritative guidance related to the accounting and financial reporting for capital assets should be applied to intangible assets, as applicable.

Donated Assets
Assets acquired through private donation of individuals or an agency Foundation should be recorded at their fair market value on the date of donation. Fair market value is the estimated amount at which an exchange would occur between a willing buyer and seller.

The acquiring Agency staff should prepare a resolution accepting ownership of the asset to be approved by Madison Common Council. Once the resolution has been approved, notification must be sent to Finance staff to record acquisition of the donated asset. This notification should include:

- description of the asset
- how/when and from whom it was acquired
- the valuation and how it was valued
- approved council resolution file ID

Maintenance
Expenses to ensure assets are in working order or to maintain the original use of the asset are maintenance expenses. These expenses do not extend the useful life of the asset beyond the expected useful life at acquisition or increase the future functionality/capacity of the asset. These expenses were an expected cost at the time of purchase. Replacements of roofs (portions), plumbing, HVAC, carpet, or engines are considered maintenance expenses.

Regardless of the dollar amount, maintenance costs are to be expensed and not capitalized. Costs should be charged to repairs or maintenance. This will allow for agency/finance staff review of maintenance accounts to confirm that costs were indeed maintenance rather than amounts that should be capitalized.

Renovation/Improvements
Renovation/Improvement costs must first equal or exceed the $10,000 capitalization threshold as defined previously. Additionally, the project must extend the useful life of the original asset or increase the future functionality/capacity of the asset. If both criteria are met, the renovation/improvement project may be capitalized. Projects not meeting defined criteria need to be expensed as maintenance. Assets (or its parts) removed during renovation/improvement projects should be retired.

Additions
Additions increase the size or operational functionality/capacity of an existing asset through an expansion or extension project. Additions do not involve renovations and are different from maintenance costs; for example, a new wing on an existing building. These additions represent a new separate asset and will be capitalized if the $10,000 threshold is met.

Tagging
Generally, all capital assets will be assigned an inventory tag number. Some assets will not be tagged due to the nature of the asset. The asset number will still be recorded within the financial system though not affixed to the asset. Examples of items not needing a tag would be buildings or software.

Physical Inventory
Agency staff is required to complete yearly review of capital assets assigned to their agency. In addition, Finance Department staff is required to participate in completing physical inventories annually. The agenda of physical inventory review by Finance staff is based on a 3-year revolving schedule established by the Accountant responsible for capital assets.

Nature and Timing
Planned yearly reviews of inventory by agency staff will be conducted following the close of the third quarter. This allows for timely reporting of necessary inventory adjustments, addition, or deletions to capital asset Accountant applicable to current year financial statements.

Inventory reviews scheduled to be conducted by Finance staff will be performed during the second and third quarters of a given year. Additional “as needed” inventory reviews will be conducted when Finance staff becomes aware that questionable activities, such as theft, misuse and/or unauthorized disposal of City property, may have occurred.

Depreciation/Amortization
In accounting terms, depreciation/amortization is the process of allocating the cost of tangible property over a period of time; the assets estimated useful life. Estimated useful life is the approximate number of months or years that an asset will be able to be used for the purpose for which it was purchased. In determining useful life, consider the asset’s present condition, use of the asset, construction type, maintenance policy, and how long it is expected to meet service needs. Rather than deducting the asset’s cost as an expense in the year of acquisition, the asset is depreciated/amortized. Generally, at the end of an asset’s useful life, the sum of the amounts charged for depreciation in each accounting period (accumulated depreciation) will equal original cost less salvage value.

Salvage value is the expected remaining value when the asset is no longer useful for its intended purpose. It is generally assumed to be the amount for which the asset could be sold at the end of its useful life. With the exception of infrastructure, assets as assumed to have no salvage value.(See Depreciation/Amortization schedule)

The straight-line method of depreciation/amortization, with an assumed salvage value of zero, is the City’s preferred method of depreciation/amortization. Straight-line is a time-based method used when the service life of the asset is affected primarily by the passage of time. See table below for depreciation/amortization guidelines. It is also recommended that depreciation/amortization for partial periods be computed using the half-year convention. Half-year convention dictates that an asset will be treated as though it were placed in service or disposed of on the first day of the seventh month of the fiscal year. One-half of a full year’s depreciation/amortization is allowed for the asset in its first year placed in service, regardless of when it was actually placed in service during that year. During the year of disposal, one-half of a full year’s depreciation/amortization is calculated.

The exception to half-year convention will be infrastructure. All infrastructure network additions will be depreciated using the full-year convention. Full-year convention states that assets will be treated as though they were placed in service or disposed of at the beginning of each fiscal period. A full year’s depreciation is allowed for the asset in its first year of service, regardless of when it was actually placed in service during the year. During the year of disposal, no depreciation/amortization is calculated.

Depreciation/Amortization Schedule

To be used as standards for more common items. Classes and estimated useful lives are not all inclusive. Contact Finance Department staff for further clarification.

MAJOR CLASSES	**ESTIMATED USEFUL LIFE / SALVAGE VALUES**	**CAPITAL ASSET SYSTEM DEFAULT**
Land	No depreciation	0
Land Improvements (inexhaustible)	No depreciation	0
Land Improvements (exhaustible)	15 / 0% Salvage	15
Construction/Infrastructure in Progress	No depreciation	0
Infrastructure:		
Streets	40 / 20% Salvage + Land Value	40
Bridges	70 / 10% Salvage	70
Traffic Signals	40 / 0% Salvage	40
Street Lights	40 / 0% Salvage	40
Bike Paths	40 / 20% Salvage + Land Value	40
Buildings and Building Improvements	20-55 / 0% Salvage	30
Machinery and Other Equipment	5-15 / 0% Salvage	10
Art, Historical Treasures and Library Collections	3-7 / 0% Salvage	7
Vehicles	5 / 0% Salvage	5
Computer Hardware	3-5 / 0% Salvage	3
Intangibles	Varies Refer to Engineering or Agency	Varies Contact Finance Department staff
Internally Generated Software		
Licenses/software	3-5 / 0% Salvage	
Permanent Easements	No depreciation	
Limited-term Easements	Amortized over life of easement	