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POLICY MANUAL - FIXED ASSETS

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Synopsis

- 1) Fixed assets are tangible in nature and have a useful life longer than one year.
- 2) G.S. 159-26(b)(8) requires local governments to maintain "a ledger or group of accounts in which to record the details relating to the general fixed assets of the unit or public authority." The LGC will no longer issue long-term debt for units having a fixed assets opinion qualification.
- 3) A fixed assets system is important because it provides for effective property management, control, and safeguarding of a large public investment. It also can assist in making management decisions, and it can prevent possible misstatement of financial statements.
- 4) Accounting classifications of fixed assets are land, improvements other than buildings, buildings, operating plants, equipment, vehicles, and construction in progress. Recording of public domain or infrastructure-type fixed assets in the accounting records is optional. Generally, infrastructure general fixed assets are not capitalized because these assets are immovable and of value only to the government.
- 5) To avoid recording assets with immaterial values, local governments should set minimum unit values below which an asset is not recorded in the fixed assets records. The dollar amount set should be a policy decision of the governing board.
- 6) Each fixed asset should be assigned a control number. All equipment should be tagged.
- 7) Fixed assets should be accounted for at cost or estimated historical cost if actual cost is not available. Donated fixed assets should be recorded at their estimated fair market value when received. Estimated costs can be calculated by using price deflator tables to discount replacement costs.
- 8) The initial fixed assets inventory involves identifying and describing all land and buildings, and identifying and tagging all equipment.
- 9) The existence, location, and condition of all fixed assets should be verified by taking an annual inventory.

- 10) Regardless of the method of payment, if a local government acquires most of the benefits and risks of ownership of a property and assumes title, the property must be recorded as a fixed asset.
- 11) Unlike a capital lease, an operating lease does not transfer the benefits and risks of ownership to the local governmental unit. A capital lease exists if at the inception of the lease it transfers ownership to the governmental unit by the end of the lease term, or it contains a bargain purchase option, or the lease term is 75% or more of the estimated economic life of the asset, or the present value of the minimum lease payments is at least 90% of the fair value of the property. With leases involving land, a lease must fulfill one of the first two above to be accounted for as a capital lease. For capital leases, a unit should record a fixed asset and the related obligation.
- 12) Under the North Carolina Constitution, it is generally unconstitutional for a local government to dispose of property for less than its fair market value. However, in certain cases a contract with the receiving party to put the property to some public use constitutes sufficient consideration for the conveyance.
- 13) Subject to certain limitations, a local government may dispose of real or personal property belonging to it by:
1) private negotiation and sale; 2) advertisement for sealed bids; 3) negotiated offer, advertisement, and upset bid; 4) public auction; or 5) exchange.
- 14) Office of Management and Budget Circular A-102 sets requirements for the use and disposal of fixed assets acquired with federal financial assistance.
- 15) Depreciation should be recorded in the accounts of proprietary funds and some trust funds. Although not required, calculation of depreciation for assets recorded in the general fixed assets account group is encouraged for cost accounting purposes. Even if calculated, depreciation should not be recorded in the governmental funds; however, accumulated depreciation may be recorded in the General Fixed Assets Account Group.
- 16) The objective of depreciation is to charge each accounting period for the estimated loss in economic value of the depreciable assets used during the period.

17) Theoretically, a depreciation method should be selected that achieves the most realistic reflection of the loss in economic value of the asset. There are two commonly used depreciation approaches - uniform rate of depreciation (straight-line) and accelerated depreciation.

Introduction

Fixed assets are tangible in nature and have a useful life longer than one year. They are classified as land, improvements other than buildings, buildings, operating plants, equipment, vehicles, and construction in progress. Fixed assets can be both movable and immovable. Items of insignificant value, while they may meet the above criteria, are normally expensed instead of being considered fixed assets.

Important Considerations

Local governments and public authorities are required by G.S. 159-26(b) (8) to maintain "a ledger or group of accounts in which to record the details relating to the general fixed assets of the unit or public authority."

Fixed assets records are required under GAAP and are necessary for the local government's auditor to render an unqualified opinion on its financial statements. Governmental units having an unqualified opinion on their statements are viewed favorably by bond rating agencies and normally pay lower interest rates on their bonds. To meet GAAP requirements, governmental units should record the fixed assets at cost when historical records are available and at an estimated historical cost when no historical records exist. The LGC will no longer authorize the issuance of long-term debt for any units having a fixed assets opinion qualification. Fixed assets information also is required for a Comprehensive Annual Financial Report to qualify for the Government Finance Officers Association's Certificate of Achievement for Excellence in Financial Reporting.

Benefits of a Fixed Assets Accounting System

Establishing and maintaining complete and accurate records accounting for fixed assets is important for several reasons. First, the value of fixed assets for most governmental jurisdictions is large. Therefore, adequate accounting procedures and records are essential for effective property management (including risk management) and control. Second, the stewardship responsibility involved in safeguarding such a large public investment is of the utmost importance to sound financial administration. Third, adequate fixed assets records can assist in making management decisions. Proper use of these records may prevent unneeded assets from being purchased. When budgeting for and preparing routine preventative maintenance

and replacement schedules management may use these records to determine whether maintenance costs are too high for particular assets. Fixed assets records also could be used to help clarify long-term capital budgeting needs. Finally, accurate and complete fixed assets records can prevent the possible misstatement of a local government's financial statements. Otherwise, assets such as those acquired under capital leases and joint ventures could be overlooked.

Classification of Fixed Assets

Fixed assets owned by the governmental unit should be recorded in the accounting records. Accounting classifications of fixed assets are:

Land - A fixed assets account that reflects the acquisition value of land and the rights to land owned by the governmental unit. It includes all land held in fee simple and all rights to land that have no termination date.

Improvements Other Than Buildings - A fixed assets account that reflects the acquisition value of permanent improvements (other than buildings) that add value to the land or improve the use of the land. Examples of such improvements are: fences, retaining walls, drainage systems, sidewalks, parking lots, and driveways. Note that when used with fixed assets, the terms improvement and betterment have different meanings. Improvements are fixed assets permanently attached to land. Betterments are additions to or changes in existing depreciable assets intended to increase their efficiency or prolong their useful lives.

Recording of public domain or infrastructure type fixed assets in the accounting records is optional. This category of fixed assets includes roads, bridges, curbs and gutters, streets and sidewalks, drainage systems, and similar assets that are immovable and of value only to the governmental unit.

Buildings - A fixed assets account that reflects the acquisition value of permanent structures owned by the governmental unit used to house persons and property. Permanently installed fixtures to or within these structures are considered parts of the structures. The costs of major improvements to structures are included in this account.

Operating Plants - A fixed assets account that reflects the acquisition value of plants used to provide the services of utilities, including both the buildings and equipment.

Equipment - A fixed assets account that reflects the value of tangible property not permanently affixed to real property, used in carrying out the operations of the governmental unit. Examples of equipment are machinery, furniture, and vehicles.

Vehicles - A fixed assets account that reflects the value of motor vehicles owned by the local government.

Construction in Progress - A fixed assets account used when a government reports amounts expended on an uncompleted building or other capital construction project. These subclasses such as buildings, improvements, and equipment might be used. When the project is complete, the cumulative costs are transferred to another appropriate fixed assets account.

Recording Fixed Assets

Governmental units may acquire fixed assets by several methods. Possible acquisition methods include purchase, lease-purchase, installment purchase, construction, eminent domain, tax foreclosures, and gifts. The method of acquisition of fixed assets should be properly recorded on the books of account and in subsidiary records that provide detailed information on each asset.

To avoid recording many assets with low values that do not, in the aggregate, amount to a material portion of the value of the fixed assets, local governmental units should set minimum asset values below which an asset is not recorded in the fixed assets records. The following guidelines on significant values are recommended; however, significant values should be based on the size of the unit.

Land - All land and permanent rights to land (e.g., easements) should be recorded without regard to any significant value.

Improvements Other Than Buildings - Improvements other than buildings that cost \$500 or more should be recorded as fixed assets.

Buildings - All buildings should be recorded at acquisition cost without regard to significant value. Additions

costing \$500 or more should be recorded as fixed assets.

Operating Plants - All buildings classified within the operating plants account should be recorded at acquisition cost without regard to significant value. Additions to these buildings costing \$500 or more should be recorded as fixed assets. All equipment classified within the operating plant's account costing \$500 or more should be recorded as fixed assets. Additions costing \$250 or more to this equipment should be recorded as fixed assets. Equipment costing less than the above should not be recorded except:

1. Assets costing less than \$500 for which property records are required to be maintained by the terms of a grant or other agreement should be capitalized at \$1.00 for each separate asset record.
2. Equipment costing less than \$500 that the governmental unit desires to control may be capitalized at \$1.00 for each separate asset record. (Examples: calculators, computer software, etc.)

[Note: In the examples above, the purpose for recording the asset record at a \$1.00 value is to maintain a dollar amount control over all asset cards.]

Equipment and Vehicles - Equipment and vehicles costing \$500 or more should be recorded as fixed assets. Additions costing \$250 or more to equipment and vehicles should be recorded as fixed assets. Equipment and vehicles costing less than the above should not be recorded unless they meet the criteria listed for equipment under operating plants.

Construction in Progress - Construction in progress should be recorded at acquisition cost without regard to significant value.

The dollar amount used in deciding whether an asset is of significant (capitalized or expensed) value should be a policy decision of a local government's governing board. The \$500 amount is included as an example. Local governments are free to establish a different level if they so desire. Smaller units of government probably should use a lower dollar amount as a threshold for capitalizing assets (\$250, \$200, etc.). Since the cost for donated assets is \$0, the determination of whether to capitalize donated

assets would be based on their fair market value. When a government decides to increase its threshold for capitalization, all old assets not meeting the new requirement should be removed from the fixed assets records.

Controlling Fixed Assets

All assets must be physically identified and clearly marked, and the responsibility for their custody must be assigned. Two alternative methods for assigning control numbers are presented below.

One method of assigning control numbers is to categorize the classifications of general fixed assets and preassign blocks of numeric codes for the future development of fixed assets control numbers. A suggested method of accomplishing this for small and medium-sized governmental units is illustrated below. Larger governmental units may need additional digits in their numeric codes. In addition, a 2-3 digit location/department prefix code may be helpful in controlling assets by location/department, as well as by asset-type.

| <u>General Fixed Assets Categories</u> | <u>Block Assignment of Numeric Codes</u> |
|--|--|
| Vehicles | 0001-0999 |
| Equipment: | |
| - Office machinery and equipment | 1000-2999 |
| - Furniture and fixtures | 3000-4999 |
| - Other equipment | 5000-5999 |
| Operating Plants | 6000-6999 |
| Buildings | 7000-7999 |
| Improvements Other Than Buildings | 8000-8999 |
| Land | 9000-9999 |

Another method of assigning control numbers is to assign numbers in consecutive order to fixed assets without regard for asset-type or their location. Though this method is simpler, the method of assigning control number by asset type is highly preferred.

[Note: Only items of equipment are to be physically tagged with fixed assets control numbers. For internal control purposes, fixed assets such as buildings, improvements other than buildings, and land are assigned sequentially numbered fixed assets control numbers in the accounting records but are not physically tagged.]

Valuation of Fixed Assets

Fixed assets should be accounted for at cost or if the cost is not practicably determinable, at estimated historical cost. Donated fixed assets should be recorded at their estimated fair market value when received.

Cost - The cost of a fixed asset includes the purchase price or construction cost (including costs of engineering studies) and ancillary charges necessary to acquire the asset or to place it in the intended location and condition for use. Ancillary charges include costs such as transportation charges, site preparation, professional fees, legal claims directly attributable to asset acquisition, and certain interest costs during construction. (The local government's accounting policy on capitalization of interest costs incurred during construction should be disclosed and applied consistently.) For equipment, the costs of any testing also should be capitalized. [Note: The costs of engineering studies on the feasibility of a project are sometimes properly expensed rather than capitalized at the time they are incurred if a decision on whether assets will be constructed has not been made. If these studies eventually lead to the acquisition or construction of assets, the unit should capitalize these costs (if significant) as part of a project. For example, engineering costs for the expansion of a water and sewer system may be expensed if there is not a

definite project. If the decision is made later to go through with a project, these costs should be capitalized and the expensed amount reversed (if significant).]

Estimated Historical Cost - Governmental units are sometimes required to establish appropriate fixed assets accounting records after many years of operating without such records. In such situations, the original purchase documentation may not be available, or an inordinate expenditure of resources may be required to establish original asset costs precisely. Therefore, it may be necessary to estimate the original asset cost of such assets on the basis of documentary evidence available, including price levels at the time of acquisition, and to record these estimated costs in the appropriate fixed asset accounts. In some units, the cost may not be known; but information and records may be available showing the year of acquisition. In this instance, historical appraisal cost can be used. Historical appraisal cost is defined for this purpose as the current appraised value adjusted to the year of acquisition using the appropriate construction indices, such as the Handy-Whitman Table (a subscription service available to utility companies) or The Engineering News Record (a weekly technical magazine whose publisher issues a semiannual index upon request). If the exact date of acquisition and cost are not known, but the general period of acquisition and cost are known, an average year during the period and a reasonable estimated cost may be used. Information on the approximate time of asset acquisition can be obtained from such sources as building cornerstones and old newspaper clippings. The important concept is to obtain a reasonable estimated cost to record the assets on the books and establish accountability. In order to have the auditor render an unqualified opinion, the fixed assets values only need to be materially correct. If the unit has documentation for assets that were recently acquired, this will probably represent the bulk of the dollar value of the unit's total fixed assets. The depreciated carrying values for older assets will probably not be a large part of the total fixed assets value. Using estimated costs does create some margin of error in the fixed assets accounting records as compared to the proper recording at acquisition. However, such errors should be immaterial and should diminish over time as assets are retired and replaced, and estimated costs are replaced with actual costs. Local governments should involve their auditors in the process of establishing estimated historical costs, since the auditor must render an opinion on the unit's financial statements, which will include these estimated costs. Local governments also can contract with qualified firms for the preparation of asset valuations. The extent to which historical costs

have been estimated and the methods of estimation used should be disclosed in the notes to the financial statements.

Valuation Considerations - Valuation considerations by category of fixed assets include:

Land - If the land is purchased, the valuation includes such costs as purchase price, legal fees, filling and excavation, and other costs directly related to the acquisition of the land and its preparation for use. Rights of way and easements are recorded at purchase cost plus legal costs. If land is acquired by a gift, the valuation recorded should be the appraised value at the time of acquisition. Proceeds from the salvaging of any assets removed from the land reduce the land's cost (i.e. funds received from the sale of the components of an existing building on the land).

Buildings, Improvements Other Than Buildings, and Construction in Progress - If purchased or constructed, the valuation includes such costs as the purchase price, acquisition legal fees, and other professional fees (related to design or construction). If acquired by gift, the valuation recorded should be the appraised value at the time of acquisition.

Equipment - The basis of valuation of purchased equipment includes the net contract price, transportation charges, and the cost of installing special devices or other preparations required to ready the asset for its intended use. The basis of valuation of donated equipment is the appraised value at the date acquired.

Operating Plants - The basis of valuation for the building components is the same as for buildings. The basis of valuation for the equipment components is the same as for equipment.

Initial Inventory of Assets

To set up a fixed assets system, an initial inventory must be taken.

Land, Improvements Other Than Buildings, Buildings, Operating Plants (Building Components), and Construction in Progress - The initial inventory of real property should begin with the identification of all building sites owned by the unit. For each site, all parcels of land and rights in land, all buildings, and all improvements other than buildings should be listed. Buildings should be identified and described at least by reference to the original project. Any additions or improvements which have been made since the original construction should be identified and listed separately. All other parcels of land and rights in land

should be identified as well. Rights in land include easements and rights of way. The inventory should be compared with the local government tax supervisor's records to ensure that no parcels have been omitted.

[Note: While conducting inventories of each site, list all data found at the site identifying time of construction. For example, dates on cornerstones and contractor labels on heating plants will help to identify the project.]

Equipment and Operating Plants (Equipment Components) - The initial inventory is a multipurpose operation. At the time of the initial identification of each asset, an identification tag or stencil is affixed to the asset, the complete description is recorded, the physical condition is assessed, and the fixed assets control number is assigned. All equipment should be tagged, including equipment that is being leased to the unit.

Strict control must be maintained during the inventory-taking process to assure that uninventoried items are not moved to areas previously inventoried, or vice versa.

Annual Fixed Assets Inventory

The existence and condition of all fixed assets should either be verified annually as a part of the year-end closing process or on a cycle basis during the year.

Accounting for Fixed Assets

Fixed assets transactions arise primarily from acquisitions and disposals of fixed assets. These transactions appear first in the expenditure ledger as purchases, or in the revenue ledger as revenues from the disposal of fixed assets. After the end of each month, the transactions for the month should be journalized and recorded. The minutes of the governing board should be inspected for any transactions not recorded in the expenditure accounts, e.g., donated assets, assets received from another government entity, or assets not recorded in the revenue accounts. **It is important that fixed asset records be maintained once they have been established.**

Purchase of Fixed Assets Through Noncancelable Leases or Installment Agreements

Local governmental units may acquire fixed assets with cash or through leases or other financing arrangements such as bonds, notes, and installment purchases. (Note: Use of debt and obligations similar to debt is limited to certain

types of governmental units as defined in the General Statutes.) Regardless of the method of payment, if the local governmental unit acquires most of the benefits and risks of ownership of an asset, the asset must be recorded as a fixed asset of the appropriate fund or account group of the local governmental unit. Accordingly, the liability incurred to acquire the property also must be recorded as a liability of the appropriate fund or account group of the local governmental unit.

Leases - Fixed assets do not always have to be constructed or purchased outright in order to be of benefit to a local government. Fixed assets may be temporarily utilized through a rental agreement, known as an operating lease. In other situations, the utilization of leased fixed assets may be such that the unit has in effect purchased the asset by virtue of the length of its use of the asset, or the amount of payments it has made to use the asset. This type of lease is known as a capital lease.

A lease is an operating lease if it does not transfer the benefits and risks of ownership to the local governmental unit. Operating lease payments are recognized as expenses/expenditures to the local governmental unit when they become payable. The fixed assets leased through operating leases are not capitalized; however, they should be inventoried and tagged for control purposes. According to Governmental Accounting Standards Board Statement 13, lease payments will generally be recognized as expenditures/expenses as specified in the lease contract unless the lease terms are designed so that the lessor is subsidizing the lessee and part of the lease payments are actually interest charges. This will usually be indicated by rent holidays or below market payments at the beginning of the lease term. See GASB Statement 13 for further information.

A lease is a capital lease if at the inception of the lease it meets any one of the following criteria:

- a) The lease transfers ownership of the property to the governmental unit by the end of the lease term.
- b) The lease contains a bargain purchase option (an option extending to the lessee the right to purchase the leased property at a price so favorable that the exercise of the option appears, at the inception of the lease, to be reasonably assured).
- c) The lease term is 75% or more of the estimated economic life of the leased property.

- d) The present value, at the beginning of the lease term, of the minimum lease payments is at least 90 percent of the fair value of the leased property to the lessor.

If the beginning of the term falls within the last 25 percent of the total estimated life of the leased property, criteria (c) and (d) are not used for classifying the lease. For leases involving land, either conditions (a) or (b) must be met. If title to the land will not be transferred to the lessee at some point, the lease is not a capital lease.

Once a lease has been determined to be a capital lease, the governmental unit should record the asset acquired and the corresponding obligation at the present value of the minimum lease payments minus any portion representing executory costs and related profit. However, if the fair market value of the leased property is lower than the present value of the net lease payments, the asset and obligation should be recorded at the fair market value of the leased property. To determine the present value of the net lease payments, the local governmental unit must use the lower of its incremental borrowing rate (the rate, that at the inception of the lease, the lessee would have incurred to borrow, over a similar term, the funds necessary to purchase the leased property) or the implicit rate computed by the lessor, if available.

Installment Purchases

Fixed assets purchased by incurring installment obligations must be capitalized. The basis of valuation of a fixed asset purchased with an installment sales agreement is the lower of the market value of the fixed asset or the net present value of the sales agreement plus the closing costs and the other costs of the purchase. The net present value of the installment sales agreement must be recorded as a long-term obligation in the appropriate fund or account group.

Disposals of Fixed Assets

A unit may not dispose of an asset which continues to have a public purpose. Under the North Carolina Constitution, it is generally unconstitutional for a local government to dispose of property for less than its fair market value. A gift of property or a sale at well below market value constitutes the granting of an "exclusive privilege or emolument" to the person receiving the property, which is prohibited by Article 1, Section 32, of the Constitution. Most of the procedures by which a local government is permitted to sell or otherwise dispose of property are

competitive, and the North Carolina Supreme Court has indicated that the price resulting from an open and competitive procedure will normally be considered appropriate unless strong evidence indicates that it is so significantly below market value as to show an abuse of discretion.

It is not always constitutionally necessary that a local government receive any monetary consideration when it conveys property. A contract with the receiving party to put the fixed asset to some public use constitutes sufficient consideration for the conveyance. (The receiver in this case is usually, but not always, another government.) G.S. 160A-277 provides that a local government may lease, sell, or convey, with or without monetary consideration, land or interest in land to a volunteer fire department or to a volunteer rescue squad for the purpose of constructing or expanding volunteer fire department or rescue squad facilities. G.S. 160A-279(a) provides that "whenever a city or county is authorized to appropriate funds to any public or private entity which carries out a public purpose, the city or county may, in lieu of or in addition to the appropriation of funds, convey by private sale to such an entity any real or personal property which it owns.

G.S. 160A-266(a) and (b), sets out three competitive methods of sale, each of which is appropriate in any circumstance: sealed bid; negotiated offer and upset bid; and public auction. Privately negotiated exchanges of property are also permitted in any circumstance (so long as equal value changes hands) and privately negotiated sales or other disposition of property is permitted in a number of limited circumstances. These various methods of disposition are summarized below. In undertaking any of them, a local government must remember that the statutory procedure must be exactly followed or the transaction risks invalidation by a court.

1. Advertisement for sealed bids:
 - a. The same rules apply as in purchasing (G.S. 143-129; see Purchasing Policy, Section 30, in this Policies Manual).
 - b. There is one modification for real property. An advertisement for sealed bids must be published in a newspaper that has general circulation in the local government's area not less than 30 days before the date fixed for opening bids. (Publication must occur one week before the bids are opened if only personal property is being

sold.) The advertisement should generally describe the property, tell where it can be examined and when and where the bids will be opened, state that a five percent bid deposit is required and will be retained if the successful bidder fails to consummate the contract, and reserve the board's right to reject any and all bids. Bids must be opened in public and be recorded in the board's minutes. The award is made to the highest bidder.

2. Negotiated offer, advertisement, and upset bids:
 - a. The governing body may solicit or receive an offer to purchase property.
 - b. The offeror must make a deposit of 5% of the amount offered to be considered by the unit.
 - c. The offer must be advertised ten days before the sale is consummated. The advertisement should include a notice that within 10 days any person may raise the bid by not less than ten percent (10%) of the first one thousand dollars (\$1,000) and five percent (5%) of the remainder.
 - d. If an upset bid is received, steps b. and c. must be repeated until no further bids are received.
3. Public auction:
 - a. The governing body must pass a resolution authorizing the sale; describing the property to be sold; and specifying the date, time, place, and terms of sale.
 - b. Notice of the sale of the real property must be published once at least 30 days before the sale. For personal property only, the notice must be published at least 10 days before the auction.
 - c. High bids received at the sale must be reported to the governing body and accepted or rejected within 30 days.
 - d. If the bids are rejected, the property may be readvertised for sale.
 - e. The resolution may require the highest bidder to make a bid deposit in an amount specified in the resolution.

4. Private negotiation and sale of personal property (one item or a group of similar items) valued at less than \$10,000 or exchange of government-owned facilities for like facilities of comparable value:

- a. The governing body must pass a resolution authorizing the sale.
- b. The resolution must be published once after passage.
- c. The sale cannot be consummated until ten days after publication of the resolution.

Real property and personal property valued at \$10,000 or more (for an item or a group of similar items) may be exchanged as permitted by G.S. 160A-271 or may be sold under the requirements of items 1., 2., or 3. above. Private negotiation and sales of these items are only allowed as permitted by G.S. 160A-277 and 160A-279. Exemptions are allowed under G.S. 160A-266(b) for the disposal of real or personal properties with certain historical or architectural significance to a nonprofit corporation or trust whose purposes include the preservation or conservation of real or personal property. Real property and personal property valued at ten thousand dollars (\$10,000) or more for any one item or group of similar items also may be exchanged as permitted by G.S. 160A-271.

Before any real or personal property is disposed of by a department in a governmental unit, notice should be circulated to other departments that the property is considered surplus.

The previous statutory references are authority for municipalities. For counties, G.S. 153A-176 references G.S. 160A, Article 12 giving counties the same authority to dispose of property as municipalities.

Fixed Assets Acquired With Federal Financial Assistance

The federal government issued a revised OMB Circular A-102 (March 11, 1988), regarding uniform standards governing the utilization and disposal of property furnished by the federal government or acquired in whole or in part with federal funds by nonfederal political subdivisions. These requirements are set out in the common rule to OMB Circular A-102. In general, the requirements are:

DEPARTMENT OF STATE TREASURER POLICIES MANUAL
FIXED ASSETS POLICY
SECTION 20 PAGE - 17

1. Fixed assets acquired with federal funds are restricted to the following uses:
 - A. Real property - Unless otherwise provided by federal statutes, real property is to be used for the originally authorized purpose as long as needed for that purpose. Local governments are not to dispose of or encumber its title or other interests.
 - B. Equipment -
 - (i) The grant program for which the asset is acquired as long as there is a need for the property to accomplish the purpose of the grant program, whether or not the program continues to be supported by federal funds.
 - (ii) If the property is no longer needed in this grant program, it may be used, in the following order of priority, for other grants of the same federal agency, or grants of other federal agencies.
2. When fixed assets are no longer used as shown in 1. above, they may be disposed of as follows:
 - A. The property may be used for the unit's official activities:
 - (i) With fair compensation to the federal agency based on the percentage of federal participation in the original grant program times the current fair market value, or
 - (ii) Without reimbursement to the federal agency if the property cost is less than \$5,000.
 - B. The property may be disposed of under the common rule of OMB Circular A-102.
 - (i) When real property is no longer needed for the originally authorized purpose, the unit should request disposal instructions from the federal awarding agency. The common rule provides for retaining the property, selling it, or transferring title. Whether the property is retained by the local unit or sold, the local unit must compensate the federal agency for its percentage of participation in the cost of the original

purchase times the fair market value of the property. If title to the property is transferred to the awarding agency, the local unit is likewise compensated.

(ii) When original or replacement equipment (nonexpendable, tangible property) acquired under a grant is no longer needed for the original project or program or for other activities currently or previously supported by a federal agency, disposal should be made as follows:

- a. Items of equipment with a current per-unit fair market value of less than \$5,000 may be retained, sold, or otherwise disposed of with no further obligation to the federal awarding agency.
- b. Items of equipment with a current per-unit fair market more than \$5,000 may be retained or sold and the federal awarding agency shall have a right to be compensated for its share of the equipment.

(iii) If there is a residual inventory of unused supplies exceeding \$5,000 in total aggregate fair market value upon termination or completion of the award, and if the supplies are not needed for any other federally-sponsored programs or projects, the local government shall compensate the federal awarding agency for its share.

Any unusual problems encountered or clarifications needed should be discussed with the federal granting agency (through the applicable State agency, if the grant is a pass-through grant).

3. In addition, the common rule specifies that the grantee's property records shall include the following data:
 - A. Complete description of property, including serial numbers, location, use, and the condition of the property.

- B. Acquisition date and cost, the purpose for which acquired, name in which title is held, and the source and amount of federal participation in the cost.
- C. Complete information on the disposition of the property including date of disposal and sales price of the property.
- D. A physical inventory at least every two years verifying the existence and current use of the property.
- E. A control system to prevent the loss, damage, or theft of the property.

Additional procedures must ensure that maintenance is adequate, usage is permissible under 1. above, and unauthorized dispositions are not made.

Financial Reporting Considerations

For audited financial statement purposes, additions to fixed assets and the related incurring of financial liabilities must be disclosed in accordance with generally accepted accounting principles. See 1990 Codification of Governmental Accounting and Financial Reporting Standards, Sections 1400 and L20, for a discussion of disclosure requirements for fixed assets and for long-term obligations. Also, see the Financial Accounting Standards Board Statement of Financial Accounting Standards No. 13, "Accounting for Leases" for examples and discussion of disclosure requirements for both operating leases and capital leases.

The following disclosure requirements for depreciation were established by APB Opinion No. 12:

1. Depreciation expense for the period,
2. Balances of major classes of depreciable assets, by nature or function, at the balance sheet date,
3. Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance sheet date, and
4. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets.

Depreciation

Depreciation accounting is an important element of the income determination process for proprietary funds. Accordingly, depreciation of fixed assets accounted for in a proprietary fund should be recorded in the accounts of that fund. Proprietary funds include Enterprise Funds and Internal Service Funds. Depreciation also is recognized in those Trust Funds where expenses, net income, and/or capital maintenance are measured.

Proprietary Funds are used to account for a governmental unit's operations and activities that are similar to those often found in the private sector in that they should be self-supporting. The generally accepted accounting principles applicable to proprietary funds are the same as those applicable to similar private sector businesses. The measurement focus is upon the determination of net income, financial position, and changes in financial position.

Enterprise Funds are used to account for operations or activities:

- that are financed and operated like a private business enterprise - for which the governing body intends that costs (including depreciation) of providing goods or services to the public on a continuing basis be financed or recovered primarily through user charges, or
- for which the governing body has decided that periodic determination of revenues earned, expenses incurred, and net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.

Internal Service Funds are used to account for the financing of goods or services provided by one department or agency to other departments or agencies of the governmental unit, or to other governmental units, on a cost-reimbursement basis. Examples of activities frequently accounted for as Internal Service Funds are data processing centers, motor pools, and central office supply activities.

Proprietary Fund fixed assets are capitalized in the fund accounts because the fixed assets are used in the production of goods or services provided and sold. Depreciation of these fixed assets must be recorded to determine total expenses, net income, and changes in fund equity.

Depreciation of general fixed assets should not be recorded in the accounts of governmental funds. Governmental funds (the General Fund, Special Revenue Funds, Capital Projects Funds, and Debt Service Funds) measure inflows and outflows of financial resources. Since depreciation expense is neither an inflow nor an outflow of governmental fund financial resources, it is not recorded in the accounts of such funds. While depreciation is not recorded in the accounts of governmental funds, it may be calculated for cost finding purposes such as analyzing costs associated with vehicle operation, garbage collection, and data processing services. Besides these routine activities, calculating depreciation can be of benefit for determining reimbursable costs under grant provisions establishing fee schedules. It also can assist the governmental unit in "make or buy" or "do or contract for" decisions.

Finally, accumulated depreciation related to general fixed assets may be recorded in the General Fixed Assets Account Group at the option of the governmental unit. When recorded, the entry should increase the Accumulated Depreciation account(s) and decrease the Investment in General Fixed Assets account(s).

Depreciation Considerations

Depreciation is an element of expense resulting from the use of long-lived assets. It is conventionally measured by allocating the expected net cost of using the asset (original cost less estimated salvage value) over its estimated useful life in a systematic and rational manner. The objective of depreciation is to charge each accounting period for the estimated loss in economic value of the depreciable assets used during the period. This implies an ability to:

Estimate the economic useful life of each asset.

Predict the probable salvage value.

Estimate the rate at which the economic value of the asset will be consumed during its economic life. (This is especially important when other than straight-line depreciation is to be used.)

Estimating Useful Life. In estimating the economic useful life of an asset, consideration has to be given to:

The physical environment in which the asset is to be used (hot, cold, caustic, dry, moist, pressure vacuum, etc.).

The physical characteristics of use (continuous, intermittent, fixed or portable, stable or alternating) as well as the operating conditions of weight, force, and friction to be encountered.

Physical resilience or ability to sustain full utility and value with minor repetitive maintenance, as opposed to material progressive deterioration with use, irrespective of continuing maintenance.

Obsolescence potential - susceptibility to economic loss of value because of technological, fashion, or other changes that reduce an asset's relative economic suitability for its intended purposes.

Salvage Value. To estimate the probable salvage value of a particular asset, judgements must be made as to:

Potential for market appreciation in the secondhand market - This is particularly important for relatively short-lived assets, or assets retaining a high level of market acceptance. For example, certain models of business machines are attributed to have particular operating characteristics that are considered superior to those in later models, and thus they remain in demand at a high secondhand value while other later models often depreciate in value quickly after the initial sale. Certain classes of tools and shop equipment are subject to the same phenomenon.

Potential for alternate uses through renovation and rebuilding - Where there is a good market for a secondary use, the salvage value of a particular asset may remain well above a typical salvage expectation.

Selection of a Depreciation Method

Theoretically, a depreciation method should be selected that achieves the most realistic reflection of the loss in economic value of the assets being used or, for cost accounting purposes, that allocates a reasonable portion of the cost of an asset to the revenue produced (per unit of production or per unit of time).

There are two commonly used depreciation approaches available to local governmental units:

1. A uniform basis or rate over the useful life of the asset (straight-line method); and

2. Decreasing charges over the useful life of the asset, i.e., an accelerated rate in the early life of an asset (declining balance method).

Uniform Rate of Depreciation - Straight-line. Using the straight-line method of depreciation, the cost or other basis of the asset, less the estimated salvage value, is divided by the number of years of useful life to arrive at an annual depreciation charge. This method is simple to apply and will provide satisfactory results where the useful life and salvage value of an asset can be estimated with some degree of accuracy. Because of its simplicity, it is the most widely used method by local governments.

Accelerated Depreciation. The declining balance method produces a more rapid write-off in the early years of life, followed by smaller charges as an asset nears its termination. As with all depreciation methods, this method requires an estimate of the useful life of the asset. Regular annual straight-line depreciation expressed as a percentage of the acquisition cost is then multiplied by 1.5 (150% declining balance) or 2 (double declining balance) to arrive at an adjusted rate to apply to the declining balance. If an asset has a ten-year useful life, the fixed rate applied to the declining balance will be 20% under a double declining method and 15% under a 150% declining balance method. Each year, the amount of depreciation computed and charged in the previous year is deducted from the cost or other basis and the fixed depreciation rate is then applied to the remaining balance. The asset's carrying value should never be depreciated below the salvage value.

One other accelerated method is the sum-of-the-years'-digits method. The sum-of-the-years'-digits method results in a declining depreciation charge each period by applying a declining fraction each year to the depreciation base. The denominator of this fraction is the sum of the years' digits. For example, an asset with a 10-year life would have a denominator of 55 (10+9+8+7+6+5+4+3+2+1). The numerator of the fraction is the years' digits taken in reverse order (10 in the first year, 9 the second year, etc.). Therefore, the numerator represents the number of years remaining in the assets' life as of the beginning of the year. This method is not commonly used because of its complexity.

An accelerated method of depreciation is often applied in situations where there is a high rate of technological change and uncertainty that may render an asset obsolete long before its physically useful life is completed. Some assets are subject to rapid deterioration in the early years

and thus become unsalable as secondhand units with only scrap value remaining. Nevertheless, such assets may continue to function for a considerable period with proper maintenance. This disparity between loss in market value and loss of utility value makes it desirable to pick up the major loss in value for these types of assets in the early years through an accelerated depreciation method.

Two additional methods of depreciation used by units include the group and the composite methods. These methods usually simplify the process of calculating depreciation expense.

Group Depreciation: Group depreciation can be utilized when a group of homogeneous (similar) assets is purchased together. They can be capitalized in one asset account and treated as a single asset for depreciation purposes. The group depreciation rate is based on the average life of the assets in the group. Depreciation is accumulated in one contra-asset account and is calculated by multiplying the group depreciation rate by the balance in the asset account. No gain or loss is recognized when an item is retired because the entire asset is not retired. A total net gain or loss on the group is normally not recognized except in extraordinary circumstances. Additional assets may be included by adding their costs to the asset account. Depreciation is computed as follows: $\text{Depreciation} = (\text{Total Asset Cost} - \text{Salvage Value}) / \text{Average Asset Life}$.

Composite Depreciation: Composite depreciation can be utilized with heterogeneous assets which may have similar characteristics or purposes. The assets are combined in one asset account and depreciated accordingly. No gain or loss is normally recognized except in extraordinary circumstances. For example, suppose the following assets are placed in service:

| <u>Asset</u> | <u>Cost</u> | <u>Salvage Value</u> | <u>Life</u> | <u>Annual Depreciation</u> |
|--------------|-----------------|----------------------|-------------|----------------------------|
| A | \$30,000 | \$6,000 | 10 yrs. | \$2,400 |
| B | 20,000 | 3,600 | 4 yrs. | 4,100 |
| C | <u>10,000</u> | <u>---</u> | 4 yrs. | <u>2,500</u> |
| | <u>\$60,000</u> | <u>\$9,600</u> | | <u>\$9,000</u> |

Assuming straight line depreciation is used, the composite depreciation rate is computed as follows: $\text{Depreciation Rate} = \text{total annual depreciation} / \text{total cost} = 9,000 / 60,000 = 15\%$.

Depreciation is then charged at 15% of the cost of assets in service at that time until book value equals the estimated salvage value of \$9,600. Additional assets may be included

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by adding their cost to the asset amount and determining a new composite depreciation rate.

Depreciation Methods - An Illustration - The table below illustrates application of the straight-line, double declining balance, and sum-of-the-years'-digits methods of depreciation using the following assumptions: asset cost - \$100,000; estimated salvage - \$15,000; estimated useful life, 10 years.

Straight-Line

| <u>Years</u> | <u>Factor</u> | <u>Depreciation Base</u> | <u>Depreciation Charge</u> | <u>Year-End Book-Value</u> |
|--------------|---------------|------------------------------|--------------------------------|--------------------------------|
| 1 | 0.10 | \$85,000 | \$8,500 | \$91,500 |
| 2 | 0.10 | 85,000 | 8,500 | 83,000 |
| 3 | 0.10 | 85,000 | 8,500 | 74,500 |
| 4 | 0.10 | 85,000 | 8,500 | 66,000 |
| 5 | 0.10 | 85,000 | 8,500 | 57,500 |
| 6 | 0.10 | 85,000 | 8,500 | 49,000 |
| 7 | 0.10 | 85,000 | 8,500 | 40,500 |
| 8 | 0.10 | 85,000 | 8,500 | 32,000 |
| 9 | 0.10 | 85,000 | 8,500 | 23,500 |
| 10 | 0.10 | 85,000 | <u>8,500</u> | 15,000 |
| | | | \$85,000 | |
| | | | ===== | |

Double
Declining Balance

| <u>Years</u> | <u>Factor</u> | <u>Depreciation Base</u> | <u>Depreciation Charge</u> | <u>Year-End Book-Value</u> |
|--------------|---------------|------------------------------|--------------------------------|--------------------------------|
| 1 | 0.20 | \$100,000 | \$20,000 | \$80,000 |
| 2 | 0.20 | 80,000 | 16,000 | 64,000 |
| 3 | 0.20 | 64,000 | 12,800 | 51,200 |
| 4 | 0.20 | 51,200 | 10,240 | 40,960 |
| 5 | 0.20 | 40,960 | 8,192 | 32,768 |
| 6 | 0.20 | 32,768 | 6,554 | 26,214 |
| 7 | 0.20 | 26,214 | 5,243 | 20,971 |
| 8 | 0.20 | 20,971 | 4,194 | 16,777 |
| * 9 | 0.20 | 16,777 | 1,777 | 15,000 |
| 10 | 0.20 | 15,000 | <u>0</u> | 15,000 |
| | | | \$85,000 | |
| | | | ===== | |

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Sum-Of-The-Years'-Digits

| <u>Years</u> | <u>Factor</u> | <u>Depreciation Base</u> | <u>Depreciation Charge</u> | <u>Year-End Book-Value</u> |
|--------------|---------------|------------------------------|--------------------------------|--------------------------------|
| 1 | 10/55 | \$85,000 | \$15,455 | \$84,545 |
| 2 | 9/55 | 85,000 | 13,909 | 70,636 |
| 3 | 8/55 | 85,000 | 12,364 | 58,272 |
| 4 | 7/55 | 85,000 | 10,818 | 47,454 |
| 5 | 6/55 | 85,000 | 9,273 | 38,181 |
| 6 | 5/55 | 85,000 | 7,727 | 30,454 |
| 7 | 4/55 | 85,000 | 6,182 | 24,272 |
| 8 | 3/55 | 85,000 | 4,636 | 19,636 |
| 9 | 2/55 | 85,000 | 3,091 | 16,545 |
| 10 | 1/55 | 85,000 | <u>1,545</u> | 15,000 |
| | | | \$85,000 | |
| | | | ===== | |

*[Note: In the last two methods illustrated above the asset is not depreciated below the salvage value of \$15,000.]

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