



Department of Infrastructure and Planning



A guide to asset accounting in Local Governments

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About this guide

This guide to asset accounting has been prepared for Local Governments in Queensland by the Department of Infrastructure and Planning with the valuable assistance of the Institute of Public Works Engineering Australia, the Local Government Association of Queensland, Queensland Treasury Corporation and the Queensland Audit Office.

It is designed to support Mayors, Councillors and employees of Local Governments in understanding key aspects of asset accounting and the relationship to asset management.

The *Local Government Act 2009* and supporting regulations, and specifically the Finance, Plans and Reporting Regulation 2010, signal a new approach to infrastructure funding decisions for Local Governments in Queensland. In the past, concepts such as ‘funding depreciation’ were used to establish a link between capital expenditure and required levels of funding. These old concepts are no longer sufficient to address the issues being faced, with the new approach emphasising long-term asset management plans and long-term financial forecasts.

Achieving and maintaining sustainability in Local Government requires consideration of services, service levels, associated costs and associated risks. The appropriate management of the infrastructure of Local Government requires asset management estimates and asset accounting estimates that are realistic and support decision making.

This guide seeks to clarify and simplify important elements in the asset accounting process.



Introduction

Depreciation has become a very confusing topic to many people in Local Government. While the idea is inherently simple, the calculation, valuation and use of depreciation can be very complex.

Depreciation appears in financial statements and reports as an expense. Assets wear out over their lifetime, and depreciation recognises this, by allocating a portion of the asset value as an expense each year of its life.

The fact that assets wear out means that the asset owners and managers are always considering the eventual replacement of the assets. This inevitably leads to conversations about funding sources.

The total amount of depreciation (depreciable amount) over an asset's lifespan is exactly the same regardless of the depreciation method used.

The straight-line method is only one depreciation method available to Local Governments—albeit a widely used method. The straight-line method allocates an equal amount of depreciation as an expense over the asset's useful life. Other depreciation methods should be used where a different pattern is more appropriate.

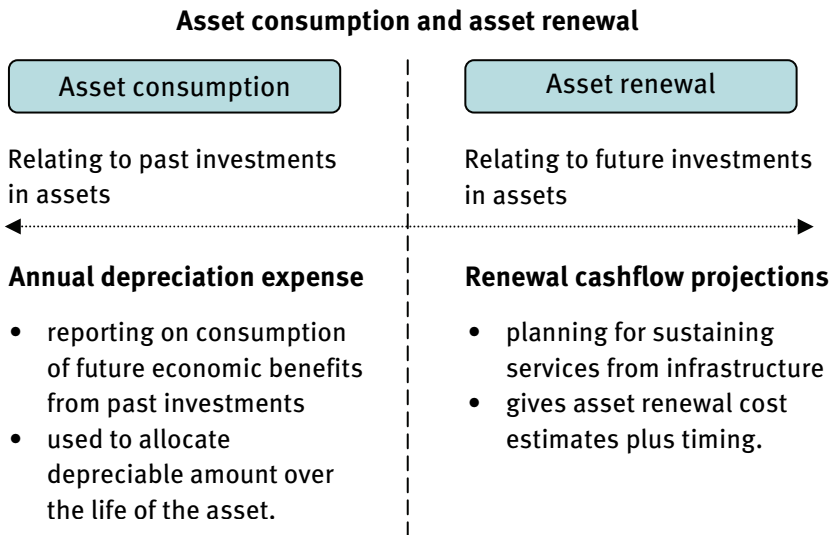
Irrespective of the depreciation method used, careful consideration of the remaining useful lives of assets and associated end of life (residual) values will lead to more accurate calculation of depreciation.

It is a mandatory requirement to recognise network assets (such as roads, the water supply network, sewerage network and buildings) at a quite detailed (component) level. Each separate component of the network asset has a different useful life. This approach provides a much more accurate depreciation calculation.



Local Governments should prepare asset management plans that indicate the future funding needed to maintain, replace and expand the asset base. These asset management plans and the associated forward forecasts of expenditure requirements provide a more accurate indication of the Local Government’s ongoing funding needs.

The diagram below illustrates the key differences between depreciation and planning for asset renewal and is reproduced from the Institute of Public Works Engineering Australia’s Australian Infrastructure Financial Management Guidelines 2009.





The asset accounting process includes a large number of assumptions and accounting estimates.

Asset accounting is largely concerned with ensuring that the accounting records and financial reports of the Local Government provide an accurate view of the change in the asset base over the financial period. Change in the asset base occurs through acquisition and disposals of assets, revaluation and depreciation.

Planning for future funding requirements for the renewal of the asset base requires financial projections drawn from properly formulated asset management plans. This is one of the primary reasons why there is such a current emphasis on the development of asset management plans for infrastructure assets.



Key concepts

Why do Local Governments have infrastructure assets?

Infrastructure supports many of the services provided by Local Governments—for example, roads, bridges, community buildings, water and sewerage services. These assets usually have long lives and the ongoing management is a core component of the business of Local Governments.

Acquisition of infrastructure assets

Assets may be acquired or created in a number of ways. These include construction by Council, by external purchase or lease, or by donation or by contribution—for example by a developer as part of the development process.

Depreciation

Depreciation is an expense.

Depreciation represents the allocation of the value of an asset over its estimated useful life to the Council. In a more technical sense, depreciation is the systematic allocation of the depreciable amount (gross value less estimated residual value) of an asset over its useful life.

Key take away

Depreciation is an expense, but without an immediate associated cash flow. It is not a funding mechanism for the replacement of an asset.



Accurate measurement of depreciation

The calculation of depreciation is based on a number of estimates, including the value of the asset, its residual value and its useful life. All of these estimates are subject to review on an annual basis to ensure that they remain reasonable.

The value to be depreciated (depreciable amount) is the current gross value of the asset less its residual value.

The useful life is the expected lifetime of the asset—the number of years over which the asset is expected to be able to provide its service.

The residual value is the estimated amount that would remain at the end of the useful life of the asset.

Key take away

Depreciation is not an exact science. It is an estimate based on the adoption of these key principles.

Methods of measuring depreciation

A variety of depreciation methods can be used to allocate the value (depreciable amount) of an asset over its useful life. The expected pattern of consumption of the asset's future benefits should determine which method to use.

The straight-line depreciation method is appropriate where the service being provided by the asset is consistent over a long period of time. This is the case for many infrastructure assets.

The Australian Accounting Standards list a number of different methods that can be used, each of which calculates depreciation in a slightly different way. The method chosen should best reflect the future expected use of the asset (pattern of consumption), provided this can be practically and reliably determined. Straight-line is the



most commonly applied method. (Institute of Public Works Engineering Australia 2009, section 12.13.3)

The methods commonly used in Local Government include the:

- straight-line method
- diminishing balance method
- units of production method.

All methods of depreciation will result in the same total expense over the long-term life of the asset.

Depreciating assets that will not be replaced

Depreciation is not related to the decision about whether an asset will be replaced at the end of its life.

The replacement decision influences future capital expenditure requirements, which will appear in asset management plans and long-term financial forecasts. Future funding requirements and the sources of funds to meet those requirements are determined through the long-term planning processes of the Local Government.

Depreciation of assets that are being fully maintained

When an asset is acquired or created by a Local Government, there is an assumption that it will be properly maintained over its life. Even if fully maintained, the asset will at some time reach the end of its useful life and must therefore be depreciated.



Splitting the major components of complex assets

Many infrastructure assets are actually comprised of a number of separate (component) assets, each with a different useful life and each with a unique management plan.

Separating an asset into its components will result in assessments that are more accurate. Roads are a practical example. It is common practice to separate a road into its component assets of earthworks/formation, pavement and wearing surface (seal) for asset management and asset accounting purposes.

Depreciation does not fund capital expenditure

Depreciation is an expense associated with the use of the asset.

Depreciation is an expense in the operating budget and financial statements. It is not a funding mechanism. The level of funding required for capital expenditure is determined by the asset management plan, and should be set out in the Local Government's long-term financial plan.

Local Governments need to effectively allow for the ongoing funding of:

- existing services—operations, maintenance, asset renewal, asset upgrade and proposed variations
- new services and assets as required.

The term 'funding depreciation'—previously used as a means of emphasising the need to allow for funding for the replacement of assets currently in use—is no longer appropriate. Emphasis is now placed on Local Governments understanding and planning for



long-term infrastructure funding needs. These changes are reflected in the Regulations that support the *Local Government Act 2009*.

Unfunded depreciation

The term ‘unfunded depreciation’ was used in the past to identify the amount of annual depreciation that was deliberately not being funded in budgets of the Local Government. Reference to the term can be found as far back as 1992–93.

Unfunded depreciation was a response to the ‘funding depreciation’ theme that was gaining prevalence at the time.

A significant drawback of ‘unfunded depreciation’ is that a lack of funding on renewals over a long period of time creates an infrastructure backlog, leading to future sustainability issues for the Local Government. The *Local Government Act 2009* emphasises long-term planning and the use of asset management plans.

Asset accounting and asset management

Asset accounting is an integral and essential part of the asset management process.

Both asset accounting and asset management rely on the Local Government having a complete record of its asset base. The asset management process considers the management of each asset over its useful life, taking into consideration scheduled maintenance, ongoing capital expenditure requirements and retirement decisions. Asset management considers services, service levels, costs and risks associated with the management of the assets.

The asset management process provides data on estimated residual values and remaining useful lives that are used by the asset accounting process to produce accounting entries for the financial statements of the Council.



The relationship between asset accounting, asset management and financial sustainability

Asset management is the activity a Local Government uses to sustainably manage its assets and asset systems to achieve its corporate plan. This includes asset performance, risks and expenditures over the asset's life cycle.

Asset accounting records, identifies and creates the accounting entries associated with owning or controlling an asset.

The asset register is an important link between the two processes. Inconsistent record keeping and unnecessary data entry can be avoided if the asset register is more fully integrated into the asset management information.

Events that typically give rise to the need for an accounting entry include:

- acquisition or creation of an asset
- expenditure on enhancement that is not of a repair or maintenance nature
- depreciation
- revaluation
- disposal or other decommissioning event.

Financial sustainability of a Local Government is stated in the *Local Government Act 2009* as when a Local Government's infrastructure capital and financial capital are able to be maintained over the long-term. This definition emphasises Local Governments maintaining the infrastructure asset base while remaining financially viable. Being able to maintain the infrastructure asset base requires asset management plans.

**Key take away**

The link between asset management and financial sustainability is very strong. It is highly unlikely that an organisation will achieve financial sustainability without quality asset management planning and processes.

The role of Mayors and Councillors in asset management

Mayors and Councillors have a vital role to play as stewards of the valuable infrastructure assets that provide services to their communities and that Local Governments control.

Mayors and Councillors have responsibility for the Council's strategic planning, including the long-term community plan and long-term financial plan. Infrastructure assets play a key role in being able to deliver on the objectives of the community plan.

The Mayor and Councillors are responsible for assessing and establishing the services delivered by Council, the service levels associated with each service and the corresponding level of risk that the Council is willing to bear associated with that level of service. These factors influence the cost of the service being offered and therefore the level of revenue needed to fund operations.

Asset managers provide options and advice to the Mayor and Councillors on the cost and risk implications associated with different levels of service.



Funding capital expenditure with debt

Debt is appropriate for funding capital expenditure, provided the Local Government can meet the obligations for principal and interest in the financial plan. Debt can often prove more appropriate than other options such as funding from operating cash flows as this can put immediate pressure on cash and working capital.

There are a range of potential funding sources such as rates, fees, charges, grants and loan borrowing. Local Governments require ongoing, large investments in infrastructure assets to deliver services and a prudent level of borrowings is justified.

Asset management from engineering and accounting perspectives

In theory, the engineers and accountants of a Local Government should be on the same page. As much as possible they should share integrated data within their asset management and asset accounting systems, all built from a common asset register. The asset register should incorporate unique and meaningful identifiers, ideally sorted by asset class and location.

In particular accountants and engineers should have a common view of useful life, remaining useful life, impairment and value of assets, including residual values.

Engineering data is invaluable in determining useful life and remaining useful life and must be realistically and fully incorporated into the final accounting estimates used.



Useful resources

To assist agencies in undertaking their annual revaluation and impairment testing processes Queensland Treasury has released two checklists:

- *Checklist for Revaluations – Interim and Comprehensive Revaluations*, available as Appendix 5.1 of Non-Current Asset Policies for the Queensland Public Sector (Queensland Treasury January 2010)
- *Checklist for Testing and Adjusting for Impairment*, available as Appendix 7.3 of Non-Current Asset Policies for the Queensland Public Sector (Queensland Treasury January 2010).

These checklists are available on the Queensland Treasury website at: www.treasury.qld.gov.au/office/knowledge/docs/non-current-asset-policies/.



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Mayor and Councillor checklist

Mayors and Councillors have an important role in providing stewardship for infrastructure assets.

Fulfilling this responsibility requires:

- setting the expected levels of service for the Council's services
- agreeing on the acceptable level of risk and cost for the expected levels of service
- approving Council's asset management policy, strategy and asset management plans
- ensuring that funding decisions are made based on long-term asset management plans
- evaluating asset management performance, to ensure that the Council's assets provide the services as expected.





Department of Infrastructure and Planning
PO Box 15009 City East Qld 4002 Australia
tel +61 7 3227 8548
info@dip.qld.gov.au

www.dip.qld.gov.au