

Urgent Issues Group

Interpretation 1030

September 2004

Depreciation of Long-Lived Physical Assets: Condition- Based Depreciation and Related Methods



Australian Government

**Australian Accounting
Standards Board**

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AUSTRALIA

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Other enquiries:

Phone: (03) 9617 7600
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PREFACE

Main Features of UIG Interpretation 1030

This Interpretation is applicable to annual reporting periods beginning on or after 1 January 2005. Early adoption of this Interpretation is not permitted. Application of this Interpretation will begin in the context of adopting all Australian equivalents to International Financial Reporting Standards. The requirements of Accounting Standard AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards* must be observed. AASB 1 requires prior period information, presented as comparative information, to be restated as if the requirements of this Interpretation had always applied. This differs from previous Australian requirements where changes in accounting policies did not require the restatement of the income statement and balance sheet of the preceding period.

The Interpretation identifies the characteristics of condition-based depreciation and other related depreciation methods that do not satisfy the requirements of Accounting Standard AASB 116 *Property, Plant and Equipment*. Such depreciation methods have been proposed to be applied in relation to long-lived assets such as infrastructure assets, particularly where the assets are subject to detailed management plans to maintain the service levels of the assets.

Comparison with Superseded Requirements

There is no substantive difference with the previous requirements in Australia in the superseded UIG Abstract 30 *Depreciation of Long-Lived Physical Assets, including Infrastructure Assets: Condition-Based Depreciation and Other Related Methods*. Changes in depreciation rates are treated as changes in accounting estimates, and thus are accounted for prospectively, as was required by Abstract 30. When an entity's depreciation methods differ from the requirements of this Interpretation, the entity accounts retrospectively for the change in depreciation methods in accordance with the transitional requirements in AASB 1. Abstract 30 also required retrospective adjustment in such cases.

URGENT ISSUES GROUP
INTERPRETATION 1030
***DEPRECIATION OF LONG-LIVED
PHYSICAL ASSETS: CONDITION-BASED
DEPRECIATION AND RELATED METHODS***

Interpretation 1030 is set out in paragraphs 1 to 20.

ISSUE

1. With the adoption of accrual accounting by local, state, territory and Commonwealth governments, there has been increased interest in methods of depreciation of long-lived physical assets, including those assets described as “infrastructure” assets or an infrastructure system (hereafter, the term “infrastructure assets” is used to encompass infrastructure assets and infrastructure systems). This interest has intensified with the increased privatisation of public sector activities and the increased application of “user-pays” and “purchaser-provider” models of service delivery for public sector entities.
2. Many of the activities of local, state, territory and Commonwealth government entities are capital intensive. For example, there is significant investment in the physical assets that comprise the infrastructure necessary to support the services provided by state, territory and local government road, footpath and sewerage networks; public transport systems; and water storage and distribution systems. Many private sector business entities and public sector trading enterprises also invest heavily in the physical infrastructure necessary to enable them to continue to produce the goods and services they sell. For these public and private sector entities, the depreciation charge is a major expense item, and in some cases the single major expense item.
3. Accounting Standard AASB 116 *Property, Plant and Equipment* requires the depreciable amount of an asset to be allocated on a systematic basis over the asset’s useful life. Some commentators argue that depreciation methods that have conventionally been adopted in respect of long-lived physical assets, including infrastructure assets, are not appropriate for such assets, particularly when they are controlled by public sector entities, because, for example:

- (a) these assets have very long useful lives, are often “complex” assets comprising a number of components and are constantly rehabilitated during the course of their lives, so that it is often not possible to develop a reliable estimate of their useful life;
 - (b) variations in estimates of useful life, rate of consumption of future economic benefits (or service potential) or residual value will have a major impact on the operating result of the entity;
 - (c) in practice, it is not possible to distinguish between maintenance expenditure and expenditure to enhance the future economic benefits of the asset, so that maintenance and depreciation expenses cannot be reliably determined; and
 - (d) the information required to implement these depreciation methods does not “fit” with the information necessary for asset management purposes.
4. In response to these concerns, some public sector entities have adopted, or are considering the adoption of, alternative approaches to the depreciation of long-lived physical assets. These alternative methods are often described as Condition-Based Depreciation (CBD) methods. While CBD methods may vary in detail, they usually require the condition of the asset to be assessed periodically, often on an annual basis. The cost of restoring the asset from its current condition to a predetermined service level is then estimated and any increase in the restoration cost beyond that estimated in the prior reporting period is recognised as depreciation expense. In addition, all expenditures made in respect of the maintenance and refurbishment of the asset are recognised as an expense in the period in which they are incurred.
5. In many cases, CBD methods are linked to a detailed asset management plan incorporating the estimated maintenance, refurbishment and rehabilitation work required to maintain current or required service levels of the asset over the long term, often 20 years or more. Under some CBD methods, the estimated costs of maintaining the asset over this period are converted to an annual annuity. The annuity is compared with the actual maintenance, refurbishment and rehabilitation expenditures incurred during the reporting period and any shortfall between the amount of the annuity and the expenditure incurred in the period is identified as the depreciation expense because the shortfall represents a deterioration in the service level of the asset. This depreciation expense, together with the maintenance, refurbishment and rehabilitation expenditures incurred during the reporting period, is recognised in profit or loss as an expense.

6. Adoption of CBD or similar methods of depreciation can have a significant impact on the operating results of public and private sector entities. Differing views are held about the extent to which all, or some, CBD methods comply with the requirements of AASB 116. Concern has been expressed that, in the absence of specific authoritative guidance, diverse, and potentially inappropriate, practices may develop and/or become entrenched. Some commentators note that whatever the benefits of CBD and similar methods for asset management, cost projection, cash flow budgeting and pricing purposes, for financial reporting purposes the depreciation method adopted by an entity must comply with the requirements of AASB 116.
7. The issue is what, if any, characteristics of CBD and similar methods of depreciation contravene the requirements of Accounting Standards?

CONSENSUS

8. **Condition-based depreciation and other methods of depreciation of long-lived physical assets, including infrastructure assets, that include any of the following characteristics do not comply with AASB 116, and shall not be adopted:**
 - (a) **the depreciation expense is not determined by reference to the depreciable amount of the asset;**
 - (b) **the depreciation expense is determined without consideration of technical and commercial obsolescence, such as potential changes in consumer demand, and related factors which can influence the consumption or loss of future economic benefits during the reporting period;**
 - (c) **expenditure on maintenance and on enhancement of future economic benefits are not separately identified where reliable measures of these amounts can be determined, and are not recognised as an expense of the reporting period in which the expenditure was incurred in the case of maintenance expenditure or as an asset in respect of asset enhancement expenditure;**
 - (d) **the asset is presumed to be in a steady state and a “renewals accounting” approach is adopted whereby all expenditure on the asset is recognised as an expense in the period in which it is incurred without consideration of whether that expenditure enhances the future economic benefits of the asset; and**

- (e) **the major components of complex assets are not identified and are not depreciated separately where this is necessary to reliably determine the depreciation expense of the reporting period.**

Application

- 9. **This Interpretation applies when AASB 116 applies.**
- 10. **This Interpretation applies to annual reporting periods beginning on or after 1 January 2005.**
- 11. **This Interpretation shall not be applied to annual reporting periods beginning before 1 January 2005.**
- 12. **The requirements specified in this Interpretation apply to the financial report where information resulting from their application is material in accordance with AASB 1031 *Materiality*.**
- 13. **When applicable, this Interpretation supersedes Abstract 30 *Depreciation of Long-Lived Physical Assets, including Infrastructure Assets: Condition-Based Depreciation and Other Related Methods*, as issued in January 2000.**
- 14. **Abstract 30 remains applicable until superseded by this Interpretation.**

DISCUSSION

- 15. AASB 116 requires the depreciable amount of an asset to be allocated over the asset's useful life on a systematic basis that reflects the consumption of the asset's future economic benefits. AASB 116 defines depreciable amount as the cost of an asset, or other amount substituted for cost, less in either case the residual value of the asset. The Standard also requires that expenditure subsequent to the initial recognition of a non-current asset is to be capitalised when, and only when, it is probable that future economic benefits associated with the expenditure will flow to the entity and the cost can be measured reliably.
- 16. This Interpretation requires the depreciation expense to be determined by reference to the depreciable amount of the asset after consideration of such matters as obsolescence and other factors that might give rise to consumption or loss of the future economic benefits represented by the asset. The Interpretation also requires maintenance and asset enhancement expenditures to be separately identified and recognised in

accordance with the requirements of AASB 116 where these amounts can be reliably determined.

17. Condition assessments are used as a mechanism to determine whether, and the extent to which, the future economic benefits of an infrastructure or other long-lived asset have been consumed during the reporting period, and to confirm the pattern of consumption of those future economic benefits. Condition assessments do not involve the pricing of the future economic benefits consumed during a reporting period but can provide input for such purposes. The methodologies adopted for condition assessments will often generate reliable measures of the future economic benefits consumed during the reporting period in accordance with the requirements of AASB 116.
18. Under some CBD and similar methods, the depreciation expense for a reporting period is determined by reference to the current replacement cost, as at the reporting date, of the future economic benefits consumed during that period. Consistent with the requirements of AASB 116, this Interpretation does not allow such an amount to be recognised as a depreciation expense where it would be materially different from that which would be determined by reference to the depreciable amount of the asset. However, where such CBD or similar methods are adopted by public or private sector entities that revalue their assets to current values on a regular basis, the depreciation expense determined under the CBD or similar method may not be materially different from the expense that would have resulted had depreciation expense been determined by reference to the depreciable amount of the asset.
19. This Interpretation prohibits the use of the renewals method of accounting for financial reporting purposes. The renewals method of accounting assumes that the asset is in a steady state and that subsequent expenditure on the asset will not increase future economic benefits of the asset, but will maintain the future economic benefits at existing levels. As such, all expenditure on the asset is treated as maintenance expenditure and recognised as an expense in the period in which it is incurred, and an additional depreciation expense is not recognised. This Interpretation reflects the view that rarely, if ever, will it be possible to reliably determine that an asset is in a steady state. In addition, such a steady state is likely to change at any time as, for example, consumer demand and entity objectives change. Whether an asset is maintained in a steady state as a consequence of expenditure on the asset during the period will be reflected by:
 - (a) an analysis of whether the future economic benefits provided by the asset have been consumed during the reporting period and whether expenditure on the asset has restored or increased those future economic benefits; and

- (b) the recognition of maintenance and depreciation expense in accordance with the requirements of AASB 116.
20. Some CBD and similar methods propose that a provision for future maintenance be recognised. However, AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* indicates that a provision for future maintenance cannot be recognised as a liability. Furthermore, AASB 116 states that when each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied.

REFERENCES

Australia

The Urgent Issues Group discussed Issues Paper 04/3 “Revision of Various UIG Abstracts for 2005” in relation to this Interpretation at its meeting on 22 July 2004. In developing the superseded Abstract, the UIG discussed Issue Summary 99/7 “Methods of Depreciation of Long-Lived Physical Assets, including Infrastructure Assets: Condition-Based Depreciation and Other Related Methods” and related papers at meetings on 12 August, 23 September, 4 November and 16 December 1999.

Accounting Standard AASB 116 *Property, Plant and Equipment*

Accounting Standard AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*

Canada

CICA Handbook Section 3061 *Property, Plant and Equipment*

International Accounting Standards Board

International Accounting Standard IAS 16 *Property, Plant and Equipment*

New Zealand

Financial Reporting Standard FRS-3 *Accounting for Property, Plant and Equipment*

United Kingdom

Financial Reporting Standard FRS 15 *Tangible Fixed Assets*

United States of America

Accounting Research Bulletin ARB 43 *Restatement and Revision of Accounting Research Bulletins*, Chapter 9 – Depreciation