



Financial Sustainability Program

Information Paper 17

Depreciation and Related Issues

June 2008



Introduction

Depreciation is an accounting concept that measures and spreads the cost associated with the using up of an asset over its useful life. Australian Accounting Standards define depreciation as 'the systematic allocation of the depreciable amount of an asset over its useful life'. For most Councils depreciation is the second largest expense item appearing in their annual income statements (employee costs is usually the largest).

The Independent Inquiry into the Financial Sustainability of Local Government conducted in 2005 recognised the significance of Councils' annual depreciation expense to their financial positions. The Inquiry also noted concerns within Local Government about the reliability of recorded depreciation data and made recommendations aimed at:

“ improving the consistency and comparability of accounting policies impacting upon the measurement of the key financial sustainability indicators, especially depreciation and other assets accounting policies.”

Implementing soundly-based depreciation and other asset management policies is central to the achievement of comparability in the measurement of Councils' financial performance and position and to this end the Inquiry noted that;

“Standardising depreciation (and asset valuation) policies, and ensuring their correct implementation, must be a high priority for local government in South Australia.”

This information paper deals with the topic of depreciation and related issues. It presents a discussion on what depreciation is, why it is important and issues associated with its measurement in a Local Government context. It aims to provide an overview of these issues rather than providing technical detail and provide a focus for further discussion. More detailed work on the preparation of Australian Infrastructure Financial Management Guidelines (AIFMG) is currently being undertaken by the Institute of Public Works Engineering Australia and a consultation draft of these guidelines was made available in April 2008. The LGA, through its Asset Management Project Group, has supported this national work and provided comment on the draft guidelines. The LGA is currently preparing technical information papers on the topics of depreciation, valuation and costing for assets (including overheads) that will supplement the coverage of these topics in the AIFMG and provide an additional reference for South Australian Councils.

The LGA recognises that the issues presented and discussed in this paper are extremely significant to Councils' assessments of their own financial performance. The paper should provide a greater understanding of depreciation and its measurement and a context for further work to provide clear guidance to Councils.

This paper should be read in conjunction with other information papers which highlight the increasing demands on Councils and the importance of efficiently managing the delivery of services. Information papers have been, or will soon be, prepared on the following topics:

- Financial Sustainability
- An Overview of Audit Mechanisms
- Audit Committees
- Scope of External Audit – Audit Specification
- Efficiency and Economy Audits
- Infrastructure and Asset Management (Policy and Planning)
- Service Delivery Framework including the Role of Shared Services
- Long-term Financial Plans
- Local Government Financial Indicators

- Debt Management
- Governance in Local Government
- Targets for Local Government Financial Indicators
- Model Framework for Council Annual Business Plans
- Model Work Program for Council Audit Committees
- *Treasury Management (currently being prepared)*
- Model Format for Long-term Financial Plans
- *Financial Policies Framework (currently being prepared)*
- *Financial Governance (currently being prepared)*
- *Funding Policies and Strategies (currently being prepared)*
- *Audit Committee Reporting (currently being prepared)*
- *A New Approach to State-Local Resourcing (currently being prepared)*

A number of manuals, guidelines, templates, technical definitions, codes, standards and similar documents supporting this series of information papers are also being prepared by the LGA to provide practical assistance to Councils.

For an update on available information papers or information about other documents and activities, including briefing and training sessions, please visit our website at: www.lga.sa.gov.au/goto/fsp.

What do the Act and Australian Accounting Standards require?

Australian Accounting Standard AASB 116 provides Councils with a choice of carrying all assets in their balance sheets at either historical cost less accumulated depreciation or fair value.

As highlighted by LGA's Financial Sustainability Inquiry, adoption of a policy of valuation at historical cost less accumulated depreciation can, in some cases, result in a materially incorrect statement of asset values and related depreciation expenses. Accordingly, Clause 9 of the Local Government (Financial Management) Regulations 1999 requires the revaluation of **all material non-current assets** in accordance with AASB 116 which in effect limits the choice of carrying value otherwise available under the standard. The effect of this is that these assets (e.g. roads, drains, footpaths) must be carried at fair value. The Regulations continue to allow assets such as plant, machinery and equipment to be carried at their historical cost less accumulated depreciation.

In all other respects (e.g. choice of depreciation methods, calculation of residual values and useful lives, frequency and disclosure of revaluations, splitting assets into separate component parts), the Regulations simply require Councils to comply with AASB 116.

The Local Government Act provisions and Australian Accounting Standards referenced above are set out in Attachment 1.

Why worry about depreciation?

Calculating depreciation is both more critical and challenging for Local Governments than for most other sectors. Councils' audited financial statements for 2006-07 indicated that depreciation represented 23% of their total operating expenses.

Councils have a large range and number of high value assets relative to their revenue. Many of these are long-lived infrastructure assets that once acquired are held for their entire usable life. Markets for trading second-hand infrastructure assets generally do not exist so their fair value at any time is hard to determine. It is also not easy to determine exactly how long they will last in service.

Even though it does not directly result in a cash outlay depreciation is a real cost of conducting business and given its magnitude warrants far more attention than most. The challenges of estimating depreciation are a key reason why Councils should be increasingly sharing and comparing their approaches to estimating depreciation.

Depreciation is not easy to measure but with care and understanding a reliable estimate can cost-effectively be determined. The benefits of so doing are very significant.

Sound financial management requires that Councils have a reliable approach to estimating their depreciation expense. An understanding of its depreciation expense is vital to a Council when:

- making decisions about the level and nature of services that the Council can provide based on an understanding of the full costs of providing all services;
- making pricing decisions even if full cost is not the basis for pricing;
- ensuring that all costs are included in rates policy decisions.

In short an organisation which does not make reasonable estimation of its depreciation is making decisions blind to its long-term financial situation.

In the past, most Local Governments traditionally prepared budgets based on cash costs. Until recently they did not include non-cash operating expenses like depreciation in their budget assessments when determining their revenue needs for the budget period. As a result the operating expenses associated with providing services to the community in any year generally exceeded the operating revenue generated. This has directly led to issues of inter-generational inequity since the current generation was not contributing a fair portion of the cost of long-lived assets. Many Councils typically were not raising sufficient revenue to fully fund asset replacement when required.

Unless a Council consciously and explicitly intends not to replace certain assets, or is prepared to operate with less or lower standard assets and provide less or lower standards of services in future, it should always strive to ensure operating revenue matches operating expenses (including depreciation costs) on average over any 3 year period. That is, it should ensure that its spending is the same as its income over this period. If a Council incurs an operating deficit then it has insufficient revenue to offset all of its expenses. It is spending more than its income. All other things being equal an operating deficit in the income statement will result in a corresponding increase in liabilities or reduction in assets (or a combination of both) in the balance sheet.

Reliably calculating depreciation necessitates keeping asset values up to date and regularly reviewing their useful lives. This information is needed for sound asset management which itself is a critical key to Councils' financial sustainability.

Accounting for assets

Accountants report costs differently depending on whether they are of a capital or operating nature.

Capital costs are costs of significant value that are expected to generate benefits over a period longer than a year. They are shown as assets in a balance sheet. Buildings, plant and equipment are common classes of Local Government assets but usually infrastructure assets such as roads are far more significant in total value.

Operating costs are typically day to day expenses. Generally the benefits from the expenditure are used in the short-term (e.g. fuel or electricity) to support either ongoing activity or one-off initiatives that do not generate measurable long-lived benefits. Costs of maintaining an asset (e.g. servicing a vehicle or fixing a pothole) are also operating expenses because they do not extend the expected life of an asset but are necessary to preserve the value of the asset and its expected service life.

Not all operating expenses for a period involve cash spending. Depreciation is an example of an operating expense for a period that does not involve cash spending. It is included along with other operating expenses in the income statement and results in a reduction in the carrying value of assets in an entity's balance sheet.

The size of the depreciation expense shown in a Council's income statement will depend on a number of factors including the:

- service life of assets which is influenced by the operating environment and the Council's required service standards from the assets;
- Council's asset maintenance and asset renewal/replacement programs;
- the method used to calculate the depreciation expense; and,
- the value of the Council's assets and the approach taken to determining valuations.

These factors should be documented and analysed in the Council's Infrastructure and Asset Management Plan resulting in the specification of the projected financial implications arising from the Council's holding of assets.

When should asset related costs be capitalised and when should they be expensed?

In order for a Council to be able to make confident financial decisions based on information contained in its financial statements, it is important that accounting information be appropriately recorded. This requires Councils to have clear and sound accounting policies and practices (that are supported by their auditor) about when outlays will be capitalised and when they will be expensed. Capitalising a cost means that it will be spread over a number of financial reporting periods while expensing a cost sees it dealt with in the current period.

A small value purchase like a \$2.95 calculator may last a long time and provide ongoing benefits but its modest cost is unlikely to warrant its capitalisation and subsequent depreciation over future accounting periods. Instead it would be expensed. Its value is low and the impact on the income statement of fully expensing it in one year, rather than over several, will be immaterial.

Where minor works are carried out e.g. pothole repairs to, or patrol grading of, a road such outlays should be expensed. They do not extend the life of an asset. Instead they are a cost that is required to maintain the asset so that its existing embedded service potential is realised.

On the other hand the cost of resealing a road should be capitalised.

Under Regulation 8 of Local Government (Financial Management) Regulations, 1999 Councils must follow Australian Accounting Standards in their accounting records and financial statements. These require individual component parts of assets to be recorded separately where their cost is relatively significant (see also discussion below on depreciating assets by their component parts). As such the seal of a road is treated as an individual asset and it therefore follows that the cost of its replacement (i.e. resealing the road) should be capitalised.

Capitalising or expensing decisions are not always clear cut. Where road repairs involve resealing or re-sheeting a relatively large area (e.g. because it is cost effective to do so), should this be treated as an expense? In practice a long road is broken down in an asset register not only into component parts but also into section lengths (e.g. between intersections). If when carrying out repairs, the whole of a road between two intersections is resealed or re-sheeted, and to a standard that would make it unnecessary to do so again for a long time, the outlay may be appropriately capitalised. Any assumed remaining recorded value in the replaced asset would then be written off.

Adopting a policy on the threshold for the recognition of expenses as capital or maintenance (this may vary for different assets) will make these sorts of decisions easier and consistent.

How is depreciation measured?

Most Councils now accept the need to allow for depreciation as an expense when making their budget revenue decisions. Careful consideration is required on the best approach to calculating the appropriate annual depreciation expense so as not to under or overstate costs on which revenue decisions and financial performance are assessed.

There is no single correct answer. Every entity that prepares financial statements grapples with this issue. It is not always easy to predict how long an asset will provide a cost-effective service, what its value will be on disposal and the way it depreciates. It is therefore also not easy to determine how much of the asset's value to expense, as a loss, each year. Although it is important to make sound estimates of value, useful life and residual value, accounting standards require the review of depreciation methods and amounts annually. This allows for the ready correction/improvement of the original estimates.

So how should the consumption of assets be measured and apportioned over time?

Asset Consumption and Asset Lives

Australian Accounting Standards require that depreciation methods reflect *“the pattern in which the asset's future economic benefits are expected to be consumed”* (see paragraph 60 AASB 116; Property, Plant and Equipment). Depreciation methods are all based either on the asset's expected lifetime or usage during the life of the asset and Councils should choose a method that best practically reflects the way an asset is used up.

Where asset consumption is influenced more by usage than age, and it is easy to measure usage, it makes sense to base depreciation rates on this. Plant, like graders for example, may be depreciated on the basis of hours of operation and vehicles perhaps on kilometres travelled. Most Local Government assets are more appropriately depreciated on the basis of the period of expected ownership (i.e. the asset's useful life to the owner) whether it is a computer, building, footpath, road or stormwater drain.

An asset should be held for the amount of usage or length of time for which it can provide service at the required level in the most cost effective manner. An asset's remaining useful life is therefore the amount of time until it is expected to be replaced or renewed. The value of the asset at the end of its useful life is its residual value. Where an established market for the asset exists the residual value will be measured by its market value. Where a market does not exist the residual value will usually be zero (or a 'scrap value').

Within a Council, or between Councils, similar assets may have different lives and be depreciated at different rates. Even with regular patrol grading the pavement on an unsealed road will gradually wear away. Councils need to determine the ride quality they wish, and can afford, to strive to maintain and this together with the operational and environmental factors will determine how often such roads need to be re-sheeted. As a result a Council might have some unsealed roads it believes warrant re-sheeting frequently, say every 8 years, and others that it considers should only be re-sheeted say every 15 years. The period over which the pavement is depreciated should be consistent with these varying expected useful lives. Where a road is formed but not sheeted, or was originally sheeted but the pavement has effectively worn away and is no longer re-sheeted either for reasons of financial constraint or changes in needs, then there is no pavement to depreciate.

In each case above the depreciation expense shown in the operating statement should reflect the service potential that is being consumed. A Council that effectively provides a lower standard of service, or has favourable environmental and operating conditions that enable assets to last longer, will incur lower depreciation expenses.

Approaches to calculating depreciation

If it is decided that depreciation should be based on the period of ownership there are still various methods that need to be considered. Methods that are often suggested as being appropriate for use in Local Government include:

Straight-line depreciation

The straight-line method allocates an equal amount of depreciation each year (ignoring the impact of any review of asset values, useful lives and residual values) based on the difference between the initial purchase price and the expected value at the time of anticipated disposal, spread over the full period of ownership.

Diminishing-value depreciation

Assets that have a well established second hand market like plant and vehicles often lose proportionately more resale value early in their lives. In these circumstances the diminishing-value method, which calculates depreciation by applying a fixed percentage rate to the value of the asset net of the accumulated depreciation to date, may be most appropriate. This method results in a proportionately lower depreciation charge each subsequent year over the life of an asset (ignoring the impact of any review of asset values, useful lives and residual values).

Consumption-based depreciation

This method is based on measuring the level of an asset's remaining service potential. The calculated depreciation reflects the proportion of the asset's future economic benefits consumed in the period.

Condition-based depreciation

Engineers often argue that the technical condition of some assets only degrades marginally in the early periods of their lives but more and more rapidly in later periods. Condition-based depreciation (assuming it was cost effective to reliably determine) would result in small depreciation charges early in an asset's life and progressively larger ones as it ages – a somewhat opposite outcome to the diminishing-value method.

It should be noted that Australian Accounting Standards Interpretation 1030 determined that condition-based, and other, depreciation approaches that display any of five documented characteristics do not comply with AASB 116 and shall not be adopted (please see the specific detail of Interpretation 1030 in Attachment 1 to this paper).

Depreciating assets by their component parts

Paragraph 43 of AASB 116 requires each part of an item of property, plant and equipment with a cost that is significant in relation to the item's total cost, to be depreciated separately. The benefits of doing this are particularly apparent when the component parts have significantly different useful lives.

A sealed road for example can be thought of as made up of 3 key components, its base (earthworks), the pavement itself and an asphalt seal. The base can normally be expected to last a very long time (in many cases indefinitely) with the pavement having a shorter expected life (e.g. 40 years) and the seal a much shorter life (e.g. 20 years). Each of these 3 components needs to be recognised separately. In this example the pavement and seal should be depreciated at

different rates and the base should not be depreciated at all. If the pavement and seal were depreciated as one asset then this could lead to a significant over or under-statement of costs for a period depending on which life expectancy was used.

For example if it was assumed that the pavement and seal would last 40 years then the depreciation expense calculated and recognised in the accounts would be lower than the rate of deterioration of the seal component, leading to an understating of the cost of consumption of the combined asset. It would then be more likely that current users of the road would be undercharged for their usage. Conversely, depreciating the pavement and seal together over 20 years would mean that the rate of consumption of the road had been overstated with the likelihood that users would have been charged more than the cost of the services that had been used up. Unsealed roads should be similarly treated.

Measuring Asset Values

The depreciation rate and method selected attempts to reflect the rate of consumption of an asset's service potential. In order to determine the cost of this consumption the depreciation rate needs to be applied to the value of the asset. Valuing assets for recognition in financial statements is not as simple as it may first appear.

Australian Accounting Standard AASB 116 requires assets to be recorded at fair value or historical cost less accumulated depreciation. However the Local Government (Financial Management) Regulations 1999 restrict this to fair value only for infrastructure assets while allowing for historical cost valuation for short-lived assets such as plant, equipment etc. Paragraph 6 of AASB 116 defines fair value as *"the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction"*. Paragraph 33 advises that in the absence of market based evidence, fair value may be estimated using a depreciated replacement cost basis i.e. the cost of replacing the asset today less the value of the asset that has been 'used up' to date.

Councils often receive assets free of charge or at less than market value e.g. infrastructure provided by developers. These assets should not be shown at what they cost the Council but at their replacement cost. This allows stakeholders to appreciate the full value of assets a Council is responsible for managing and the cost of using up their service potential as reflected in the recorded annual depreciation charge.

Regularly revaluing assets

Assets can have a change in value for reasons other than as a result of their consumption with use or age. As a result of inflation it often costs more to replace an asset than its original purchase price. Advances in technology, exchange rate movements and changes in market supply and demand conditions can also mean that prices for some assets may increase by considerably more or less than the inflation rate (and may even decrease in price) between periods.

Paragraph 31 of AASB 116 requires revaluations to be made with sufficient regularity so as to ensure that the carrying amount of assets at the reporting date is not materially different from that which would be determined using the 'fair value' definition. In practice auditors are usually satisfied if a Council formally reviews all asset values about every 3 to 5 years but also may require some classes to be reviewed more frequently where there is reason to believe that fair value has changed significantly. By keeping asset values up to date a Council provides readers of its financial statements with more accurate information on the current value of assets that it has under management and the cost, in today's prices, of the consumption of its assets' service potential during the period.

Where a Council re-values all its assets in one period and then not again for a period of 3 or more years it may then discover that the large increase in the value of its assets following revaluation

has caused a corresponding jump in its recorded depreciation expenses and a marked downturn in its financial operating result. The reality is that the reported operating result for such a Council in the intervening years between revaluations would probably have been 'flattering' because its depreciation expenses would have been based on asset values that were progressively becoming out of date.

Re-valuing (say) one-third of all assets (by value) each year rather than all assets every (say) 3 years would generally result in more up to date information over the three years and smooth the impact arising from changing asset values, on the depreciation expense recorded in the operating statement. Where a Council revalues only a proportion of its assets in a year it should do this on a whole class of asset basis and not just for particular assets within a class.

The more regularly assets are re-valued the more accurate will be a Council's reported depreciation. There is obviously an additional cost in more regularly revaluing assets and the costs of so doing need to be considered relative to the benefits. It should not be assumed that Councils need to engage professional valuers to determine 'fair value' revaluations of all their physical assets. Valuers are well positioned to assist where markets exist for the sale of assets (e.g. land and buildings) but market-based evidence is usually lacking in regard to the valuation of infrastructure assets. Councils are often likely to have the knowledge and evidence in-house from their infrastructure construction and asset management work to accurately assess the replacement value of an asset and the proportion of economic life remaining in existing assets. Providing this evidence is well documented it is likely to be acceptable to an auditor as a basis for in-house revaluation of infrastructure assets.

Councils should also consider annually adjusting asset classes with significant value (e.g. infrastructure) by a suitable index between comprehensive periodic revaluations. Australian Accounting Standards are silent on the issue of indexing asset values between revaluations to fair value however an auditor may, for example, be willing to accept annual indexing of asset values between formal revaluations using an appropriate price index as giving a reliable outcome. The Australian Bureau of Statistics (ABS) produces a range of price indices which might be appropriate and Transport SA has developed an index which it applies to its road network annually (and which is approved for such use by its auditor, the Auditor-General).

Where a Council has built a road during the year and has as a result been able to determine up to date costs this information also may be useful in determining current standard unit rates that can be applied to revalue its other similar assets. Regardless of which index is used it needs to be recognised that it is by definition no more than an approximation and is not a substitute for a formal regular periodic revaluation of asset values.

Impairment of assets

An asset is considered to be impaired when the value at which it is carried in a Council's financial statements is greater than the amount that Council could recover from its disposal. While depreciation estimates the planned consumption of an asset, impairment measures losses in the value of an asset (usually unplanned) from causes other than normal using up of the asset. Both are expenses associated with owning assets. An impairment loss is recorded as an expense at the time the impairment is identified.

'Greenfields' and 'brownfields' considerations in valuing assets

Engineers often refer to the initial construction of an asset on otherwise undeveloped land as a 'greenfield' situation and the replacement of it on a now developed site as a 'brownfield' situation (note the term 'brownfield' can also apply when a new asset is constructed on a site that has previously been developed for other purposes and there are either additional costs or savings with the provision here of a new asset compared with a 'greenfield' site).

There is currently conjecture amongst engineers, asset managers, accountants and others in Local Government and elsewhere as to whether assets should be valued (and therefore the annual depreciation expense determined) based on a 'greenfields' or brownfields' scenario.

Australian Accounting Standards make no reference to the terms 'greenfields' and 'brownfields'. Ensuring assets are recorded by their significant component parts makes it easier to determine fair value taking account of 'greenfields' and 'brownfields' implications. In many instances revaluation of asset components will effectively assume a 'brownfields' scenario.

So which depreciation method should Councils use?

The community can accept that a Council's pricing and rating decisions should be based on recovering operating expenses. However some depreciation methods result in higher or lower recorded expenses depending on whether an asset is old or new and the community may find it hard to embrace pricing and rating decisions that are impacted by the age of the Council's assets. For example the use of the diminishing-value method would lead to recording a higher cost for the operation of a community bus when the bus is new than when it is old (all other things being equal). Conversely the adoption of condition-based depreciation would lead to a Council charging higher rates when its road network is old and giving users lower standards of ride comfort.

Councils generally own a very large number of assets, and it is likely that these assets were acquired at different points in time and have different expected periods of ownership. It follows therefore that many Councils are likely to have a reasonably even spread of assets between those that are relatively new, approaching a point where they will need replacement and in between. In such circumstances the aggregate level of depreciation charged is not likely to be materially different regardless of whether the Council applies the diminishing-value, condition-based, consumption-based or straight-line depreciation method.

While Australian Accounting Standard AASB 116; Property, Plant and Equipment does require the method chosen to reflect 'the expected pattern of consumption of the future economic benefits embodied in an asset' (see paragraph 61), **straight line depreciation** is commonly applied in Local Government and elsewhere and is widely accepted by auditors as appropriate and conforming with Australian Accounting Standards. This method is easy to calculate and understand and it makes sense therefore to use the straight-line method coupled with frequent re-valuation of assets unless an alternative is considered more appropriate.

Can we compare depreciation between Councils?

It is sometimes suggested that where two Councils have a similar stock of assets their annual calculated depreciation expense should also be similar. There are several reasons why even when Councils have identical assets they may appropriately record significantly different depreciation expenses in any given year.

First, two councils may have similar stock of assets but their communities may have different service level requirements from some of these assets. The impact of this may be that one Council adopts a longer life and therefore records a lower depreciation expense for these assets than the other Council.

Second, an asset may have cost one Council (and/or be appropriately valued by it at) much more or less than the other. For example constructing or re-sheeting a road in a locality where materials must be trucked long distances is likely to add significantly to a contractor's or a Council's costs for the road works. There have also traditionally been significant differences between Councils as to which costs they treat as overheads and how they are then allocated. Overhead accounting practices are becoming more consistent across the Local Government sector but some Councils

still either have higher overhead costs or allocate a higher proportion of their indirect costs as overheads to the cost of works and services compared with others. As a result even when the depreciation rate is the same between Councils the 'cost' or 'value' to which the rate is applied can vary, resulting in a difference in the actual depreciation expense recorded.

Furthermore an identical asset may last longer/wear out quicker if used in different circumstances. A road heavily trafficked by large vehicles is likely to reach the end of its economic life (i.e. the point where it is more cost-effective to replace than repair) much sooner than a lightly used one that is very rarely used by heavy vehicles. Where such circumstances can be reliably predicted depreciation rates should reflect reality. Similarly, soil or climatic conditions and the quality of available materials can have a big impact on the expected life of a road. Again where the impact of these factors is material and can be reliably predicted then depreciation rates should take this into account.

Even if two Councils were identical in all respects they would still record different levels of depreciation expenses if they both re-valued their assets in aggregate and at the same frequency but in different years (unless they re-valued annually).

Auditors are required to review the carrying value of assets and the depreciation method and rates applied by an entity and satisfy themselves that they conform to Australian Accounting Standards requirements. Typically they will seek to establish that the values and useful lives assigned to assets and methods and rates of depreciation applied are appropriate based on local environmental and operating circumstances and history and relative to accepted practices elsewhere.

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Attachment 1: Local Government Act Provisions and Australian Accounting Standards Relating to Depreciation

Local Government (Financial Management) Regulations 1999

Part 3—Accounting principles

8—Accounting standards

- (1) Unless otherwise specified by these regulations, a council, council subsidiary or regional subsidiary must ensure that all accounting records, accounts and financial statements are prepared and maintained in accordance with all relevant Australian Accounting Standards.
- (2) Unless otherwise required or permitted by another law, a council, council subsidiary or regional subsidiary must ensure that reporting on a function, activity, good or service of the council, council subsidiary or regional subsidiary contained in its financial statements, or in any other external financial report prepared by the council, council subsidiary or regional subsidiary, is made according to a full cost attribution basis.
- (3) For the purposes of subregulation (2), an external financial report is a report of a financial nature prepared for the information and use of a person or body external to the council, the council subsidiary and the council which established the subsidiary, or the regional subsidiary and any constituent council (as the case may be).

9—Revaluation of assets

- (1) A council, council subsidiary or regional subsidiary must undertake a revaluation of all material non-current assets in accordance with the requirements of Australian Accounting Standard AASB 116.

Australian Accounting Standard AASB 116 Property, Plant and Equipment (Selected Paragraphs)

Objective

1. The objective of this Standard is to prescribe the accounting treatment for *property, plant and equipment* so that users of the financial report can discern information about an entity's investment in its property, plant and equipment and the changes in such investment. The principal issues in accounting for property, plant and equipment are the recognition of the assets, the determination of their *carrying amounts* and the *depreciation* charges and *impairment losses* to be recognised in relation to them.

Definitions

6. The following terms are used in this Standard with the meanings specified.

Carrying amount is the amount at which an asset is recognized after deducting any accumulated depreciation and accumulated impairment losses.

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other Australian Accounting Standards, for example, AASB 2 *Share-based Payment*.

Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value.

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

Entity-specific value is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.

Fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

An *impairment loss* is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Property, plant and equipment are tangible items that:

- (a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- (b) are expected to be used during more than one period.

Recoverable amount is the higher of an asset's net selling price and its value in use.

The *residual value* of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Useful life is:

- (a) the period over which an asset is expected to be available for use by an entity; or
- (b) the number of production or similar units expected to be obtained from the asset by an entity.

Aus6.1 The following term is also used in this Standard with the meaning specified.

A *not-for-profit entity* is an entity whose principal objective is not the generation of profit. A not-for-profit entity can be a single entity or a group of entities comprising the parent and each of the entities that it controls.

Measurement at Recognition

15. An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost.

Aus15.1 Notwithstanding paragraph 15, in respect of *not-for-profit entities*, where an asset is acquired at no cost, or for a nominal cost, the cost is its *fair value* as at the date of acquisition.

Measurement after Recognition

29. An entity shall choose either the cost model in paragraph 30 or the revaluation model in paragraph 31 as its accounting policy and shall apply that policy to an entire class of property, plant and equipment.

Cost Model

30. After recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses.

Revaluation Model

31. After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the reporting date.

33. If there is no market-based evidence of fair value because of the specialised nature of the item of property, plant and equipment and the item is rarely sold, except as part of a continuing business, an entity may need to estimate fair value using an income or a depreciated replacement cost approach.

36. If an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued.

Depreciation

43. Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.

Depreciable Amount and Depreciation Period

50. The *depreciable amount* of an asset shall be allocated on a systematic basis over its useful life.

51. The *residual value* and the useful life of an asset shall be reviewed at least at the end of each annual reporting period and, if expectations differ from previous estimates, the

change(s) shall be accounted for as a change in an accounting estimate in accordance with AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*.

56. The future economic benefits embodied in an asset are consumed by an entity principally through its use. However, other factors, such as technical or commercial obsolescence and wear and tear while an asset remains idle, often result in the diminution of the economic benefits that might have been obtained from the asset. Consequently, all the following factors are considered in determining the useful life of an asset:
- (a) expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output.
 - (b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.
 - (c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset.
 - (d) legal or similar limits on the use of the asset, such as the expiry dates of related leases.
57. The useful life of an asset is defined in terms of the asset's expected utility to the entity. The asset management policy of the entity may involve the disposal of assets after a specified time or after consumption of a specified proportion of the future economic benefits embodied in the asset. Therefore, the useful life of an asset may be shorter than its economic life. The estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets.

Depreciation Method

60. The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.
61. The depreciation method applied to an asset shall be reviewed at least at the end of each annual reporting period and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed to reflect the changed pattern. Such a change shall be accounted for as a change in an accounting estimate in accordance with AASB 108.
62. A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the units of production method. Straight-line depreciation results in a constant charge over the useful life if the asset's residual value does not change. The diminishing balance method results in a decreasing charge over the useful life. The units of production method results in a charge based on the expected use or output. The entity selects the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method is applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits.

75. Selection of the depreciation method and estimation of the useful life of assets are matters of judgement. Therefore, disclosure of the methods adopted and the estimated useful lives or depreciation rates provides users of the financial report with information that allows them to review the policies selected by management and enables comparisons to be made with other entities. For similar reasons, it is necessary to disclose:
- (a) depreciation, whether recognised in profit or loss or as a part of the cost of other assets, during a period; and
 - (b) accumulated depreciation at the end of the period.

Australian Accounting Standard Interpretation 1030

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.