Depreciation

A QUICK REFERENCE GUIDE FOR ELECTED OFFICIALS AND STAFF

AUDAX AT FIDELIS

QUEENSLAND TREASURY CORPORATION

This booklet is a quick reference guide to help you to:

- understand the purpose and function of accounting for and reporting on the depreciation of assets, particularly infrastructure assets (IAs), and
- ask relevant questions of managers and technical officers to ensure you have reliable information about the depreciation of your council's IAs and what is reported in your council's annual financial reports.

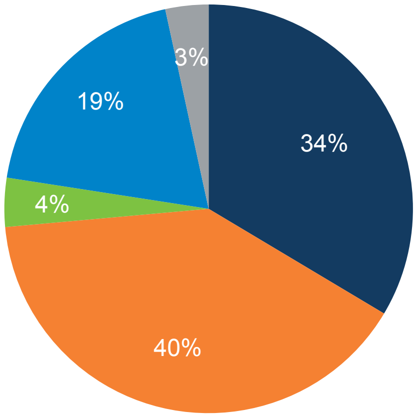
Depreciation and your council

Depreciation expense reflects one of the costs of providing local government services and accounts for around 20-25 per cent of the average local government operating budget; it is an important issue for you and your council. Depreciation expense is linked to the measurement of the financial performance of your council.

With a large number of Queensland local governments routinely recording operating deficits, and while operating deficits can arise for a number of reason, evidence suggests that local governments may be depreciating their assets too quickly. It may also be that asset values are overstated.

Elected members are ultimately responsible for the information reported in a council's annual financial reports. The mayor and chief executive officer must sign declarations that the annual financial statements have been prepared in accordance with the accounting rules and present an accurate view of council's financial position and performance, while councillors must adopt the annual financial accounts by resolution.

As council leaders, you need to understand the concept of depreciation and its linkage to long-term financial planning and sustainability.



In the 2011-12 financial year, total depreciation was $1.6 billion

- Employee benefits
- Materials and services
- Finance costs
- Depreciation and amortisation
- Other operating expenses

Understanding depreciation expense

One of the difficulties encountered is achieving a common understanding across council of exactly what depreciation expense is. Your finance team will probably have a different view to your asset management team, and to your engineering team and, in all likelihood, to you.

What is depreciation expense?

Put simply, depreciation expense allocates the ‘using up’ of the capacity of an asset to provide services over its useful life.

The cost or value of an asset is allocated periodically (usually annually) over the term in which it is used to provide services.

What depreciation expense is not

Depreciation is not about funding the replacement of the asset when the asset’s capacity to provide services is used up.

The charging of depreciation expense is not related to decisions about:

- whether and/or when an asset will be replaced, or
- whether a cash reserve is established.

Why is depreciation expense relevant?

Depreciation expense is an essential component in understanding the full cost of the services your council provides. However, it does not determine what you charge users for a particular service.

Understanding the effect of the decisions you make when pricing a service is essential to long-term financial planning and hence to your council’s long-term financial sustainability.

To be relevant, the calculation of depreciation expense must be robust; it must accurately reflect the reduced capacity of an asset to provide services in future periods.

POINTS TO NOTE

Depreciation expense is not a cash expense; it is an accounting treatment to represent the value of an asset consumed during the period reported on.

Accounting for depreciation is not specific to local government; private sector businesses also account for depreciation.

Understanding the accounting rules

Depreciation is an accounting concept, and the determination and reporting of depreciation expense in a council's annual financial statements is governed by the Australian Accounting Standards Board (AASB).

AASB 116 Property, Plant and Equipment sets out the basic principles to be followed.

SOME POINTS TO NOTE (AASB 116)

Physical assets are required to be recognised in the accounts if it is probable that:

- the future economic benefits/usefulness embodied in the asset will eventuate, and
- the cost or value of the benefit is capable of being measured.

The allocation of the asset's cost (or value) is to be expensed over its useful life in accordance with accrual accounting principles. This is to ensure that the asset's cost or value is more evenly matched against the revenue earned or benefits derived from the asset.

Some terms you may hear

Below are some common terms you may hear in relation to depreciation as defined in ***AASB 116 Property, Plant and Equipment.***

Terms	Definition
Asset cost or value	The cost of an asset, or other amount substituted for cost (fair value).
Depreciation	The systematic allocation of the depreciable amount of an asset over its useful life. (The amount estimated to have been used up during the reporting period).
Depreciable amount	The fair value of the asset less its residual value.
Residual value	An estimate of the value of the asset on disposal or at the end of its useful life.
Useful life	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.

Calculating depreciation expense

A simple example – a motor vehicle

- **Fair value:** the vehicle's purchase price was $50,000
- **Residual value:** it is estimated that its trade-in value at the end will be $10,000
- **Depreciable amount:** $40,000 (fair value less residual value)
- **Useful life:** the vehicle will be used for four years

For illustration purposes only

The formula

Depreciation expense	=	Depreciable amount ÷ useful life
	=	$40,000 ÷ 4 years
	=	$10,000 per annum

Impact on financial statements

Year 1	
NON-CURRENT ASSETS	
Motor vehicle	$50,000
Less accumulated depreciation	$10,000
Written down value	$40,000

Year 2	
NON-CURRENT ASSETS	
Motor vehicle	$50,000
Less accumulated depreciation	$20,000
Written down value	$30,000

Year 3	
NON-CURRENT ASSETS	
Motor vehicle	$50,000
Less accumulated depreciation	$30,000
Written down value	$20,000

Year 4	
NON-CURRENT ASSETS	
Motor vehicle	$50,000
Less accumulated depreciation	$40,000
Written down value	$10,000

Three major challenges with depreciation expense

While the motor vehicle example is straightforward, there are many complicating issues when applying the accounting concept of depreciation to infrastructure assets.

Many of these issues are subjective, can be open to interpretation and can lead to differing answers to the same question.

1. Valuation of assets

In most cases, local governments value their infrastructure assets using 'depreciated replacement cost'; the valuation is the minimum it would cost to replace the existing infrastructure assets with a modern equivalent that provides similar benefits.

Depreciated replacement cost will rise or fall over time in line with movements in construction costs. This means the annual depreciation expense amounts can move around from one reporting period to another, which will impact council's annual operating result.

2. Estimating useful life

In practice, estimating the useful life of infrastructure assets is extremely difficult.

One reason for this is that infrastructure assets are mostly managed so as to prolong their useful life almost indefinitely while providing the required level of service.

The assets are regularly renewed; for example, resurfacing of roads or, with composite assets, replacing individual components to prolong the asset's useability. Difficulties in estimating a useable life may compromise the calculation of depreciation expense.

It also means that the estimated remaining useful life of the infrastructure asset may not accurately reflect its actual physical condition, especially for a council with sound asset management practices.

3. Estimating residual value

Estimating residual value is difficult because there is limited demand for second-hand public infrastructure. As a consequence, many local governments previously used a residual value of zero for their infrastructure assets. This means that the entire value of the infrastructure asset is used to calculate depreciation expense.

Where a local government does allocate a residual value, which will lower the annual depreciation expense, the local government must provide a reasonably 'robust' rationale as to:

1 why a residual estimate is being included, and

2. how it has been determined.

POINTS TO NOTE

Council must be able to satisfy the auditors of the reasonableness of the estimate of asset valuation, useful life and residual value.

Certifying the financial statements

Elected officials are required to adopt their council's annual financial statements by resolution. Furthermore, mayors and chief executive officers certify that their council's annual financial statements have been prepared in accordance with accounting rules and present an accurate view of the financial position, performance and cash flows.

When adopting the financial statements and/or making this declaration, you are making assertions in relation to:

a) **completeness**: that all infrastructure assets commissioned by the council that should be financially recognised have been.

b) **existence**: that all recognised infrastructure assets have been acquired by the council and are in service.

c) **valuation**: that accepted accounting measurement and recognition principles have been applied.

d) **presentation and disclosure**: that infrastructure assets and related data is current and complete, and that appropriate disclosures have been made.

e) **accuracy**: that infrastructure assets and related information is mathematically accurate and classified correctly.

f) **rights and obligations**: that the council acknowledges its obligation to manage all recognised infrastructure assets controlled by it.

A way forward

Given your council's enormous investment in infrastructure assets, it is vital your approach and accounting treatment supports the delivery of services in a cost-effective and sustainable manner.

QTC recommends that councils regularly review their accounting policies relating to the valuation, re-valuation and estimation of useful lives of infrastructure assets and, critically, ensure these policies support their infrastructure asset management plans.

In broad terms, a review would:

- clarify or confirm council-wide understanding of the nature, purpose and rules concerning the accounting concept of depreciation
- review the adopted infrastructure asset valuation and depreciation methodologies to ascertain
  - whether the approach is the most effective
  - whether the approach is well understood
  - the assumptions that have been made
  - who performed the valuations and the scope of work, and
  - whether the results are intuitive and support informed decision making.
- evaluate the internal non-current asset accounting policies to determine their relevance to actual experience, and
- assess the asset management plans and test their alignment with the long-term financial plan.

POINTS TO NOTE

Depreciation is a significant cost for local governments and ensuring your council's depreciation expense is appropriate is a significant and highly specialised undertaking. It will involve many stakeholders, such as your asset accounting team, audit committee, internal and external auditors, and valuers.

While this involves substantial investment of resources and time, QTC believes this investment is necessary to fully understand your council's financial performance and to plan for future financial sustainability.

QTC provides training courses on many aspects of financial management tailored to your council. These courses are facilitated by highly qualified professionals with extensive experience working with local governments and can assist you to take the first step on this important journey.

Councils interested in learning more about QTC's financial management training options can contact QTC on 07 3842 4600 or through your QTC Client Account Manager.

AUDAX AT FIDELIS

QUEENSLAND TREASURY CORPORATION

GPO Box 1096
Brisbane Q Australia 4001

Telephone: +61 7 3842 4600
Facsimile: +61 7 3221 4122

www.clients.qtc.com.au