AASB Staff FAQs

Local Governments and Accounting Depreciation

Local governments that are required to prepare general purpose financial statements in compliance with Australian Accounting Standards are subject to the depreciation requirements of the Standard AASB 116 *Property, Plant and Equipment* in the same way as for-profit and not-for-profit entities in the private sector, as there are no modifications to the depreciation requirements for the financial statements of public sector entities.

Q1 What is accounting depreciation?

The general requirement for depreciating property, plant and equipment (PPE) assets, which includes infrastructure assets such as roads, is for the 'depreciable amount' to be allocated (or 'depreciated') over the estimated useful life of the asset to the entity. AASB 116 presumes that, with the exception generally of land, the estimated useful life of a PPE asset is limited. The depreciable amount is the cost (or revalued amount – typically used by public sector entities) recognised for the asset in the entity's accounting records, less the estimated residual value of the asset.

The depreciable amount (the cost or other recognised amount less the residual value) is depreciated over the estimated useful life of the asset, using one of various acceptable methods specified in the Standard. This reflects the consumption of the future economic benefits of the asset over the financial year. The annual depreciation amount is recognised as an expense in profit or loss, except for depreciation amounts for assets that are used in developing or creating other assets, which are added to the cost of those assets. The depreciation expense recognised in the period is not a cash expense, i.e. it does not require a cash payment to other parties or the setting aside of cash amounts as a sinking fund.

Q2 Does depreciation reflect asset maintenance requirements?

Depreciation is an allocation of the cost (or revalued amount) of a PPE asset over the useful life of the asset, to recognise that some of the future economic benefits (or service potential) of the asset are used up by the entity in operating the asset during the period. Depreciation is not intended to reflect any changes in the current value of the asset or the cost of replacing the service potential of the asset that has been consumed during the period.

Therefore, an asset is depreciated for financial statement purposes even if its current value is increasing or stable, or if it is subject to ongoing maintenance with the result that its useful life is maintained instead of decreasing as the asset is used by the entity.

AASB 116 requires maintenance expenses on an asset to be distinguished from expenditure that does enhance the future economic benefits of the asset, which should be added to the carrying amount of the asset rather than expensed. Replacing depreciation expenses with expensing all maintenance and other asset-related expenditure is therefore not permitted by the Standard.

Q3 Does depreciation help to fund asset replacement?

Depreciation is not based on whether the entity expects to replace the asset at the end of its useful life. Depreciation indicates that the future economic benefits of an asset are diminishing as the asset is used by an entity, and signals that the replacement of assets will need to be considered as assets reach the end of their useful life to the entity. Whether the entity intends to replace an asset is a separate decision, typically kept under review as an asset ages and gets closer to the end of its useful life.

Depreciation does not provide funds for the replacement of assets, whether at the end of their useful life or prior to then. Even if depreciation expenses reduce a reported surplus (or increase a reported deficit) and consequently have some effect on a local government setting rates for the next financial year, there is no guarantee that any change in the cash inflows for the entity will contribute to the replacement of depreciable assets if and when the entity aims to do so. Cash is fungible and can be used for any purpose, even if intended to be used for a specific purpose, such as funding asset replacement. (This is also the case for private sector entities that pay dividends to equity holders, since the test for dividends under the *Corporations Act 2001* is now a solvency test, rather than a payment-only-out-of-profits test – that is, depreciation does not provide the entity with funds.)

An entity decides whether to replace or to dispose of a fully (or partially) depreciated asset based on its needs when the asset is no longer useful to the entity. The funding of that replacement is not affected by the asset being fully or only partially depreciated. The entity has to determine how best to fund the cost of a replacement asset, when desired, whether that is through accumulated cash balances, revenue, new borrowings and/or grants from other entities or governments.

Q4 How does depreciation relate to solvency and financial sustainability?

An entity is regarded as a going concern when it is expected to be able to settle its obligations as they fall due. AASB 101 *Presentation of Financial Statements* (paragraph 26) indicates that the assessment of whether the going concern assumption is appropriate as the basis for the entity's financial statements should consider all available information about the future, which is described as at least twelve months from the end of the reporting period.

The going concern assumption therefore focuses on the solvency of the entity over the next reporting period. AASB 101 notes that a wide range of factors might need to be considered, such as the current and expected profitability of the entity, debt repayment schedules and potential sources of replacement financing. However, the profitability of an entity is affected by non-cash income and expenses, such as depreciation expenses, which should be taken into account in assessing solvency.

Accordingly, it is inappropriate to consider only the "bottom line" (i.e. the operating surplus or deficit) in an entity's statement of profit or loss (or operating statement) – and not also the nature of the income and expenses – in assessing whether an entity is a going concern. For example, continuing operating deficits due to significant non-cash expenses, such as depreciation of major infrastructure assets, do not reflect upon the cash resources available to the entity or its ability to generate cash inflows in the future, whether through revenue (e.g. rates), borrowings or grants. The statement of cash flows and the reconciliation of profit or loss to cash flows from operating activities will also assist the user of the financial statements to assess the continuity of cash flows through the operations of the entity. The reconciliation includes adjustments for non-cash expenses.

On the other hand, financial sustainability is generally regarded as an assessment of the ability of an entity to continue its activities over the longer term, not just the next financial year. The notion is not defined in or addressed in the Accounting Standards.

A number of ratios typically have been used in assessing the financial sustainability of local governments. Ratios that compare annual depreciation expenses to maintenance/capital expenditure during the financial year or to projected asset maintenance expenditure requirements need to be considered with care, since the depreciation expense does not necessarily reflect the decline in the service potential of the assets over the period. Furthermore, the trend in ratios is likely to be more meaningful than ratios for a single period.

Consideration also needs to be given to whether an entity intends to replace assets. Distinguishing depreciation expenses for assets that are not intended to be replaced may have a significant effect on ratios. Accounting Standards do not address the construction of such ratios based on financial statement information or their analysis.

Several jurisdictions in Australia are working on improving the assessment of financial sustainability of local governments. For example, the Queensland Government has recently published *Financial Management (Sustainability) Guideline 2024*, which addresses nine financial sustainability measures for local governments.

A local government might comment on its solvency and/or long-term financial sustainability, including asset management and replacement policies, in its annual report. Such commentary could be very helpful to users of the financial statements, particularly when the local government continues to report operating deficits due to significant non-cash expenses such as depreciation.