

from ratepayers and other operating activities to cover both cash and non-cash items to achieve a balanced budget.

If insufficient operating revenue is generated to cover all operating expenses then the council will incur an operating loss and operating expenses to the extent of the loss will be unfunded. As cash items are, by their nature, funded from cash balances when the transaction takes place, it is the non-cash items that are unfunded. Consequently, when a local government incurs an operating loss it will have unfunded depreciation equivalent to the extent of that loss.

Q8. Where do we get the money to replace our infrastructure assets?

The replacement of infrastructure assets can be funded from external sources such as grants or borrowings, or through internal sources such as reserves and depreciation, to the extent that it has been funded. However, government grants, which may be available for new assets, are generally not available for replacement of existing assets. Local governments can create reserves from current operating revenue to meet the anticipated future needs for replacement of infrastructure assets. While prudent, it is not a requirement, however, for the equivalent cash funds to be held. In the answer to Q6 it was identified that by fully funding depreciation, local governments can increase their cash balances. While this cash could be invested for future replacement of existing assets it could alternatively be used to acquire new non-current assets or repay existing loans without reducing the capital base of the local government. The Capital Funding Statement is a useful internal management tool to monitor funding for the replacement of infrastructure assets.

Q9. What happens if we have continually high levels of unfunded depreciation?

As indicated in the answer to Q7, unfunded depreciation arises when a local government incurs an operating loss. As depreciation is likely to be a significant operating expense for local governments, high levels of unfunded depreciation will therefore represent significant losses. Over time, if a local government continues to have high levels of unfunded depreciation, the accumulation of these losses will erode the capital base of the local government and will impact upon its financial viability. The inability to fund depreciation from operating revenue will also mean that the local government has to place greater reliance on external funding sources for asset replacement.

Q10. Do we have to fund depreciation on assets that will not be replaced?

In the answer to Q3 it was identified that depreciation determines how much needs to be charged to ratepayers to reflect the value of services provided by those assets. On this basis it could be argued that depreciation on all assets represents a cost of service that should be charged to ratepayers and consequently funded.

However, there is strong support in the local government sector for not funding assets that will not be replaced. As it is the intention of local governments to provide ongoing services to their ratepayers it could be presumed that assets currently used for provision of services that would not be replaced would be in the minority. Consequently unfunded depreciation associated with these assets would be unlikely to be significant. Furthermore, by deciding not to charge ratepayers on the basis that assets will not be replaced, the capital base of the local government will continue to be eroded and the current ratepayers are using up equity that has either been provided in the past or will have to be provided in the future, leading to intergenerational inequity.

Conclusion

This publication has been developed to provide Mayors and Councillors of local governments with a clearer understanding of unfunded depreciation, its causes and implications. However, each local government, as part of its strategic asset management plan, needs to determine the extent to which its own depreciation expense needs to be funded each year having regard to the level of service provided to its ratepayers, its asset replacement requirements and its capacity to source and service external funding.

Where the rates base of a local government is insufficient to generate the level of operating revenue needed to meet its annual operating expenses (including the level of depreciation expense that should be met each year) the local government may experience difficulties in remaining financially viable in the longer term and appropriate strategies to address these concerns will need to be developed in consultation with stakeholders.

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Queensland Audit Office

Management of Infrastructure Assets by Local Governments

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Introduction

For many years, in addition to scheduled audit visits, QAO representatives have visited regional Queensland areas to meet with Mayors, Councillors and Management of local governments. These visits have allowed QAO to obtain first hand knowledge of local developments, initiatives and concerns while providing the opportunity to advise local governments on emerging issues of audit interest in the local government sector. While the topics discussed during these visits have varied considerably from council to council, the subject of “unfunded depreciation” continues to be a talking point.

Information relating to unfunded depreciation has been reported in a number of Auditor-General’s Reports to Parliament but it is apparent that there is not a widespread and common understanding of what unfunded depreciation means or what the implications are for a council with unfunded depreciation.

While unfunded depreciation has been the primary focus for many in the local government sector, it is important to recognise that this is but one element of infrastructure asset management and needs to be addressed and managed in that context.

This publication, presented in a question and answer format, is intended to provide further clarification of the term unfunded depreciation within the overall context of management of infrastructure assets.

Common questions

Q1. Why do we need to manage our infrastructure assets?

To enable the provision of services to their ratepayers, local governments control and manage infrastructure assets which are largely unique to the public sector. These infrastructure assets include roads, bridges, footpaths, water reticulation and sewerage assets and airstrips. These assets generally have a very long useful life and can only be used for the intended purpose of providing the local government’s services. In 2003-04, local governments in Queensland (excluding Brisbane City Council) managed approximately \$20 billion dollars in infrastructure assets.

The costs associated with the maintenance, depreciation and replacement of these assets form a material part of the annual expenditure of all Queensland local governments.

As these assets have such long lives, the associated costs identified above will be spread across different generations of ratepayers. Effective management of these assets will help to ensure there is intergenerational equity among ratepayers with no generation unnecessarily subsidising or being subsidised by another.

Q2. What will help us manage our infrastructure assets?

In order to effectively manage infrastructure assets, each local government needs to have a long term strategic asset management plan that incorporates —

- assessment of the capacity of the infrastructure assets to provide the required services;
- assessment of changing future infrastructure needs due to likely changes in population and demand;
- a maintenance program to optimise the performance and maximise the effective useful lives of infrastructure assets;
- Future replacement needs for infrastructure assets.
- identification of likely sources of funding, both internal and external, for future infrastructure requirements (eg revenue, reserves, borrowings, grants);
- accurate and timely valuation of all infrastructure assets;
- accurate calculation of annual depreciation expense taking into account the effective useful life and residual value of each infrastructure asset; and
- determination of the annual depreciation expense to be recouped from the users of the services provided by those assets.

Q3. Why do we depreciate our non-current assets?

Depreciation is the systematic allocation of the decline in value of non-current assets over their useful lives and is reflected as an expense in a local government’s operating statement each year. In the majority of cases, non-current assets have a finite life and their value diminishes over this life as they are used by councils to provide services and other benefits to their ratepayers. Depreciation recognises this decline in value over time and the annual depreciation expense identifies how much needs to be charged to ratepayers each year to reflect the value of services and benefits provided to them from those assets.

Q4. How do we make sure we charge the right amount of depreciation?

To ensure the right amount of depreciation is charged each year local governments must accurately estimate the useful lives of their non-current assets and the value remaining in those assets at the end of their lives, usually referred to as the residual value, which, in some cases, may only be the scrap value of the asset. The reliability of these estimates will have a direct impact on whether the correct depreciation expense is charged and it is important that these estimates are reassessed each year.

In determining useful lives and residual values, consideration also needs to be given to the components of complex infrastructure assets where each element is likely to have a different life and residual

value. In the case of roads infrastructure, for example, the useful lives and residual values of the formation, pavement and seal are significantly different and therefore need to be depreciated at different rates.

The cost or value of an asset (or major components) less its residual value is the depreciable amount of the asset and it is this amount that needs to be expensed over the life of the asset.

Q5. Why do we need to depreciate our assets when they are fully maintained?

Maintenance of non-current assets by local governments will keep those assets in working order and will maximise their useful lives. At some point in time, however, these assets will either become too expensive to maintain or they may become obsolete and need to be replaced. Planned maintenance on assets needs to be taken into account in determining an accurate estimate of the useful lives and residual values of those assets to ensure the right amount of depreciation is charged. If assets are not properly maintained, their useful lives will be much shorter, resulting in a higher depreciation expense.

Q6. Does depreciation provide funds for asset replacement?

Depreciation does not, in itself, provide funds for asset replacement. As indicated in the answer to Q3, the annual depreciation expense identifies how much needs to be charged to ratepayers each year to reflect the value of services and benefits provided by those assets. Generally, if a local government has a balanced operating budget, which means that sufficient operating revenue is generated to cover all operating expenses, including depreciation, the amount of revenue equivalent to the depreciation expense (as depreciation is a non-cash item) represents an increase in cash balances which could be used as a funding source for asset replacement or new asset procurement.

Q7. What happens if we don’t have a balanced operating budget?

Generally, if a local government doesn’t have a balanced operating budget its ratepayers are not being charged the right amount for the services they receive each year, leading to inequities arising between different generations of ratepayers as one generation subsidises, or is subsidised by, another generation.

In formulating their budgets, local governments need to be aware of the distinction between different types of expenses. There are those expenses that involve the outlay of cash (cash items – typically payments for goods and services and employee costs) and there are those that are derived from accounting entries and do not involve the outlay of cash (non-cash items – typically depreciation expense and increases in provisions). Sufficient revenue needs to be generated