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Mr Neil Castles
Local Government Depreciation Taskforce
Department of Local Government, Water and Volunteers
QUEENSLAND

Via email: depreciationtaskforce@localgovernment.qld.gov.au

Dear Mr Castles

Enhancing depreciation outcomes in Queensland local government

As one of the largest professional accounting bodies in the world, CPA Australia represents the diverse interests of more than 175,000 members working in over 100 jurisdictions and regions around the world, working in diverse roles across public practice, commerce, industry, government and academia throughout Australia and internationally. We welcome the opportunity to provide feedback to the Local Government Depreciation Taskforce on its review into considering opportunities to enhance depreciation outcomes in Queensland local government. We make this submission on behalf of our members and in the public interest.

In developing this submission, CPA Australia has consulted with members and other stakeholders working within the Queensland local government and broader Queensland public sector, and with our members working in the public sector across different jurisdictions across Australia.

We do not believe the focus of the project reflected in the title of the taskforce (Local Government Depreciation Taskforce) adequately reflects the broader issue at hand. The terms of reference for the taskforce notes that "the general view is that the financial sustainability of local government continues to weaken". We believe that the broader concern of financial sustainability of local government is the problem that needs to be addressed and that the narrow focus on just the matter of deprecation is potentially distracting away from this wider problem.

Asset management is an integral part of local government sustainability, and depreciation is one factor amongst many that contributes to such asset management. It is a fact that all assets will depreciate over time through various factors including consumption, the passage of time and obsolescence. The depreciation expense that is required by accounting standards and recorded in local government financial reports is a mere reflection of this fact. It should also be noted that depreciation by itself does not have any direct correlation to decisions surrounding asset replacement or maintenance as part of a council's asset management.

While depreciation is an important measure, it should be interpreted carefully and complemented by real-world asset data, forward-looking service planning, and an understanding of the financial and demographic pressures facing councils. Councils should continue to focus on whether their asset renewal strategies are realistic, affordable, and aligned with community needs and be mindful of the judgment and variability involved in how depreciation is calculated

The Australian public sector is a world-leader in adopting and adhering to international accounting standards that facilitate high levels of transparency and accountability by government entities across all three tiers of government. The pursuit of high-quality financial reporting based on international accounting standards not only requires those

with appropriate knowledge and skills to prepare the information included in such financial reports, but also those who can comprehend the information derived from such reports and act upon them accordingly.

We acknowledge that the depreciation expense is an estimate based on a number of asset-related factors including useful life, componentisation, carrying value and residual value etc. Suitably qualified accountants with the relevant knowledge and experience in these matters are necessary to ensure the appropriate depreciation estimate is established every year. Asset management experts, asset valuation experts and assurance providers also play a part in ensuring the asset values and associated depreciation are appropriately reflected in financial statements.

We offer the following recommendations to address the broader issue of financial sustainability within Queensland local government, including asset management and asset depreciation. We have incorporated these recommendations into four broad areas of equal importance. A strategic plan and call to action that incorporates these, and other recommendations will go a long way in addressing some of the challenges currently being faced by Queensland local government.

Systemic and centralised solutions

Recommendation 1: A state-wide uniform, detailed approach to asset management

A state-wide uniform approach to financial sustainability that includes a centralised framework to support asset management is necessary to ensure consistent and streamlined asset management practices across all local councils.

We note the Department for Local Government, Water and Volunteers (the Department) provides a framework that takes an integrated approach to asset management. In respect of this, the Queensland Audit Office performance audit report (QAO audit report) from 2023-24, Improving asset management in local government (Report 2: 2023-24), finds that:

- There are gaps in asset management practices
- Greater support is needed to build asset management capability

The QAO audit report also finds that the detailed guidance provided by the Department for asset management lacks detail and does not sufficiently address all asset classes owned by local governments.

We agree with the recommendation made in the QAO audit report that specific guidelines should be provided to support councils integrate their planning and reporting documents, that enables amongst other things, the facilitation of the calculation of depreciation and budgets for future capital works.

Specific guidelines for asset management should include:

- Valuation for different asset classes
- Asset componentisation
- Establishing residual value (where relevant. Residual value may not be relevant to some assets such as stormwater drains or roads)
- Useful life

The guidelines could also provide practical examples, case studies and other support on related matters such as obsolescence and impairment.

A centralised approach to providing support services to councils in how the above guidelines are applied in practice could be considered. This could be in the form of a “shared services” approach to certain aspects of asset management such as the provision of valuation services, key technical staff, information systems and infrastructure provided through a centralised authority that could be part of the Department. This approach will also develop and assist with the collection of better data on asset management practices, to assist with forward planning and improved asset management practices. We note other jurisdictions have considered a centralised approach to asset management. For example, the report arising from ‘The future of local government review’ in Tasmania made similar recommendations (refer recommendations 13, 30 and 31).

A further suggestion the Queensland government may wish to consider is a state-wide reserve or fund that is held to finance asset management and replacement for local councils as the need arises. This approach would require contributions from all councils towards the common fund that would provide financial support to councils for their asset management activities as the need arises. We however appreciate there are a number of practical challenges associated with this idea, particularly given the varied types and sizes of councils that exist across Queensland.

Skills and capabilities

Recommendation 2: Build asset management skills and capabilities within local government

A framework, guidelines and policies for good asset management should be complemented by a finance team of suitably qualified individuals with the appropriate knowledge and experience to implement and maintain asset management practices within local government.

Qualified accountants and other professionals play a critical role within multi-disciplinary teams (spanning finance, asset management, sustainability and other operations) by contributing expertise such as valuation, strategic, financial reporting and management accounting. Such expertise should also include a degree of objectivity and forensic capability, particularly where councils rely on external expertise for aspects of asset management, such as asset valuations.

We acknowledge that technical expertise relating to operational asset management generally resides in areas outside the finance team (e.g. within engineering teams). However, there should be some expertise within finance teams that includes a broad understanding of the asset management practices followed by the council and how these impact on the council's financial sustainability. There should also be close collaboration between council finance teams and the department(s) within which asset management technical expertise resides.

Broader sustainability considerations

Recommendation 3: Ensure good asset management is complemented by broader sustainability practices

As we note previously, asset management is one aspect of local government financial sustainability. Although asset management is a significant contributor, there are other factors that also contribute to financial sustainability.

We note the Department has developed and published a local government sustainability framework that sets out both financial and non-financial factors that influence local government sustainability. We believe this framework sets out a comprehensive set of principles that provide an adequate basis for ensuring local government sustainability.

We would like to highlight the following factors that we believe should be considered as a part of a holistic approach to financial sustainability:

- **Grant funding:** As part of a council's asset management strategy, there should be strategic consideration given to whether grant-funded assets are essential to the provision of council services, or they are an optional that provides added benefit beyond what a council is expected to provide to its population. With the latter, not only will a council have to incur the depreciation expense of the asset, but it will also have potentially created an expectation amongst its population that the asset will continue to be made available permanently, resulting in the need to maintain and potentially replace the asset in the future.
- **Cost escalation and input price volatility:** Good asset management strategies should have inbuilt forecasting features that takes into account inflationary pressures and also caters to variability in future prices for maintaining and replacing assets.
- **Forecasted population growth and infrastructure demand:** Australia's population is growing, both through organic growth and immigration. This growth has a direct impact on many councils, requiring expanded services which has an impact on their asset management into the future.

- **Councils' organisational capacity to deliver planned capital works:** Council asset management plans should include consideration of whether they have the capacity and capability to deliver planned capital works, either through inhouse expertise, externally sourced expertise or a combination of both.
- **Non-financial sustainability factors should also be taken into account:** Whilst the focus of the framework is on financial sustainability, we believe some consideration should be given to other non-financial sustainability factors such as the climate-change impact on local government. As climate change accelerates, this could lead to an increasing frequency of natural events (including natural disasters) that could affect many communities across Queensland. Climate change impacts could be twofold. Firstly, there could be a higher burden on existing assets such as stormwater drains due to greater and more frequent rain events. Secondly, damage caused to infrastructure due to adverse climate events could also have an impact. The sustainability framework should incorporate principles to guide councils build stronger resilience capabilities to mitigate against climate-related risks and uncertainties.

Accounting considerations

Recommendation 4: More accurately reflect financial estimates of asset values and depreciation

As noted above, depreciation is an estimate that reflects the consumption of an asset through both its use and other factors. The accounting for assets and their depreciation by Queensland local government is based on Australian Accounting Standards (AAS) issued by the Australian Accounting Standards Board (AASB). The AAS are legislative instruments issued by a statutory authority, the AASB. The AAS are based on International Financial Reporting Standards (IFRS), adopted across many countries and reflecting global best practice in accounting and financial reporting. We therefore consider the accounting framework used by the Queensland local government as appropriate and fit for purpose.

We make the following recommendations to improve accounting for assets, their depreciation and other related matters:

- **Componentisation of assets:** Better componentisation of assets into distinct parts can lead to more accurate depreciation estimates for those parts. A consistent approach to such componentisation across assets of a similar nature across councils would also be helpful, and this could be achieved through a centralised framework as noted above.
- **Consistent estimation of useful life:** Concerns have been raised in other State jurisdictions about the inconsistency in how useful life is calculated for the same or similar assets across different councils. A centralised approach that introduces consistency in estimation of useful life will help with ensuring standardisation of this aspect of asset management and its accounting. Councils should implement policies to annually review asset useful lives and document upgrades, and ongoing maintenance or improvements that can justify extended estimates of asset useful lives. Factors such as impairment and obsolescence should also be taken into account when estimating useful life.
- **More accurate depreciation estimates:** Whilst a straight-line basis of depreciation is simple to implement and follow it does not necessarily provide the most accurate reflection of asset consumption. A more sophisticated depreciation methodology based on consumption can assist with a more accurate reflection of asset consumption in the deprecation expense. However, we note that additional data that comes at a cost is needed for more sophisticated depreciation methodologies. Councils have to consider the costs/benefits when determining the best approach to estimating depreciation.
- **Ignore irrelevant factors:** We understand some councils may consider depreciation as irrelevant when there is an expectation that the asset is unlikely to be replaced. Similarly, councils holding assets received as a grant or funded through grants may hold a view that these assets may not be replaced unless a grant is received to fund replacement of such assets. This is an incorrect approach as this does not reflect the consumption of the asset through a suitable depreciation expense.

- **Impairment:** Obsolescence of assets can sometimes lead to a write down of the asset to nil value, which results in depreciation becoming a redundant matter for that asset. Whilst true obsolescence is a valid reason to write down asset value, this should be used appropriately and in line with the relevant AAS (AASB 136 *Impairment of Assets*). It should also be noted that an asset becomes obsolete only if it's no longer in used or in service. If some of the service potential of the asset is continuing to benefit the council, then the asset cannot be considered obsolete.
- **Impact of financial sustainability measures:** Financial sustainability measures recommended by the Financial Management (Sustainability) Guideline includes an Operating Surplus Ratio. For councils to meet the benchmark of greater than 0%, they would need to ensure their revenue exceeds expenses, the latter of which includes the depreciation expense. There may be a concern that increasing rates and charges to cover depreciation, which is a non-cash flow expense is difficult to justify. Whilst we appreciate this concern, it is essential for councils to set aside funds to maintain and replace assets as they are consumed. Not recognising depreciation or by reducing the depreciation expense inappropriately, councils may not be in a position to accurately undertake asset management and asset replacement policies, including adequately funding those assets and activities.
- **Ratios should be considered holistically and not in isolation:** Key sustainability ratios including the Operating Surplus Ratio should not be considered in isolation when establishing whether a council is meeting its sustainability measures. Even though depreciation is not a cash expense, where a council does not meet the benchmark of 0% or above, some may believe that the non-cash expense of depreciation is a contributing factor. Similarly, this does not take into consideration the possibility that not all council assets are funded through council-generated revenue. Some of its assets could be generated through other sources such as grants. Furthermore, as noted in the AASB FAQ *Local Governments and Accounting Depreciation*, it is inappropriate to consider only the "bottom line" in an entity's statement of profit and loss. Consideration should be given to the nature of income and expenses, and the entity's ability to generate cashflows in the future that will contribute to its asset maintenance and replacement.
- **Recognition of grant revenue:** AAS require councils to recognise grants associated with assets in accordance with AASB 15 *Revenue from Contracts with Customers and* AASB 1058 *Income of Not-for-Profit Entities.* Importantly, councils, as not-for-profit entities, are unable to apply AASB 120 *Accounting for Government Grants and Disclosure of Government Assistance* (AASB 120). AASB 120 allows an entity to match and recognise revenue from grants as expenditure is incurred in respect of that grant. This allows for grant revenue or income to be recognised over time and may mitigate the impact of depreciation expense incurred in future years for a grant-funded asset. Advocacy efforts with the AASB may be necessary for it to consider whether AASB 120 could be allowed for application of not-for-profit entities, including councils.
- **Revaluations:** Council assets are generally carried at fair value and are required to be revalued every year to establish fair value. In an inflationary environment, asset values are likely to increase over time and this in turn could place pressure on the depreciation expense relating to assets carried at higher value. Often councils rely on external expertise to provide asset valuations. Whilst this may be necessary, finance teams within councils should possess sufficient competence to challenge independent valuations obtained from external providers and ensure the values are objectively and appropriately arrived at.
- **Asset upgrades and maintenance:** Councils should invest in regular maintenance and upgrades of their asset portfolios, which can legitimately extend asset useful lives and delay disposal or replacement, thereby minimising annual depreciation expense.
- **Work in progress:** Assets under construction that are not yet available for use do not have to be depreciated as they have not yet been used or consumed by the entity. Asset management practices and policies should include criteria to identify such assets separately, and the process of moving completed assets out of work in progress into the assets-in-use category that becomes depreciable.

Should you have any questions or wish to discuss further, please contact Ram Subramanian, Financial Reporting Lead at ram.subramanian@cpaaustralia.com.au.

Yours sincerely

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