4.001 In Part 2 of this report, we discussed the experience of the early nine in relation to:

- asset management plans;
- accounting policies for infrastructural assets; and
- valuing infrastructural assets.

4.002 In Part 3, we explained the specific issues which resulted in a qualified audit opinion being issued on the financial statements of the Waipa District Council for the year ended 30 June 1998.

4.003 The purpose of this Part is to outline developments in relation to accounting for infrastructural assets, and to comment on what we believe are the remaining key issues.

Generally Accepted Accounting Practice

4.004 In our report on local government last year,[1] we discussed the requirement to comply with generally accepted accounting practice (GAAP) and the Accounting Standards Review Board (ASRB) decisions in relation thereto. While the early nine were required to comply with GAAP in preparing their 1997-98 financial statements, the remaining local authorities do not have to comply until they prepare their financial statements for the year ending 30 June 1999.

4.005 In summary, the ASRB has advised local authorities that in complying with SSAP-3: *Accounting for Depreciation* and SSAP-28: *Accounting for Fixed Assets* (both of which standards it has directed as having authoritative support):

- it agrees with our criteria for minimum acceptable accounting for infrastructural assets;[2] and
- it notes that compliance with those criteria is acceptable until such time as a new financial reporting standard covering these matters is approved by the ASRB and becomes effective.

1 *First Report for 1998*, parliamentary paper B.29[98a], pages 57-59.

2 *Second Report for 1997*, parliamentary paper B.29[97b], pages 15-17.

Developments in Generally Accepted Accounting Practice

4.006 An exposure draft of a new financial reporting standard to replace SSAP-3 and SSAP-28 – ED-82: *Accounting for Property, Plant and Equipment* – was issued in March 1998. We understand that the Financial Reporting Standards Board (FRSB) of the Institute of Chartered Accountants of New Zealand (the Institute) is still considering submissions on that exposure draft. We are hopeful that a new standard will be issued before the end of 1999.

4.007 We have given careful consideration to the proposals in ED-82 and have made comprehensive submissions to the FRSB on matters which we consider need further attention. It was particularly pleasing to note that the Society of Local Government Managers and a number of individual local authorities made submissions on this exposure draft.

4.008 There are three specific issues of concern to us on which we comment below:

- component approach;
- valuation; and
- relationship with the Local Government Act 1974.

Component Approach

4.009 ED-82 proposes that, in certain circumstances, it is appropriate to allocate the cost of an item to its component parts and account for each component separately. It suggests that this is the case when the component parts have different useful lives or provide benefits to the entity in different patterns, thus requiring different depreciation rates and methods.

4.010 Some local authorities have raised concerns that this requirement results in extensive record-keeping requirements, and that the cost may not equal or may exceed the benefits of such a detailed approach. We consider that the component approach is an essential part of ensuring reliable accounting for infrastructural assets. Nevertheless, we acknowledge the concerns raised by some authorities, and have encouraged the Institute to provide more detailed guidance to help local authorities and others to account meaningfully for complex assets such as infrastructure.

Valuation

4.011 Consistent with SSAP-28, ED-82 permits infrastructural assets to be carried at either cost or valuation. Determining reliable values for many infrastructural assets is difficult. Furthermore, the valuation directly influences the measure of depreciation or decline in service potential that is recognised, and thus has a real impact on the determination of the revenue requirements of local authorities. We consider this issue in Part 11 on pages 73-78. In short, it is important that guidance on valuation of infrastructural assets (and in fact all assets) is clear and able to be reliably implemented. We are not yet satisfied that this is the case.

4.012 We have encouraged the Institute to give more thought to the valuation aspects of ED-82 and, in conjunction with the New Zealand Institute of Valuers, to seek to reach agreement on an approach which ensures that meaningful and useful information is reported.

Relationship with the Local Government Act 1974

4.013 A principle of the Local Government Act 1974 is that "operating revenues in any financial year should be set at a level adequate to cover all projected operating expenses."[3]

4.014 Section 122A of the Act states that "operating expenses" and "operating revenues" have the meaning given to them under GAAP. Depreciation is thus an operating expense, and is required to be funded in the sense that revenues need to be earned to ensure that the full amount of depreciation is covered each year.

4.015 As a consequence of the above, GAAP – in particular, the financial reporting standard which arises from ED-82 – will have a direct impact on the funding requirements of local authorities. A number of local authorities have expressed

3 Section 122C(1)(f), as inserted by the Local Government Amendment Act (No. 3) 1996. An exception exists in respect of short-term borrowing, reserves, etc. – see section 122J.

concern about the requirement to "fund depreciation". This issue was considered in our report on local government last year[4] and is considered further in Part 11 of this report.

4.016 We believe it important that the appropriate accounting for infrastructural assets is considered as an issue in its own right. The relationship between GAAP and the Local Government Act 1974 should be considered separately. We have brought the issue to the attention of the Institute and suggested that, in due course, it should raise the matter with the ASRB. We have also discussed the issue with the Department of Internal Affairs.

Renewal Accounting

4.017 Pending the promulgation of a new financial reporting standard, we are continuing to accept the measurement of decline in service potential using either a traditional depreciation approach or a "long-run average cost of renewals" approach. This approach was set out in our criteria for minimum acceptable accounting for infrastructural assets (see paragraph 4.005). We no longer accept a "pure renewal accounting" approach, which simply equates the amounts expended in a period to renew or reinstate assets with the decline in service potential in that period.

4.018 Whether the long-run average cost of renewals approach will continue to be acceptable under any new financial reporting standard remains unclear. Experience over the last year has suggested that such an approach may, when applied carefully, result in a measure of decline in service potential that is not materially different to traditional depreciation. However, this approach is significantly more complex than traditional depreciation. Furthermore, the component approach to accounting for infrastructural assets (as proposed by ED-82) addresses many of the concerns which led to the development of different approaches to accounting for decline in service potential, such as different forms of renewal accounting.

4 *First Report for 1998*, parliamentary paper B.29[98a], pages 71-78.

4.019 One specific issue has arisen which requires comment. Our criteria for acceptable accounting for infrastructural assets (see paragraph 4.005) indicates that a minimum period of 20 years should be used to determine the long-run average cost of renewals. We have experienced circumstances in the past year where a 20-year period provided an inappropriate and unreliable measure of the decline in service potential.

4.020 In those instances, we insisted that the entities extend the renewal period to ensure that a reliable measure was obtained. Where entities adopt the long-run average cost of renewals approach, they should ensure that the renewal period adopted is sufficiently representative to enable a reliable measure of decline in service potential to be determined. We will be monitoring this issue carefully.

Conclusion

4.021 For a number of years we have placed significant emphasis on accounting for infrastructural assets, as have local authorities. We have learnt a great deal during that time. We are hopeful that a new financial reporting standard will be able to be implemented by local authorities in a way which is reasonable and ensures that meaningful information is reported to stakeholders. We will continue to exercise our best endeavours towards that end.