Accounting for the derecognition of parts of infrastructure assets following ‘replacement’ expenditure

Introduction

1. External auditors raised a new issue with the accounting treatment for the valuation of infrastructure assets in the 2020/21 accounts of some local authorities. This issue was raised after the County Council’s accounts for 2020/21 had been signed off by EY and therefore did not affect the opinion of the accounts for that year. However, the CIPFA LASAAC Local Authority Code Board has since established a task and finish group and conducted an urgent consultation in an attempt to resolve this national issue, which affects all local authorities with infrastructure assets.

2. There is no suggestion that the County Council is not properly budgeting for the expenditure on its highways infrastructure assets or charging incorrect amounts to the taxpayer through its capital programme or revenue budgets. The issue is a purely technical issue relating to Balance Sheet valuations that does not affect budgets or decision making by the County Council.

3. This briefing note provides additional detail to support the Statement of Accounts 2021/22 report to the Audit Committee’s meeting of 28 September 2022.

How does the County Council account for the valuation of highways assets

4. In line with the requirements of the CIPFA Code of Practice, the County Council holds its highways assets at depreciated historical cost (DHC) and charges depreciation over 20 years on a straight-line basis. This means that the Balance Sheet value of expenditure on highways will equal the initial amount spent less 1/20 of that amount for each year since the expenditure took place. For example, £200,000 of initial expenditure would be depreciated at £10,000 per year and therefore valued on the Balance Sheet at £190,000 after one year, £100,000 after 10 years and so on.

5. Clearly, in practice each individual road will not have an asset life of exactly 20 years. However, depreciation is based on a reasonable expectation at the time the asset is created. For highways assets on average, analysis in 2016/17 suggested a 20 year asset life was reasonable and that using this average across all assets did not create a materially different result to variable lives per asset.

6. Assets held at DHC do not get revalued and where assets are ‘replaced’ the County Council assumes that on average these assets have been fully depreciated (and are therefore worth £nil). This is based on the assumption that the 20 year asset life is reasonable on average, supplemented by the fact that the County Council does not have the funding to replace assets before they have reached the end of their useful life. Therefore, for the County Council, it is

assumed there is £nil value to write off the Balance Sheet when parts of the highways network are replaced.

7. Take the example of a road assessed by the Highways team to require resurfacing. Although to road users the road is essentially the same road, the resurfacing from an accounting point of view is argued to be ‘replacing’ the old road surface and the old road surface therefore needs to be derecognised.

8. When you derecognise an asset or an element of it, you need to remove the associated asset value from the Balance Sheet, because you don’t have that asset anymore. The County Council assumes the ‘old’ road surface has reached £nil value and there is therefore £nil to derecognise. It therefore simply adds the cost incurred in resurfacing the road to the Balance Sheet valuation of its highways assets and then depreciates this amount over the next 20 years.

9. Statutory arrangements mean that depreciation is not a proper charge to the General Fund and any depreciation is therefore reversed out of the General Fund to unusable reserves. It does not therefore affect the revenue budget or the council tax requirement.

What is the issue?

10. CIPFA’s description of the issue notes that accounting for infrastructure assets has not historically been considered to be an area of significant audit risk. This is because of the inalienable nature of the assets (benefit is only derived by using them) and the fact they are held at depreciated historical cost (it was deemed too costly to revalue regularly to enable assets to be held at current value).

11. The CIPFA note highlights that derecognition of highways assets has not previously been considered to affect asset balances because (a) normal custom and practice has been to assume the assets are expected to be fully used up before replacement and (b) it is assumed assets are properly depreciated in line with the CIPFA Code.

12. It is difficult for the audit firms to test the asset valuations of local authorities, however, because of the limitations on historical information relating to when the assets were first recorded on the Balance Sheet (this started in the early 1990s) and because of local authority reorganisations. It is also hard to identify clearly from accounting records which parts of the assets are being replaced.

13. For the County Council, a single asset is held on the Balance Sheet for all highways assets as at 2016/17. Post 2016/17, a single asset is held per financial year and depreciated over 20 years. Thus, there is insufficient detail within the financial ledger to identify individual parts of the highways network. This detail has not previously been required in working to the normal custom and practice regarding highways assets, in meeting the requirements of the CIPFA Code, or for previous audits.

14. One proposal from CIPFA is to remove the need to report Gross Book Value and Accumulated Depreciation and instead to focus solely on the value on the Balance Sheet (the Net Book Value). This would remove some potential historical ambiguities but may not be sufficient to enable auditors to gain full satisfaction. A statutory prescription from government has also been mooted.

What do the audit firms want local authorities to do?

15. To allow audit firms to test and prove that assets had been fully derecognised from the Balance Sheet on ‘replacement’ each individual road would need to be held as a separate asset on the Balance Sheet, potentially further broken down by component (foundations, road surface etc). This would then create a 1:1 relationship between work carried out on individual roads and their representation in the accounting system. When a road is replaced, any remaining value associated with that individual asset could then theoretically be identified and derecognised.

16. However, while it would be relatively straightforward in this scenario to do so for an asset that was fully replaced, it would almost always be the case that only part of a road would be replaced (e.g. the foundations are not replaced and/or only part of a road is resurfaced). In this case, even more detailed records and the professional judgement of the Highways team or other experts would be required to allow the County Council to assess what proportion of the existing asset had been replaced. An appropriate methodology would then be required to assess what (if any) outstanding value remained for the section of the asset being replaced so that this part could be derecognised from the Balance Sheet. The ‘replaced’ section of road would then need to become a new asset, splitting a road that was initially one asset on the Balance Sheet into two.

17. Given the scale of the highways network within Hampshire (approximately 5,500 miles of roads plus associated bridges and street furniture including street lights, traffic lights, sensors, signage etc) there would be significant cost implications to maintaining accounting records at individual road level, which would provide little if any practical benefit to the taxpayer as the carrying value of the highways assets on the Balance Sheet does not impact the budget or the County Council’s decision making. Indeed, this was CIPFA’s view back in 2016/17 which resulted in the consolidation into a single asset all the highways assets held within the accounting system at that point, including the historic assets added in 1994. Therefore, even if detailed records are kept in future, it is not possible to recreate the accounting entries for existing highways assets held on the Balance Sheet that were capitalised during or before 2016/17 and it will not be until 2036/37 that these asset values have been fully depreciated and removed from the Balance Sheet.

18. The County Council is sympathetic to the position of the audit firms, as they are required to conduct their audits in accordance with the requirements of auditing standards. The County Council is, however, hopeful that a pragmatic solution will be found to resolve this issue at a national level given the significant costs that would be involved to alter the current approach in the way described above and the fact that it would create minimal if any tangible benefit to do so.