

Urgent Issues Group

Interpretation 1055

September 2004

Accounting for Road Earthworks



Australian Government

**Australian Accounting
Standards Board**

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PREFACE

Main Features of UIG Interpretation 1055

This Interpretation is applicable to annual reporting periods beginning on or after 1 January 2005. Early adoption of this Interpretation is not permitted. Application of this Interpretation will begin in the context of adopting all Australian equivalents to International Financial Reporting Standards. The requirements of Accounting Standard AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards* must be observed. AASB 1 requires prior period information, presented as comparative information, to be restated as if the requirements of this Interpretation had always applied. This differs from previous Australian requirements where changes in accounting policies did not require the restatement of the income statement and balance sheet of the preceding period.

The Interpretation requires an entity to identify which of its road earthwork assets are depreciable and which are non-depreciable. Road earthworks can represent another exception (besides land) to the expectation that all physical assets have limited useful lives, based on the similarity between land and earthworks. Any assessment that certain road earthworks do not have a limited useful life is to be based on engineering reviews of the useful life of the earthworks, including expected physical deterioration and technical obsolescence, and after consideration of commercial obsolescence factors.

Comparison with Superseded Requirements

There is no substantive difference with the previous requirements in Australia in the superseded UIG Abstract 55 *Accounting for Road Earthworks*. Changes in depreciation rates are treated as changes in accounting estimates, and thus are accounted for prospectively, as was required by Abstract 55.

URGENT ISSUES GROUP
INTERPRETATION 1055
ACCOUNTING FOR ROAD EARTHWORKS

Interpretation 1055 is set out in paragraphs 1 to 23.

ISSUE

1. Roads are major infrastructure assets for some entities. Road assets comprise a number of components, such as formation or earthworks, drainage, and the road pavement and seal. Earthworks are carried out to prepare the land for the construction of drainage, the road pavement and seal, and other structures. Earthworks typically include clearing the land and reshaping and aligning the land surface through cutting, filling, grading and compacting soil and rock to suit the type of road to be constructed. The amount of construction work involved in building a road depends on many factors, including the nature of the terrain, soil drainage characteristics and weather patterns.
2. Accounting Standard AASB 116 *Property, Plant and Equipment* requires the depreciable amount of an asset to be allocated on a systematic basis over the asset's useful life. The Standard presumes that, with the exception generally of land, a characteristic common to all tangible assets held on a long-term basis is that their useful lives are limited. Land typically has an unlimited useful life, with some exceptions, such as quarries and sites used for landfill.
3. There are different views concerning whether the earthworks component of road assets should be depreciated, with some entities taking the view that it is not feasible to reliably estimate a useful life for earthworks, and other entities determining depreciation on the basis of an estimated average useful life. Concern has been expressed that, in the absence of specific authoritative guidance, diverse or unacceptable practices may occur or develop in accounting for road earthworks. This will undermine the relevance and reliability of general purpose financial reports.
4. The issues are whether particular road earthworks may be assessed as not having a limited useful life, similar to land, and therefore not subject to depreciation, and whether it is possible to reliably estimate a

useful life over which particular road earthworks with a limited useful life should be depreciated.

CONSENSUS

- 5. Road earthworks shall be recognised as assets only in accordance with the requirements for the recognition of an item of property, plant and equipment in AASB 116.**
- 6. The depreciable amount of road earthwork assets that have limited useful lives shall be allocated on a systematic basis over their useful lives, based on best estimates of those useful lives. Difficulty in estimating the useful life of an asset does not justify non-depreciation of the asset.**
- 7. Road earthwork assets that are assessed as not having a limited useful life shall not be depreciated. Such an assessment shall be based on engineering reviews of the expected physical wear and tear and technical obsolescence of the particular earthworks and on consideration of commercial obsolescence and legal or other limits on the use of the earthworks.**
- 8. The depreciation or non-depreciation of road earthwork assets shall be reviewed at least at each reporting date, to ensure that the accounting policy applied to particular earthwork assets reflects the most recent assessment of the useful lives of the assets, having regard to factors such as asset usage, physical deterioration and technical and commercial obsolescence.**

Application

- 9. This Interpretation applies when AASB 116 applies.**
- 10. This Interpretation applies to annual reporting periods beginning on or after 1 January 2005.**
- 11. This Interpretation shall not be applied to annual reporting periods beginning before 1 January 2005.**
- 12. The requirements specified in this Interpretation apply to the financial report where information resulting from their application is material in accordance with AASB 1031 *Materiality*.**
- 13. When applicable, this Interpretation supersedes Abstract 55 *Accounting for Road Earthworks*, as issued in May 2004.**

14. **Abstract 55 remains applicable until superseded by this Interpretation.**

DISCUSSION

15. AASB 116 requires the depreciable amount of an asset to be allocated over the asset's useful life on a systematic basis that reflects the consumption of the asset's future economic benefits, with the Standard defining useful life in relation to the availability of the asset to the entity. The depreciation expense is determined by reference to the depreciable amount of the asset after consideration of such matters as obsolescence, changes in demand and other factors that might give rise to consumption or loss of the future economic benefits represented by the asset. AASB 116 states that, with some exceptions, land has an unlimited useful life and therefore is not depreciated. Where land has a limited useful life, it is depreciated.

Some Earthworks Similar to Land

16. This Interpretation adopts the view that road earthworks represent, in some circumstances, another exception to the expectation that all tangible assets have limited useful lives. This view is based on the similarity between land and road earthworks when the service potential of the earthworks is expected to be retained due to the absence of any events that cause physical deterioration, such as excessive usage, flooding or land movement, and the earthworks are not expected to become obsolete in the foreseeable future. Some roads and their earthworks may have limited useful lives because of their connection with an operation or activity that has a limited useful life. For example, roads associated with a particular mine normally would become obsolete when the mine reached the end of its useful life.
17. AASB 116 requires disclosure in relation to each class of property, plant and equipment of the depreciation methods and the useful lives or depreciation rates used. That is, a class of assets can include particular assets that have different lives – a single useful life need not be appropriate for all the assets in a class. Consistent with this, it is necessary under this Interpretation for an entity to assess which of its road earthwork assets do not have limited useful lives and which do have limited useful lives. Application of a single useful-life estimate across all of an entity's road earthwork assets, or even across all depreciable road earthwork assets, is unlikely to result in a reliable depreciation estimate.

Physical Deterioration

18. Road earthworks may not be subject to material physical deterioration. For example, the resealing of roads or the reconstruction of the road pavement that may be required as a result of environmental factors such as the weather and road usage levels may be carried out on top of the existing earthworks. Road improvements, such as increasing the traffic capacity or improving the alignment, can also make use of the existing earthworks. Additional earthworks may be required, but these need not replace the existing earthworks.
19. However, if earthworks are replaced during the reconstruction of a road, the earthworks (or the appropriate portion) are derecognised and the cost of the replacement earthworks is recognised as an asset in its place. This approach is consistent with the requirement in AASB 116 that an item of property, plant and equipment ceases to be recognised on its disposal.

Obsolescence

20. Earthwork assets are subject to possible technical or commercial obsolescence, regardless of the physical use of the asset. Technical obsolescence occurs as an asset becomes out-of-date due to technological advances, and commercial obsolescence occurs as the asset becomes redundant through a fall in demand for its services. For example, earthworks may become obsolete when a road is realigned for safety or other operating reasons or is replaced by or closed by a new access road or bypass road. In such cases, the particular earthworks affected are derecognised, consistent with the requirements in AASB 116 when no future economic benefits are expected from the use or disposal of an item of property, plant and equipment.
21. When the replacement or redundancy of particular earthworks is planned or expected under a future capital works program, the useful life of those earthworks is assessed on that basis. In such a case, the earthworks would be expected to have a limited useful life, requiring either a reassessment of the rate of depreciation or the commencement of depreciation where the earthworks were previously treated as non-depreciable.
22. Road transport possibly could be replaced in the future by some other means of transport or else road earthworks might require significant reconstruction to remain useful. This Interpretation is based on the view that this possibility should not be reflected in the best estimate of the useful life. Under this approach, the useful lives of earthworks

would need to be reassessed should such a technological change become probable.

Transition

23. AASB 116 requires changes in depreciation rates (e.g. due to a reassessment of the estimated useful life) and depreciation methods to be accounted for as a change in an accounting estimate in accordance with AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*. AASB 108 specifies that changes in accounting estimates are recognised prospectively by being recognised in the period of the change, if the change affects that period only, or in the period of the change and future periods, if the change affects both. Under the prospective recognition of changes in accounting estimates, depreciation recognised in prior reporting periods is not changed by an adjustment recognised either in profit or loss or in retained earnings. This approach applies to both the initial application of this Interpretation and to its subsequent application by an entity.

REFERENCES

Australia

The Urgent Issues Group discussed Issues Paper 04/3 “Revision of Various UIG Abstracts for 2005” in relation to this Interpretation at its meeting on 26 August 2004. In developing the superseded Abstract, the UIG discussed Issue Summary 04/1 “Accounting for Earthworks” at meetings on 12 February, 18 March and 4 May 2004.

Accounting Standard AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*

Accounting Standard AASB 116 *Property, Plant and Equipment*

Canada

CICA Handbook Section 3061 *Property, Plant and Equipment*

International Accounting Standards Board

International Accounting Standard IAS 16 *Property, Plant and Equipment*

New Zealand

Financial Reporting Standard FRS-3 *Accounting for Property, Plant and Equipment*

United Kingdom

Financial Reporting Standard FRS 15 *Tangible Fixed Assets*

United States of America

Accounting Research Bulletin ARB 43 *Restatement and Revision of Accounting Research Bulletins*, Chapter 9 – Depreciation

Governmental Accounting Standards Board GASB Statement 34 *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments*