Queensland Government
Department of **Local Government, Sport and Recreation**

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Service Delivery Division

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Local Government Bulletin

Financial Accounting Technical Paper – Water Reform in South East Queensland

Purpose

The purpose of this bulletin is to advise local governments that a financial accounting technical paper has been released concerning the water reform in South East Queensland.

The paper discusses issues and provides guidance on accounting and reporting for councils who were affected by the transfer of bulk water supply, transport and associated assets and liabilities to the Queensland Bulk Water Supply Authority (BSA) and the Queensland Bulk Water Transport Authority (BTA).

Background

The *South East Queensland Water (Restructuring) Act 2007* provides for the progressive transfer of the bulk water supply, transport and associated assets of councils in South East Queensland to the BSA and BTA. These assets are being transferred by transfer notice during the period 1 January to1 July 2008.

The Department has developed this technical paper which has been reviewed by the Queensland Audit Office.

Further information

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Financial Accounting Technical Paper – Water Reform in South East Queensland

<u>Date</u>: 18 July 2008

<u>Title of Paper:</u> Accounting for water reform in South East Queensland

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There are a number of technical accounting issues associated with reporting the transfer of bulk water supply, transport and associated assets and liabilities to the Queensland Bulk Water Supply Authority (BSA) and the Queensland Bulk Water Transport Authority (BTA).

This document discusses those issues and provides guidance to councils in respect of the correct treatment to be applied. This paper has been reviewed by the Queensland Audit Office.

At a broad level the major impacts are:

1. The sale of the shares of SEQWater should be recognised at the effective date specified in the transfer notice with any gain or loss on disposal recognised in profit or loss;
2. The sale of the assets and liabilities of AquaGen should be recognised at the effective date specified in the transfer notice and any gain/loss on disposal recognised in profit or loss;
3. All other bulk water supply, transport and associated assets and liabilities transferred to BSA and BTA stemming from Transfer Notices gazetted up to 30 June 2008 and where applicable subject to an Interim Service Level Agreement (ISLA) should be de-recognised as at 1 July 2008.

    a. Assets should continue to be classified by Councils as Non Current Assets – Property Plant and Equipment up to the 1 July 2008
    b. The assets should continue to be depreciated up to 1 July 2008
    c. The assets should be assessed for impairment by those Councils at the reporting date of 14 March 2008 or 30 June 2008
    d. Where applicable, all loans to be settled as part of the compensation should be classified by Councils as Current Liabilities at reporting date
    e. Additional note disclosure relating to the transfer should be included in Council's financial statements as at 14 March 2008 or 30 June 2008 (refer Appendix A).

Background

The *South East Queensland Water (Restructuring) Act 2007* provides for the progressive transfer of the bulk water supply, transport and associated assets of councils in South East Queensland to the BSA and BTA. These assets are being transferred by transfer notice during the period 1 January to1 July 2008.

The transfers being effected include shares in SEQWater, the bulk water assets owned by individual councils and associated contracts, land, licences and employees. Compensation for the shares in SEQWater was paid in two instalments; on the 1 February 2008 and the 24 April 2008.

Interim Service Level Agreements (ISLAs) between councils and the BSA/BTA provide for the operation and maintenance of many of the assets, and the collection of associated revenue, during the period between the date specified in the transfer notice and 1 July 2008.

From 1 July 2008 BSA and BTA will sell water services and have responsibility for the operation and maintenance of the assets.

Recognition of revenue and de-recognition of assets

The conditions in paragraph 14 of AASB 118 Revenue need to be satisfied in respect of the disposal proceeds in order for Council to recognise the disposal and de-recognise the assets (paragraph 69 of AASB 116: *Property, Plant and Equipment*). These conditions are as follows:

(a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
(b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
(c) the amount of revenue can be measured reliably;
(d) it is probable that the economic benefits associated with the transaction will flow to the entity; and
(e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.

With the transfer of the shares of SEQWater these conditions will be met at the effective date specified in the transfer notice (1 February 2008). The transaction should therefore be recognised on 1 February 2008.

The assets and staff of Aquagen were transferred on 28 February 2008 with all conditions for the recognition of revenue being met at that date. The transaction should therefore be recognised on 28 February 2008.

However these conditions will not be met until 1 July 2008 for the other bulk water supply and transport assets of Councils. An examination of the ISLAs indicates that the significant risks and rewards of ownership remain with each council until 1 July 2008 as follows:

- each council will receive all the revenue and pay all the costs associated with the operation and maintenance of the bulk water assets;
- no payments will be made to the councils by BSA/BTA in the event that revenues from services do not cover the costs of supplying those services;
- if revenues exceed costs, councils are not required to make payments to BSA/BTA;
- councils will manage the capital works program relating to the bulk water assets in accordance with an agreed capital expenditure program and budget; and
- councils have to maintain public liability, professional indemnity and workers compensation insurances.

Councils should therefore not recognise the transfer of those bulk water supply, transport and associated assets until 1 July 2008.

Presentation and measurement of bulk water assets in financial statements at 14 March 2008 (ceasing councils) or 30 June 2008 (continuing councils)

The assets and liabilities specified in the transfer notice for each council will need to be appropriately presented and disclosed in Council's financial statements for the period ending 14 March 2008 or 30 June 2008.

The carrying amounts of the assets will need to be re-measured to fair value less costs to sell. Any impairment loss that is recognized reduces the carrying amount of the non-current assets. Employee benefits continue to be measured in accordance with AASB 119 *Employee Benefits.*

The consideration that is to be paid to each Council as determined by Queensland Treasury represents the fair value. Initially, Council will need to use the Interim valuation issued by Queensland Treasury to determine this value. If the final valuation is known at the time the financial statements are adopted, that valuation should be used.

Any impairment which is allocated to an item of property, plant and equipment should be adjusted against the asset revaluation reserve for the particular class of non current assets to the extent there is a balance, for that class, in the revaluation reserve. Where the asset revaluation reserve for the class is insufficient to cover the total amount of the adjustment, any remaining amount will be recognised as an expense.

As the bulk water assets are continuing to be held by the Council up to 1 July 2008 councils will need to recognise all associated revenue and expenses, including depreciation, until that date.

Repayment of debt

The compensation that councils receive from the transfer of the bulk water and other assets will be/has been applied to the repayment of debt in the first instance.

For most councils this transaction is simply the application of the compensation proceeds to the redemption of debt, in which case the liability for the debt that is to be paid should continue to be recognised and presented in Council's financial statements until the compensation is actually applied to reduce that debt. The liability should be classified as a current liability at reporting date.

When the debt is repaid from the compensation, the amount of compensation proceeds used to repay it may not equal the book value. Any loss on extinguishment of the debt should be shown as a borrowing cost (AASB7.20). Any gain on extinguishment should be shown under Other Income when it arises. At 14 March or 30 June 2008 councils may need to disclose this transaction as a non-adjusting post balance sheet event (AASB110.10).

Accounting Standard Requirements

(A) Does AASB 5 *Non-current Assets Held for Sale and Discontinued* Operations apply to the transfer of the bulk water assets from the relevant councils to the BSA/BTA?

Relevant paragraphs of AASB 5:

6 An entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

7 For this to be the case, the asset (or disposal group) must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups)and its sale must be highly probable.

8 For the sale to be highly probable, the appropriate level of management must be committed to a plan to sell the asset (or disposal group), and an active program to locate a buyer and complete the plan must have been initiated. Further, the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value. In addition, the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification, except as permitted by paragraph 9, and actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

A disposal group is defined in AASB 5 as:

A group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. The group includes goodwill acquired in a business combination if the group is a cash-generating unit to which goodwill has been allocated in accordance with the requirements of paragraphs 80-87 of AASB 136 Impairment of Assets or if it is an operation within such a cash-generating unit.

The transfer of the bulk water assets was a decision of the State Government for an amount decided by the State Government, and not a local government management decision.

The view presented in this paper is that the assets should not be classified as "non-current assets held for sale".

The transaction is not subject to the usual terms and conditions of sale of such assets as it is a forced transfer for compensation and there is not normally a ready market for such assets. It should be noted that under paragraph 7 of AASB 5 the assets would need to be available for immediate sale but this is not the case here as they are subject to a legally binding transfer notice to the government

Management was not committed to a plan to "sell" the assets or disposal groups, and was not undertaking an active program to locate a buyer and complete the plan prior to the decision being made by the State Government. The assets had not been and were not being actively marketed at a sale price reasonable in relation to their current fair value.

The intention of AASB 5 is to account for assets where management is presently in the process of locating a buyer for its assets but does not presently have in place a contract for sale. This is clearly not the case here where at no stage were management undertaking a process to market their assets as means of selling them at value approximating their fair value. All decisions made including the compensation to be paid were done by the State Government and as such AASB 5 would not be appropriate.
The sale should be treated in the same way as any disposal of a non-current asset. The carrying value of the assets should be written down to the recoverable amount (i.e. impaired) prior to disposal occurring. As the assets are not being "held for sale" they should continue

to be depreciated by the councils until 1 July 2008 as the councils will be in control of the assets until that date.

(B) Can the transfer of the assets be classified as a "discontinued operation"?

A "discontinued operation" is defined in AASB 5 as:

> *a component of an entity that either has been disposed of or is classified as held for sale and:*
>
> *(a) represents a **separate major line of business or geographical area of operations**;*
> *(b) is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations; or*
> *(c) is a subsidiary acquired exclusively with a view to resale.*

At 14 March or 30 June 2008, the assets have not yet been disposed of and, as per the above, do not meet the definition of held for sale.

The area of business that normally includes the bulk water assets being transferred is Water and Sewerage. Based on the letter from the Treasurer to the Councils, only bulk water assets are being transferred, which will not include the waste water treatment plants or sewerage assets. If this holds for each council, the transfer relates only to part of a business unit and therefore does not represent a separate major line of business or geographical area of operations.

In this case therefore the transfer would not meet the definition of a "discontinued operation".

In the previous year, the Queensland Water Commission released its final report to the Queensland Government on the Urban Water Supply Arrangement in South East Queensland. The report outlines a range of structural and regulatory reforms proposed for urban water supply arrangements in South East Queensland including enhanced economic regulation and pricing.

(a) Bulk Water

The South East Queensland Water (Restructuring) Bill 2007 established four new statutory bodies which transferred the control of bulk water infrastructure from existing local government water businesses. The new entities comprise:

- Two new bulk water supply authorities, to be owned by the State Government, and include water storage and manufactured water facilities;
- A State-owned bulk water transmission company, to own the major ‘water grid’ assets in South East Queensland; and
- A Water Grid Manager to operate the water grid.

Pursuant to a transfer notice gazetted on xx xx 2008, Council’s bulk water assets and certain freehold land, inventories and employees will be transferred to the bulk water supply and transport entities on 1 July 2008.

Compensation for the transfer will be paid initially to the Queensland Treasury Corporation for repayment of debt owing with any balance then remaining paid to Council

Transfer details	Note	1 July 2008 $000
Assets		
Inventories held for distribution		
Property, plant and equipment		______
Liabilities		
Accrued employee benefits		( )
Loans – Queensland Treasury Corporation		( )
Provisions – Employee benefits		(_____)
Book value of net assets to be transferred		
Compensation to be received		______
Net gain on transfer		______

A gain of $ arises from the use of different methods to determine the value of the assets to be transferred as determined by the State Government and their book values according to Council’s valuation methodologies.

Included in capital work in progress at year end (refer note) is an amount of $ that is expected to be transferred upon completion of the underlying projects. Consideration is expected to be received on transfer based on cost less related subsidies received from the State Government plus interest on capital employed. Subsidies amounting to $ are included in unearned revenue at year end (refer note).

A gain of $ will arise from the early settlement of the Queensland Treasury Corporation loan. This represents the difference between the book and market values of the loan on 1 July 2008 based on the interest rate applicable on that date (refer note). These loans have been classified as current liabilities at year end. The loans are measured at book value at the year end rather than the market value.

(b) Distribution and Retail Water

Further reforms proposed by the Queensland Water Commission include the creation of:

- A single “distribution” company jointly-owned by local government to own and operate the region’s water and wastewater reticulation networks and wastewater treatment plants; and
- Between three and ten “retail” companies jointly owned by local government.

Commencement of the distribution and retail companies and the transfer of assets and operations from Council to those companies are unlikely to occur prior to 1 July 2010. As the impact of these changes is not yet determined, no account has been taken of them in preparing this financial report.

APPENDIX B: SUGGESTED JOURNAL ENTRIES

14 MARCH 2008 AMALGAMATING COUNCILS AND 30 JUNE 2008 CONTINUING COUNCILS

IMPAIRMENT OF NON CURRENT PHYSICAL ASSETS

Possible impairment of transferred bulk water assets (where compensation received 1 July 2008 < carrying amount of assets 14 March 2008 or 30 June 2008)

Dr Asset Revaluation Reserve
Dr Impairment loss expenses (where ARR for asset class is insufficient)
Cr Accumulated Impairment for asset class

30 JUNE 2009 AMALGAMATED COUNCILS AND CONTINUING COUNCILS

1 JULY 2008 DEPRECIATION OF TRANSFERRED NON CURRENT PHYSICAL ASSETS FOR 3 ½ MONTHS (AMALGAMATED COUNCILS ONLY)

Dr Depreciation Expense
Cr Accumulated Depreciation for asset class

(taking into account any accumulated impairment)

1 JULY 2008 TRANSFERS OF ASSETS AND LIABILITIES TO BULK WATER ENTITIES AND RECEIPT OF COMPENSATION

TRANSFER OF NON CURRENT PHYSICAL ASSETS

Dr Accumulated depreciation
Dr Accumulated impairment (if impaired)
Cr Gross carrying value
Dr Transfer compensation clearing account
Cr Gain on transfer (if applicable)

TRANSFER OF INVENTORIES

Dr Transfer compensation clearing account
Cr Inventories carrying value
Cr/Dr Gain/Loss on transfer (if applicable)

TRANSFER OF EMPLOYEE BENEFITS

Dr Accrued/provisions for employee benefits
Cr Transfer compensation clearing account

RECEIPT OF COMPENSATION AND EXTINGUISHMENT OF DEBT

Dr Cash at bank
Dr QTC loans (book value)
Dr Finance costs (where gain/loss on repayment at MV)
Cr Transfer compensation clearing account

No cash flow for extinguishment of debt