



ADVISORY

A GFOA *advisory* identifies specific policies and procedures necessary to minimize a government's exposure to potential loss in connection with its financial management activities. It is *not* to be interpreted as GFOA sanctioning the underlying activity that gives rise to the exposure.

Considerations on the Use of the Modified Approach to Account for Infrastructure Assets (2002) **BUDGET and CAAFR)**

Background. The Governmental Accounting Standards Board (GASB) allows governments to use the *modified approach* to account for qualifying networks or subsystems of infrastructure assets. Under the modified approach, infrastructure is treated as an inexhaustible capital asset, thereby eliminating the need for depreciation accounting. Governments must demonstrate that they are maintaining networks or subsystems of infrastructure assets at a selected condition level to qualify to use the modified approach.

Recommendation. The Government Finance Officers Association (GFOA) recommends that governments consider the following factors in the process of deciding whether to use depreciation accounting or the modified approach for a given network or subsystem of infrastructure assets:

- ***Usefulness of data for managerial purposes.*** The modified approach provides information on capital assets that clearly is of value for the budget process and for asset management purposes. It also has the advantage of avoiding the costs associated with the depreciation of infrastructure assets.
- ***Potential impact of prospective depreciation.*** There is a de facto "penalty" on governments that choose the modified approach but later convert to depreciation accounting, either by choice or necessity (i.e., failure to achieve targeted condition levels). Specifically, governments making the conversion to depreciation accounting are required to depreciate the full cost of the network or subsystem over its estimated *remaining* service life (i.e., *prospective* application of depreciation as a change in accounting estimate). Consequently, a change to depreciation accounting late in the life of a network or subsystem of infrastructure assets could result in elevated levels of annual depreciation expense for an extended period (See Exhibit 1).
- ***Inherent capital bias.*** As just noted, the modified approach creates a de facto accounting "penalty" for governments that fail to maintain their infrastructure assets at selected condition levels. No such penalty applies, however, for failure to adequately fund other essential services. This disparity in treatment creates an inherent bias in favor of capital-related outlays. As a result, the use of the modified approach could distort the process used by governments to set budget priorities.
- ***Unmatched debt.*** Under regular depreciation accounting, capitalizable improvements include expenditures that either 1) lengthen the useful life of a capital asset or 2) increase the efficiency or effectiveness of a capital asset. If a government selects the modified approach, however, only the second type of improvement may be capitalized. Consequently, a major, debt-financed project designed to lengthen the life of a network or subsystem of infrastructure assets accounted for using the modified approach would result in a government's reporting a significant liability with no corresponding asset related to the construction. Furthermore, the debt would be included as part of the calculation of *unrestricted net assets* rather than as part of the calculation of *invested in capital assets net of related debt*, which could produce a deficit balance in *unrestricted net assets*.

- **Reliance upon interested parties.** It is to be expected that officials responsible for maintaining infrastructure assets will play a major role in selecting condition level targets and in performing condition assessments. As a result, those with the greatest interest in encouraging infrastructure investment are in a unique position to promote that agenda.
- **Decreased comparability.** The use of the modified approach decreases the comparability of cost data among governments.

A balanced and informed decision on whether a government should use the modified approach for a given network or subsystem of infrastructure assets should take into consideration all of these factors.

Approved by the GFOA's Executive Board, October 25, 2002

Exhibit 1

Effect of Converting from the Modified Approach to Depreciation Accounting

Assume that two governments each construct the same type of infrastructure subsystem at a total cost of \$40 million. Further assume that Government A chooses to use depreciation accounting (estimated useful life of 40 years), whereas Government B elects to use the modified approach. Finally, assume that Government B fails to maintain targeted condition levels at the end of 30 years and therefore must convert to depreciation accounting for the remaining estimated useful life of the asset (i.e., 10 years). Depreciation expense for the two governments would be as follows:

Period	Depreciation Expense	
	Government A	Government B
Years 1-30	\$1 Million/year	\$0/year
Years 31-40	\$1 Million/year	\$4 Million/year
Total 40 years	\$40 Million	\$40 Million