Local Government
New Zealand
te pūtahi matakōkiri

Depreciation in the local government context

There has been much comment over the requirement for the local government sector to account for and fund depreciation. The purpose of this paper is to put context around the requirements to include depreciation in the accounts and budgets of local authorities.

The legislation and accounting standards

Section 100 subsection 1 of the Local Government Act 2002 (LGA) states:

> *A local authority must ensure that each year's projected operating revenues are set at a level sufficient to meet that year's projected operating expenses.*

The requirement to set operating revenues at a level sufficient to meet operating expenses includes depreciation because section 111[1] (LGA) obliges councils to follow generally accepted accounting practice (GAAP) which includes a definition of "operating expenses." As depreciation is defined as an operational expense it must be included with other operational costs, including interest, when a council sets its operating revenue.

What the legislation requires is that councils ensure that projected revenues are at least equal to projected operational expenditure including depreciation, *unless it is prudent to do otherwise.* The cash or funding generated by the revenue may be used for present capital needs (including renewals,) debt reduction or set aside for future capital needs. This helps ensure sound asset management practice and continuity of service to future generations.

Purpose of depreciation

There is confusion over the purpose of depreciation. Many believe that the purpose of depreciation is to provide for the replacement of an asset. In fact depreciation reflects the use or consumption of the service potential implicit in an asset. GAAP defines depreciation as follows:

> **Depreciation** is the systematic allocation of the depreciable amount of an asset over its useful life.

As depreciation reflects the consumption of the asset over its useful life, there are two critical factors in determining this expense. The first is the asset cost or revalued amount, and the second is the asset's useful life. It is therefore not related to the physical wearing out of the asset.

The purpose of depreciation is not to provide for the replacement of the asset(s), however this may be an intended or unintended consequence.

1 All information that is required by any provision of this Part or of Schedule 10 to be included in any plan, report, or other document must be prepared in accordance with generally accepted accounting practice if that information is of a form or nature for which generally accepted accounting practice has developed standards.

The approach to depreciation in the local government context is no different than the commercial sector, where depreciation is accepted as a legitimate operating expense. The only real difference is that the useful lives of local government infrastructure assets are significantly longer than many assets used in the commercial sector.

Funding or cash implications of depreciation

In the local authority context, depreciation is especially important as it ensures that today's ratepayers pay their fair share (and only their fair share) of consumption of the assets. Depreciation is therefore a vital component in the process of setting rates and charges.

As depreciation is a non-cash item of expenditure, the inclusion of the depreciation expense within total operational expenditure will result in a funding surplus from operations. It is then a council's decision as to how that surplus funding should be allocated. Broadly, there are four options:

I. repay debt
II. pay for renewal expenditure
III. acquire new assets
IV. transfer to a reserve for the replacement or future renewal of an asset.

While these are the most common options, there is no reason why a council cannot apply another option if it believes that this option is a prudent[1] use of council's funds.

Generally a council should consider all options across its different activities and then the decision should be made as part of its Financial Strategy.

Exceptions to the balanced budget requirement

Much of the concern around section 100 has arisen from the notion that this section requires the "funding of depreciation." This has been interpreted by many as the transfer of the depreciation expense to a specific reserve or accumulation of cash to be used either for the replacement of an asset or for the loan repayment associated with the acquisition of that asset. In fact, there is no direct legal requirement to "fund depreciation" in this way, despite the widespread assumption. However, there is a requirement to be *prudent* in the setting of funding levels.

Prudence

What the Act does is create a contestable presumption that forecasting a surplus is financially prudent.

Financial prudence is not defined in the Act. But the legislation provides some insight into what is intended by this phrase. In the standard dictionary sense *prudent* means "careful," "sensible" or "in the habit of acting with careful deliberation." A local authority that does not operate a balanced budget and has been cavalier in its treatment of the above matters may well be acting imprudently.

There is one other statutory reference that provides an indication of Parliament's view of what is considered financially prudent. Section 102 specifies certain financial policies which are required to be adopted by every council. The legislative rationale for requiring these policies is "in order to provide predictability and certainty about sources and levels of funding." This can be seen as an indication that predictability and certainty of funding levels and sources was seen as an element of being financially prudent.

Prudence in relation to a local authority establishing the level of operating revenue for the purposes of LTP forecasting / budgeting would require that local authority to set operating revenue at a level that reflects an unbiased assessment in areas of judgement, and is based on the best available information. The most significant area of judgement that impacts on the level of forecast operating expense, is the useful life of the numerous components comprising the infrastructure assets of the Council. This judgement will also affect the level of operating revenue needed to enable councils to adequately fund the level of service represented by their forecast operating expenses. Another judgement included in the determination of operating revenue includes the level of revenue sources, other than rates, in any period.

2 Section 101 requires a council to manage its revenues, expenses, assets, liabilities, investments, and general financial dealings prudently and in a manner that promotes the current and future interests of the community

Hierarchy of prudent financial management

Section 101 – Prudence and sustainability

A requirement to manage finances prudently and in a way that promotes the current and future interests of the community

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Section 101A – Financial Strategy

A requirement to adopt a financial strategy that informs and guides the assessment of funding and expenditure proposals

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Section 102 – Funding and financial policies

A requirement to adopt a set of funding and financial policies to provide predictability and certainty about sources and levels of funding

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Section 100 – Balanced budget requirement

Projected operating revenues must be set at a level sufficient to meet projected operating expenses unless prudent not to.

Section 100 exemptions

Section 100 is in two parts. The first part relates to the requirement to have a balanced budget, as discussed above. The second part relates to exemptions: the circumstances where councils can decide not to have a balanced budget and the criteria under which this circumstance can be made.

(1) A local authority must ensure that each year's projected operating revenues are set at a level sufficient to meet that year's projected operating expenses.

(2) Despite subsection (1), a local authority may set projected operating revenues at a different level from that required by that subsection if the local authority resolves that it is financially prudent to do so, having regard to—

(a) the estimated expenses of achieving and maintaining the predicted levels of service provision set out in the long-term plan, including the estimated expenses associated with maintaining the service capacity and integrity of assets throughout their useful life; and

(b) the projected revenue available to fund the estimated expenses associated with maintaining the service capacity and integrity of assets throughout their useful life; and

(c) the equitable allocation of responsibility for funding the provision and maintenance of assets and facilities throughout their useful life; and

(d) the funding and financial policies adopted under Section 102.

The LGA provides local authorities with a set of exceptions where they may depart from the requirements of the balanced budget. However, these exceptions do not provide a licence for any local authority to depart at will from a balanced budget. For example, a political decision to hold back on the amount of depreciation a council may "fund" to keep rates down in an election year does not meet the criteria of a valid exemption. The stipulations of the LGA require careful thought and analysis of the funding needs and the overall financial strategy to best deliver sustainable community services over the long term.

The legislation requires councils to consider all four criteria in Section 100, not just one of them. In summary the subsections refer to:

(a) the estimated expenses of achieving and maintaining the predicted levels of service and maintaining the service capacity and integrity of assets throughout their useful life; not just in the 10 years of the LTP, but for the whole life;

(b) the projected revenue available to fund i.e. having the cash available at the right time;

(c) the equitable allocation of responsibility for funding to ensure the revenue is fairly charged; and

(d) the funding and financial policies which ensure that there is certainty about the sources of funding required.

Within the Act, the balanced budget test in section 100 focuses on deficits. While an operating deficit may indicate that the local authority's levels of service and / or financial operations are unsustainable and may result in current costs being shifted to future generations, a surplus does not necessarily mean that the LTP is therefore financially prudent.

One method a number of councils are using to meet the provisions of section 100 is to set revenue using the average of future renewal expenditure rather than the forecast depreciation expense. In these cases the depreciation is still recognised as an expense but not used for the setting of revenue. This is sometimes known as the Long Run Average Renewal approach (LRARA.) This approach averages the renewal expenditure for the next 25 to 35 years and uses this average in the calculation of funding requirements. However, LRARA cannot be used to calculate the depreciation expense as LRARA is forward-looking and this does not comply with the accounting concept of consumption. However if depreciation is calculated correctly then over the life cycle of an asset (ignoring the impacts of inflation and revaluation) the depreciation expense and an LRARA-based funding calculation would have the same or similar value.

Basis of depreciation

As depreciation reflects the consumption of the asset over its useful life, there are two critical factors in determining the expense.

The cost of the asset or the revalued amount

While the cost of an asset is relative easy to ascertain, because councils' assets provide benefit for a long period of time (50-100 years), councils revalue this cost to reflect the fair value (book value) of the asset. The fair value of all infrastructural assets is based on Depreciation Replacement Cost (DRC). DRC is the replacement cost based on the replacement value of an equivalent asset, less the accumulated depreciation.

As a result of revaluing assets, depreciation will increase. However, as the purpose of depreciation is to charge the people who are using the asset for their share of the use of that asset, if the value has increased, in theory the people using the asset should pay a greater share. If the value has increased so do the future renewal costs.

The useful life of the asset

One of the most difficult tasks in assessing the depreciation expense is assessing the asset's useful life. While there are standard useful lives and while manufacturers often give a minimum useful life, there are a number of factors that can dictate the ultimate useful life of an asset. These factors can be grouped into either condition-based or performance-based factors. "Condition" relates to the physical attributes of the asset, while "performance" relates to the ability of the asset to meet the level of service requirements.

The range of useful lives are reflected in each council's accounting policies. These accounting policies are included within the financial statements and they can vary significantly from council to council. It is not uncommon for one council to have a standard useful life of 80 years and another council to have a standard useful life of 160 years for the same asset. These differences are due to a range of aspects, including construction methods, environmental constraints, topography and soil types. The change in useful lives will result in a different depreciation expense.

Summary

Councils are required to operate a balanced budget unless it is prudent not to. Because depreciation is defined as an operational cost, councils must, in order to balance their budgets, raise sufficient revenue to match the total of their operational expenses (unless there are prudent reasons not to.) There are many myths about depreciation, such as that it involves building up funds to replace assets at the end of their useful lives. While this may be a side-effect, the depreciation requirement is not dissimilar to the requirement placed on businesses, the chief difference being that councils must depreciate assets that have very long lives.

Depreciation is important not simply because the government requires it but because it is designed to ensure that today's ratepayers pay their "fair share" for the amount of the council's assets that they consume, essentially through wear and tear. So what we describe as a depreciation expense is essentially the cost of undertaking necessary maintenance and renewal to ensure council assets continue to perform as expected: something that reflects good governance and stewardship of our community's built up investments.