COUNCIL SUPPORTING POLICY 2009

POLICY TITLE:	**Funding Depreciation And Use Of Depreciation Reserves**
Lead Policy	**Revenue and Financing**
Minute Ref:	**M09/50**
Date Adopted:	**23 June 2009**

1. POLICY OBJECTIVES

- To determine the extent to which Council funds depreciation expenditure.
- To determine the uses of depreciation reserves.

2. PRINCIPLES

Council must manage its financial dealings prudently and in a manner that promotes the current and future interests of the community.

Council needs to appropriately fund the economic use of its assets.

Council should match the cost of delivering its services with the appropriate revenue sources.

Council's funding of depreciation and its use of depreciation reserves must comply with Generally Accepted Accounting Practice (GAAP).

Those who benefit from the existence and/or use of an asset should contribute to the costs.

3. DEFINITIONS

Depreciation is the measure of the consumption of the economic benefits embodied in an asset whether arising from use, the passing of time or obsolescence.

Depreciation Reserves are the accumulated funds retained by each activity from the depreciation which is funded each financial year, less any outgoings to pay for capital renewal of assets or debt repayment.

New Capital Expenditure is the expenditure incurred to bring an asset to its working condition for its intended use. It also includes works which upgrade and enhance a significant expenditure component of an asset restoring it beyond its original design capacity and/or estimated life.

Renewal Capital Expenditure comprises of works which upgrade and enhance a significant component of the asset, restoring it to its original size, capacity and condition.

4. BACKGROUND

Depreciation

Depreciation is calculated on all Council's fixed assets excluding land. Depreciation is an operating expense recorded in Council's financial statements. Council raises revenue (from rates, user charges, or other sources) to fund its operating expenses including depreciation, as required under the Local Government Act (S.100).

Depreciation Reserves

Within each of Council's activities, revenue is raised to fund the depreciation expense, and the money is transferred to a depreciation reserve for that activity.

These reserves are used to fund the replacement of existing assets at the end of their useful lives. When an asset is replaced (that is, it is not a new asset), it is described as renewal capital expenditure. New capital is almost always funded by loans, but there are many instances where an asset purchase is a mixture of renewal and new capital expenditure.

These reserves are also used to repay debt.

Fully Funding Depreciation

In certain circumstances the effect of fully funding depreciation may result in current ratepayers bearing a funding obligation that could be argued is not entirely fair and equitable. Such circumstances include:

- Where assets have a very long useful life,
- Where assets are relatively young and in good condition, and
- Where major draw-downs against depreciation reserves to fund the renewal of assets are not anticipated.

In these circumstances, fully funding the depreciation expense will result in depreciation reserves accumulating over time. The interest that is earned on the accumulated reserves can then be used to offset the need to fund depreciation in later years.

In order to mitigate this effect, policy has been designed to fund internal debt retirement from depreciation reserves. Further mitigation is also achieved by discounting depreciation for certain activities.

Discounting of Depreciation Funding

Discounting depreciation funding recognises the future interest revenue earned by the depreciation reserve balance that will accumulate under the above circumstances where assets have very long asset lives. The funding requirement in early years is adjusted downwards so that current ratepayers are not disadvantaged compared to future ratepayers. This results in improved inter-generational equity.

Discounting depreciation funding reduces the extent to which operational expenditure needs to be funded. However, the reduced revenue stream means that Council will have reduced internal funding sources and therefore will have increased external borrowing requirements.

Vested Assets

When a subdivision development is completed and a compliance certificate issued, infrastructure assets contained in the subdivision are vested to Council by the developer. Council owns the asset and hence must fund the depreciation on these assets.

5. POLICY STATEMENT

5.1. Funding Depreciation

Council will, in each financial year, fully fund depreciation to the extent of the LTCCP/Annual Plan and Budget to recognise the consumption of economic benefits embodied in the asset, except where discounting occurs.

Council may discount the funding of depreciation if the Group Manager: Business Services considers it appropriate having considered:

- The remaining asset lives;
- Condition of the assets;
- Extent of existing depreciation reserves.

Where the funding of depreciation is discounted, Council will make up the funding shortfall for the activity from future interest earned on depreciation reserves.

Council recognises that it will have to carefully manage depreciation reserves for activities where discounting has occurred to ensure that the level of discounting is appropriate.

The source of an asset is not relevant when considering the funding of depreciation. Vested assets will therefore be treated the same as any other Council-owned asset.

5.2. Use of Depreciation Reserves

Revenue collected to fund depreciation will be retained by the activity and utilised to

- fully fund the replacement of existing assets at the end of their useful lives, and/or
- repay debt (in accordance with the Debt Retirement Support Policy).

Council will ***generally*** maintain sufficient balance in each activity's depreciation reserve to allow the replacement of the activity's assets.

In determining what constitutes a 'sufficient balance' for an activity, Council will consider:

- the total value of the activity's fixed assets,
- the mix of assets held by the activity, and
- the projected useful lives of those assets.

Balances held in depreciation reserves will earn or pay interest which will be paid into or deducted from the reserve on a monthly basis.

Depreciation reserves may be permitted to become overdrawn, but only if:

- the depreciation reserves will be overdrawn for a short period (3 years); and
- there is strong evidence the reserve will be returned to and maintained at a positive position thereafter.

At any particular point in time, balances held in depreciation reserves do not need to be supported by actual cash reserves. Balances held in depreciation reserves may be loaned to other Council activities (refer to the Treasury Policy).

Where the depreciation reserves of an activity have been fully utilised, Council will use external borrowing to fund any remaining loan requirements for renewal capital expenditure.

6. RELEVANT DELEGATIONS

The Group Manager: Business Services has delegated authority to assess when discounting of depreciation funding should occur.

The Chief Executive has delegated authority to implement this policy, but may sub-delegate any aspect to the Group Manager: Business Services.

7. REFERENCES AND RELEVANT LEGISLATION

Treasury Lead Policy.

Debt Retirement Supporting Policy.