Background

11.001 The Local Government Amendment Act (No. 3) 1996 enacted a new requirement that operating revenues in any financial year be set at a level adequate to cover all projected operating expenses (section 122C of the Local Government Act 1974). While councils have traditionally ensured that the majority of operating expenses are covered by revenues, for the first time councils were required to cover depreciation too. This is why public debate has focused on depreciation, and why we address the issue here.

11.002 In our report to the House last year,[1] we indicated that some of the exemptions to the requirement to fund depreciation were difficult to understand. The full impact of the legislative requirement has only recently become apparent. This was because councils did not have to make provision for the funding of depreciation until their 1999-2000 annual plan. As a result, during the period late-1998 to early-1999, councils grappled with the ramifications of the requirement as they prepared their annual plan.

11.003 Auditors sought our advice as to how they should react to any breaches of the legislation. We needed to ensure that our reporting practices clearly identified those situations where the failure to fund depreciation was going to have an ongoing or significant impact on the community. We considered the various issues surrounding the funding of depreciation in late-1998 and, after extensive consultation with the local government sector, released a policy paper in January 1999. Our policy paper was written for auditors, but was also made available to local authorities so that they were aware of the criteria the auditors would be applying.

1 *First Report for 1998*, parliamentary paper B.29[98a], pages 69-78.

Why Fund Depreciation?

11.004 A range of reasons exists as to why depreciation should be funded. These reasons include:

- to provide funds for the replacement of assets;
- to facilitate inter-generational equity;
- to achieve economic efficiency aims (such as "the level playing field"); and
- to ensure that the users of the service pay the real cost.

11.005 When drafting our policy, we tended towards the latter as the primary reason, while at the same time acknowledging that elements of the other reasons may have been considered when councils were making decisions about revenue requirements.

At What Level Should the Funding of Depreciation Test be Applied?

11.006 Again, we face a range of possibilities. The test could be applied by asset, group of assets, function, significant activity, or at the council overall level.

11.007 While section 122C of the Local Government Act indicates that the test might be by council overall, section 122O requires that funding policies be adopted by function. In contrast, the annual plan (and annual report) is prepared by significant activity, and the audit focus is therefore on activities.

11.008 From a practical perspective, we have advised auditors to focus on significant activities but, where there is evidence that an individual function at a lower level is at risk, they may find it necessary to do further testing. For example, where a council has water, wastewater and stormwater as a single significant activity, while that significant activity may overall be funded, there could still be a risk that one element (such as stormwater) is not being fully funded. This could have an ongoing impact on the community.

11.009 We are aware that many councils when preparing their 1999-2000 annual plan had less than perfect information on their infrastructural assets. For many, their asset management plans are likely to be far more comprehensive later in the year, in time for their 1999 annual audit. This was seen as an issue for one year only – annual plans for future years will generally provide a much better guide to the true costs of councils.

What Options Does the Auditor Have in Relation to a Breach?

11.010 The Audit Office has no discretion to ignore breaches of the legislation. As a first step, we would expect a council to explain to its community why it has deviated from the legislative requirement. In some cases, the explanation by the council would be sufficient disclosure. However, if the breach is sufficiently serious in our view, we may take the issue further by either drawing attention to it in the audit report or qualifying the audit opinion.

11.011 It was important for us to give guidance to auditors as to how to assess the impact on the community. This involved assessing whether or not the assets were providing critical/essential community services. For example, for assets which have a significant ongoing impact on the community, the auditor would ensure that any negative impact was clearly reported to the community. This is likely to apply to assets such as stopbanks, and water, wastewater, and stormwater systems. Only if the auditor felt that there was a risk that the community would be seriously disadvantaged (for example, possibility of system failure), or if the council explanation to the community was misleading, would the auditor need to take further action.

11.012 For community assets of a non-strategic nature, providing that the council has been transparent about the issue, has consulted its community, and has obtained community buy-in through the annual plan process, it is unlikely that the auditor would pursue the issue. For those assets, disclosure of the breach in the council's annual plan would be sufficient.

11.013 For roading the issue was more complicated, as Transfund New Zealand currently funds its share of maintenance and capital works but does not fund depreciation. Our view is that, while we expect councils to fund their own share of depreciation, it would be unrealistic to expect councils to also fund the share it can reasonably expect to be met in the future by Transfund. Providing that the community has been consulted and is aware of the impact of any such funding shortfall, no further comment would be made by the auditor.

Ongoing Issues

11.014 When calculating the impact of funding depreciation, a number of councils have plotted the future costs of replacing components of the assets and maintaining the system over the life of the asset, and have then compared that to the amounts provided by funding depreciation. In many instances, councils that fully fund depreciation would have significant cash surpluses for a number of years.

11.015 One example brought to our attention was a water supply for a relatively small rural township. At the end of 20 years, a cash surplus of approximately $500,000 would have accumulated – being the difference between the amount funded by way of depreciation and the amount used to replace components of the network. Most of that $500,000 would not be required for a further 30 years.

11.016 Councils are questioning the need to build up such huge cash reserves. While a council would be free to use those reserves for other activities (and that would be reasonable as an internal banking arrangement), to use those reserves to subsidise other activities would run contrary to the funding policies the council has adopted.

11.017 The impact of the requirement to fund depreciation will need further analysis for the 1999-2000 annual audit planning round.