

## **EXTRACT FROM CIPFA 2002 DISCUSSION PAPER – THE ROLE THAT DEPRECIATION COULD PLAY IN LOCAL GOVERNMENT FINANCE**

### 1 EXECUTIVE SUMMARY

1.1 Depreciation is defined in accounting as the measure of the cost or revalued amount of the economic benefits of a long life asset that have been consumed during the period.

#### **In the private sector**

1.2 Depreciation is an accepted mechanism for private sector companies. This means that in the private sector a company should make the following assessment when determining whether to acquire fixed assets:

- (a) the company will not be constrained by the need to resource the asset immediately, since it will not be required so to do
  - (b) an investment appraisal will be carried out to confirm that the assets will make an acceptable contribution to the company's profits within the desired timescale
  - (c) if the appraisal is favourable, the company will plan its capital expenditure based on assessments of the future affordability of depreciation charges that will be charged to profit and loss accounts over the assets' useful lives
  - (d) the company must also look at the cash flow implications of the capital expenditure to ensure that it will have cash available to meet all cash outgoings – where there is a shortfall, then borrowing will be required and the company will have to assess the affordability of the consequent interest payable from profits
  - (e) if borrowing is necessary at any time, the company will assess whether its overall level of debt is acceptable.
- 1.3 Depreciation guides investment decisions over the whole life of a fixed asset by requiring an assessment of the ability to generate

income to cover the rate at which the economic benefits inherent in the asset will be consumed.

- 1.4 Generally accepted accounting practice requires that resources are retained within the business through the charge for depreciation made to the profit and loss account to cover the cost of using up the economic benefits of assets. However, it does not require that the particular resources so retained are either applied or set aside to the particular asset(s) concerned, to capital expenditure generally, or to the repayment of debt. Managerially, the company is required to manage its resources in aggregate, and will very quickly get into trouble if it does not meet its on-going commitments.

### **Historical cost and current value bases for depreciation**

- 1.5 There are two primary bases for measuring the economic benefits consumed by an organisation in its use of assets: the historical cost basis and the current value basis.
- 1.6 Under the historical cost basis, assets are initially recorded in the balance sheet at their historical cost, and at historical cost less depreciation thereafter. Depreciation then spreads the cost of the asset over its useful life. This is a relatively simple process. Also, for fairly short life assets, the values recorded in the balance sheet throughout their lives are probably not materially different from their intrinsic economic value. However, for very long life assets such as buildings, if they are recorded in the balance sheet at historical cost less depreciation, over time the values shown in the balance sheet will diverge from their value to the business, because of increases in property values.
- 1.7 Many private sector companies do use the historical cost basis for depreciation. However, they are able, under generally accepted accounting practice, to adopt a policy of regularly revaluing assets at their current value, ie their worth to the business at today's prices. Depreciation is then calculated using the current value of assets. In this case, depreciation represents the real cost of the economic benefits consumed during the year. As the real cost at today's prices is almost always greater than the historical cost, the cumulative effect of the depreciation charges on the current value basis will be to generate more cash than would be needed to cover the original

outgoing. It also relates directly to long term sustainability, because the cost of any replacement asset at the end of the original asset's life will also have risen.

- 1.8 In the private sector, companies can choose whether to use the historical cost or the current value basis, so long as they apply their choice consistently. In the public services, most assets are now required to be valued at current value.

### **Applying a depreciation model within local government**

- 1.9 The assessments outlined in paragraph 1.2 above have close congruencies with the fiscal rules for government spending especially in ensuring that the costs and benefits of public expenditure are shared fairly between generations:

- (a) the golden rule: over the economic cycle the Government will only borrow to invest and not to fund current expenditure; and
- (b) the sustainable investment rule: public debt as a proportion of national income will be held over the economic cycle at a stable and prudent level.

- 1.10 This report argues that, bringing the fiscal rules and generally accepted accounting practice together, local authorities could in future work to the following framework:

- (a) authorities would not be required to justify their capital expenditure plans in terms of the resources available in the year investment is to take place, but would be able to consider the financial consequences over the life of the assets to be acquired
- (b) investment appraisals would be performed to confirm value for money, with all options being able to be judged equally on their whole life implications, in contrast to the current system that focuses exclusively on the implications at the point of investment
- (c) if the appraisal is favourable, the authority would schedule its capital expenditure based on assessments of the future

affordability of depreciation charges that would be charged to revenue accounts over the assets' useful lives

- (d) central government/devolved administration influence on local authority capital investment could be exercised through revenue support for such investment
- (e) the authority would consider the cash flow implications of the capital expenditure to determine whether at any time it would need to borrow to cover the cash outgoings necessitated by the investment. Where there is a shortfall, then borrowing will be required and can be taken out in accordance with proper practices for treasury management. The authority would have to assess the affordability of the consequent interest payable from revenue accounts
- (f) where borrowing would be necessary, the authority would assess the prudence of its overall debt burden, including in the event of an unfavourable change in economic circumstances.

1.11 The benefits of depreciation accounting can only fully be realised in this framework if generally accepted accounting practice is implemented without constraint. For example, allowing depreciation to be an absolute charge that impacts on financing allows the impact of capital investment to be judged equally against alternative spending options. If a company has a building that requires increasing amounts of repairs and maintenance to keep it standing, a proper judgement can be made of maintaining the property against the alternative costs of demolishing and rebuilding. The company would not have to make separate judgements about what it could afford from its discrete revenue and capital budgets but about the affordability of the resources consumed in any year as expenses in the profit and loss account.

1.12 It is, however, recognised that there are other pressures that have led the government to indicate that it wishes to maintain the current revenue/capital resources divide for local government. Indeed, local government might also prefer to retain this split, at least in the medium term. Policy reasons for retaining this would include:

- (a) local government expenditure impacts on both local and central taxation and the government may wish to continue to have a direct impact separately on the effects of revenue pressures and of capital pressures on taxation
- (b) a concern that capital investment continues in the face of pressures for increased support for day-to-day expenses
- (c) a concern that over the medium term, not borrowing is only for a capital purpose.

1.13 Therefore, two general options for keeping a revenue/capital divide whilst moving further towards generally accepted accounting practice in the short term are considered in this report:

- (a) a reserve option – controlling the resources that authorities generate from depreciation charges
- (b) a cash balance option – controlling the cash that authorities generate from depreciation charges.

Details for both these options are given in the report.

### **Issues of affordability and the possibility of a phased introduction**

1.14 The introduction of a depreciation model within local government would have a very significant impact in terms of the need to generate resources. Currently, depreciation is charged within the service accounts of local authorities, but this is in effect reversed out of the accounts prior to establishing the annual financing requirements for the authority, and replaced with the statutorily determined minimum revenue provision (England and Wales)/loans fund repayment (Scotland). There is one exception to this currently: for the HRA in England, depreciation equal to the major repairs allowance for the authority (calculated as part of housing subsidy) is charged to 'the bottom line'.

1.15 Therefore full depreciation accounting would have huge 'bottom line' impact. This would need to be taken into account by national government and devolved administrations during

spending reviews, and by local government during budget setting.

- 1.16 If it is desired to gradually phase in the requirement for local authorities to charge depreciation to the bottom line, then this would be possible technically. The easiest way of phasing in the depreciation charge would be through the reserves option described in chapter 7, by means of additional journal entries between the appropriations section of the consolidated revenue account and reserves, in order to limit the impact on the bottom line of the local authority.
- 1.17 However, it must be recognised that, because of statute with respect to capital finance, local authorities are currently not retaining sufficient income to cover the real costs of the using up of capital assets. Any phased introduction would perpetuate this situation, albeit to lesser extent than is currently the case.

**Links with the prudential code, government fiscal strategy and the whole of government accounts process**

- 1.18 There are a number of other factors that, together, support the further consideration of applying full depreciation accounting to local government accounts.
- 1.19 A new prudential framework for local authority capital investment has been announced for England, Wales and Scotland. Under the prudential framework, local authorities will be responsible for deciding how much they can afford to borrow, drawing on a prudential code that is being developed by CIPFA. The prudential code will require local authorities to consider the short and medium term affordability, and the long term sustainability of their capital investment. The prudential code is being designed to be operable within a number of different support mechanisms. However, full depreciation accounting, which requires the charging and resourcing of depreciation, would have a particularly good fit with the prudential code and prudential framework. This is because full depreciation accounting is specifically designed to charge to the revenue account the economic benefits that are consumed by the using up of fixed assets.

1.20 Depreciation accounting also has a synchronisation with the government's fiscal strategy. In particular, depreciation has an explicit role to play in the operation of the golden rule, because the government defines the current budget as the difference between current receipts and current expenditure including depreciation.