DATE: June 28, 2004

TO: City Council Colleagues

FROM: Mayor Bern Beecham, and Council Members Kleinberg, Mossar and Ojakian

SUBJECT: Accounting for Depreciation in the Operating Budget

Recommendation

We recommend Council direct Staff to bring to the Finance Committee a discussion of whether and how Palo Alto should include explicit depreciation expenses in our Operating Budget. This discussion should be scheduled so that subsequent policy decisions by Council can be implemented in the next two-year budget.

Discussion

Our Operating Budget is presented in a form that is consistent with all standard accounting practices for local government. These standard practices do not call for including depreciation in the Operating Budget.

Depreciation represents the decline in value, or consumption, of assets including infrastructure. Standard accounting practices for private corporations require depreciation be recorded as an expense in corporate income statements. This expense directly affects profit/loss (surplus/deficit) and indicates whether the corporation is drawing down its resources without replacing them.

We should know at what rate we are consuming our infrastructure. We should be sure we are setting aside adequate funds for maintenance and replacement.

Palo Alto has been progressive in the development and presentation of our budget. We have been at the forefront of implementing the latest accounting standards (GASB 34). We have doubled our annual capital expenditures over the past five years and have committed $40 million to general fund capital projects in the past four.
Even with these accomplishments, we have had no way to comprehensively quantify the funds needed for ongoing support of our infrastructure during our budget discussions.

Private corporations use a somewhat different set of accounting standards than local governments. Corporations must record depreciation of assets and deduct that amount from revenues in order to calculate their bottom line. Financial institutions and investors demand this in order to accurately determine whether the corporation is genuinely balancing its books.

Recent GASB 34 standards specify for the first time that we calculate depreciation of all our assets including infrastructure. The statement of activities in the City’s Comprehensive Annual Financial Report includes this depreciation expense. In addition, our new SAP software can track the value of our assets over time. This tool provides the opportunity to evaluate revenues, expenses and transfers to our capital fund so as to better understand whether our Operating Budget is balanced once depreciation is factored in.

In discussions with staff, relevant issues need to be defined and understood in order to present in our next Operating Budget a full assessment of depreciation.

We ask for our colleagues’ support of this recommendation in order to give us a better understanding of how our assets and infrastructure are consumed and how to adequately fund their renewal.