

## Towards “Fair” Asset Management

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### Abstract

Asset management is not the sole responsibility of the asset manager but instead should have input from planners, accountants, valuers and auditors.

Planners will assist asset managers in matching the service levels of the asset management plans to the community requirements.

Accountants and valuers will ensure that the infrastructure assets are reflected fairly in the Councils financial statements. A fair value for the assets in the balance sheet allows the ratepayers to assess the worth of the Council. A consumption based depreciation ensures the users of the asset are paying their fair share.

Auditors will enforce transparency and consistency by ensuring that the financial requirements of the asset management plans are represented in the financial planning, budgeting and strategy documents.

The challenge for the asset manager is to draw the other parties into the asset management philosophy and approach. This will require the asset manager to adopt an open and inclusive approach within the executive team.

### Introduction

“Local Government infrastructure should serve the needs and priorities of the community within the agreed role of local government. Such infrastructure should be of satisfactory standard in terms of providing services in a relevant function, safe, reliable and cost efficient manner.”<sup>1</sup>

I would like to propose that the achievement of this statement is not the sole responsibility

of the Asset Engineers. Infrastructure asset management is no longer just the realm of asset managers but should also involve planners, accountants, valuers and auditors to provide for a holistic approach.

### Asset Management

To understand the proposition we need to be clear on our definition of asset management.

Infrastructure asset management is the process of creation, acquisition, maintenance, operational rehabilitation and asset disposal to ensure the assets provide the agreed level of service, to present and future customers.

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<sup>1</sup> Are Councils Sustainable? – Independent Inquiry into the Financial Sustainability of NSW Local Government. March 2006

Asset management planning is the physical identification and description of the assets, determination of the service levels of the assets, development of the understanding of the condition of the assets and the systemic monitoring and analysis of the asset performance. All these functions are encapsulated within an “Asset Management Plan”. An Asset Management Plan is usually developed for a class of assets based on the functional aspect of the assets, with similar assets grouped together.

### Service Levels

Asset management starts with determining the service levels that are to be provided by the assets.

It is critical that the service levels are reflective of the community requirements and not just the asset manager’s desires. The most appropriate way to understand service level requirements is to involve the community in the service level determination.

Service levels will vary within each community and change with the changing demographics and economic state of the community. In addition to understanding the current user’s needs, the future needs of the community must also be forecast. Communities requirements may be significantly affected by the external influences such as facilities offered by other communities and the function their multiplicity plays within an overall region or area, such as either a service town for a wider rural community or transport corridor in a large urban area.

Therefore it is critical that planners are involved to assist the asset managers in understanding and planning. The inclusion of planners will also assist in ensuring Councils strategic documents are consistent with the Asset Management Plans.

Achieving community involvement to determine these service level drivers is an easy statement to make. However, as most Councils’ have experienced, it is difficult to get community engagement unless they can realise the tangible impact to them. Like

everyone in our consumer society, the impact will be only understood if explained in two dimensions – what are the services and facilities available for use (and what state they are in) and how much it will cost to maintain the assets at this level. Hence the “cost” is a critical dimension to asset management.

### Expenditure

For asset managers, the challenge is to translate the service levels into the operational, maintenance, renewal and new work requirements in a manner that is consistent and fair.

The four aspects of expenditure are outlined below:

**Operational:** These are the day-to-day operational activities that have no affect on asset condition but are necessary to keep the asset appropriately utilised and operating.

**Maintenance:** This is either the planned or unplanned expenditure required to ensure existing levels of service are met and includes other expenditure on the asset that is not capital expenditure.

**Renewal:** Renewals work consists of either rehabilitation or replacement. Rehabilitation is the re-instatement of the structural components of assets to ensure that required levels of service are met and the prolonged asset life is achieved. Replacement is the disposal and substitution of an asset with an equivalent or enhanced standard asset.

**New Works:** New work is the creation of a new asset that did not exist previously or the expansion or increase in the existing asset beyond its original design capacity, size or service potential.

The two questions in regard to expenditure are “what is the appropriate level?” and “how should it be funded?”.

The driver for deciding the “how much” is a outcome of the service levels. The decisions around service level and consequent replacement and renewal should be detailed

in the Asset Management Plan by the asset managers.

## Funding of Expenditure

The “how should it be funded” question must be considered in context type of expenditure.

Operations and maintenance expenditure is the part of the annual operating budget and should be funded from General Revenue.

The funding of renewals and new work is more complex as Council must consider the intergenerational funding consequence.

Loan funding or borrowing is an appropriate source of revenue for the acquisition of new infrastructure. The repayment of the loan and servicing of the debt should met by Councils operating surpluses. This is usually achieved by the funding of the depreciation. That is the depreciation is included as an expenditure item in the total expenditure that Council must fund. The revenue inflow is assigned to repay the principle and interest of the loan. This process ensures the appropriate distribution of cost as the current and future users are paying for the debt and debt servicing costs. The process assumes that when the asset requires replacing, a new loan will be raised to fund the new asset.

Renewals creates a more complex debate. Based on the same premise as above, the depreciation should be treated as expenditure in the operating statement and be set aside for the repayment of the loan raised to create the asset.

However within NSW, the majority of expenditure on renewals is related to infrastructure that has been in place for some time. Due to Councils traditional policy of limited or no debt, the loans raised in the past for the creation of infrastructure have been repaid through past operating surpluses. That is they have been paid for by the past generations.

The funding for renewals depends on the type of the renewal. If the asset has reached the end of its useful life and the renewal is either the rehabilitation or replacement of the

asset, then new loan funding should be raised and the cost of servicing the debt met over the life of the asset via the depreciation charge. This allocates the funding cost to the present and future users.

However, currently many Councils are finding that the renewals expenditure is to address the “backlog” of renewals. This is renewal expenditure created from deferred maintenance, and is now required to be spent to bring the existing asset up to service level. Borrowing to fund this backlog does not provide for financial sustainability as the future ratepayers are paying for the past deferred expenditure (which should have been paid for by past generations) and for their share of the consumption of the current asset. This is one of the issues that Council’s are currently grappling with in relation to achieving sustainability.

The policy for funding of infrastructure asset expenditure, both operating and capital, should be agreed and stated within Councils Strategic Plans and Financial Policies. It is important that the asset managers ensure that the accountants understand the implications and apply the correct funding mechanism for the expenditure.

Finally it is critical that the expenditure requirements from the Asset Management Plans are translated into the Annual and Management Plan budgets. Often there are two sets of figures – the expenditure required (asset managers view) and the expenditure that can be afforded (the accountants view). The asset managers must involve and work along side the financial staff to ensure the synergy of expenditure and funding that is reflective of the Asset Management Plan requirements. This “trade-off” is a critical debate to be had when the asset management plans, budgets and financial plans are being prepared. A lack of

integration between these documents can not continue.

## Depreciation

As mentioned earlier depreciation is the funding mechanism for asset replacement

and therefore it is critical that the correct amount is applied.

Depreciation is the systemic allocation of the depreciable amount of an asset over its useful life, in other words it is used to allocate the decline in service potential over the life of the asset. The purpose of depreciation is to ensure that consumers of the assets pay their fair share.

Traditionally accountants and the asset managers differ on what is depreciation. The consumption (asset manager) depreciation is that it should be the decline in the service potential of the asset. However accountants have previously focused on the allocation of the cost over the life of the asset (straight line depreciation). But with the increasing focus on asset management and the introduction of the AASB 1041 and AAS10 – Revaluation of non-current assets standards, the accountants view is being replaced by the asset management consumption approach.

## Valuation

The standards allow for assets to be carried in the books at cost or “fair” value. The question becomes how is fair value defined?

Traditionally Councils have carried assets at cost and this has had two significant impacts. The depreciation has been calculated on a straight line based on generic useful lives resulting a charge that is not reflective of the amount that is any reflection of the consumption of the service potential of the asset.

Secondly, the value on the balance sheet is not reflective of the “fair” value of the assets. It does not provide the ratepayers with a indication of the worth of the infrastructure and therefore they cannot judge if the Council is increasing the worth of the community.

The accounting profession has recognised that fair value can not always be clearly defined and have accommodated this by the use of a hierarchy of options which have been adopted in the International Financial Reporting Standards. This hierarchy is outlined below:

**Market Evidence:** This is the willing seller, willing buyer situation. This is particularly relevant for property. However, much of Council’s infrastructure is of a specialised nature that is not of the form that can sold on the open market.

**Cashflow:** Next hierarchical option is discounted cashflow. This assumes that the asset is generating a reasonable cash return. Again, although Council infrastructure often does generate a return, it is at a less than optimal rate to reflect the provision of a community service.

**Optimised Depreciated Replacement Cost:** The final option for determining fair value is the Optimised Depreciated Replacement cost. The majority of Councils assets are valued under this approach which is the same as the approach supported by NAMS NZ.

ODRC is the current gross replacement cost of the improvements less allowances for physical deterioration and optimisation for obsolesce and the relevant surplus capacity. ODRC should include the fair value of any land the asset resides on.

There are three components to the definition: replacement cost, optimisation of the asset, and the depreciation of the asset.

The replacement cost is the cost to replace the asset with an asset of similar design and performance in today’s market. This means that Council will need to understand the components of the asset and be able to determine fair market rates for these components.

To understand the second component we need to clarify the terms used. Obsolesce is the outmoded design. Relevant surplus capacity is the excess capacity that is not currently used and there is no reasonable prospect of use. Therefore to determine ODRC you need to be able to assess the assets performance against its service level to determine relevant surplus and obsolesce. This brings us back to the initial statement that the starting point of asset management is to determination of service level.

The final component is depreciation.

Depreciation is calculated by:

fair value x remaining useful life

useful life plus residual value.

The useful life assigned to the asset can significantly affect the depreciation calculation. Useful life should be specific to the particular asset or at least the major asset class. Factors such as design standards, construction quality, material quality, operational stresses, maintenance practices and history, asset working environment and, external stresses should be considered. Economic life factors such as demand impacts (service levels), legislative and environmental standards, regulatory restrictions, technology redundancy should also be considered.

The assessment of three components can be a complex task. Many asset managers are fully engaged in the operational asset management and do not have the time to perform such assessments. Therefore it is often appropriate for asset managers to employ the assistance of infrastructure valuers to provide the technical expertise.

### **The “fair” asset value**

Asset information on operational, maintenance, renewals and new works expenditure and funding, plus depreciation are core components in the Councils Long Term Financial Strategy.

The use of a “fair” value of the assets in the financial statements, in conjunction with the asset management plans, provide the community with an assessment of the worth of the infrastructure that they are being asked to fund.

The ‘fair’ allocation of the consumption of the asset in the terms of funded depreciation will assist the Council to provide sustainable asset management for current and future community’s.

This can only be achieved if the asset managers work with the planners, valuers and accountants to ensure they understand and apply the asset management concepts.

### **The future**

In New Zealand, the Local Government Act 2002 drove the adoption of the approach of recording assets at fair value and accounting for depreciation on a consumption basis. The Act also required clear linkage from the asset management plans into the financial statements of the Long Term Community Consultation Plan (LTCCP) which incorporates the financial budget for the next ten years.

The production of the second round of LTCCP’s has just been completed for adoption in July 2006. These plans have been audited by the Officer of the Auditor General and the preliminary commentaries imply that the linkage between the asset management and the financial statements is still weak. In particular the level of service defined in the asset management plans is often not the level of service funded in the LTCCP.

Hence the final party that should be involved is the auditor who can verify that the Council has delivered an integrated asset management “fair” value in its financial statements.

### **Summary**

I believe asset managers have three key challenges ahead that they must address as part of the senior management team of Council.

Firstly they must ensure that community driven service levels are incorporated into the asset management plans.

Secondly they must ensure that the infrastructural assets are recorded in Councils financial statements using a “fair value” methodology.

Thirdly they must ensure that that the financial requirements in the asset

management plans are integrated into the financial budgets.

To achieve these challenges, asset managers must act as leaders to facilitate the planners, accountants, valuers and auditors working together. Asset managers will need to draw the other parties into the asset management philosophy and approach to provide holistic asset management.

## References

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## Author



**Julie Clausen** has considerable experience providing both strategic and operational financial advice to Local Government. As the manager of the financial team and business leader for revenue and rate funding of a large Regional Council, Julie has developed an extensive knowledge of Local Government financial requirements. Julie was a member of the working party that developed the Local Government explanatory “Knowhow Guide” at the introduction of the NZ Local Government Rating Act (2002). As a consultant she has assisted Councils, both in New Zealand and Australia, with financial strategy and funding policy development, and in particular the development of Long Term Financial Strategies.

In previous roles that cover industry, service sector and central government, Julie has lead a number of key initiative projects including the design and implementation of corporate service functions, capital investment evaluations, financial modeling, budget design and implementation and information system evaluation and implementation. She has facilitated and project managed a number of cross organisational teams established to promote and implement improved business processes and systems.