Public Expenditure Management Peer Assisted Learning

Select Issues with Asset Management

Mark Silins, TCOP Expert

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Definition of Assets

- **An asset is a resource controlled** by the entity as a result of past events and **from which future economic benefits** are expected to flow to the entity
- This could be in the form of future cashflows or **in terms of services** (not-for profits)
- **an asset shall be recognised if, and only if:**
  - **(a) it is probable that future economic benefits associated with the item will flow to the entity; and**
  - **(b) the cost of the item can be measured reliably.**
- **Control** is a key determining factor in recognising assets – Public Private Partnerships (discussed later)

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Practical Implications of the Definition - Land under Roads

- A Road is an infrastructure asset and the land under the road is also an asset
- What is the value of the land under a road?
  - The cost at acquisition? – for a new road this could be the cost of the land acquisition
  - Fair value? – how to measure fair value?
  - One option used is to determine the value of equivalent undeveloped land in proximity to the road (NSW)
  - What happens to the land once it is part of a road? Can it be converted for other use?
  - Would you consider it impaired, that is, the carrying value is higher than its recoverable value?

Practical Implications of the Definition

- Australian Accounting Standard (AAS) 1051 indicates that land under roads is an asset. It is therefore subject to the same assessment criteria of other fixed assets
- There is a debate however as to whether its value can be reliably measured
- What this illustrates is the complexity in determining fair value in this situation and the risks to decision making if the values are materially incorrect
- Infrastructure Assets present an interesting balance sheet challenge for governments (this is discussed later under Fair Value)
- PPPs are also another interesting challenge regarding the definition of assets relating to the concept of control

Classes of Assets

Financial Assets

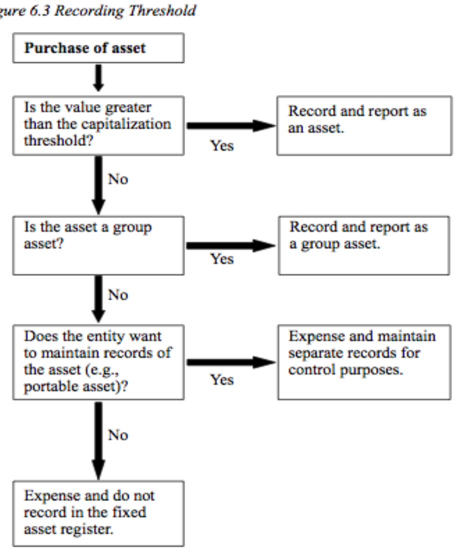
- Cash and cash equivalents
- Revenues receivable
- Loans and advances to other governments
- Other loans and advances
- Investments
- Derivatives

Non-Financial Assets

- Inventories
- Heritage assets (*not compulsory under IPSAS*)
- Property, plant and equipment
- Infrastructure assets
- Military assets
- Investment properties
- Biological assets and agricultural produce
- Intangible assets

Low Value Asset Threshold

Figure 6.3 Recording Threshold



Low Value Assets - Thresholds

- The use of a capitalization threshold reduces the cost of gathering data because it decreases the total number of assets that have to be recorded and tracked financially
- Under this arrangement a decision is made about the materiality of certain lower value assets
- One method sometimes used by entities is to set an initial capitalization threshold (sometimes referred to as the de minimis level)
- This can be determined by targeting a percentage (for example, at least 95%) of estimated total assets by value. The value at which the target percentage is achieved determines whether it is expenses or capitalised
- The approach effectively fully depreciates (expenses) the low value asset on acquisition
- The asset continues to be recorded in the assets register for control and management purposes but does not have a financial value for the purposes of financial reporting beyond the year of acquisition.

Two Options for Presenting Assets in the Financial Statements

Current/Non-Current

- Strengths
  - The usual “for profit approach it is well understood
  - Provides useful ratios for determining performance and risk
- Issues
  - May be less appropriate for government reporting and analysis, given the fact that most of what government does is not focused on profit
  - Most assets by value are not going to provide future cashflows but future service potential

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Two Options for Presenting Assets in the Financial Statements

Non-Financial/Financial

- Strengths
  - Reflects a government's budget structure. NF assets are typically the investment/capital part of the budget while financial assets are primarily focused on financing for the budget
  - It has strong links to macro-fiscal and statistical reporting
  - Provides for a strong integration of GFSM and financial reporting
- Issues
  - Is not aligned with the standard commercial (IFRS) format for reporting

Both options are supported under IPSAS 17

Australia reports both in its Consolidated Financial Statements

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Fair Value - Definition

- This is important because fair value measurement is consistent with both IPSAS and GFSM – but it can be complex
- **Fair value is the price** that would be **received to sell an asset** (or paid to transfer a liability) in an orderly transaction between **market participants** at the measurement date.
- **Fair value is a market-based measurement**, not an entity-specific measurement.
- For some assets and liabilities, observable market transactions and market information will not be available.
- **When a price for an identical asset (or liability) is not observable**, an entity measures fair value using another valuation technique that **maximises the use of relevant observable inputs and minimises the use of unobservable inputs.**

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Principles underpinning Fair Value

- **Valuation techniques** – an entity must use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value
- Valuation techniques include the market approach, income approach and cost approach.
- Inputs to valuation technique.
  - Level 1 based on quoted prices,
  - Level 2 based on other observable inputs and
  - Level 3 based on unobservable inputs.
- The valuation technique selected must maximise the use of observable inputs and minimise the use of unobservable inputs.

NSW Guideline Fair Value

- New South Wales Government (subnational equivalent to an Oblast) has devised a detailed 45 page guideline on determining fair value. It includes specific guidance on valuation for major classes of assets
- While the standards allow revaluation at cost or fair value, NSW is mandating **fair value** to ensure consistency with GFSM (and AAS) for consolidated reporting
- Many assets in the public sector have few or no alternative uses and many infrastructure assets are specialised. Thus it is important to clarify the meaning of 'fair value' for assets with few or no alternative uses.
- Restrictions imposed by government also substantially eliminate alternative uses of assets.
- If alternative uses for assets are not available they should not be taken into account in valuing particular assets, especially specialised infrastructure and the land under them.

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NSW Guideline Fair Value (cont)

- For example, the potential for mining in a designated national park generally should not be taken into account when determining highest and best use. Mining may be physically possible and economically feasible because there is a market for the mineral deposits that are present in the national park. However, mining may not be legally permissible due to the statutory protection of the national park.
- The policy now requires Qualified External Valuations regarding fair value for some assets
- The policy also refers to the **International Valuation Standards Framework**

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Service Concessional Arrangements (SCA)- IPSAS 32- Typical Relationship

- The grantor is a public entity that authorizes the private operator to make use of an asset for providing a public service - eg. toll road, hospital, prison
- The operator is a private entity (or it could be a State Owned Enterprise) that uses the asset for providing a public service under the supervision of the grantor
- The grantor compensates the operator for the services provided during the duration of the arrangement

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Service Concessional Arrangements- IPSAS 32- Determining Control

- (1) The grantor controls or regulates what services the operator must provide with the asset, to whom it must provide them, and at what price; and
- (2) The grantor controls—through ownership, beneficial entitlement or otherwise—any significant residual interest in the asset at the end of the term of the arrangement

Note:

- For a whole-of-life asset, only (1) is needed.
- The above definition is similar to the concept of "economic ownership" in GFSM 2001
- Two models exist for (SCA) - financing and operating (and a combination of both)

Financial Liability model ("government-funded")

- Initially, the grantor (government) record the asset and an equivalent liability at fair value
- The implication of this is that it will increase the fiscal deficit!
- The grantor accounts as expenses (and cashflows):
  - Asset depreciation;
  - Finance charge (interest);
  - Charges for services provided by the operator
- The grantor accounts as financing: Reduction in liability (repayment of principal)

Grant of a Right to the Operator model ("user-funded")

- Initially, the grantor (government) record the
- asset and an equivalent liability at fair value
- The grantor accounts as expenses:
  - Asset depreciation;
- The grantor accounts as revenues:
  - The revenue accrued during the contract period
- The grantor accounts as financing:
  - Reduction in liability (repayment of principal), equivalent to the accrued revenue in each year
- Note: There is no interest or charges for service paid by the government
- Where a combination of financing and the operator model are in place IPSAS 32 requires that they be accounted for separately.

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Recognition

- Does the SCA/PPP meet the criteria of control?
- If yes it should be recognised as an asset and liability
- Define the nature of the concession – financing or operational or both
- Ensure the correct accounting treatment is applied throughout the life of the concession
- Report PPPs separately

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Beyond the Accounting

- Integration of PPPs into the overall budgetary framework is important
- This is an alternative source of financing public goods – thus it should be included in both the budget estimates, the Medium Term Fiscal Framework, and fiscal risk assessments
- For financing PPPs they should be included in overall debt ceilings and targets
- For operational PPPs a clear understanding of the costs and benefits is required
- There is also an issue with PPPs – morale hazard. What happens if the benefits do not materialise eg failure of the partner, lower than estimated cashflows?
- Even if you do not recognise the asset you must recognise the **contingent liability**

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Summary

- Asset recognition has three elements future benefits, control and reliable measurement
- Low Value assets can be fully depreciated on acquisition
- Some countries are choosing to present assets according to a GFSM structure, that is financial and non-financial
- Fair Value ensures that asset valuation aligns with statistical reporting. It also ensures access to a range of valuation techniques which reflect the unique nature of public sector assets –however it can be complex
- PPPs need to be properly managed and recognised in the Balance Sheet where they meet the definition of an asset. At a minimum they must be reflected as contingent liabilities and integrated into the budgetary fiscal framework

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Questions

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