Joint Committee of Public Accounts and Audit

"Review of Accrual Budget Documentation", 22 June 2001

Additional Submission

ASSET MANAGEMENT AND THE CAPITAL USE CHARGE

Emeritus Professor Allan Barton
School of Business and Information Management
The Australian National University

INTRODUCTION

The importance of good asset management cannot be overemphasised. A substantial amount of funds are invested in assets ($116bn, comprising $54.5bn in financial assets and $61.5bn in physical assets, BP10, 2001-02) and the costs of maintaining them are also substantial. Provision of information on assets is one of the major benefits flowing from the use of accrual accounting in the public sector. Beforehand, asset management was a neglected area of public sector administration and many official reports drew attention to it (MAB 1991, 1997; JCPAA 1998; DOF 1994; ANAO 1995-96, 1997-98, 1998; NCA 1996).

ASSET MANAGEMENT IN THE BUSINESS SECTOR

The type of information required for good asset management in the business sector is well known. Asset purchase, retention and use, and disposal decisions are based on the interaction of value-in-use (VIU) and value-in-exchange (VIE), where:

VIE is the current market price of the asset, either its buying or selling price according to whether the decision relates to purchase, or retention v sale of the asset.

VIU is the estimated net cash receipts from future use and ultimate disposal of the asset, discounted back to the present date at the firm's cost of capital. The cost of capital is the capital charge.

An asset is purchased where the VIU • VIE;

- likewise an existing asset is retained where the VIU • VIE;
- and an asset is sold where VIU < VIE.

In the business sector, asset prices are normally readily ascertainable except for specialised custom-built assets. They are inputs into a productive process to generate future net cash inflows for the owner, and wear out over time (except land). Sales

revenue must cover all operating costs, depreciation expense and the cost of capital for the firm to be profitable and survive.

ASSET MANAGEMENT IN THE PUBLIC SECTOR

Asset management in the public sector is much more complex than in the business sector because of the heterogeneous roles of government in managing a nation and the heterogeneous nature of assets used. For example, in the case of heritage and environmental assets, they are not inputs into a productive process but are the ends of public enjoyment etc in themselves; many public sector assets do not produce cash revenues though they incur substantial costs, eg community assets, defence equipment; and the benefits often flow directly to the public as users and not to the government as owner, eg community and heritage facilities. These complications result in many public sector "assets" not complying with the technical accounting concept of an asset as "…future economic benefits controlled by the entity…" (SAC4, para 14).

It is useful to classify public sector "assets" into five categories:

1. assets used in general government administration;
2. economic infrastructure assets used to produce goods and services for sale to the public;
3. man-made social infrastructure assets;
4. natural social and environmental infrastructure assets;
5. military weapons systems.

i. Assets used in general government administration – eg. office equipment, buildings and vehicles. These are the same types of assets as are used in the business sector. They should be accounted for and managed in the same way as normal business assets.

ii. Economic infrastructure assets - eg energy systems, transport systems, water, sewerage and drainage systems. Enterprises in these industries generally have a natural monopoly of service provision because of large economies of scale and the need to service geographic regions. They generally make substantial use of natural capital assets eg. crown land, as well as man-made facilities. Their assets are largely business-type assets but the enterprises are subject to community service obligations, and in many cases, environmental protection considerations. Infrastructure enterprises were formerly largely controlled by governments as

GBEs; many of them have now been privatised but they are generally subject to government regulation and public obligations beyond those imposed on normal commercial firms. Current professional accounting standards are not designed to cover the special issues raised by these industries.

iii. Man-made social infrastructure assets – eg. schools, hospitals, universities, war memorials, art galleries and museums. They provide benefits of a non-cash social nature to the community and not to the government. In many cases they take the form of assets held in trust by government for the nation and are to be protected and preserved for future generations.

iv. Natural social infrastructure and environmental assets - eg. parklands, national parks, river and drainage systems, beaches and native forests. Again these are non-cash generating facilities providing benefits to the public at large and not to the government. Many of them are declared to be assets held in trust for the nation and are to be protected and preserved for future generations.

v. Military weapons systems. These are for use in the event of national conflict, and the non-cash benefits flow to the nation.

The critical assets in categories iii), iv) and v) all result from specific government decisions and should always remain under the control of parliament in a democratic nation. Governments decide to establish schools, museums, community and national parks, defence weapons systems and so on because citizens delegate decision-making with respect to such facilities to government. They are public goods which can be more efficiently and effectively supplied by government than by private firms. Public goods markets have very different characteristics to private goods markets and present accounting standards and rules for asset management have little relevance for them. Decisions about their establishment and disestablishment should not be delegated to public sector managers (bureaucrats) as they must remain as government policy decisions; whereas decision about the purchase, use and disposal of everyday administrative assets are of no concern to parliament and should be delegated to bureaucrats.

Public goods assets cannot be accounted for in the same ways as commercial assets because of differences in the nature of these assets and/or the markets in which they are

used. In many cases they cannot be reliably valued in financial terms because they do not generate cash inflows, they cannot be sold and there are no commercial markets for them. Attempts to place artificial financial valuations on them are misguided – the data are misleading for their good management as they are normally not relevant for their use – purpose, and the financial valuations are not reliable. The application of commercial market values to them, in those cases where similar assets exist, eg. works of art, is not appropriate because of the different end-purpose. Normal commercial asset accounting should be confined to administrative assets used in the public sector (including those used by the defence forces, museums, art galleries and national parks administration), and not be applied to the specialised public goods assets (weapons platforms, museum and art collections, and the national parks etc themselves).

CAPITAL USE CHARGE (CUC) ARRANGEMENTS

DOFA's Guidance Note (2001) outlines the arrangements for the CUC. Briefly, they require that:

- The CUC is payable by Commonwealth agencies on their end of year net assets as a dividend to the Government;
- funding of the charge is based on opening net assets and is included in the agency's budget appropriation;
- the rate is set annually, and it has been reduced from 12% to 11% in the current budget;
- the rate reflects the cost of capital to industry and it is about double the cost of government borrowed funds;
- the charge is not levied on administered assets, amounts of asset revaluations made within the year, and on pre-existing assets recognised for the first time;
- the CUC is an internal allocation and charge in each agency's budget, and it is eliminated in the consolidated budget papers of the Government.

Purposes Served by the CUC

The charge serves three major purposes –

- it forces management to recognise that the funds invested in assets have a cost;
- it enables full costing of service provision;
- it is in accord with National Competition Policy and it requires that agencies include the cost in their bids where service provision is subject to competitive tendering from external suppliers so as to ensure a 'level playing field'.

These purposes are commendable and the charge should assist in changing public sector management culture towards paying more attention to the need for efficient asset management. It should encourage more rational asset acquisition, use and maintenance policies, and disposal of surplus or obsolete assets. The charge is similar to that used in private markets, where it is referred to as the cost of capital which is used to discount estimated future net cash flows back to their present values. It should promote greater efficiency in service provision by subjecting public sector agencies to competition from external suppliers on a 'level playing field'.

Some Issues Concerning the CUC

Notwithstanding the above potential advantages, the CUC raises some problems and its application can be abused, with negative consequences for efficiency in asset management. These include:

i. The basis and reliability of asset valuation on which the CUC is funded/levied.

Professional accounting standards on asset valuation are vague and lax and evidence from the corporate sector, particularly in the case of company collapses, indicates how these standards are subject to widespread abuse. The situation may improve to some extent in the future as WEF 1 July 2001, asset valuation bases for the public sector are limited to historical cost or fair value, where fair value is a notion of current market value. Asset valuations are important as they impact on depreciation charges and hence profit; and on asset investment and hence measures of financial position and rate of return on investment. In turn, this information influences corporate share prices and the functioning of the capital market.

Where asset markets are not competitive and active, market prices of assets are not readily available and the resultant valuations can be 'soft' numbers. In general, this occurs with those specialised resources used to provide public goods (as outlined earlier in my submission), though prices of most assets used in normal administration are readily ascertainable. Where asset valuations are 'soft' and unreliable, there is scope to manipulate them to suit the agency's financial interests. For example, adopting higher asset valuations increases both the initial funding to the agency of the CUC (which is then invested to generate income for the year) and the annual depreciation charge (which is also funded and invested until the asset is replaced). The agency benefits notwithstanding payment of a higher-than-otherwise dividend on the inflated net assets

at the year's end. This aspect reinforces the case for excluding public goods assets from the CUC.

ii. The CUC can provide an incentive to wrongly dispose of assets during the year.

Because the funding is based on opening net assets and the levy is based on closing net assets, the agency gains funds from the decline in net assets over the year. This incentive is appropriate where the assets disposed of are surplus to requirements. However it could provide an incentive to dispose of needed assets and rent them back under an operating lease (as distinct from a financial lease which has to be disclosed as an asset). This may be an expensive option for the agency over the longer term. Leasing can have cost advantages in some situations, but in others it does not. Each leasing proposal requires a cost-benefit evaluation to ascertain the appropriate decision. Security of use of the asset is also a relevant consideration in evaluating the lease option.

iii. Scope of asset covered by the charge.

Currently the CUC excludes administered assets from its ambit. I would argue that it should be restricted to assets used in everyday administration and it should not include the public goods assets as outlined earlier in my submission as well as administered assets. Hence it should not be applied to general community assets (parklands, sporting ovals etc), heritage and cultural assets (war memorials, art gallery and museum collections), environmental assets (national parks, river and drainage systems, native forests on crown land etc.), military weapons systems, and schools, universities and hospitals.

In the case of all these public goods assets, the decision to provide, expand or curtail them should reside with the government. They all involve questions of public policy, and in a democratic nation, the responsibility for these decisions rests with the government and not with bureaucrats. Governments are elected by citizens to make these collective decisions on their behalf, and they are answerable to the electorate. In contrast, there are no public policy questions concerning the purchase/disposal of administrative assets – these are properly agency management decisions.

Furthermore, governments should be encouraged to take a strategic, long term national approach to the disposal of major assets which are surplus/obsolete for the agency. For example, obsolete military equipment and sites can be important facets of the nation's

history and culture. The Imperial War Museum at the former RAF base at Duxford in England provides a fascinating history of the development and role of aircraft in war, and it attracts large numbers of visitors. The Australian Naval Aviation Museum at HMAS Albatross is a most worthy exhibit of this component of Australia's military history.

iv) The level of the rate used as the CUC.

The rate used, ie. 11%, is about double the cost of borrowed funds to the government, and it reflects the cost of capital to industry generally. The low cost of capital to government results from its taxing powers (which remove bankruptcy risk) rather than from the less risky nature of its investment expenditures. There is no general agreement in economic theory as to whether the cost of funds to government should or should not include this substantial risk premium in the analysis of the costs of government (Fleming and Mayer, 1997; Brealey *et al* 1997). But in any case it should be noted that the inclusion of the commercial risk premium in the rate introduces a large non-cash charge which is a fictional one.

v) The artificial nature of the arrangement.

In the context of the Commonwealth budget, the arrangements adopted can be characterised as a pea and thimble trick – the funds are provided to the agency up front and then taken back at the year's end, subject to some adjustments to the level of asset holdings over the year. Such accounting tricks can backfire if abused and cast doubts over the integrity of the accounting information systems. They can encourage management to focus on maximising their gain from the CUC rather than on good asset management over the long term (see i) and ii) above). They can give the impression that, like private firms, agencies are aiming to maximise their profits. Many citizens would object to this notion of government agencies striving to generate profits rather than serving the public interest, and particularly so in those agencies providing public goods. For example, it raises the question of the distinction between the nation's defence forces and a bunch of profit-seeking mercenaries.

In reality, no simple rule can lead to good asset management in the public sector. Asset management must be related to the roles of government and the purposes to be served by the assets. A long term, strategic approach must be adopted. I strongly endorse the approach outlined in the ANAO's Asset Management Handbook (1998). The CUC should only be used as a guide to the management of administrative assets within the set

of principles outlined in the ANAO Handbook. An alternative and simpler mechanism for providing incentives to dispose of surplus assets is to allow agencies to retain the funds realised up to some prescribed limit. However this mechanism also has limitations in that there can be significant externalities or synergies which impact on other agencies, eg. location, compatibility of office equipment and information systems. In all cases, management must remain cognisant of the internal opportunity cost of using scarce capital funds on this project or that project. Recognition of the opportunity cost of funds forces management to rank proposed projects in order of priority until the budget is exhausted.

vi) The CUC and competitive neutrality.

Competitive neutrality is an appropriate principle to apply where the options exist of internal v external outsourcing of service provision. In general, the commercial cost of capital rate is the appropriate one to use in measuring the cost of internal service provision so as to facilitate competition on a level playing field. However this rate should be applied only as an average target rate. Private suppliers can readily undercut internal provision in the knowledge that agencies are required to use an 11% profit margin on net assets. They can engage in pricing policies which verge on being predatory and knock out the ability of the agency to provide the service later on. At subsequent rounds of tendering, the agency remains at the mercy of the market. Private suppliers do not use a standard profit margin in seeking new business – their margins vary over a wide range according to market competition in each product at the time. As well, private suppliers can use a high proportion of debt funds on which interest expense is tax deductible, with the result that their cost of capital after tax lies far below 11%. Thus, the playing field for agencies may not be a level one with the imposition of an 11% CUC.

Furthermore, it is not necessary to include a CUC in the accounting information systems of agencies to bring about competitive neutrality. Private firms do not do so – rather, they add a profit margin outside the accounts to their estimated costs.

Conclusion

A CUC can have merit if it is used intelligently within the context of the asset management principles recommended by the ANAO, is applied to administrative assets only, and allows for some flexibility in competitive tendering. However the principle

can be subject to abuse, and there are alternative mechanisms available to promote good asset management.

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COMMONWEALTH CASH MANAGEMENT AND CASH BUDGETS

Emeritus Professor Allan Barton
School of Business and Information Management
The Australian National University

In my submission to the Round Table Public Hearing, 22 June 2001, I stated that cash budget information is required for the efficient management of the Government's cash balances (Barton 2001, pp. 5-6), I wish to expand on my brief comments therein.

The Government's cash inflows and outflows do not occur on a flat basis throughout the year. Some tax revenues flow in on a fairly uniform pattern, eg PAYG tax, while company tax and provisional tax revenues follow a seasonal pattern with quarterly peaks. Likewise, there can be peaks in expenditures on capital purchases, debt redemptions and special one-off expenditures; while most expenditures, eg social security payments, transfers to the States and non-budget government institutions (hospitals, universities etc), payroll and sundry administrative expenses, follow a fairly uniform pattern over the year. As a consequence, the Government's net cash balances fluctuate over the course of the year. In particular, it must borrow funds at various times within the year (even though the annual budget is in surplus) to fund its expenditures. This it does mainly through the sale of Treasury Notes to the money market. At 30 June 1999, the Treasury Notes on issue amounted to $7 bn (ANAO Report No. 14, October 1999). Conversely cash surpluses are used to redeem these Notes and long term Bonds, for deposits in the Government's Reserve Bank account, and for purchase of non-government securities.

For efficient cash management, an entity requires a cash budget for the coming year, showing the estimated cash inflows and outflows (classified by line items) on a daily basis. In particular, arrangements must be made in advance for the issue of Treasury Notes or other borrowing, and the amounts and time schedules must be predetermined; and conversely for the use of surpluses which are not to be left as bank deposits. This daily cash budget should be updated each day to form a rolling cash budget for the

coming year. The cash budget for each day begins with the opening cash balance which the Government obtains from the Reserve Bank. However this information represents only the starting point for each day's budget, and by itself it is not sufficient information for efficient cash management over the coming year.

The information for efficient cash management can not be obtained from an accrual budgeting system unless the cash budgets (and accounts) are designed as a subset of the accrual system. This is not a difficult task if the accounting information system is designed to do so. Unfortunately they are often not so designed. The Accounting Standard AASS28 Cash Flow Statements which is followed by many entities contains fundamental flaw in its description of the "direct" method of cash flow statement preparation.

Paragraph 38 stipulates that: "Cash flows from operating activities shall be presented using the direct method whereby the relevant cash inflows and cash outflows are reported in gross terms…"

Paragraph 40 describes the direct method as "…presenting cash flows from operating activities…as gross cash inflows and outflows. This information can be obtained either by using an accounting system which directly records and analyses the cash flows in relation to each transaction or by adjusting sales, cost of sales and other items in the profit and loss statement…for non-cash items…" (my emphasis added).

The Standard thus confuses the direct method of preparation with the reporting of gross (as against net) cash flows. The adding-back method is an indirect method of preparing the statements, and should not be included in the Standard as a direct method.

The reason for this treatment can be traced back to its predecessor, the Funds Statement. The Funds Statement was intended to include all external transactions of the entity, whether for cash or credit. It underlies Budget Statement 9 information prepared in accordance with the ABS General Finance Statistics framework. The Funds Statement was originally developed by external financial analysts by removing all non-transaction items (depreciation and other internal allocations) from the published balance sheets of companies. They did this by adding back these internal allocations to the balance sheet accounts. But it is unnecessary for the entity itself to adopt this adding back method as all the information is available internally, and in greater detail and by short-time

periods, for use by management. Management must have this information frequently if it is to manage transactions and resources efficiently. Preparation of cash flow statements by the adding back method deprives them of their cash management use. Under this method, cash flow statements cannot be prepared until the accrual financial statements are finalised. The non-cash items are then removed from the statements to derive the cash flow statement. This process takes several months to complete after the end of the year, and the statements cannot be used for daily cash management throughout the preceding year.

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