

AMQ  
International's

# STRATEGIC # 318 ASSET MANAGEMENT

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## THE SEVEN DEADLY SINS OF DEPRECIATION pp 2-8

**David Hope, Skilmar Systems**, and I have compiled the '7 deadly sins of depreciation' - these are things that you should not believe or 'act as if' they are true - and neither should you allow others to do so. How many sins have you committed? *Keywords: Depreciation; Asset Renewal; Interest; Loans*

## THE MAY-JUNE CHALLENGE - a reminder - the deadline looms! p 8

## BENCHMARKING FOR BEGINNERS pp 9 - 13

A long time ago I promised to produce an e-book on 'benchmarking for beginners'. As happens in life, other things intervened. But here, at last, is PART ONE. There are five parts, which will be published in this and the next 4 issues of "Strategic Asset Management.

**PLEASE COMMENT AS WE GO ALONG.** Your views and experience are welcomed inputs and will greatly improve the final product. All contributors will be acknowledged.

When completed, a revised version - incorporating the feedback that I have received - will be available for you in the form of the promised **E-BOOK** that you can download for free. *Keywords: benchmarking; performance; informal; formal; comparison; demonstration*

*Please consider - and enjoy!*  
*Penny*

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## The Seven Deadly Sins of Depreciation

**Sin # 1.** *Believing or 'acting as if' (or allowing others to believe or 'act as if')*

**The annual depreciation amount gives you the amount you should spend this year on renewal to 'sustain the assets'.**

**It doesn't. And it can't. They are two different things, doing two different tasks.**

**Depreciation** is a method of allocating the cost of the asset evenly over its life cycle. It is the same each year, no matter whether the asset is young or old, in good condition or bad, has just been acquired or is in the process of being renewed. It is a financial (paper) transaction.

**Renewal**, on the other hand, is a physical activity being carried out on an asset and it is (or should be) based on age, condition and renewal profile (factors that are not taken into account in the calculation of depreciation). For any given asset, in any given period, it can be as low as zero or as much as ten or twenty times, or even more, the average depreciation amount.

Even for an organisation as a whole, it cannot be assumed that renewal of different assets will neatly 'dovetail'. In fact, all of the evidence suggests the contrary. There will be periods when renewal is relatively low and other periods when it is relatively high. Even when we took all the councils within a state, as was done for the Victorian local government infrastructure study "Facing the Renewal Challenge" and the South Australian local government infrastructure study "A Wealth of Opportunities", there was no 'averaging out'. Serious fluctuations and trend lines remained.



**Devil:** Hey, you know it makes sense. Depreciation tells you how much of the asset is worn out. Renewal makes good that wearing out. To be sustainable you must match your wearing out with your renewal. And, sure, renewal is lumpy, but over the whole portfolio it evens out.

**Angel:** You wish! The actual renewal needing to be carried out in any given period fluctuates according to the age of the asset and the renewal profile of the assets – and neither of these factors is taken into account in depreciation. Using depreciation as a proxy is useless – painting by numbers! Only an analysis of the asset's ability to fulfil its service needs – as reflected in a good AM Plan, can tell you what is needed each year.





**Sin # 2.** *Believing or 'acting as if' (or allowing others to believe or 'act as if')*

**Depreciation is a mechanism to fund loan repayment or asset renewal!**

**No, it isn't!** They are three (3) different things doing three (3) different tasks.

1. **Depreciation** is an allocation of the value of the economic benefits yielded by the asset over the time frame that the asset provides those benefits. From an accounting perspective, depreciation is treated as an operating expense and its purpose is simply to provide useful information on the total cost of providing services. It does not represent a 'fund' for any purpose - loan repayment or asset renewal
2. **Loan Repayment** is a change in the form in which an organisation's wealth is held. Cash holdings (current assets) are reduced, but so are its liabilities - by an equal amount. Net assets remain at the same level, just differently configured. Depreciation does not represent a separate cash reserve that can be accessed for this purpose, it is simply a cost, like any other, to be allocated against revenues.
3. **Asset Renewal** is a choice, along with new capital expenditure, that organisations have to make as to how to spend their money, based on their service delivery requirements.



**Devil:** To hell with that! Everyone knows that asset renewal must come first!



**Angel:** Yes, there is good reason for placing a higher focus than we currently do on asset renewal, BUT, it is important to remember that when we do, our 'haves' (those who have assets and their services now) get all the attention, and our 'have nots' (those without assets and asset services) miss out. When service delivery needs are changing, we cannot assume that asset renewal should always take precedence.



**Sin # 3.** *Believing or 'acting as if' (or allowing others to believe or 'act as if')*

**Including depreciation and interest costs in fees and charges is double-dipping!**

**No, it isn't! These are two separate costs.**

**Depreciation** represents the average annual wear and tear on the asset, the wearing out of its service potential, or store of economic benefits.

**The interest cost** is an **additional expense** that the consumers bear because they want to enjoy the benefits of the asset before they can afford the total cost – just like a mortgage for your house.



**Devil:** Sure, but including both depreciation and interest costs, say in housing prices, makes such houses unaffordable. So it must be double dipping. And anyway, if you paid for assets out of reserves then you wouldn't have to pay interest charges at all.



**Angel:** Not recording costs does not make the asset any cheaper. It just makes the costing less reliable and relevant. If the asset was purchased from reserves rather than leaving that money in an investment earning interest, there would still be a cost incurred - it just wouldn't be so obvious.



**Sin # 4.** *Believing or 'acting as if' (or allowing others to believe or 'act as if')*

**It's impossible to know the useful life and the residual value of an asset so it is a waste of time calculating depreciation!**

**No, it isn't!**

We can make good estimates of useful life and residual value based on our knowledge and experience with similar assets.

**From the asset management perspective,** we can adjust the useful life and residual value in our asset registers and plans as we get better information.

**From the accounting perspective,** accounting standards recognise that many of the figures in financial statements are accounting estimates. Accounting standards require that the useful life and the residual value be re-assessed annually, and, if there is a material difference, the recalculation of the depreciation charges. It's the 80/20 rule in operation!

It is better to have information that helps us set directions rather than none at all.



**Devil:** Depreciation is a waste of time anyway. No-one ever uses it. It just fills a space in the balance sheet.



**Angel:** Not so. It can be used for setting charges where there are fees for services. And where there are no fees, it is used as an estimate of the average annual cost of the asset - along with interest fees.



**Sin # 5.** *Believing or 'acting as if' (or allowing others to believe or 'act as if')*

**Depreciation should be based on asset condition!**

**No, it shouldn't. But asset renewal should!**

The engineer's regular determination of asset condition is like the accountant's regular review of useful life and residual value – the systematic monitoring of the asset to ensure that future actions, whether physical or reporting of value, are made in the light of sound knowledge. However, asset value is not determined by condition of the asset *but by the future economic benefits the asset will provide*. It is important not to confuse the engineer's perspective, condition, with the economic perspective, value of future economic benefits.

Where the engineer's measure of condition becomes important is in determining whether the asset will achieve its expected useful life. Condition of the asset tells the engineer if the asset is tracking along its degradation curve as expected. If asset condition is lower than expected this may mean that the asset will have a shorter useful life and the useful life should be adjusted down. Where condition is better than expected this may mean that the asset will have a longer useful life and a corresponding increase in useful life and reduction in depreciation charge should be made.



**Devil:** Condition based depreciation reflects the cost of maintaining the asset in good condition over a foreseeable future period. It is thus grounded in reality, unlike the fictional depreciation amount.



**Angel:** True, but the amount required to maintain the asset in good condition varies according to how close we are to the next major renewal or refurbishment point. It is good for financial planning but it would be unfair to use this figure in charge outs, for those consumers who are paying when the asset is at its worst, would end up paying the most! Depreciation is used for costing - and maybe charging - and renewal projections are used for deciding on intervention actions. Depreciation and Asset Renewal serve different purposes.



**Sin # 6.** *Believing or 'acting as if' (or allowing others to believe or 'act as if')*

**Economic life and useful life  
are the same!**

**No, they aren't!**

The useful life of an asset is the period over which the asset will provide benefits to the organisation - i.e. it can still be 'used'.

The economic life of an asset is the period over which the asset will provide *economic benefits*. That is benefits that exceed their costs.

The useful life may thus be longer than the economic life. But there are circumstances in which it may be shorter.

For example, the economic life of a motor vehicle may be 15 years. However, if Council XYZ has a policy that it will dispose of vehicles when they reach two years of age, the useful life of the asset for Council XYZ is two years. (It then has a residual value and goes on to have a 'useful life' in another role.)

An asset can have more than one useful life. Where an organisation holds an asset from new until the economic benefits are exhausted, then, and only then, are economic life and useful life the same.



**Devil:** There is a technical life, a regulatory life, an obsolescence life, and many others and they must all be taken into account.



**Angel:** Not really, they all boil down to the two lives - useful (can it still be used?) and economic (do benefits of continued use exceed the costs)? If it cannot be used because regulations say it cannot, then its useful life is at an end. If it cannot be used because it is now obsolete, then its economic life is at an end. And this is true of the others also. They all come down to just two. But, interestingly, it may still

'pay' to use an asset beyond its economic life (providing it still has a useful life). For example if a new model is coming out that is far more cost effective than the current model that can be bought, even if benefits from the current asset are less than the costs of operating it, it may still pay to wait a bit until the new asset can be acquired.



**Sin # 7.** *Believing or 'acting as if' (or allowing others to believe or 'act as if')*

**Create your own sin!**



**David Hope and I invite you to  
tell us what popular misconception of depreciation drives  
YOU nuts!**

## **AND DEADLINE LOOMS ON OUR CURRENT COMPETITION**

**MAY/JUNE**

“If you want to change the way people act, you have to change the way they think - John Moubray,”

YET, on reflection, this seems not the way in which things actually happen. As children we were taught to say 'please' and 'thank you'. Gradually, after acting in this way for many years, we developed attitudes of politeness and gratitude.

The same may be true of AM also. Moreover we can observe and measure changes in action - we can only infer changes in thinking. This suggests that we should concentrate on working out what actions would be connected with desired attitudes, and then encourage those actions?”

**So YOUR TASK is to**

**(1) choose one AM attitude or mindset that you would like to encourage, (2) suggest an action to promote it and (3) comment on how it could be encouraged, observed and measured**

**Due Date: Friday 24th June 2011**

**BENCHMARKING FOR BEGINNERS:  
A guide for public sector asset managers  
PART ONE**

**Preface:**

**IS BENCHMARKING FOR YOU?**

Before the days of ‘plug ‘n play’ there was the ‘read me first’ file, and it kept me out of a lot of trouble when tackling new software. It is in this spirit that I have designed the current e-book “Benchmarking for Beginners”

**This book is *not* designed to tell you HOW to do benchmarking**

There are lots of manuals and textbooks for that kind of thing - rather it is here to help you think through *whether you really want to do it, why you want to do it, and what is the best way of achieving your purpose*. The idea is to help you avoid the “I wish I had known that before I started” reaction.

**And it is *not* designed to CONVINCE you to do benchmarking.**

Authors of benchmarking books and providers of benchmarking services are enthusiasts. They want to convince you of the benefits, to encourage you to be an enthusiast too. And that is a good thing.

But balance is needed. And those that point out the difficulties or disadvantages are most frequently only challenging one benchmarking method in order to support of another that they favour.

This means that both sides of the presentation are likely to be subjective. Personally I think that ‘objectivity’ is over-rated. Give me passion any day of the week! However, there are occasions when objectivity, a.k.a. clearly seeing both sides of the picture, can be useful. And the best time for such objectivity is before you start.

**Instead, it is designed to help you decide WHETHER benchmarking is right for you**

And, if so, WHAT TYPE of benchmarking will serve you best.

**It’s primary focus is the PUBLIC SECTOR.**

Most books and articles have looked at benchmarking in industry, where conditions, opportunities, motivations, drivers and constraints are different.

**And, finally, the focus is also on BENCHMARKING FACILITATED BY AN EXTERNAL CONSULTANT.**

This is not the only form of benchmarking and it may not be the best for you, so we will also look at other (non benchmarking) ways of achieving your purpose to help you decide.

## BENCHMARKING FOR BEGINNERS: A guide for public sector asset managers

### 1. WHY DO YOU WANT TO BENCHMARK?

Reasons for benchmarking may be grouped in just three categories, namely:

to improve performance,  
to demonstrate something, or,  
to exert control.

#### 1. **To improve performance** (learning and direction setting)

For example:

##### *Learning*

*'to identify, understand and implement international best practice';  
'to achieve quantum leaps in improvement (cf incremental change)';  
'to learn from others';  
to discover where improvements are possible';*

##### *Direction Setting*

*'to help determine performance targets and direction'*

#### 2. **To demonstrate something**

If your organisation's commitment to asset management isn't yet rock solid, you may wish to use benchmarking in order to demonstrate a need for resources or action or to reassure staff and decision makers that you are on the right track.

For example:

*'to show staff and decision makers we are in the lead' (e.g. in top percentile)  
'to reassure staff and decision makers that we are OK' (e.g. above average)  
'to prove to staff and decision makers that we need more funding, resources and focus to avoid falling even further behind' (e.g. below average)*

## **BENCHMARKING FOR BEGINNERS: A guide for public sector asset managers**

The first two are reasons why an AM unit may voluntarily choose to benchmark.

But involvement in Benchmarking may not always be voluntary. It may be that your boss, enamoured of the idea of benchmarking and wanting to be 'in with the latest' announces that you will do benchmarking. If this is the case, then it pays to find out whether the purpose is to improve performance or to demonstrate the current state of affairs, for the options that are open to you depend on your purpose.

Another way in which Benchmarking may not be voluntary is when it is used as a control mechanism.

### **3. To exert control**

For example:

*'to enable decentralisation yet retain an element of centralised control'*

*'to discover which units are most productive so that others may be brought up to scratch' (note that if the units themselves decide to do this themselves, it would fall into category 1)*

*'to determine which units are most deserving of funding'*

*'to create competition between units'*

If the aim is to improve performance or demonstrate the current state of affairs, the instigator is the benchmarking unit itself; but for the purpose of exerting control it will be a superior level of government, or head office v.a.v branch offices.

Whenever performance measures are used to exert control or determine funding, reporting units will have incentive to bias results in their favour. Control benchmarking is likely to be ineffective. As in the total quality movement, building quality in will outperform inspecting it in.

**The Focus of this e-book is for performance improvement or demonstration.**

Because when benchmarking is imposed on you, you have no choice in the matter - and therefore no decision to make!

## **BENCHMARKING FOR BEGINNERS: A guide for public sector asset managers**

### **2. 'INFORMAL' OR 'FORMAL BENCHMARKING?'**

#### **First, a DEFINITION.**

I deliberately avoided starting this e-book with the mandatory quotation of definitions, because benchmarking has now become a 'buzzword', meaning that it is applied to almost anything you want to apply it to.

For our purposes I want to define it simply as '**comparing yourself with others**'. The purpose for such comparison, as we outlined above, can be either to improve performance or to demonstrate the status quo.

I am omitting discussion of benchmarking as a control mechanism, although we will have reason to refer to that later. Comparison with others also excludes the search for 'best practice', but we will refer to that later as well.

#### **Informal Benchmarking**

Comparing yourself with others for performance improvement does not require a facilitator. You do it whenever you study a book of techniques developed by others or case studies, speak with others at a conference, listen to presentations, or learn from others in your own workplace or, nowadays, through the net. In fact, most of your performance improvement probably comes through these methods. And, in the beginning, it makes sense to understand your own processes and outcomes before you try to compare them with anybody else.

#### **Formal Benchmarking** (a project facilitated by an external consultant)

Why then, when you can achieve all or most of your goals using benchmarking tools internally, would you wish to take part in a formal benchmarking exercise? There are a number of reasons:

#### **BENCHMARKING FOR PERFORMANCE IMPROVEMENT**

**to overcome complacency.** Benchmarking comparisons with others can be an eye opener for those who can see no reason to change.

**to build and reinforce broad commitment to change.** Benchmarking can add that spark of competition that energises both troops and management. For this to be successful the benchmarking must be continuous.

**to develop a shared vision.** A benchmarking exercise which involves the whole organisation can lead to a deeper understanding of key business processes.

**to secure a budget commitment.** A formal facilitated benchmarking exercise needs a budget commitment in a way that informal benchmarking does not. Undertaking a formal exercise therefore ensures the budget - it does not, however, ensure that any beneficial change will result from the exercise!

## **BENCHMARKING FOR BEGINNERS: A guide for public sector asset managers**

### **BENCHMARKING FOR DEMONSTRATION**

Benchmarking for demonstration, is not so easily tackled by informal benchmarking, it really requires external involvement to achieve the necessary 'clout'. Internally developed comparison information can be used for performance improvement but the clout needed for demonstration needs external validation.

A formal benchmarking process can be used

to demonstrate that you are the **best in the business**, or at any rate close to the top. This may be carried out to give your board 'bragging rights', or to establish credibility, but it is not intended to lead on to change.

to demonstrate that you are **on par with the industry average**. This is intended to reassure those that matter that you are on the right track.

to demonstrate that you are **behind the pack**. This is usually designed as an argument for extra funding. While implying that change is needed in this case, the benchmarking itself is not intended to improve performance, merely to demonstrate the need for such improvement.

In addition to the above, there is a further reason to choose a formal benchmarking process and that is

to demonstrate that **the organisation is open to new ideas**. This is often the 'we had better do it because everyone else is' argument. Again, unless the organisation is committed to following up on the good ideas, this is really benchmarking for benchmarking's sake.

Normally you would only choose to benchmark for demonstration purposes if

- (a) you were not interested in improving performance but wished instead to show that it did not need improving
- (b) you wanted something to support your claim that performance could not be improved without additional resources. (such claims are often based on selective comparisons)

In the absence of these two objectives, you would probably be benchmarking for improvement.

**Coming in Part Two:  
What do you want to benchmark, in what detail, and with whom?**