



Report 07.788
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Committee Finance, Evaluation & Risk
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Valuation of water supply assets for 2007/08

1. Purpose

To update the Committee on the valuation of the water supply assets for the year ended 30 June 2008.

2. Significance of the decision

The matters for decision in this report do not trigger the significance policy of the Council or otherwise trigger section 76(3)(b) of the Local Government Act 2002.

3. Background

Greater Wellington Regional Council (GWRC) values its water supply, flood protection and park assets on a regular basis (usually every 5 years). These valuations are carried out by independent valuers.

The rise in construction costs has meant that these valuations may need to occur more frequently than 5 years. To that end GWRC undertook a desktop valuation of the water supply assets as allowed (in GWRC's view) by the relevant accounting standard. This valuation involved using a series of indices from the Department of Statistics and approved by an independent valuer as appropriate. However, the auditors (Audit New Zealand) disagreed with this approach, as noted in their management letter (refer report number 07.784).

GWRC has written to the Office of the Auditor General (refer Report number 07.784) contesting this view. However, it is unlikely that they will change their opinion. Their position is that only a valuation approved by an independent valuer will meet the accounting standards.

In respect of the year ending 30 June 2008 this will again be an issue with the auditors. If the auditors are of the opinion that GWRC's financial statements are materially misstated because of the water supply assets not being revalued then they will qualify the financial statements.

The qualification would be based on using the same indices that GWRC is not permitted to use in its valuation. While this may seem illogical, that is the position taken by the auditors.

4. The issue

Carrying out a full valuation of the water supply assets is a significant event as far as staff resources are concerned. Firstly, all the schedules for approximately 5,000 assets have to be put in a format suitable for use by the independent valuer. These schedules will be reviewed and validated by checking for inconsistencies. Once the schedules are available, quotations are called from a small number of valuation companies that have the expertise to carry out a valuation of this type. Expected cost is in the order of \$50,000-\$70,000. Once a valuer is selected, they will inspect most of the visible assets and arrangements will be made for them to visit the treatment plants and larger pipelines. This requires water supply staff to prepare for the visit of the valuers and accompany them during the inspections.

Once the draft valuation is completed, it is then reviewed item by item by engineering staff to check for any anomalies and these are then discussed with the valuer. Because the valuation of the assets on a depreciated replacement cost basis is not an exact science, the valuer will sometimes hold workshops with senior staff to reach consensus on what may be an appropriate life, condition or residual value for a particular asset.

In the year in which a valuation is normally scheduled, provision is made for water supply staff to fulfil their part in the valuation process. This has not been allowed for in the first half of the 2008 calendar year. As it stands, this would be particularly difficult given that we are currently short of engineering staff and are advertising to fill two engineer vacancies. If the work was to be carried out in the first half of 2008, it would probably mean deferring the completion of the Wellington Water Strategy. This includes advancing the process for a new water supply.

It is also preferable that the valuation is carried out just prior to a new asset management plan which is scheduled for 2009.

5. Audit qualification

5.1 Materiality

Deciding whether an item is material or not is part science and part art. As a guide, if a misstatement is greater than 10% of the relevant base number then it is likely to be material. If it is less than 10% then it will probably not be material.

While the auditor may use the above criteria, they are not bound by it. At the end of the day it is the auditors' opinion which is the final arbiter of whether any misstatement is material or not.

5.2 Assets

The valuation prepared as at 30 June 2007 concluded that the water supply assets were understated by \$49 million. This was not material in the context of GWRC financial statements.

The auditors used GWRC total assets as their base number. As at 30 June 2007 these were \$700.3 million, the \$49 million being some 7% of the total assets.

Based on the 10% guide noted above, the water supply assets would need to be misstated by around \$70 million.

5.3 Expenditure

Revaluating the assets upwards also increases depreciation. Depreciation is the amortisation (or writeoff) of the assets over their useful life.

For example, the \$49 million increase in the water supply assets noted above would increase the depreciation in the 2007/08 year by approximately \$1 million.

The auditors have indicated that materiality is between 1% and 3% of total expenditure.

In respect of 30 June 2007, GWRC had total depreciation of \$9.5 million and total expenditure of \$168.6 million.

It is unlikely that the financial statements would be qualified on the basis of depreciation being understated.

6. Audit qualifications

Qualifying financial statements is a serious matter for the auditors to take. For some organisations it can be life threatening. This is not the situation with GWRC. It will be annoying and irritating for GWRC, but no more. It will have none or little impact with our banks and Standard and Poors (credit rating agency).

7. Conclusions

It is uncertain as this stage whether the understatement of assets will be material as at 30 June 2008.

Total assets as at 30 June 2008 (in GWRC) will be around \$730 million. Park assets will be revalued as at 30 June 2008 but it is not known at this stage what the increase in their value will be.

Based on the \$730 million, water supply assets would need to be understated by \$73 million for the auditors to qualify for the financial statements.

However, as noted previously audit qualification is not a hard science, it is opinion.

In respect of depreciation, GWRC's depreciation will be understated by \$1.0 million, in respect of 30 June 2008. This is unlikely to be an issue for the auditors.

The other uncertainty is that GWRC will have a new Audit Director for 2007/08. It is not known at this stage what his view will be.

8. Communication

No communication is necessary.

9. Recommendations

That the Committee:

1. *Receives the report.*
2. *Notes the content of the report.*
3. *Agrees that a full valuation of the water supply assets does not occur in the 2007/08.*
4. *Notes that as a result the financial statements of GWRC for 2007/08 may be qualified.*
5. *Agrees that:*
 - (a) *GWRC continues to argue its case with the Office of the Auditor General*
 - (b) *If the auditors agree with the GWRC view, then undertake a desktop valuation.*

Report prepared by:

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