REVISIT RETIREMENT PROCESSING:

The hidden cost of underreporting and why it matters to your organization

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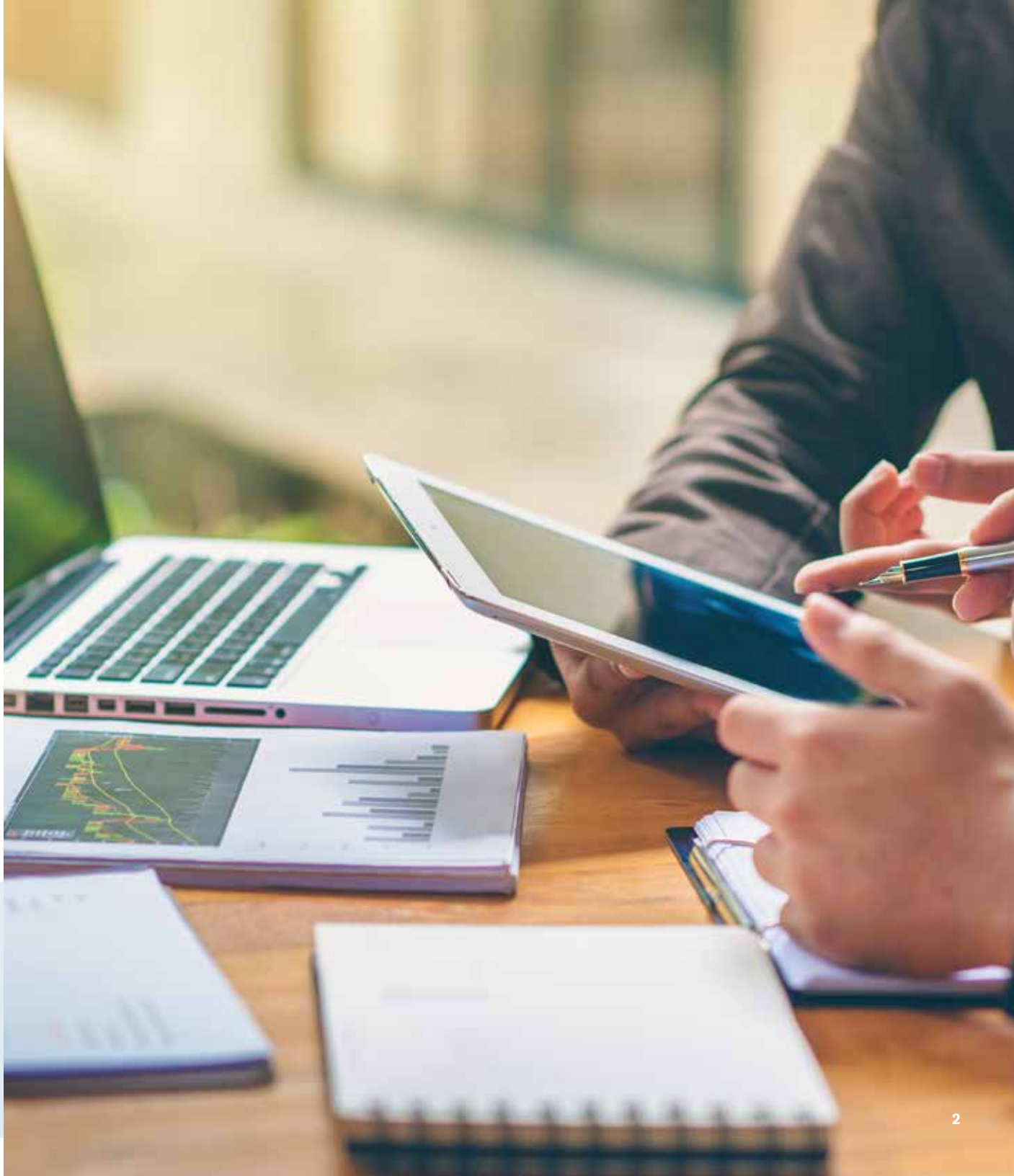
Accurate and timely retirement processing is a vitally important activity for utilities, both for accounting compliance and financial reasons. Yet it remains one of their most challenging accounting processes.

Utility accounting teams can frequently underestimate the significant impact retirements can have on cash flow, earnings and rates. Breakdowns or gaps in retirement processing can ultimately affect not only financial performance and cash flow, but also the equitability and affordability of rates, as well as the sustainability of service. If not approached strategically and managed closely, the cumulative hidden effects of underreported retirements can become impactful.

In this piece, we examine why retirement processing can be such a challenge, why retirements are chronically underreported, and some of the ways retirements can impact cash flow and financial statements. We also offer a few techniques utilities can use to improve retirement processing and optimize the corresponding financial results. While not all these considerations may apply to your organization, our aim is to give you best practices to consider and discuss with your team.

If not approached strategically and managed closely, the cumulative hidden effects of underreporting retirements can become profound.



Retirement processing is uniquely challenging.

There are several reasons why retirement reporting and processing is often more difficult than reporting and processing of new asset construction. Among the most common ones we see:

Retirements are often an afterthought. Because they're the last step in the process, by default they tend to get the least attention relative to training, QA, and consistent reporting procedures.

Accounting processes such as retirements are simply not top of mind for operations and engineering personnel. Their top priority is to provide safe and reliable service, including building the infrastructure needed to restore and sustain service from outages or storms. Expecting other departments to prioritize understanding and adhering to accounting processes isn't particularly realistic especially during weather events or often-hectic major projects.

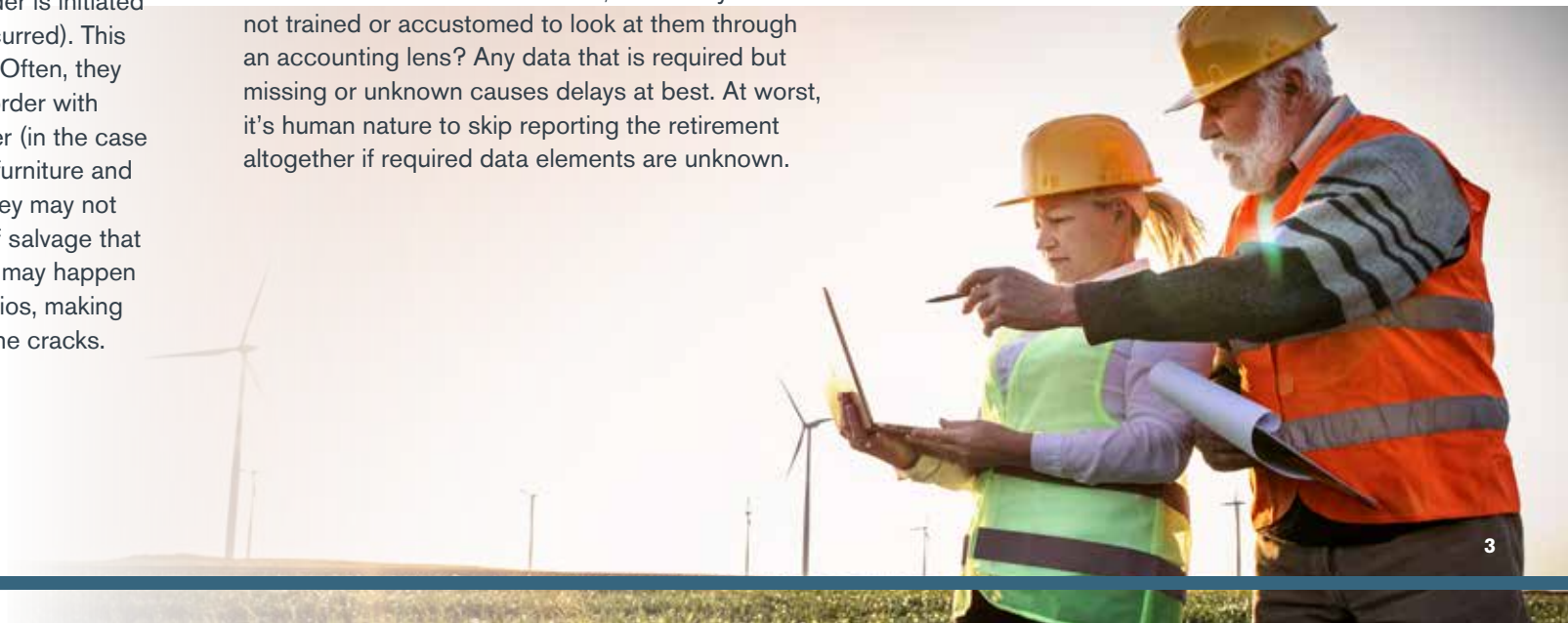
There's rarely a clear transaction or triggering event to indicate a retirement needs to occur. For new construction, there is at least some transaction or trigger that indicates assets were constructed and need to be accounted (e.g., a work order is initiated and/or material and inventory costs incurred). This isn't always the case with retirements. Often, they are just a small component of a work order with additions. They may have no work order (in the case of abandonments or assets like office furniture and equipment). In yet another scenario, they may not have unique charges in the absence of salvage that indicate retirements occurred. Or they may happen as part of emergency response scenarios, making them even more likely to slip through the cracks.

Field personnel may not know what constitutes a capitalized asset that needs to be retired versus a minor item for which the replacement is simply O&M (operations and maintenance) expense. For example, if retirement units are granular enough that poles and crossarms are both capitalized, then replacing crossarms would need to trigger a corresponding retirement. In contrast, if the retirement unit is a fully dressed pole, the replacement of crossarms is expensed and no retirement would be recorded. In other cases, the engineering elements of construction may be at a much lower level than the accounting capitalization policy. Any differences between the work units and accounting retirement units leaves a potential gap that needs to be bridged in downstream reporting to accounting.

Field personnel may not readily know some of the information accounting needs regarding assets. Then what? For example, should you require a vintage on pipe retirements, and does the crew doing the work really know what year the pipe was installed? Do you require the crew to report the USOA 300-account of the asset, when they are not trained or accustomed to look at them through an accounting lens? Any data that is required but missing or unknown causes delays at best. At worst, it's human nature to skip reporting the retirement altogether if required data elements are unknown.

Accurately recording the time spent on installation versus removal on replacement work, or other work orders that include both types of activity, can be complicated at best. In fact, it may take less time to perform the activity than to record it correctly. But how is time recorded in support of both activities (for example driving to the work site and back)? Removal costs are an important part of the retirement process, and reporting accuracy has both compliance and financial ramifications when you begin to reach any meaningful scale.

It can be tough to know when to process the accounting for a retirement versus the new asset addition on work orders with both activities. For example, if you have major work at a substation after a storm where the old assets are out of service long before the new ones go live, do your processes support different reporting dates for the retirement and addition on the same work order if needed? Reporting the retirement at the onset of replacement work can be important when you pay property taxes based on assets in service, and the new construction isn't completed until the following tax year.



Retirement processing has far-reaching regulatory and financial impacts that simply can't be overlooked.

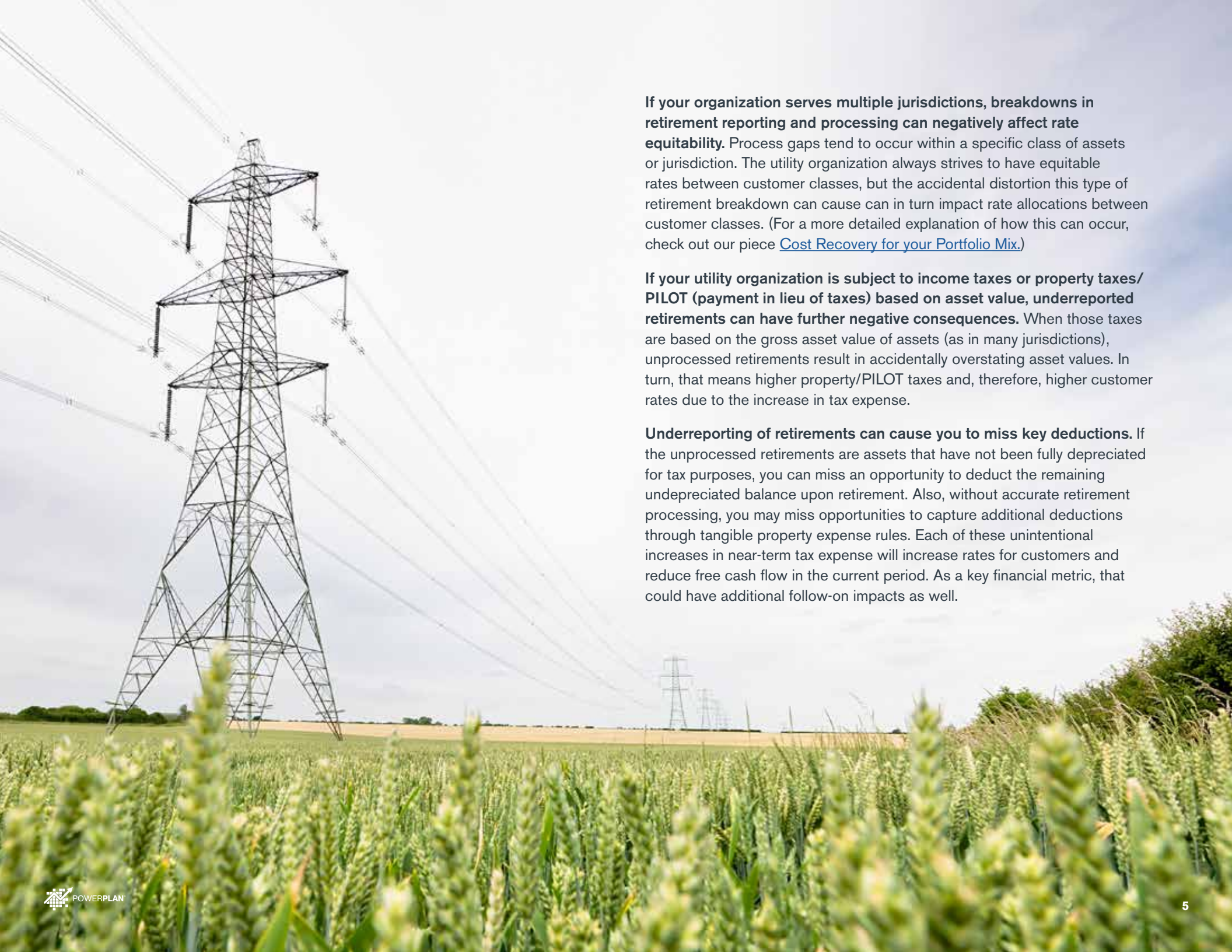
While processing retirements can be hard, it's also essential to accurate reporting. It's important to acknowledge the many important financial impacts retirements have on your ability to monitor the financial health of the organization and to chart a course of sustainable, low-cost service and reliability for your citizens and members.

Furthermore, there is broad agreement with the idea that everyone should pay their fair share and ensure costs aren't inadvertently shifted erroneously between customer classes or generations. Unfortunately, even seemingly small breakdowns or gaps in retirement processing can lead to just those types of challenges, some of which are more obvious than others. Among the many potential impacts to consider:

If you're underreporting retirement, you risk overstatement of current depreciation expense. This reduces current income, increases customer rates and negatively impacts key financial ratios.

Over time, failure to process retirements in a timely manner can artificially elongate asset lives in a depreciation study. This can in turn can increase depreciable lives. This could result in not collecting the revenue you need to fund proper repair and replacement programs, and ultimately impact service reliability.
It can also increase the long-term cost to customers from additional borrowing.

If your regulator inspects your accumulated depreciation balances, they can appear over-collected if you don't have retirements to reduce those balances. This problem is amplified if your lives are elongated. For example, say you had $100 million dollars on assets with a 40-year life, and 20 years in you have collected $50 million of accumulated depreciation. If your lives increase to 50 years, some regulators have argued that means you should have only collected $40 million accumulated depreciation at the 20-year mark and may impose refunds or reductions to rates accordingly. Furthermore, if you're underreporting retirements, then you're likely underreporting cost of removal as well. If you are accruing a cost of removal expense component for depreciation, then you may have a similar issue with the cost of removal balance appearing to be over-accrued.



If your organization serves multiple jurisdictions, breakdowns in retirement reporting and processing can negatively affect rate equitability. Process gaps tend to occur within a specific class of assets or jurisdiction. The utility organization always strives to have equitable rates between customer classes, but the accidental distortion this type of retirement breakdown can cause can in turn impact rate allocations between customer classes. (For a more detailed explanation of how this can occur, check out our piece Cost Recovery for your Portfolio Mix.)

If your utility organization is subject to income taxes or property taxes/ PILOT (payment in lieu of taxes) based on asset value, underreported retirements can have further negative consequences. When those taxes are based on the gross asset value of assets (as in many jurisdictions), unprocessed retirements result in accidentally overstating asset values. In turn, that means higher property/PILOT taxes and, therefore, higher customer rates due to the increase in tax expense.

Underreporting of retirements can cause you to miss key deductions. If the unprocessed retirements are assets that have not been fully depreciated for tax purposes, you can miss an opportunity to deduct the remaining undepreciated balance upon retirement. Also, without accurate retirement processing, you may miss opportunities to capture additional deductions through tangible property expense rules. Each of these unintentional increases in near-term tax expense will increase rates for customers and reduce free cash flow in the current period. As a key financial metric, that could have additional follow-on impacts as well.

Best practices can help you get a firm handle on your retirements processing.

There are numerous techniques utility organizations can use to make sure retirements are processed in a timely and accurate manner. Some of these techniques can help expose existing problem spots that may cause significant future financial impacts, while others help streamline the retirement process and prevent problem areas from developing. Here are a few of the suggestions we often make to utilities who are trying to improve their processes:

Do routine health checks on your retirement processing. All utilities should periodically review their process for accounting for retirements. By taking time to do this on a regular cadence, you can ensure you're using current best practices and uncovering opportunities to further button up your processes.

Look at the information that's hardest for field personnel to know and is creating the greatest resistance. Then try to remove the burden they have for reporting it. Otherwise, you risk not reporting the retirement at all. Get the information another way. For example, the original install date is typically one of the biggest challenges, particularly for mass property like poles, pipe and wire. Using mortality curves, utilities can rationally determine the most likely vintages, and process the retirements without knowing the exact vintage. A FIFO (first in, first out) methodology serves a similar purpose, but is typically less accurate and less advantageous from a property and income tax perspective.

Make a concerted effort to analyze your retirement trends over time. This is one of the most important practices you can apply. Granted, it can be hard or time consuming to do with manual systems, but utility-specific asset accounting packages can help greatly and often come with these tools already embedded.

At least annually, compare recent retirement activity to expectations based on depreciation lives and rates. If your real-life experience begins to diverge over time, that could be a sign of a bad process, or could signal your rates may need to change in the future. Either way, awareness is key for planning and/or correcting any process deficiencies. Analyzing your accumulated depreciation reserve adequacy is another good early warning metric for potential issues.

Automate the retirement of amortizable property. For some asset classes, such as office furniture and fixtures, utilities can automatically retire those assets at the end of their amortizable life. These types of assets are notorious for being retired without reporting. An automatic retirement eliminates that requirement and simplifies the information needed when adding new assets of these types as well.

Automate the recognition of removal costs based upon engineering estimates for a work order and standard costs of removal. This can help greatly with the challenge of accurately reporting cost of removal through timecards, improve accuracy and simplify tasks for field personnel who are asked to report time. Work orders should also be monitored to make sure they have both cost of removal incurred and retirements reported correctly. Utilities that use technology to automate both the accounting for removal costs and such monitoring can drive big improvements in efficiency and accuracy.

Make sure everyone is speaking the same language regarding retirements. This applies to the training of teams performing the work, as well as systems. Your asset accounting technology is pivotal to ensuring the timely and accurate flow of information from engineering teams to accounting and other downstream departments. Ideally, this technology will also automatically translate the original "engineering language" into the proper accounting and regulatory speak based upon the rules and needs of those stakeholders. This makes it easier for your operations teams to do their job efficiently, while also ensuring your accounting team can deliver on compliance and financial reporting requirements.

Use an index like Handy-Whitman to automatically calculate the historic amount based on the current value of the portion of the asset being replaced. This can help address the common problem of how to report retirements for old asset records where you have little baseline information. Handy-Whitman data can be used to support manual calculations, or in a system like PowerPlan, it can be pre-loaded and used to automatically make informed estimates based on inflation rates and historical equipment costs.

Make sure your technology is integrated in a way that enables your retirements processing. Integrated systems are a tremendous help in capturing operational information, automatically translating that to accounting activities for retirements, and ensuring nothing is missed or grossly inaccurate. They may enable retirement processing at the time the retired assets are reported out of service, even when the new assets being installed are not in service and complete. They can also automate the retirement processing on replacement jobs based upon the assets being constructed, using an automated process of matching the assets being retired based on the information in the work order and assets being constructed. These automation tools often include the ability to substitute retirement units in cases of obsolescence and modernization.

Retirements should be considered at the beginning of the construction process, not just at the end.
It's integral to a sound process and should be treated with the same importance as other key elements that occur earlier in the asset life cycle. In fact, retirements, arguably, should be considered first, with all steps leading to it designed to capture accurate data, reduce burden on non-accounting staff and prevent passive leakage of vital accounting data.

The takeaway: Automate retirements reporting so you can get accounting out of the field and back into the accounting department

Retirement processing is difficult at best without the right guidelines, training and technology tools in place. But as you know, accurate and timely reporting of retirements is key to financial reporting and your ability to provide low cost, reliable service to customers. It's also essential for leadership team to make informed, sustainable business decisions.

> ***Your ultimate goal is to systematize policy and automate translations across teams and processes as much as possible.***

By finding ways to monitor and optimize your data capture methods from operations to accounting, you can realize numerous business benefits, from lower cost of service to cost savings you can put toward capital improvements. Your ultimate goal is to systematize policy and automate translations across teams and processes as much as possible. By using a platform like PowerPlan, which automates much of the process, you can reduce burden on your field personnel, benefit from built-in best practices–and ultimately have the rich, accurate data you need to optimize capital investments, tax planning, compliance reporting, asset tracking, rate management and other critical aspects of your operations.

If you would like to learn more or discuss ways PowerPlan can help you improve your retirements processing, please contact us at +1 678.223.2800 or visit www.powerplan.com.

About the Author

Alex Elkin, Industry Solution Advisor, PowerPlan

Alex, a senior industry and solution strategist, advises PowerPlan executives and clients alike on key trends, best practices, and how clients can achieve maximum ROI from their PowerPlan deployments. Throughout his 20 years at PowerPlan, he has built extensive relationships with utilities of various sizes, offering a blend of deep technical expertise and strategic perspective. Alex founded the support function at PowerPlan and personally served in every role within this key function since its founding in 2001. Alex has worked side by side with more than 90 utilities across the United States and Canada. Prior to joining PowerPlan, Alex served in the treasury and accounting functions of PPG Industries, a Fortune 500 manufacturing firm. He graduated with distinction and Phi Beta Kappa from the University of North Carolina, Chapel Hill with a Bachelor of Arts in economics.

About PowerPlan

For more than 25 years, PowerPlan has helped North American energy companies make the right financial decisions which improve lives and power the world. Through our industry-leading expertise, innovative technology and vast experience listening to and working in tandem with our customers, PowerPlan software sets the standard that CFOs can count on.

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