



# Corporate Report

NO: F017

COUNCIL DATE: September 10, 2007

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## FINANCE COMMITTEE

TO: Mayor & Council DATE: September 10, 2007  
FROM: General Manager, Finance & Technology FILE: 1840-01  
SUBJECT: Update on PSAB Requirements and Evaluation of Vehicles and Equipment Assets/Reserve

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## RECOMMENDATION

The Finance and Technology Department recommends that Finance Committee receive this report as information.

## INTENT

This report provides information on the status of work towards the implementation of changes to the information contained in the City's financial statements, which are scheduled to come into effect January 1<sup>st</sup>, 2009. It also provides a summary of the results of a third party review that was conducted on the City's Vehicles and Equipment Replacement Reserve Fund.

## BACKGROUND

In late 2002 the Public Sector Accounting Board (PSAB), a body that has the authority to set standards for financial accounting and reporting in the government sector, released a report called "Accounting for Infrastructure in the Public Sector". A key recommendation of this report was that municipalities should record and report their capital assets in their financial statements and include information in the financial statements about the condition of their capital assets. Since that time, PSAB has introduced new standards for capital asset accounting and reporting for all municipalities in Canada, which are to take effect on January 1<sup>st</sup>, 2009. The other orders of government (Provincial and Federal) are already reporting their capital assets based on these standards.

The City's audited financial statements currently acknowledge that the City's capital assets are not amortized or depreciated over their useful life, the costs of the 'Capital Assets' are not removed upon disposal and the value of infrastructure constructed by developers and transferred to the City at no cost is not included in the statements. Effectively, all capital assets are expensed in the year that they are purchased, regardless of how long that asset will last.

For the year ending December 31, 2006 the City's capital assets were categorized in the audited financial statements as follows:

Land	\$ 339,133,000
Buildings	258,965,000
Infrastructure	1,321,522,000
Machinery & Equipment	<u>125,198,000</u>
Total	<u>\$2,044,818,000</u>

Although the City of Surrey does not currently depreciate any of its assets in its financial statements, the Financial Plan includes annual amounts for the replacement of city vehicles and equipment, information technology hardware and software and some recreation equipment. These amounts are deposited into reserve funds that earn interest. There are also reserves set up in Water, Sewer and Drainage Utilities for infrastructure replacement.

The new PSAB reporting requirements will come into effect January 2009. Staff has prepared a work plan that includes the development of an inventory of all capital assets of the City, the year of acquisition of each capital asset and the original and replacement cost of each capital asset and the remaining useful life of each capital asset.

A Project Steering Committee has been established that includes the following:

- General Manager, Finance & Technology;
- General Manager, Parks, Recreation & Culture;
- General Manager, Engineering, and
- Fire Chief.

The Committee has been meeting on a regular basis.

A Project Working Group with representatives from all City departments has also been established for the purpose of providing expertise in the evaluation of each asset category.

Selected members of both the City's Steering Committee and the Project Working Group also sit on the Lower Mainland Inter-City Focus Group, which includes representatives from Lower Mainland municipalities, the GVRD and KPMG, the City's external auditors. The Group shares ideas and discusses issues that arise each local government in the lower mainland works through the process of implementing the PSAB reporting requirements. The Group develops common approaches where feasible, in an effort to streamline the overall process. The Group also presents a unified and coordinated response to broader issues such as the current Provincial initiative related to prescribing the 'Useful life values for Tangible Capital Assets'.

There is also an informal national network of larger Canadian cities. Surrey staff confers with these other larger cities on a regular basis. Those cities, which are at more advance stages in the process, provide useful information to others.

## **DISCUSSION**

The Steering Committee has decided that the assets will be evaluated in categories, beginning with 'Vehicles and Equipment', followed by 'Land', then 'Buildings' and finally 'Infrastructure'.

Upon the conclusion of the evaluation of each category, the Committee has determined that it would be prudent to engage an independent consultant to conduct a third party review of that asset category including an analysis of the reserve funds that the City has set aside for the replacement of the category of assets.

In order to simplify the process the following guidelines will be used to evaluate each category of assets:

1. Use of the straight-line method for the depreciation of all assets (i.e., each asset is depreciated by the same amount for each year of its useful life);
2. Salvage value of each asset at the end of its useful life is zero;
3. Depreciation will be zero in the year of acquisition of the asset;
4. Depreciation will be calculated no less than annually;
5. The City will use the Provincial guidelines for establishing the useful life of each asset;
6. Capitalization thresholds of:
  - a. \$10,000 for vehicles and equipment;
  - b. \$100,000 for buildings and improvements;
  - c. \$100,000 for infrastructure, and
  - d. \$50,000 for pooled assets.

Any assets acquired by the City at a cost less than the above capitalization thresholds, will be expensed in the year of acquisition.

As the project progresses, there may be a need to refine some of the above guidelines. Upon completion of the project, all of the assumptions/guidelines that have been made by the Steering Committee will be compiled and will be used as the basis for a policy on the on-going maintenance of the asset inventories and related depreciation. This policy will be forwarded to Council for consideration and approval.

### ***Vehicle and Equipment Replacement Reserve Fund***

An evaluation of the Vehicles and Equipment asset category was completed earlier this year. Subsequently, the services of MMK Consulting, an independent accounting firm, was engaged to conduct a third party review of the Vehicle and Equipment Replacement Reserve Fund, currently valued at \$28.6 Million. The consultant's final report on their review is attached as ***Appendix A***.

The report outlines the scope of the review, the methodology used for estimating the reserve requirements and finally, the adequacy of the Vehicle and Equipment Replacement Reserve Fund as it relates to both historical depreciation and future replacement costs. The appendices contained in the report provide detailed information on 798 vehicles and pieces of equipment in the City's inventory, including for each piece the annual depreciation value, age and expected life. The appendices are not included in this report but are available for review in the Finance and Technology Department.

The assessment was based on the upcoming PSAB reporting requirements. The assessment also compared the Fund balance with the amounts required to fully replace each piece of the inventory at the end its expected life allowing for expected inflation in costs. The consultants concluded the following:

1. The Vehicle and Equipment Reserve Fund has tended to increase in most recent years, with the exception of a special transfer out in 2004 (\$3 Million was used to help fund non-growth roads projects);
2. On a historical cost basis (and PSAB reporting requirements), the overall level of funding contained in the reserve accounts is \$2.2 Million greater than the accumulated depreciation of equipment as inventoried, and
3. On a replacement cost basis, the current reserve levels are at approximately 74% of what would be required under a fully-funded replacement cost model.

Based on the above, the consultants have recommended that the City carefully monitor the value of the funding in this Reserve over time as well as the actual life of its vehicle and equipment assets so that appropriations to the Fund allow for the timely replacement of vehicles and equipment. At this time, staff is satisfied that the Fund can be managed so that vehicle and equipment replacement occurs in a timely manner without creating an undue burden on any future annual budget. Annual appropriations to the Vehicle and Equipment Replacement Reserve Fund will be set to match the necessary replacement funding. Staff will monitor the balance of the Reserve Fund to ensure that the levels increase over time to match the funding required for a fully-funded replacement cost model.

The Working Group is refining the system used for inventorying new vehicles and equipment to ensure that such new assets are properly recorded as and when the City acquires them.

### *Next Steps*

Every five years, Risk Management engages a consultant to appraise all of the City buildings for insurance purposes. The next appraisal is scheduled for 2008. The Steering Committee decided that it would be prudent to engage a consultant that would provide information needed to support the implementation of the PSAB requirements as well as the information needed by Risk Management. A consultant has now been engaged and is scheduled to begin this work in the next few weeks.

It is expected that the evaluation of both the City's Building assets and Land assets will be completed by year-end, at which time, a third party review of the requirements of those asset categories in relation to the City's Reserve Funds for these categories of assets will be completed. A report on these categories of assets will then be forwarded to City Council.

Similar work associated with the asset categories of roads, water, sewer and drainage will be completed during 2008. Once the work related to the roads, water, sewer and drainage infrastructure has been completed in 2008; Staff will prepare a 'Corporate Asset Replacement Policy' that will link the amortization/depreciation of each asset category to replacement values, upon which a full third party actuarial review will be conducted on the related City reserves. A report including conclusions and recommendations will then be forwarded to Council for consideration in good time for ensuring compliance with the PSAB reporting requirements in 2009.

The new PSAB reporting requirements only relate to the City's annual financial statements. There is no requirement for the City to include any appropriations in its annual financial plan or

budget for asset replacement. However, the PSAB requirements and the related analysis being undertaken by the City will have the following benefits to the City:

- It will allow the City to capture financial information related to its assets in a consistent and standardized manner;
- It will allow the City to manage its custodial and stewardship responsibilities more effectively by instituting greater controls over its assets, and
- It will provide the information necessary for the development of a comprehensive asset replacement strategy based on asset life cycle planning and economic evaluation.

## CONCLUSION

PSAB has introduced new standards for capital asset accounting and reporting for all municipalities in Canada, effective January 1<sup>st</sup>, 2009. Staff has prepared a work plan and commenced work in relation to that work plan to ensure compliance with the PSAB requirements by 2009.

The evaluation of the Vehicles and Equipment category of assets has been completed including a third party review of the Vehicle and Equipment Replacement Reserve Fund, currently valued at \$28.6 Million. The consultant's final report is attached as *Appendix A*.

The Building asset and Land asset categories are currently being inventoried and evaluated. A third party review of these asset categories in comparison to City's Building Reserve Fund should be completed early in 2008 after which a report will be forwarded to Council for consideration.

The roads, water, sewer and drainage infrastructure assets will be completed during 2008 with a similar third party review being undertaken on each of these types of assets. Once all of the City's assets have been evaluated, staff will prepare a 'Corporate Asset Replacement Policy' that will link the amortization/depreciation of each category of City assets with the City's financial planning process. Staff will seek assistance from third parties, as necessary, in relation to the development of this policy. Subsequently, the subject Policy will be forwarded to Council for consideration.

Vivienne Wilke, CGA  
General Manager,  
Finance & Technology

*Appendix A*



## **CITY OF SURREY**

### **REVIEW OF EQUIPMENT REPLACEMENT RESERVES**

- **FLEET AND AUXILIARY EQUIPMENT**
- **FIRE EQUIPMENT**
- **INFORMATION TECHNOLOGY**
- **PARKS, RECREATION & CULTURE**

**Submitted to:**

**City of Surrey**  
Finance Department  
Attention: Vivienne Wilke  
Suzanne Fillion  
Manoj Taank

**Prepared by:**

**MMK Consulting Inc.**  
• Stuart MacKay  
• Jim Pammenter (Associate)



## Contents

<b>1.</b>	<b>Introduction</b> .....	<b>1</b>
1.1	Scope of review.....	1
1.2	Conduct of review.....	2
<b>2.</b>	<b>Equipment Inventory and Reserve Trends</b> .....	<b>3</b>
2.1	Overview of the City's current equipment inventory.....	3
2.2	Trends in equipment reserve levels.....	4
<b>3.</b>	<b>Methodology for Estimating Reserve Requirements on a Replacement Cost Basis</b> .....	<b>6</b>
3.1	Methodology for estimating reserve requirements.....	6
3.2	Estimating future replacement cost allowances.....	6
3.3	Other significant assumptions.....	7
<b>4.</b>	<b>Adequacy of reserves</b> .....	<b>8</b>
4.1	Current reserve levels, relative to historical depreciation.....	8
4.2	Current reserve levels, relative to future replacement costs.....	8
4.3	Conclusions.....	9
4.4	Recommendations.....	10
4.5	Disclaimer.....	10



## 1. Introduction

The City of Surrey ("the City") has engaged MMK Consulting to perform an independent third party review of the City's replacement reserves for equipment. This review is part of a larger City project to implement Tangible Capital Asset Accounting and Reporting under the new standards introduced by the Public Sector Accounting Board (PSAB).

### 1.1 Scope of review

The City's equipment reserve accounts, and the reserve amounts as of December 31, 2006, are illustrated in Exhibit 1a. Three areas – fleet equipment, fire equipment, and information technology (IT) equipment – account for more than 90% of total equipment reserves.

A fourth area, parks and recreational equipment, has significant equipment assets, although the current reserves are relatively small. Accordingly, these four areas have been the City's main focus in documenting its current equipment inventory, and in our review of the equipment replacement reserves.

#### Exhibit 1a – Equipment replacement reserves, December 31, 2006

	Balance Dec. 31/06	
	(\$ million)	%
<b>Fleet Reserves</b>		
- Fleet & Auxiliary Equipment	7.79	
- Corporate Equipment	3.20	
	<u>10.99</u>	38%
<b>Fire Equipment</b>	6.83	24%
<b>Information Technology</b>	10.19	36%
<b>Parks, Recreation &amp; Culture</b>		
- Recreation Equipment	0.35	
- Sports & Leisure Equipment	0.20	
	<u>0.55</u>	2%
<b>Total<sup>1</sup></b>	<u>\$28.56</u>	100%

1. Excludes infrastructure-related reserves for LED Traffic Light and Synthetic Sports Field Replacement



## **1.2 Conduct of review**

For each of the four areas, the City has performed a detailed inventory of its existing equipment, including purchase date and cost, expected replacement date, and expected replacement cost. We have reviewed these spreadsheet databases, and have worked with City staff to address missing and anomalous data. (Additional work is recommended to further improve database consistency.)

Based on the City's equipment inventory records, we have performed an independent analysis of the required reserves, as of December 31, 2006. Our detailed analysis is contained in Appendix A (Fleet and Auxiliary Equipment), Appendix B (Fire Equipment), Appendix C (IT), and Appendix D (Parks, Recreation & Culture), and is described in the balance of this report.



## 2. Equipment Inventory and Reserve Trends

### 2.1 Overview of the City's current equipment inventory

Working with City staff, we have reviewed the results of the City's recent equipment inventory program, from which we have excerpted detailed information as contained in Appendices A through D. Points to note include:

- As illustrated in Exhibit 2a, the inventoried equipment is on average more than half way through its useful life. This is an important result, because the older a particular unit is, the more funding is needed in reserves in anticipation of replacing it.
- The City's inventory excludes many smaller-value items (the implicit assumption being that replacement of these smaller items will be funded through annual budgets rather than through the equipment replacement reserve). In consultation with City staff, for the purposes of this review we have used \$10,000 as the threshold for eligibility for funding through the equipment replacement reserve.
- Parks, Recreation & Culture have inventoried a relatively wide range of equipment and other inventory, including smaller items, mobile equipment, fixtures, and major structures. For the purpose of this assessment, we have treated mobile equipment and minor fixtures (but not major fixtures and structures) as needing to be replaced through the equipment replacement reserve.

#### Exhibit 2a – Overview of equipment inventory

	Fleet & Auxiliary Equipment	Fire Equipment	Information Technology	Parks, Recreation & Culture*	Total
Number of units inventoried	425	73	109	191	798
<b>Average age of owned inventory (years)</b>					
■ Average expected actual life (from new)	13.7	16.7	5.7	14.8	13.1
■ Average age of units on Dec. 31	8.6	10.6	3.6	6.8	7.7
■ Average portion of expected life utilized	63%	63%	63%	46%	59%

\* Excludes major fixtures and structures



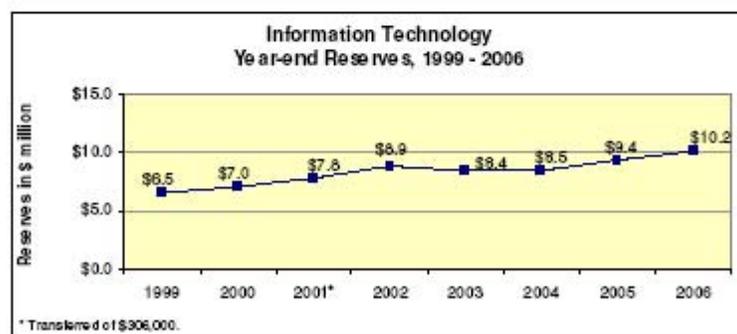
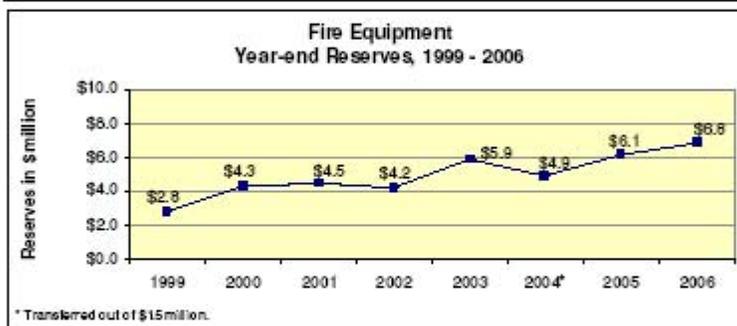
## **2.2 Trends in equipment reserve levels**

Recent-year reserve trends for Fleet & Auxiliary Equipment (including Corporate Equipment), Fire Equipment, and IT Equipment are illustrated in Exhibit 2b. As the charts show, the City's internal reserve contribution practices have allowed these three reserve funds to increase in most years, as annual fund contributions (including interest earnings on reserve balances) have tended to outpace equipment replacement expenditures. The exception to this general trend has been in those years where funds have been transferred out to other City accounts, as indicated in the notes to Exhibit 2b.

In the case of Parks, Recreational & Culture equipment, the amounts reserved as of December 31 are small (see Exhibit 1a) in relation to the values of this Department's equipment assets (see also Chapter 4).



**Exhibit 2b – Recent-year reserve trends for Fleet & Auxiliary Equipment, Fire Equipment, and IT Equipment<sup>1</sup>**



1. Parks, Recreation & Culture reserves are relatively small (less than \$1 million).

### **3. Methodology for Estimating Reserve Requirements on a Replacement Cost Basis**

This chapter documents the methodology and key assumptions underlying our analysis of reserve requirements, on a replacement cost basis.

(For the historical cost analysis to be performed under upcoming PSAB regulations accumulated depreciation has been calculated by depreciating historical costs on a straight-line basis to a salvage value, based on each unit's expected lifespan.)

#### **3.1 Methodology for estimating reserve requirements**

Our methodology in estimating the full funding reserve requirements for replacing each Department's equipment is based on an analysis of each unit:

- For each unit, we estimated the amount required to be spent from reserves in the year of replacement (i.e. future replacement cost, minus future salvage value), based on the specific assumptions detailed in the balance of this Chapter.
- We then determined the annual contribution to reserves required in respect of the asset, to generate the amount required in the year of replacement. This calculation includes an allowance for the interest earned by each unit's accumulated contributions to the reserve over time (which reduces the annual payment that would otherwise be required). The analysis assumes that an equal contribution is made to the reserve account each year.
- Based on the actual date of acquisition and expected date of replacement, we then calculated, for each unit, the amount that would be required in reserves, as of December 31, 2006, for each unit to be "on track" to create sufficient funding at time of replacement.

The reserve requirement for each Department's total inventory of assets is the sum of the individual requirements for each unit.

#### **3.2 Estimating future replacement cost allowances**

Working with City staff, we have developed the following approach to estimating replacement costs for each of the departments:

- **Fleet Equipment** – We have used an average annual cost escalation allowance of 2.5% to all fleet equipment, applied to actual purchase cost. This allowance includes non-discretionary changes (e.g. upgraded safety



equipment, model changes, etc.), but otherwise assumes replacing existing units with similar ones. (We have used this approach in preference to City staff members' direct estimates of future replacement costs, since these individual estimates vary widely in their allowances for future cost escalation.)

- **Fire Equipment** – We have used a cost escalation allowance of 2% annually for staff cars and trucks, and 3% annually for specialized equipment, applied to the City's estimates of 2007 replacement costs. These expectations are consistent with the City's internal estimates.
- **IT Equipment** – Estimation of future replacement costs is problematic in IT, since IT equipment is almost always replaced by more technologically advanced equipment. While "like kind" replacement costs typically drop over time, actual replacement costs with current technology may actually rise. For the purposes of this analysis, we have used a cost escalation allowance of 0% annually for hardware and 5% annually for software.
- **Parks, Recreation & Culture Equipment** – We have used a cost escalation allowance of 2.5% annually for all units of equipment and minor fixtures.

### 3.3 Other significant assumptions

Other significant methodological assumptions include:

- That the equipment lifetimes used in the analysis reflect actual expected replacement dates, rather than industry guidelines or standards (these guidelines are often shorter than actual lifetimes).
- That the equipment reserve fund balances (sum of the contributions in respect of individual units) at the end of any given year earn interest at the rate of 4% in the following year (consistent with recent interest rates).
- That reserves are not required for units that are currently leased, but that they are required for owned units even if these units will not be directly replaced with "like kind" (e.g. when a particular unit is being replaced with a different type of equipment).
- That otherwise, the purpose of the reserve is to replace "like kind" with "like kind," to the extent possible. (As noted, this assumption, while necessary for the analysis, is an issue in assessing IT reserves, since IT equipment is seldom replaced with like kind.)

## 4. Adequacy of reserves

This chapter assesses the adequacy of the City's reserves in terms of:

- Comparing the City's actual reserve levels (as of December 31, 2006) to accumulated historical depreciation, in accordance with the upcoming (2009) PSAB requirement to account for equipment on the basis of historical purchase costs and accumulated depreciation
- Comparing the City's actual reserve levels to what would be required to have fully funded reserves on a replacement cost basis (i.e. allowing for the impact on inflation on future equipment replacement costs).

Our analysis is based on the methodology described in the preceding chapter, and is provided in detail (on a unit by unit basis) in Appendices A through D. Results are summarized in Exhibit 4a.

### 4.1 Current reserve levels, relative to historical depreciation

Exhibit 4a (Section B) illustrates the comparison of current reserve levels to the accumulated historical depreciation of the equipment overall, and by Department. This comparison is based on the expected reporting format for 2009 under new PSAB requirements.

On a historical cost basis, the overall level of funding contained in the reserve accounts is \$2.2 million greater than the accumulated depreciation of equipment as inventoried by the City.

Results vary significantly by department. Fleet and Fire reserves are close to accumulated historical depreciation. IT reserves are significantly higher than accumulated depreciation. Parks, Recreation & Culture's reserves are much lower than the accumulated depreciation of equipment.

### 4.2 Current reserve levels, relative to future replacement costs

Exhibit 4a (Section C) illustrates the comparison of current reserve levels to the amount that would be required to be "on track" to replace each of the equipment units at the end of each unit's useful life. (See Chapter 3 for description of methodology.)

The funding requirements, when calculated on a replacement cost basis, are higher than the calculations for accumulated depreciation, and reflect the impact of building in an allowance for cost inflation.

On a replacement cost basis, current reserve levels are at approximately 74% of what would be required under a fully funded replacement cost model.



As for the historical cost analysis, results vary by Department, with IT being in the strongest position and Parks, Recreation & Culture being in the weakest position.

**Exhibit 4a – Comparison of actual equipment reserves to those required on a historical and replacement cost basis**

	Fleet & Auxiliary Equipment	Fire Equipment	Information Technology	Parks, Recreation & Culture <sup>1</sup>	Total
<b>A. Actual size of reserves</b>	\$11.0	\$6.8	\$10.2	\$0.6	\$28.6
<b>B. Comparison with PSAB Requirements (based on historical purchase costs)</b>					
■ Historical purchase costs	\$21.4	\$16.2	\$11.9	\$4.4	\$53.9
■ Accumulated depreciation	<u>\$11.1</u>	<u>\$7.7</u>	<u>\$5.7</u>	<u>\$1.9</u>	<u>\$26.4</u>
■ Net book value (NBV)	\$10.3	\$8.5	\$6.2	\$2.5	\$27.5
■ Current reserves as a percentage of accumulated depreciation	99%	88%	179%	32%	108%
■ Over/shortfall of reserves over accumulated depreciation	-\$0.1	-\$0.9	\$4.5	-\$1.3	\$2.2
<b>C. Comparison based on requirements to fund replacement costs</b>					
■ Replacement values in 2007 dollars (undepreciated)	\$27.4	\$23.9	\$13.3	\$5.3	\$69.9
■ Expected future cost	\$32.7	\$30.8	\$14.8	\$6.5	\$84.8
- Less future salvage value	<u>-\$2.0</u>	<u>-\$0.8</u>	<u>-\$0.2</u>	-	<u>-\$3.0</u>
- Required future funds	\$30.7	\$30.0	\$14.6	\$6.5	\$81.8
■ Fully funded reserve levels (replacement cost)	\$15.9	\$13.9	\$6.5	\$2.6	\$38.9
■ Current reserves as a percentage of reserve requirements (replacement cost basis)	69%	49%	157%	23%	74%
■ Over/shortfall of reserves over requirements for full funding	-\$4.9	-\$7.1	\$3.7	-\$2.0	-\$10.3

**4.3 Conclusions**

Our conclusions are as follows:

- **Accumulated Depreciation (and PSAB reporting requirements)** – For the four Departments as a whole, the total equipment reserves are greater than the total accumulated historical depreciation for the equipment inventoried.<sup>1</sup> There are significant differences among Departments.
- **Replacement Costs** – On a replacement cost basis, current reserves represent approximately 74% of the requirement for the replacement costs to be considered fully funded.

<sup>1</sup> Excluding major structures, major fixtures, small equipment (under \$10,000).



#### **4.4 Recommendations**

As illustrated in Chapter 2, equipment reserves have tended to increase in most recent years, under current contribution practices, before allowing for special transfers out. Going forward, it will be important to monitor whether the City is gaining or losing ground, in terms of the percentage funding of equipment replacement costs, on an annual basis. Accordingly, we recommend that an annual determination be made of the fully funded reserve requirements, on a replacement cost basis, based on the approach described in Chapter 3. These requirements should form the basis for ensuring that departments contribute adequate amounts to reserves, through charge-out rates and/or direct allocations, in the following year.

Our second recommendation is that the current equipment reserve policies and practices of each Department be reviewed, with the view to increasing the consistency of approach towards equipment reserves.

Our third recommendation is that additional work be undertaken to further improve and maintain the quality of the City's equipment inventory records. Much of the preceding analysis in this report is based on spreadsheet information developed by the City for the first time, and additional work would enhance the quality of this database.

#### **4.5 Disclaimer**

In preparing this report, we have relied on equipment inventory information provided by the City. Our assessment is based on numerous analytic assumptions (see Chapter 3), and the study results are sensitive to these assumptions. While we believe these assumptions to be reasonable, all projections are by nature subjective, and we cannot represent that any of the projections contained in this report will be achieved in whole or in part.